



FEFSI COMMENTS ON CESR'S CALL FOR EVIDENCE ON PROVISIONAL ISD2/FIM MANDATES

The European investment management industry, represented by FEFSI¹ welcomes the opportunity to respond CESR's call for evidence with regard to the Commission's Provisional Mandates on the Investment Services Directive of 20 January 2004.

FEFSI believes the European investment management industry will be affected by CESR's work on the implementation of the revised ISD (now FIM) at different levels:

- Firstly, investment management firms operating under the ISD offering individual portfolio management services;
- Secondly, investment management companies under the UCITS that carry out individual portfolio management as well as collective portfolio management services - are directly subject to the ISD;
- Thirdly, a significant number of units of funds are distributed through intermediaries, which in the future will be subject to the FIM (as investment advice is set to become a core activity);
- Fourthly, collective portfolio managers that offer as a "non-core" activity investment advice under the ISD.

GENERAL COMMENTS

As a preliminary comment the European investment management industry is surprised to see the breadth and depth of the mandates that have been put to CESR for technical advice. When reviewing the technical annex, in particular, the level of detail is exhaustive and against the

¹ FEFSI, the *Fédération Européenne des Fonds et Sociétés d'Investissement*, represents the interests of the European investment management industry (collective and individual portfolio management). Through its members, the national associations of the 15 EU member states, the Czech Rep., Hungary, Liechtenstein, Norway, Poland, Slovakia and Switzerland, FEFSI represents some 900 management companies being active in both collective and individual portfolio management and about 41,100 investment funds with EUR4.5 trillion in investment assets. For more information, please visit www.fefsi.org.

background that the present mandates are of a provisional nature and that more may follow once the ISD2/FIM has been adopted finally, it legitimately begs the question how CESR can be expected to complete the process - including regular interested parties' hearings and consultation rounds - within just over a single year.

FEFSI believes that in view of this workload CESR should contemplate the possibility that technical advice can also consist of recommending that no detailed rules be drafted, or that some issues are best left to the market place or participants to agree on – with or without the option of European regulators endorsing industry standards where feasible.

At this point in time, FEFSI will focus its comments on those points that are considered of more immediate concern and await CESR's draft proposals on other points.

In response to CESR's call for evidence the European investment management industry has three overriding concerns, which are:

- That the rules, which will be drafted for investment service firms, should take into consideration the specificities of portfolio management as a particular investment service. Portfolio management as an investment service is a fiduciary activity representing the “buy side” of the market;
- That adequate attention should be paid to achieving a high level of consistency between the implementing measures of the FIM and regulation under the UCITS Directive, given that many investment management firms are also fund managers;
- That CESR does not succumb to the temptation to draft overly detailed and prescriptive rules.

We therefore welcome the Commission's statement that CESR's “*advice should ensure clarity and legal certainty*”. We urge CESR to take this qualification to heart, esp. against the background of the very different structures to the investment management business across Europe. We believe CESR should aim for achieving broad risk oriented principles-based rules that can be absorbed into the diverse national contexts and regulatory environments with the aforementioned clarity and legal certainty.

SPECIFIC COMMENTS

Due to the time constraint of the call for evidence and the sheer volume of enumerated issues FEFSI will not offer proposals for wording on specific issues, but we will highlight the areas where in our eyes shunts must be set in the right direction to ensure that the specificities of individual portfolio management are taken into account and that a maximum level of consistency between the new FIM and the UCITS Directives is achieved.

Our more detailed comments will focus on four priority areas, which FEFSI considers key elements with respect to the integrity of the industry and which it closely monitors itself.

1. Organisational requirements (*Article 13 FIM*)

The organisational structure for companies under the ISD as well as under the UCITS Directive are vital elements to the preservation of the integrity of the investment management industry. We support the aim that each company must have an internal code of conduct and welcome CESR's role in defining its broad content with the aim of enabling the company's senior management to act independently, to manage conflicts of interest and to act at all times in the best interest of investors.

- *Compliance obligations and personal transactions*

In order to operate effectively, the internal control and the compliance mechanism must be independent and needs a clearly defined structure with unambiguous reporting lines directly to senior management. To ensure that employees cannot abuse their position, personal trading should be restricted; if it takes place it must be reported.

- *Obligations related to internal systems, etc*

Procedures with respect to processes necessary for the operation of the firm should be written and cover in particular the handling of conflicts of interest, the delegation of functions, the protection of assets and compliance. Trade controlling functions and asset administration should be segregated from the portfolio management.

