



Financial innovation is constant in the investment funds market, driven by the need for the industry to continue to ensure differentiation and find new sources of performance and revenue and by investor demand eg for new types

of products less correlated with the stock exchange. Producers use different approaches to answer these needs: diversification of asset (eg new geographies or industrial sectors), new investment techniques or strategies (eg hedge funds with the objective to offer "absolute return" regardless of market conditions), new product concepts (eg guaranteed products or lifestyle funds for retail investors).

Local regulatory product frameworks have been evolving over time to accommodate these evolutions and needs. **The EU regulatory framework also needs to keep pace with these evolutions to create a secure framework for the passportability of new products across European countries and to create innovative product labels that can be exported successfully out of Europe.** The UCITS Directive, which is the only existing European product legislation for investment funds has evolved over time despite the constraints of the legislative process, since the UCITS directive was not drafted following the Lamfalussy principles. The list of eligible assets allowed in the UCITS framework has been expanded over time to keep track with financial innovation. But the increasing volume of investment funds and investment products (eg certificates, notes...) that do not fall under the UCITS label and the high proportion of UCITS funds sold to institutional investors (25% of AuM according to the EU Commission) illustrate the limits of the present framework.

The bulk of the investment funds market is represented by harmonized and passportable UCITS funds - 79% of the total funds market ie 5900 Bio € - which follow the rules of the UCITS III Directive and are regulated at the EU level. But the volume of investment products structured under different product frameworks, that are mainly local, is growing with three main types of products: Non-harmonized investment funds which represent the remaining part of the investment funds market (21%) with rules differing from UCITS funds notably in terms of eligible assets (ie real estate, private equity...) and investment limits – some of these funds such as non-harmonized open ended funds do

not benefit from a product passport or from the prospectus directive; Structured products such as notes or certificates and Unit-linked life insurance products which are mainly distributed on a national basis and are estimated to represent volumes of around 2200 Bio€ (retail segment) at present: their frameworks differ from the UCITS framework, particularly in the range of assets or investment strategies covered or disclosure obligations.

These different investment products are also subject to distribution frameworks. The distribution of securities such as UCITS, non UCITS funds and structured products is governed by the MiFID directive and by local private placement regimes for institutional clients and codes of conduct. The distribution of unit-linked life insurance contracts is regulated by the insurance intermediation directive. The prospectus directive also applies to closed-ended funds and structured products.

Several questions are being at present debated between the industry and EU authorities, but are not included in the present review of the UCITS Directive (UCITS IV).

The first regulatory issue to be solved at the EU level is defining the adequate EU framework for assets not covered by the UCITS Directive - particularly the most common ones ie real estate, funds of hedge funds, private equity...- and the way to facilitate the update of EU frameworks on an on-going basis to take innovation into account.

Two main options are being considered for assets or investment techniques not covered by the UCITS Directive:

- Creating a new more flexible UCITS type framework drafted according to Lamfalussy principles – a harmonized alternative funds framework - The French asset management association has labelled this concept "alter-UCITS".
- Integrating new asset classes or techniques, particularly those targeting potentially retail investors into the existing UCITS framework, beyond the additional flexibility already introduced by the Level 2 measures that followed UCITS III.

To enable UCITS III to keep up with financial innovation, the suggestion has also been made to transform the UCITS Directive, or at least some of its key articles eg relating to eligible assets, according to the Lamfalussy principles, to allow for rapid changes to be introduced in line with market developments. Several years are indeed at present necessary to effect changes in the current UCITS framework which is a major obstacle to its evolution. A possible alternative would be to switch to a principle or risk-based approach

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requiring common indicators and measurements criteria to be defined and monitored over time.

Better qualifying the respective merits of product and distribution regulation and defining the adequate framework for each investor category is also an important issue currently debated. Product and distribution issues raised by innovation are closely connected and should be approached in a coherent way. A distribution framework such as MiFID indeed imposes rules and safeguards at the point of sale, mainly for retail investors, but cannot be a substitute to product regulation for retail investors who need to be well informed of product features in a consistent way. For institutional investors the situation is different. Many players believe that a common EU private placement regime with a lighter set of rules could contribute significantly to developing innovation, flexibility and liquidity in the investment product market. But this probably has to be an addition to adequate product regulation to avoid complex or risky products initially designed for institutional clients being sold to retail investors at a later stage.

Another major issue is how to favour further convergence in the regulatory frameworks of substitute investment products.

Many observers believe that there should be a regulatory level playing field with coherent constraints among products that target similar clients. As mentioned above, investment funds compete with other investment products (particularly notes and certificates) that operate under different regulatory frameworks and can be presented to investors as similar or substitute products. This creates level playing field issues for UCITS and exposes retail investors to potential risks that are not easily mitigated by MiFID according to many industry players. The call for evidence launched in October 2007 by the European Commission on substitute investment products has enabled to identify the main issues that need to be solved particularly regarding disclosure requirements.

Developing a new regulatory framework for assets that are not covered by the UCITS regime and a common EU private placement regime appear as the most attractive options worth testing in the near future to support further innovation. Building Lamfalussy principles progressively into investment fund frameworks also appears as a priority.

These proposals need to be approached with a coherent perspective across investor and product segments: the interests of retail investors in particular need to be safeguarded in a consistent way through the different frameworks and a level playing field should be ensured among substitute products as far as possible.

The following options should in particular be further assessed and tested by EU authorities and the industry:

1. Developing a new regulatory investment fund EU framework (a Harmonized alternative funds EU framework or "alter-UCITS") drafted according to Lamfalussy principles seems an attractive way to cover the most common asset classes not included yet in the UCITS framework: eg real estate funds, funds of hedge funds, etc... Depending on the specificities of the underlying assets it could be divided up into several sub-regimes.
2. In parallel with this evolution the list of eligible assets and investment techniques permitted in the UCITS Directive could be reviewed to make sure UCITS products remain focused on the needs of retail investors. Some needs corresponding specifically to institutional investors could probably be better covered by the framework mentioned above.
3. The frameworks of substitute products ie investment funds, notes / certificates, etc... should evolve towards greater coherence in the context of possible evolutions of the UCITS framework and / or of the creation of a complementary harmonized investment fund regime. The main issue is to make sure that similar principles apply to products sold to retail investors as alternatives for the same investment objective. Particular attention should be paid as suggested recently by the Commission to product disclosures (metrics of cost, risk-reward disclosures...). Eligible assets and investment techniques should also be closely considered.
4. Developing a common EU private placement regime would be an attractive way to foster innovation and improve market liquidity for institutional investors provided it is combined with adequate EU product frameworks to ensure that sufficient safeguards are put in place for retail investors and avoid over-complex products from being passed on to them.