EUROPEAN CENTRAL BANK

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GREEN PAPER ON THE ENHANCEMENT OF THE EU FRAMEWORK FOR INVESTMENT FUNDS

EUROSYSTEM CONTRIBUTION TO THE COMMISSION'S PUBLIC CONSULTATION

As a contribution to the debate on the enhancement of the EU framework for investment funds, the European Central Bank (ECB) would like to provide its comments on the Commission's Green Paper on the enhancement of the EU framework for investment funds[1] (the "Green Paper") published on 12 July 2005 for public consultation. These comments represent the views of the Eurosystem, which comprises the ECB and the national central banks (NCBs) of those Member States that have adopted the euro.

1. General remarks

Investment funds play an important role in the financial system for several reasons. First, their development can contribute to a better allocation of capital and investment and thus to an overall more efficient functioning of the financial system. Second, by broadening access to financial markets and diversifying investment styles and asset allocation among investor portfolios, investment funds' activities may contribute to financial stability.[2] Third, the European banking system has several links with investment funds, as the major European asset management companies are parts of banking groups. For some banking groups, a significant part of their revenues derive from controlled asset management companies, to which a significant part of their assets under management have been transferred in past years. Moreover, banks play a key role in the distribution of investment funds in most European countries. Therefore, any revision of the EU framework for investment funds can have effects on the EU banking system.

Against this background, the Eurosystem has a keen interest in developments concerning investment funds and their implications for financial integration and financial stability. In this context, it should be mentioned that, in support of its tasks, the ECB is developing harmonised and comprehensive statistics about investment funds which may be helpful also to the Commission in its further work. In addition, the ECB recalls that it provided its advice to the Council as regards amendments to the UCITS Directive,[3] and stands ready to provide it on any future legislative initiative in the field.[4]

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1 SEC(2005) 947, (COM(2005) 314 final).
2 International Monetary Fund's Global Financial Stability Report, 2005, p. 77.
3 Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), as amended.
4 Opinion of the European Monetary Institute of 27 July 1995 (CON/94/8); Opinion of the European Central Bank of 16 March 1999 (CON/98/54) published in OJ C 285, 7.10.1999, p. 9.

The Eurosystem understands that the reflections of the Commission in the area of asset management are consistent with its key political orientation for financial services policy in the years 2005-2010. In its Green Paper on the matter issued in May, the Commission highlights that future public action should focus on consolidation and simplification of existing Community legislation, while ensuring effective implementation and enforcement at national level. At the same time, a few areas, including asset management, were identified by the Commission as eligible for considering the possibility of further regulatory intervention at Community level. As expressed in its contribution to this Green Paper, the Eurosystem agrees with the attention devoted to the asset management industry.[5]

The investment funds market in Europe has grown substantially in recent years. There was a total of 42,292 investment funds by 30 June 2005, with combined net assets of 5 781,265 million euro. A great part of this amount is accounted for by collective investment funds (UCITS), of which there were at that date around 29,000 with combined net assets of 4 527,926 million euro.[6]

The UCITS framework has successfully contributed to the widespread expansion of investment funds as one of the main investment vehicles in Europe for both private and institutional investors. A further effort to remove remaining legal and regulatory barriers might promote further consolidation of the European investment funds industry and a rationalisation of the products offered with consequent benefits for investors.

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[5] Eurosystem’s contribution of 1 August 2005 to the public consultation on the Commission’s Green Paper on financial services policy (2005-2010).

[6] Data taken from FEFSI/EFAMA, the European Federation of Funds and Investment Companies and the European Fund and Asset Management Association.

2. Specific remarks

2.1 Current regulatory framework

The Green Paper on investment funds refers to the priority of the need to solve current difficulties in the use of the UCITS passport and to provide more guidance on investor protection safeguards. The Commission has already launched in the past a number of initiatives to tackle problems relating to the implementation of the UCITS Directive (such as the recommendations on the use of derivatives, the simplified prospectus, and the work in progress to clarify the eligibility of assets for investments by UCITS) and the important role of the Committee of European Securities Regulators (CESR) in this respect should be noted. The Eurosystem notes that the positive results already achieved by involving the CESR confirm the important role that Level 3 committees can play in ensuring the consistent implementation of EU legislation and promoting supervisory convergence.[7]

However, it is noted that in the case of the UCITS Directive the limited scope for comitology represents a major constraint on the effectiveness of the Lamfalussy approach and on the possibility of adapting the legislative framework to new developments. Therefore, the Commission may wish to consider the *introduction of a wider application of the Lamfalussy approach* within the UCITS Directive at the earliest possible opportunity.

