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CESR's reaction to the Reports of the Commission Expert Groups on Market Efficiency and on Alternative Investment Funds.

Background

1. The following list of key issues has been developed as CESR contribution to the Commission's White paper based on some aspect of the three Reports¹ of the Commission Expert Groups on Market Efficiency and on Alternative Investment Funds (all together "the Reports").
2. The spirit under which this document has been drafted was to find consensual areas and common grounds for a joint CESR response by all members; therefore the document is not intended to over-ride the diversity of national positions that have been expressed by some members in their individual contribution to the Commission. Indeed a number of CESR members have already made individual responses to the Commission about the Expert Group reports, some in conjunction with their finance ministries.
3. CESR believes that it is beneficial to the White paper process to provide some information also on other key issues which were examined and discussed by the Expert Group even if a consensual approach between CESR members could not be achieved at this stage. In these cases the document clearly states the different views expressed by CESR members.
4. CESR reserves the right to comment further as and if any legislative proposals are developed.

2 Reports on Alternative Investments

2.1. Introduction

5. CESR welcomes the reports of the Expert Group on Alternative Investment Funds. In particular, the report of the Sub-group on Hedge Funds represents the first opportunity of the European hedge fund industry to express its view on hedge funds and to identify areas for possible improvement and also to assess whether there are any regulatory or other obstacles at EU level which hold back the efficient organisation and development of the hedge fund industry in Europe.
6. CESR acknowledges that hedge funds are part of the European financial markets and are finding their way into portfolios of investors. In some jurisdictions they are also included to a certain extent in the retail investors' portfolios. However CESR points out that there is no clear definition of hedge fund, and that the issue of what hedge fund remains open. Distinctions between alternative investments are blurring and some clarity about the target of any future action in this field would help in providing useful contributions. In particular, further economic analysis is necessary at least to identify the major categories of hedge funds.

¹ Report of the Alternative Investment Expert Group: Managing, Servicing and Marketing Hedge Funds in Europe, Report of the Alternative Investment Expert Group: Developing European Private Equity, and Report of the Expert Group on Investment Fund Market Efficiency.

7. Moreover, the issue of what constitute a hedge fund, as well as the regulatory approach to hedge funds is under discussion in other *international fora* such as IOSCO and the Financial Stability Forum.
8. CESR is of the view that it can provide useful input to this debate. In fact CESR is currently working on the issue of possible treatment of hedge funds indices as eligible assets (as a follow-up of the CESR's advice to the European Commission on clarification of definitions concerning eligible assets for investments). CESR indicated that given the complexity of hedge funds indices and the fact that they are still developing, CESR was not in a position - at the time of giving the advice to the Commission - to recognize and recommend the eligibility of hedge funds indices for the purposes of UCITS' investments.
9. CESR supports the position taken by the Commission Expert Group that modifications to certain extent of the UCITS directive might be necessary to allow the fund industry to evolve, thus enhancing the EU framework for investment funds.
10. However, in analysing the proposals of the industry and in suggesting any action in this field it should be taken into account that the UCITS directives while ensuring investor protection have provided a label for products which are freely marketed to investors (and particularly the retail investors) within Europe by an industry which has reached significant importance for the overall European economy.

2.2. Cross-border marketing and distribution of alternative investments

11. The issue of the cross-border marketing and distribution of alternative investments should be carefully analysed. As for other aspects of the regulation applicable to the financial services industry in Europe the first issue to be analysed is to whom the products are distributed. In fact, there is a difference depending on whether an investment product is intended to be sold to retail investors or to professional investors only.
12. CESR believes that it should focus its attention mainly on products which are intended for retail investors. Wholesale markets, as also recognised in the Lisbon agenda, deserve less regulatory efforts.
13. In its report, the Expert Group puts forward the view that alternative (non-harmonised) investment funds should be able to be distributed to retail investors on a cross-border basis, as long as the sale takes place in accordance with the provisions of MiFID.
14. CESR cannot accept this view. CESR position is motivated by the following reasons:
 - a) **investor protection.** UCITS are subject to a high degree of control over their structure (eg the depositary) and their investment and borrowing powers. Because of these safeguards, they are suitable for distribution to retail clients on a cross-border basis. By contrast, alternative investment funds may be subject to only limited (or to none) investor protection features in these areas;
 - b) **competitive effects.** One of the main benefits to a manager in setting up a UCITS is the ability to market the product on a cross-border basis, subject to the notification procedure. However, if the view is taken that cross-border marketing is possible instead simply by using intermediaries who are complying with MiFID, then there would seem little incentive for the manager to establish a UCITS rather than an alternative fund (when the alternative fund might involve less cost through having a lower degree of investor protection). The Expert Group's opinion therefore seriously undermines the UCITS Directive.
15. A harmonised private placement regime, as mentioned for example in the Expert Group report on private equity, could provide a way forward having the potential to widen and deepen the EU's capital markets and improve market efficiency without hampering investor protection.



