



**Eurofi 2008 -
Thursday 11/09/08**

**Session [1A] - TAKING INTO
ACCOUNT INNOVATION IN
THE EU INVESTMENT FUND
REGULATORY FRAMEWORK:
Keeping up with innovation
in secured conditions**

**through potential evolutions in the product or distribution
framework of investment funds.**

The Panel

Moderator: **Marc Truchet**, Senior fellow consultant, Eurofi

Panellists: **Niall Bohan**, Head of Unit, Asset Management, DG Internal Market and Services, European Commission;

Alain Leclair, Chairman, French Asset Management Association;

Wolfgang Mansfeld, Member of the Executive Board, Union Asset Management Holding AG, Chairman, BVI;

Jean-Paul Mazoyer, General Management Committee Member in Charge of Development, Crédit Agricole Asset Management;

Lisa Rabbe, Managing Director, Goldman Sachs International

The Debate

At the start of the session, Marc Truchet, moderating, pointed out that its purpose was to examine new challenges and innovation in investment management, not to discuss the Ucits IV Directive, which is primarily about market efficiency.

Jean-Paul Mazoyer, head of development at Crédit Agricole Asset Management (CAAM), kept to the brief, arguing that innovation was vital in fund management in the light of the high interest rates available from bank deposits and rising competition from investment banking products. In addition, the sector was facing an unusual set of circumstances: European funds were suffering strong outflows, institutional investors were showing markedly less interest than normal and the first net redemptions from hedge funds in modern history had been witnessed. On the positive side, new distribution channels were opening up and demographic changes offered fresh opportunities.

"Funds have to differentiate themselves and find new sources of performance," Mr Mazoyer said. "They need to respond to investors' demands for products with less correlation with the stock market." The

current demand among retail investors was for structured products with capital guarantees since the appetite for risky products was low. Retail investors also wanted transparency and simplicity in both the investment strategy and in its pricing. Private bank and institutional clients, on the other hand, were looking for new sources of alpha, and wished to deal with investment firms in which there was a clear separation of alpha (ie added value brought by portfolio management) from the cheaper beta products (ie performance coming straight from the market), such as ETFs.

Although the current European regulatory framework made it difficult to grow and contain costs at the same time, Mr Mazoyer said it was nevertheless possible to expand by adopting the following strategies: reduce fees to compete against capital market and banking products; broaden the product range; simplify fund documentation for cross-border business, replacing the "simplified prospectus" by a shorter harmonized EU document containing key information for investors.

Caution was urged by Alain Leclair, chairman of the French Asset Management Association, who warned that talking to the broader public and media about innovation at a time of financial crisis could be seen as a "provocation". He said: "The crisis shows people are losing their trust in finance – it is seen as obscure and dangerous, so we need to bear that in mind." He said the first task of asset management was to "demonstrate that we need complex finance at all". One certainty was that financing for infrastructure was still required and that classical tools could not meet the challenges of financing projects of such longevity. Investors would have an appetite for these subjects, provided there was transparency in the assets and in the intermediation. This was also true for investments related to the environment, private equity, real estate and so on

Investment banking products did not necessarily meet these requirements, but they would continue to win business if fund managers did not convince investors that there were regulated products that could achieve the same results as the structured bank products. Mr Leclair listed three solutions. Ucits IV: this was difficult, although he had thought that changing the framework through the Lamfalussy process could have been possible. Private placement could be an answer, such as exists in France for hedge fund and private equity products - but since the line was difficult to draw between retail and institutional investors, it could only be an "additional way". Mr Leclair said he believed the answer could lie in a third way. "When we go to China they ask us if they can invest in European private equity funds or European hedge funds. The visibility and strength of European regulation is very attractive to people around the world. As a result, Mr Leclair encouraged exploration of a concept he called the "alternative investment scheme" or "alter-Ucits" which would have greater flexibility than Ucits but would also include some stringent rules.

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The product would address the issues of transparency, valuation, conflict of interest, and would be distributed worldwide with European branding.

No discussion of innovation could be conducted entirely without reference to the Ucits framework, according to Wolfgang Mansfeld, of Union Asset Management. He said innovation could be stifled in Europe if the regulation was too narrow to capture a fresh wave of products. "We have to make the Ucits framework capable of embedding product types not already within it," he said. Product types such as funds of hedge funds and open-ended real estate funds were not yet integrated so could only be sold at national level. "I would have asked that Ucits IV would have moved ahead in this respect. We cannot go on with only a restricted list of eligible assets – this falls short."

Recent industry discussions had shown that the integration of open-ended real estate funds, for instance, in the Ucits framework should be possible, but Mr Mansfeld decried the lost time. "Harmonizing schemes will take another three to four years now, during which national schemes will develop and there will be no pan-European approach."

There was also a lack of a level playing field in terms of how similar or substitute products were regulated. Mr Mansfeld said that investment funds, structured notes and life products were often distributed using the same channels, yet were viewed on a different basis from each other by regulators. Funds were often at a disadvantage because of the stricter rules surrounding them. "Notes can take days to issue, whereas funds can take months because of all the disclosure, marketing and tax issues." In addition, investment funds had effectively been excluded from Second Pillar pensions, to the benefit of life companies.

Overall, if there was to be continued legislation at EU level, the establishment of a level playing field was essential. Distortions pose significant business risks to the fund management industry in particular. "We don't call for tighter regulation for others, we just want to prevent the gap getting wider between us and them," added Mr Mansfeld.