In the longer term, the current 'product-based' approach of the UCITS Directive may be considered as limiting the ability of the EU harmonised framework to exploit financial innovation.[8] Should all the stakeholders agree on the need for a new approach, the Commission may consider recasting the UCITS Directive along the lines of the model already adopted for the securities directives.

2.2 Specific issues

As regards the issues raised for <u>making better use of the current framework</u>, the Eurosystem agrees that some areas would benefit from further clarification. In particular, it is noted that the Market in Financial Instruments Directive (MiFID)[9] would introduce a *new harmonised framework* for conduct of business rules for financial intermediaries, which will be applicable to management companies only to a limited extent for the management of investment portfolios (Article 66 of the MiFID). By contrast, UCITS and their managers are subject only to the general principles laid down by the UCITS Directive (Article 5h), to be further specified *at national level*. Therefore, the Commission could consider whether and to what extent harmonised conduct of business rules, similar to those provided for investment firms and credit

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7 See Eurosystem's contribution to the Commission's public consultation on the Review of the application of the Lamfalussy framework to EU securities market legislation, 17 February 2005.

8 This issue has been highlighted by the CESR in its recent advice on clarification of the definition of eligible assets for investments of UCITS regarding the treatment of asset-backed securities (CESR/05-490b, p.30).

9 Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, (OJ L 145, 30.4.2004, p. 1).

institutions, should be provided for UCITS, whilst allowing for some degree of flexibility necessary to deal with national specificities. In this respect, the *preparation of Level 3 standards* by CESR could pave the way for further harmonisation of conduct of business rules for UCITS.

Equally, it is important that similar rules are applied consistently across different intermediaries when the latter are exposed to similar types of risks.

The Green Paper refers to long-term challenges that would require far-reaching adjustments to the existing UCITS framework, and seeks views on whether and how such issues should be accommodated in the longer term. More specifically, the Green Paper mentions some issues (fund pooling, rationalisation of depositary services) that would promote the further rationalisation of the European investment fund industry (as shown by the fact that the European fund size average is half that of the US average), and reduce fund management and administration costs, and thus benefit investors. On these issues the Eurosystem would like to make the following comments.

First, as regards the proposal to allow fund pooling (either by master-feeder funds or virtual pooling techniques), the Green Paper notes the legal, regulatory and supervisory risks associated with such structures, according to which the master-feeder fund (where the investment decisions are taken) would be located in one jurisdiction, while the feeder funds would be in another.[10] The Eurosystem supports the Commission's argument that this structure would require a clear division of responsibilities between competent authorities and careful consideration of whether additional investor protection safeguards should be put in place.

Second, the Green Paper notes that the industry asks for greater freedom in the choice of depositary, which Article 8 (1) of the UCITS Directive currently requires to be located in the same Member State as the management company. In view of the prospect of a higher degree of concentration in custody services over the coming years, the Eurosystem considers that effective regulation and oversight of the market infrastructure would be beneficial to the collective investment business in Europe. However, it has to be acknowledged that the UCITS Directive attributes a fundamental role to depositaries in the oversight of many of the functions of the management company (e.g. ensuring that the sale, issue, redemption and calculation of the value of units accords with the law and the fund's rules). In addition, depositaries are directly liable towards both the management company and the investors for any loss suffered by them as a result of unjustifiable failure to perform their obligations or the improper performance of their obligations (Articles 7 and 9 of the UCITS Directive), though the specific objectives of such control differ from country to country. Therefore, the Eurosystem shares the Commission's view that further harmonisation could be sought, at least of the initial and operating conditions and of the functions of the depositary, as

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[10] Commission's Green Paper, Annex, page 56.

an essential pre-condition for being authorized to provide such functions benefiting from a European passport.[11]

2.3. Alternative investment market

In its Green Paper, the Commission also addresses Europe's alternative investment market, notably the market of hedge funds. In the last few years the global hedge funds sector[12] has grown at a very rapid pace. It is estimated that, by the end of 2005, the world total of assets under management by hedge funds will have grown to € 685 billion, of which the estimated total of assets managed by hedge funds in Europe will account for approximately € 188 billion. While the great majority of hedge fund managers are based in the United States, the importance of managers located in the EU is growing. Similarly, while firms that provide financial services to hedge funds ('prime brokerage') are mainly large US investment banks, a number of European banks have also developed into important players. Finally, in a number of European countries hedge funds and similar products are becoming increasingly available to retail investors, though they still represent a relatively small share of the total asset management industry compared to UCITS.

Though hedge funds may pose challenges to the stability of the financial system, a balanced assessment should also recognise their positive contribution in areas such as the price discovery process, market liquidity, risk diversification, market discipline and financial integration. A comprehensive assessment is hampered, however, by the fact that public authorities still have only limited information about the activities of hedge funds, not least because of the continued opacity of the industry.

