ECMI Policy Brief
No. 15/April 2010

Regulatory Challenges for the EU Asset Management Industry

Karel Lannoo

The European asset management industry is feeling squeezed from all sides, as a result of growing prudential, product and conduct regulation. A new Directive, UCITS IV,[1] has only just been enacted, and already new challenges are emerging in the regulation of hedge and venture capital funds, the review of the regulatory regime for depositaries (or financial custodians) and amendments to the MiFID Directive.[2] In addition, a new European supervisory framework is in the making, which implies much stricter controls on enforcement. These changes are taking place in the context of one of the largest declines suffered by the industry in the last two decades, from which many fund managers have not yet recovered. The era of light regulation is thus definitely over.

In terms of regulation, the asset management industry as such does not exist. Rather, the regulatory regime depends upon the particular license that the financial institution in question possesses. One may be licensed as an asset management company, a bank, an insurance company, a pension fund, a broker or an investment fund, which immediately opens the possibility of major inconsistencies, duplication or arbitrage across regulatory regimes. For certain segments of the asset management business, there is no question of which regulatory regime applies, as they unambiguously fall into one of the aforementioned categories; for others, however, the vertical regulatory framework does not conveniently lend itself to the range of activities they undertake. This is especially true of financial institutions that manufacture and distribute insurance, pensions and investment products, all the while conducting regular banking activities such as deposit-taking.

The diversity of institutional frameworks governing the sector across the EU is striking. It reflects the fundamental differences in consumer preferences, cultural habits and institutional heritage, and it explains the variation from one country to another in the relative importance of these various sectors as conduits of financial intermediation. Although sectoral regulation has been harmonised to a large extent at the European level, implementation of EU rules may vary, with supervisory structures and practices continuing to differ from country to country.

This paper first briefly reviews recent developments in the EU asset management industry, followed by a discussion of the regulatory framework for asset management and the challenges ahead. We focus primarily on the UCITS and emerging non-UCITS investment fund regime, and its interaction with the MiFID regime covering investment services. We make reference to the treatment under other regimes, as necessary. Annex 1 provides an overview of the US investment fund regime for purposes of comparison with the EU system.

1. The fund management industry

The financial crisis fundamentally changed the face of the asset management industry, allowing the insurance industry to re-emerge as the leading player. Of the three traditional groups of institutional investors – investment funds, insurance companies and pension funds – the first had been the dominant group in the sector in terms of total assets

[1] Approved by the European Parliament on 13 January 2009, UCITS IV (Directive 2009/65/EC) was created to update and improve the regulatory framework for European undertakings for collective investment in transferable securities (UCITS) funds, offering greater protection and potentially wider choice for investors.

[2] The Markets in Financial Instruments Directive (Directive 2004/39/EC) provides harmonised regulation for investment services across the 30 member states of the European Economic Area. The main objectives of MiFID, which became effective on 1 November 2007 and replace the Investment Services Directive, are to increase competition and consumer protection in investment services.

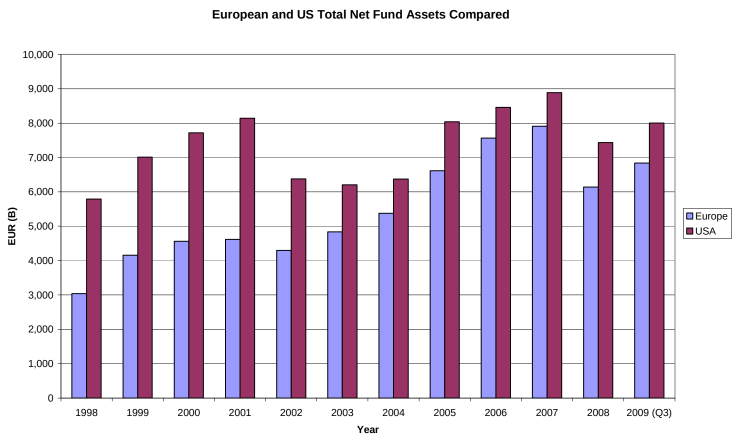
* Karel Lannoo is Chief Executive Officer at CEPS, where he also heads the Financial Markets and Institutions research unit and serves as Secretary-General of ECMI. This paper draws upon and updates the 2007-08 CEPS Task Force Report on UCITS and asset management in the EU after MiFID (see Casey & Lannoo, 2008). Research assistance by Bashir Assi and Chris Napoli is gratefully acknowledged.