Regulatory innovation was just as important as innovation in the products themselves, according to Lisa Rabbe, managing director at Goldman Sachs International. "Regulation must enhance the investment choice but manage the investment risk," said Ms Rabbe, adding that this was true for the retail market but not the wholesale market, in which Goldman Sachs was principally involved. Indeed, institutional investors had never had such choice in the geographic and asset class diversity of the funds in which they invested.

The wholesale market played an incubation role where new strategies and techniques could be tested. The areas of greatest demand currently included commodities – for uncorrelated returns – and structured products to protect against downside risk. In addition clients were

interested in hedge funds, Shariah-compliant funds, ETFs, options, socially responsible investments, certificates and warrants. Once proven, new strategies can migrate to the retail market, albeit sometimes in a slightly different form or structure. The Ucits framework for retail funds had been extremely successful and now it was time for policy makers to make the same advancements in wholesale. "We need a more extensive range of harmonised products," said Ms Rabbe. "There is great demand from outside the EU to invest in wholesale products and it would be a shame to miss out on the capital flows." Despite the proliferation of wholesale funds within national borders, they were largely trapped within their countries of origin, she continued, lamenting the "barriers, prohibitions and delays" in cross-border distribution.

While a financial services passport existed, it had not been fully extended to fund management. This was a cost drag to investors, but the worst part was the opportunity cost of not having access to a full range of funds. The way forward, as also suggested by others in the debate, could be through the private placement exemption within the fund management prospectus rules. Switzerland, Australia, Hong Kong and others all had a qualified investor base definition which gave investors access to non-public offerings. "A jurisdiction that provides barriers to sophisticated investors to choosing the best products risks losing out to jurisdictions elsewhere in the world," said Ms Rabbe.

The combined views of the fund management industry, as expressed by the panellists above, represented a "long and daunting list of wishes", said Niall Bohan, of the European Commission. There were huge issues facing asset managers and accommodating and facilitating them was a mammoth task, he added. He questioned whether the desire for cross-border distribution was to create a more efficient market or was being driven primarily by the desire to roll out more products in an attempt to increase sales. "It is striking that new products are seen as being so crucial," said Mr Bohan. "There are many other elements that can sustain success too. Innovation is not the only issue."

He acknowledged, however, that there was considerable industry frustration that the European framework did not deliver cross-border distribution. Some retail products, for instance, were arbitrarily excluded from Ucits and this needed to be addressed. Perhaps one of the difficulties was that Ucits "was the only game in town". It was the only proven passport mechanism so fund managers focused exclusively on it for all their needs. There was an "unhealthy" pressure to expand the Directive to accommodate all kinds of products. The framework was designed for retail, for the man in the street and should continue to be the starting point for any product that falls within it, he believed. It should continue to hold no surprises for investors, have the risks clearly disclosed at the outset and performance that matched the risk profiles. Mr Bohan said:

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“Do these principles put limits on the framework? Yes, investors cannot access some of the best funds and the widest range, but they have to be subject to the above caveats. Innovation is a secondary consideration to safety.”

Having a regulated kitemark for products that opened doors to investors from countries outside the EU was advantageous for European fund managers. An “alter-UCITS”, as suggested by Mr Leclair, could be a good idea. For institutional products, there needed to be an effective, functioning private placement regime not necessarily specific to funds. This would build on the Ucits experience of transparency and provide an effective channel for all those qualified to participate. But such an idea must be created between the counterparties themselves, not dictated by official channels, Mr Bohan said. “The Commission has made its priority increasing competitiveness through Ucits IV.”

He defended the Commission against the widespread perception that its approach was “incremental” and did not proceed rapidly enough. Differentiated approaches were required for the retail and institutional markets. He believed that a piecemeal approach to looking at specific fund types was sub-optimal and looked forward to a time where a coherent view could be developed covering all fund types and the whole range of products respectively for retail and for institutional investors. But this would mean “thinking outside the Ucits box.” He concluded: “We should close the chapter on Ucits IV now and move on.”

The proposal of a physical presence in the local domicile was the cornerstone of Eurofi’s working paper and was a well thought out proposal, said Mr Comporti. He agreed it could work as an interface with capital no longer required until full rules have been implemented, and the idea should be further analysed to assess whether the physical presence would

bring sufficient benefits to supervisory arrangements. He asked whether the purpose was to create a legal responsibility towards clients and regulators or whether it would perform specific functions. “Is it the first, the other, or a combination of the two?” Mr Comporti said. The additional cost, even for a light scheme, needed to be borne in mind. Cesr’s advice would follow the Lamfalussy process. It would set out the provisions for Level 1, which the Commission could then make into legal text. There was still important work to be done on harmonising rules between member states, which Cesr was involved in. There needed to be a clear split of the responsibilities between the fund managers, depositaries and regulators, which was not easy in all cases. Depositaries played an important role, Mr Comporti said, but there was some discussion about whether they should be given additional functions. There also needed to be a sound framework between regulators in terms of co-operation, supervision and enforcement. Mr Comporti emphasised that his comments should be regarded as personal thoughts ahead of Cesr’s formal deliberations.

Ucits was a good brand and it should be kept that way, said Mr Klinz, summing up the debate. Mr Klinz was satisfied that the industry at large believed that a passport could become reality. But it was paramount that the retail investor should not suffer under any circumstances and that protection should be maintained. At the same time, the market should be opened up further and go towards more harmonization. In the European Parliament, there was a group working on the Lamfalussy process and supervisory structures to ensure the future of Ucits and other products in future years. The Commission, he said, had taken the question of the management passport seriously. Cesr too, was working hard to come up with answers. In addition, there seemed to be a large consensus within the industry about how to deal with the challenges.

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