With respect to accounting, the investment firm should follow the general – or specific – national accountancy practices and have independent auditors, verifying this regularly. In this context we understand that the comments in the technical annex only refer to the investment firm's accounts, not to the rules applicable to the portfolios managed on behalf of clients.

- *Obligation to avoid undue additional operational risk in the case of outsourcing*

The firm must have a strict policy with respect to the delegation of own functions to third parties (outsourcing). To ensure consistency, the rules applicable for firms carrying out individual portfolio management should be consistent with the rules laid down in Article 5g of the UCITS Directive.

Special attention is required should tasks be delegated to a company of the same group.

▪ *Protection of clients' assets*

When a firm holds assets belonging to clients which it does not entrust to an external depository, it must have strict rules with respect to the separation of such assets from the firm's own assets. Clients must be informed of the identity of the custodian.

2. Conflicts of interest (*Articles 18 & 13(3)*)

FEFSI supports a principles-based approach to conflicts of interest, which focuses on identifying where such conflicts exist. As investment managers produce a single output – investment funds and/or asset management – they do not have the same conflicts of interest as – for example – sell-side analysts in relation to research. In the case of investment management, conflicts of interest may arise from different situations:

- i. Between clients if the same firm manages different portfolios (CIS and/or on a client-by-client basis);
- ii. Client interests vs. interests of the firm and its employees;
- iii. Client interests vs. interests of the firm's parent/ affiliate company.

To avoid potential conflicts of interest, the investment manager needs to adopt strict rules and procedures and to take appropriate measures. In this context, particular attention must be paid to:

- Treating all clients fairly (e.g. in allocating trades, in distributing units of funds, ...);
- Relationship/transactions with affiliates;
- Fees and commissions to clients.

We have noted that two types of conflict of interest that have been raised in the technical annex (under 3.2) may need specific attention, i.e. the distribution of units of CIS, and soft commissions.

On the issue of distribution of units of CIS, FEFSI strongly believes that the protection of investors' interests will depend on the quality of advice provided. The rules should ensure a high quality of advice for a multitude and complexity of products, whilst distinguishing between advice and information. The act of providing information such as that contained in the simplified prospectus should not be construed as equivalent to giving advice. From the investor's point of view it is important to know what service he/she is getting, whereas from the investment manager point of view, providing advice as opposed to information carries with it issues of liability and additional costs.

In this context, CESR's harmonised Conduct of Business Rules of April 2002 show the way in the right direction, in particular standard 72 on "good advice".

On the matter of soft commissions, FEFSI believes that it is essential that consistent rules should apply to both collective and individual portfolio management. In this context, we would like to refer to the FEFSI/EAMA Discussion Paper on „Trade Quality Best Practice“ of July 2003 (see attachment).

3. Conduct of business obligations (*Article 19 §§ 2, 3, 7, 8*)

Again, when defining standards e.g. for disclosure, client communication etc., consistency between collective and individual portfolio management (in particular for retail clients) should be achieved, in particular with regard to, for example, performance and risk presentation standards. The investment fund industry has developed valuable approaches in this regard, e.g. the FEFSI model simplified prospectus and user manual.

Differentiation must be made between professional and retail clients of asset management firms. It is supposed that institutional clients will clearly define themselves in the management contract which information they want to get from the asset manager, which might be, but is not necessarily, very detailed. Further regulation does not seem necessary.

Retail clients on the other hand need higher protection.

4. Best execution (*Article 21*)

Investment management companies, as a general rule, have a fiduciary duty of best execution towards all their investors for whom they manage money irrespective of their retail or professional nature². However, we accept that differentiation should be made between these two categories of clients, as professional clients will in all likelihood be better prepared to define themselves what they understand under "best execution".

Nonetheless, to safeguard at all times the legitimate interests of the client and to avoid that one investor is favoured over another, the investment firm must establish clear policies and procedures with respect to order execution that must be explained to retail clients.

² For details, please see attached FEFSI/EAMA Discussion Paper on „Trade Quality Best Practice“

In conclusion, FEFSI is highly appreciative of the indicative work plan for the first set of provisional mandates and we look forward to the scheduled possibilities of two rounds of public hearings and consultations, and urge CESR not to restrict the possibility of a preliminary consultation to transaction reporting and cooperation issues alone but to the work of all three Expert Groups.

We hope that you find these comments helpful and we would welcome an opportunity to explain them in more detail should you desire such.

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Enc. 1 (*FEFSI/EAMA Discussion Paper on „Trade Quality Best Practice“*)