Papers in the ECMI Policy Brief series provide insights into regulatory initiatives that affect the European financial landscape. They are produced by specialists associated with the European Capital Markets Institute, which is managed and staffed by the Centre for European Policy Studies (CEPS) in Brussels. Unless otherwise indicated, the views expressed are attributable only to the authors in a personal capacity and not to any institution with which they are associated.

Available for free downloading from the CEPS website (http://www.ceps.eu)
© Copyright 2010 Karel Lannoo. All rights reserved.

since 2004. By the end of the third quarter of 2009, net assets of the European investment fund industry totalled €6,840 billion, which represented an increase of 12.4% compared to the end of 2008, but still a decline of 14.5% compared to the end of 2007, when net assets totalled €7,909 billion. By comparison, by the end of 2008, the European insurance industry's assets totalled €6,910 billion, a decline of 5% as compared to end 2007. The pension funds managed assets, which totalled €3,094 billion by the end of 2007, were estimated to have declined by 15-20% by the end of 2008.[3]

Figure 1. Net assets of European and US investment funds



Sources: European Fund and Asset Management Association (EFAMA) and Investment Company Institute (ICI). European data include UCITS (about 75%) and special funds (including a limited number of hedge funds). US data include primarily mutual funds (about 90%), closed-ended funds, exchange-traded funds and units of investment trusts. Q3 data for the latter three were not available at the moment of publication.

The dramatic decline in the European investment fund industry in 2008 was a reflection of the extraordinary events in financial markets around that period: global stock markets recorded huge losses and the financial system experienced big outflows of money, especially from equity investment funds. The decline in the European investment fund industry was even more dramatic as equity funds comprise only 35% of funds in Europe (by assets), and a significant part of these were invested in funds with a guaranteed minimum equity. By comparison, the European insurance industry, which also manages long-term savings plans in life insurance products and group insurance plans, managed to consolidate its image as a genuine long-term institutional investor.

The evolution of the European and US fund industry has been fairly comparable over the last years, although the recent decline was sharper in the EU, and the recovery was more pronounced in the US. Assets managed by the EU and US fund industries amount to 88% of the global fund management industry (according to ICI).

Recent events in financial markets had a direct bearing on the investment fund industry, and on its future structure. The demise of Lehman Brothers meant that some funds got blocked in bankruptcy procedures, as derivative financial instruments were used by the bank in the management of the funds. Some banks had also made use of collateralised debt obligations (CDOs) to support guaranteed equity products and in money market funds. The large-scale fraud perpetrated by Bernard Madoff, which was revealed at the end of 2008, was a further blow to the fund industry, but also signalled that regulatory issues have to be dealt with at the global level. Many European professional fund managers had invested in Madoff funds (in fund of funds or feeder fund structures) but had not taken proper measures to ensure a complete separation between the fund manager, on the one hand, and the depositary or custodian, on the other.

The decline in the European fund industry emphasised even more the need for further consolidation, as the average size per fund declined. The average size of European funds is one-fifth the size of an average US fund (!). The sub-optimal average UCITS size brings about higher operational costs for investment management, a high total expense ratio (TER) and a duplication of infrastructure.[4] In this sense, the asset management industry performs below its potential, the cost of which is passed on to the user. The main causes are to be found in the high level of fragmentation, the absence among investors and firms of a European market concept and the remunerative *niche* markets that funds can target, exploiting differences in tax and regulatory regimes across Europe. The UCITS IV amendments, discussed below, address only a part of these challenges.

The long-term impact of the financial crisis on the fund industry is not yet entirely clear, but some initial conclusions can be drawn:

1. Too many funds were too closely run by the deposit-taking bank as an alternative savings instrument. Still today, about 75-80% of the funds are distributed by banks in the EU, a situation that can hardly be considered to be healthy in the aftermath of the financial crisis.
2. Hence, measures need to be elaborated to support the separation between banks and fund managers and to come to a fuller application of the open architecture framework.
3. This calls, inter alia, for a stricter application of conflict-of-interest rules, as enshrined in the EU's MiFID Directive.

2. The UCITS regime

With the latest changes in the course of implementation, the UCITS regime governing the EU's investment fund sector has reached a high degree of maturity, but at the same time a

[3] The sources for sector data are taken from the European professional organisations: European Fund and Asset Management Association (EFAMA) for investment funds in the EU (Investment Company Institute or ICI for the US), CEA (European insurance and reinsurance federation) for insurance companies and EFRP (European Federation for Retirement Provision) for pension funds. Investment fund data do not cover private equity and hedge funds, as the latter are mostly domiciled outside the EU.