16. Such a regime would provide access only for certain qualified investors, and would not be aimed at allowing access to alternative investments by retail investors.
17. As a grouping of national regulators CESR could lead discussions to develop acceptable parameters for such a regime.

2.3. Role of custodian/depository

18. Some CESR members have concerns about the suggestions expressed in the report that Member State regulators should not impose a requirement for the appointment of a domestic custodian/depository upon European hedge funds. The report notes that such a requirement can have a negative effect on the returns a fund can generate, while not, in their view, significantly increasing the level of investor protection.
19. However, if the custodian is not located in the same jurisdiction as the scheme, it will be difficult to supervise their activities in relation to the hedge fund and, in particular, enforce the requirement that ensures that they delegate in an appropriate manner.
20. Moreover it is important to note that a custodian/depository has two roles in relation to regulated collective investment schemes. One of the roles of the custodian/depository is oversight and the other safekeeping. Prime brokers are required to have custody of the hedge fund's assets while the custodian/depository still has responsibility for the oversight function. CESR is of the view that a European harmonised approach regarding the custodians/depositories could be discussed.
21. Such an approach would not preclude the possibility to explore other models than those relying on the custodian/depository in case the hedge fund is not intended for distribution to retail investors.

2.4. Private Equity

22. CESR acknowledges that the Experts' proposals are not a prelude to Commission's legislative initiatives targeting the private equity sector. Therefore, the legal, tax and operating environment in which private equity develops will keep on being determined largely at national level. CESR deems sensible the invitation to Member States to learn from developed and successful EU markets that have developed a more private equity-friendly environment. Private equity plays a vital role in mobilising capital to allow companies to grow and develop, to the benefit of the wider economy.
23. CESR, nonetheless, is willing to monitor growth in the private equity market as it presents a number of issues that warrant consideration: impact of the private equity market on the efficiency of the overall capital markets; increased risk to financial stability stemming from the leverage and illiquidity inherent in private equity structures, appropriateness of transparency and disclosure standards, conflict of interest, etc.

3 Report of the Expert Group on Investment Fund Market Efficiency

3.1. Introduction

24. CESR wishes to state its support to the need to foster efficiency at different levels of the fund production value chain as long as the savings attained are passed to investors to a large extent. Any new benefit to investor should not however come in detriment of their protection. This balance is important to maintain investor confidence in UCITS, a feature of this product that is beneficial to the fund industry itself.

25. CESR has done work in a number of areas covered by the UCITS Directive to improve its functioning and increase co-operation between national regulators (eg eligible assets and simplification of the notification procedure). CESR believes that apart from legislative improvements, that might be initiated and for which a certain amount of time might be necessary before being agreed upon, attention should be paid to fully exploiting all potential tools existing in the UCITS Directive.
26. In this respect CESR outlines the benefits which could derive to the market from the Level 2 measures on the eligible assets, as well as from the implementation of the guidelines on the simplification of the notification procedure of UCITS.
27. Nevertheless, the Directive itself pre-dates the Lamfalussy structure for financial services legislation, and there are subjects where improving the efficiency of UCITS regulation might require consideration of changes at Level 1.
28. In making these changes it is important to concentrate on allowing Lamfalussy-style co-operation into areas of the UCITS Directive where such an approach is likely to yield material benefits through work by CESR – rather than on completely re-writing the Directive afresh, which would divert considerable time and resource away from improving the current operation of UCITS regulation.