Through its participation in various international groups, the ECB is actively involved in the current debate on hedge funds. With the assistance of the Banking Supervision Committee (BSC), efforts are enhanced to gain a better understanding of the implications of hedge funds for the European financial system. In this respect, the BSC recently analysed the links between large EU banks and hedge funds[13]. The work of the BSC indicates that recent developments in the hedge fund industry may not necessarily pose a direct threat to financial stability in the EU through banks' direct exposures to hedge funds, which mainly take the form of financing and investment exposures. Nonetheless, banks may also be affected indirectly, for example if hedge fund activities lead to dislocations in financial markets or cause strains for non-EU prime brokers with spill-over effects to EU banks. For banks selling hedge funds or hedge fund-related products, in particular to retail clients, reputational risk may be another potential hazard. Hence, direct exposures may underestimate the true risks that hedge funds pose to EU banks and the financial system at large.

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[11] Communication from the Commission to the Council and to the European Parliament, Regulation of UCITS depositaries in the Member States: review and possible developments, 30 March 2004, (COM(2004) 207 final).

[12] All estimates are from International Financial Services London.

[13] BSC report on "Large EU banks' exposure to hedge funds".

The Eurosystem supports the approach taken so far at the international level to address the financial stability concerns created by hedge funds, primarily through their interaction with regulated firms, in particular banks. Both the supervisory community and the private sector have already taken important initiatives in the area of risk management which the Eurosystem fully endorses.[14]

Nevertheless, any developments in the hedge fund industry that might adversely affect financial stability should be carefully monitored and the present stance of the Eurosystem might have to be reviewed if proved to be necessary for financial stability or prudential reasons.

The Eurosystem is of the view that the forthcoming Capital Requirements Directive, which will introduce into Community law the new capital standards agreed by the Basel Committee on Banking Supervision,[15] will provide a flexible and appropriate framework for addressing possible concerns related to banks' exposures to hedge funds. In particular the 'supervisory review process' will allow banking supervisors to take any specific measures to address such risks, not at least with regard to capital adequacy. The Committee of European Banking Supervisors (CEBS), which aims at achieving convergence of supervisory practices at the European level, can play an important role in this field.

However, it is equally important that these different initiatives are effectively implemented by banks, without being compromised as a result of competitive pressures. Moreover, both market participants and authorities should remain vigilant to new developments in the hedge fund industry. Banks should continuously and prudently manage the risks stemming from their counterparty relationship with hedge funds, carefully monitor their investments in them and adopt very prudent valuation methodologies. At the same time, authorities should continue and enhance their dialogue with the asset management industry, in order to further improve transparency and market practices.

Any debate on possible direct regulation of hedge funds should take the following aspects into account. First, regulation would be confronted with the challenge of providing a sufficiently precise legal definition of 'hedge fund'. At present, there is no shared agreement at the international level on the exact definition of a hedge fund. Hence, a clear differentiation from other forms of investment may not be straightforward.[16] Second, the Eurosystem highlights that, given the nature of the hedge fund business and the high concentration of these funds in off-shore centres, any direct regulation can only be effective if it is well coordinated at the international level.

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[14] Basel Committee on Banking Supervision (1999), "Sound Practices for Banks' Interactions with Highly Leveraged Institutions"; Counterparty Risk Management Policy Group (2005), "Toward Greater Financial Stability: A Private Sector Perspective".

[15] Basel Committee on Banking Supervision (2004), "International Convergence of Capital Measurement and Capital Standards".

[16] It should be noted in this regard that the Eurosystem is considering the feasibility of collecting euro area statistics on hedge funds, which *inter alia* involves the development of a harmonised definition of hedge funds for statistical purposes.

Third, and linked to the previous aspects, there are a number of financial instruments that may have hedge fund-like characteristics, such as some structured notes and insurance policies. Any regulation at EU level should therefore take into account the possible 'level playing field' effects across different financial sectors. Finally, although there is at present no specific regulatory regime in the EU for hedge funds, several aspects of their activity already fall within the remit of existing Community measures, such as the Markets in Financial Instruments Directive, the Prospectus Directive[17] and the Market Abuse Directive.[18]

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In conclusion, the Eurosystem fully endorses the current reflections of the Commission to assess the possible need for further Community initiatives in the area of asset management and stands ready to provide support to the further work that the Commission might undertake in this field.

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[17] Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC (Text with EEA relevance), (OJ L 345, 31.12.2003, p. 64).

[18] Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse), (OJ L 96, 12.4.2003, p. 16).