3.2. Authorisation and notification of UCITS

29. CESR would like to recall the peculiarity and complexity of UCITS, which require different layers of regulation applicable to the manager, to the depositary, and to the product.
30. In this context any comparisons with the Prospectus Directive are not straightforward in terms of existing regulatory approach to the UCITS and the responsibilities bestowed on regulators. UCITS are highly regulated products, specifically addressed - on a continuous basis - at retail investors that call for an ongoing monitoring of the fund itself but also of the managements company and the depositary. These features call for a thorough involvement on the side of the regulator at the time of authorising the product. This regime is intrinsically different from the one envisaged under the Prospectus Directive which requires that the prospectus contains all information necessary to enable investors to make an informed assessment on the investment.
31. However, the reality that competing products to UCITS can be launched using Prospectus Directive mechanisms must be recognised, and CESR agrees that administrative delays in getting investment funds to host markets should be reduced; CESR acknowledges that the aim of the UCITS Directive is that home state authorisation and therefore the passport of the UCITS has to be fully operational. In this respect, CESR's Guidelines to simplify the notification procedure of UCITS represent a significant improvement to the current situation.
32. Progress on the implementation of these guidelines is subject to review by CESR. Therefore, within a reasonable timeframe it will be possible to assess whether UCITS pass-portability has objectively improved.
33. Notwithstanding the above, certain CESR members would favour a simplification of the notification procedures at Level 1. Others feel that before deciding on possible amendments a proper assessment of the benefits deriving from the above mentioned guidelines should be made.
34. Regarding the language issue, CESR would like to recall that correct, sufficient, and unambiguous information for the investor is one of the core elements of investor protection provided for by the Directive. Therefore, any innovation in the area of investor information should be respectful with these provisions.



35. In particular, certain CESR members are of the view that an approach as the one followed in the Prospectus Directive which requires only the summary to be translated in the domestic language could raise issue of investor protection in the UCITS field. In this context it is important to consider the actual use of product documentation by investors when making product decisions or when they are being advised.

3.3. Mergers

36. CESR appreciates the effort made in the report to answer in advance any possible supervisory objections to the procedure put forward and welcomes estimates on unexploited economies of scale that, if resolved, could boost fund performance. CESR recognises that the expectation is that increasing the size of the fund could be beneficial to the investors. However, further analysis is needed in this respect, especially in cases where funds merge with others located in Member States where the average costs are higher. Some CESR members will be monitoring closely the evolution of fees in merged funds to see if these expectations are met.

37. The information and reporting requirements introduced in the proposed merger framework cater extensively for investor protection but at the same time, surface some problems and uncertainties for competent authorities. For instance, it remains to be addressed how authorities of merging funds will coordinate to statute jointly on the merger's completion and how could UCITS in different forms (corporate or contractual) could merge cross-border.

38. In spite of the mentioned problems, CESR is of the view that the proposals tabled should be seriously examined by the Commission in view of the benefits that would potentially arise. Moreover, their implementation will require substantial amendments to the existing directives and the developments of appropriate arrangements among regulators. .

3.4. Pooling

39. The Expert Group's proposals on virtual and entity pooling require in-depth assessment, a task which could be undertaken by CESR, drawing on the experience of its members where virtual pooling is already a feature of their marketplace.

40. The aim of the work would be to examine the operational and legal aspects of virtual pooling, as well as to advise on the changes at Level 1 that might be necessary for entity pooling to be possible. Although not a substitute for fund mergers, pooling also provides the capacity for investors to benefit from economies of scale.

41. In this respect, CESR agrees it is the right venue for regulators to discuss such issues.

3.5. Management company passport

42. The issue of a full passport for the management company is one of the most debated. It was already discussed at the time when the UCITS Directive was agreed.

43. In fact, there are issues to be addressed and solved in this respect. The most difficult appear to be the issue of the split of the supervision of the UCITS and the supervision of the management company.

44. Split supervision is, in practical terms, a very difficult issue to be addressed also taking into account that the supervision of investment funds gets increasingly more related to the process of how the funds are managed. Supervision of the fund and that of the management company are tightly interlinked. Therefore, a management companies' passport is expected to require a high level of cooperation and integration among EU supervisory systems and the enforceability of the decisions taken by the competent authority must be ensured.

45. However, these issues must be weighed against the potential gains from a fully-functioning passport. As well as the opportunity for investors to benefit from economies of scale, risk management and related controls may function more effectively – to the benefit of investor protection - if they can be centralised. At this juncture, CESR members hold different views on the question.

3.6. Depositary

46. The report mentions that Member States should allow branches of EU established banks to act as depositary for locally domiciled funds. According to CESR, this recommendation should be clarified in the light of the existing provisions in the Second Banking and MiFID Directives. The issue of insolvency proceedings affecting the depositary when located in a different country should also be addressed. Regarding the delegation of custodial functions to licensed custodians located elsewhere in the EU, CESR acknowledges that this is a practice not necessarily shared by all its members whose potential extension would require the harmonisation of certain regulatory features: definition of asset safekeeping, legally binding assurances on restitution, etc.

47. Some CESR members have concerns that if the custodians is not located in the same jurisdiction as the UCITS, it will be difficult to supervise their activities in relation to the fund and, in particular, enforce the requirement that ensures that the delegation takes place in an appropriate manner.

48. CESR is also of the view that a European harmonised approach regarding the custodians/depositories and the feasibility of a passport for depositaries could be discussed in the longer term.