[4] The average total expense ratio in Europe is easily 25% to 50% higher than in the US, where it is 0.85% for equity funds and 63% for bond funds (according to ICI data).

high degree of complexity. The latest legislative text, which consolidates the previous measures into one single document, should open a further phase of European-wide consolidation of the sector, but at the cost of a higher degree of specialisation. Compared to the initial 1985 Directive, UCITS IV is five times longer, measured by the number of words in the new text.

EU regulation governing the free provision of financial services in the asset management industry across borders under home country rules started with the UCITS Directive of 1985. The UCITS (Undertakings in Collective Investments in Transferable Securities) Directive introduced harmonised *product* regulation for investment funds that were allowed for cross-border sales in the EU (and the countries of the European Economic Area). It was followed in the early 1990s with directives defining the terms under which the banking, insurance and investment services sectors could ‘passport’ their *services* across the EU on the basis of authorisation from their home state regulator (see the table in Annex 2). The UCITS Directive was amended and expanded in 2002 and, later in 2009, to become more of a horizontal asset management directive to reflect the increasing convergence of the core sectors of the financial services industry. An agreement was also reached in 2002 on the last outstanding piece of free provision of cross-border services regulation in the financial services sector, the pension funds Directive. In the meantime, the new wave of the Financial Services Action Plan (FSAP) had started to come into effect, most importantly with the MiFID (Market in Financial Instruments Directive).

The 1985 UCITS Directive opened the way for the cross-border sale of investment funds in the EU. Subject to some general criteria regarding authorisation, legal structure, investment policies and disclosure, units of open-ended funds that invest in transferable securities could be sold freely throughout the EU. Marketing and tax rules do not fall within the scope of this Directive, which means that they remain regulated by host-country regulators. Prospectuses have to be translated into the official language of the host country, for example, and local consumer protection regulation – often very different between countries – had to be respected. Nor did the Directive harmonise the prudential requirements of the companies managing investment funds either. For example, it did not set a minimum capital standard or solvency requirement. This was subsequently modified by the 2002 amendments.

The asset allocation rules of UCITS I were essentially quantitative. UCITS funds could invest in a diversified portfolio of listed equity and debt securities, respecting the 5/10/40% rule: 5% limits apply to stock of a single body (which can be extended to 10% by the home country authorities), and an overall limit of 40% for the total of large single blocks of securities. A limit of 10% is applied for non-listed securities. Exceptions are applied for government or government-guaranteed paper. The limit applicable for investment in other funds was 5% of the whole portfolio, meaning that funds of funds were not permitted. Real estate and commodity funds were excluded from the Directive, as were other alternative investments, including hedge funds and private equity, and money market instruments.

The 2002 UCITS amendments expanded the scope of activities that were possible under the UCITS I Directive. One Directive – the UCITS III Product Directive (2001/108/EC) – widened the investment possibilities of funds to include instruments such as OTC derivatives and allowed for new forms of funds, such as funds of funds, money market funds, cash funds or index tracker funds. A second Directive – the UCITS III Management Directive (2001/107/EC) – detailed minimum standards, including the introduction of a minimum level of own funds to be held by a fund management company for prudential purposes, and broadened the permissible activities of the fund management company. It also introduced a simplified prospectus, which provides for key factual information about a UCITS to be presented to investors in an accessible and uniform format. The UCITS III Directive grants the ‘single license’ to fund management companies in the broad sense of the word. It comprises not only the management of investment funds – the core services – but also other activities related to portfolio management, such as pension funds for individuals, investment advice, safekeeping (custody) and administration of investment funds, which are seen as non-core or ancillary.[5]

In 2007, the European Commission proposed a further set of amendments to the Directive. UCITS IV was formally adopted by the EU in April 2009, and it must be implemented by July 2011 at the latest. The latest amendments formally allow for a genuine European passport for UCITS management companies, permitting a separation between the location of the management company and the place where the funds are registered. UCITS IV facilitates cross-border mergers of UCITS**,** which will make it possible to increase the average size of European funds. In the same vein, UCITS IV allows for master-feeder structures, which have been previously specifically excluded due to fund diversification rules.[6] All these measures should allow for entity pooling, generate scale economies and thus contribute to a consolidation of the sector, which should serve the end-users of the funds. UCITS IV further eases cross-border marketing of UCITS by simplifying administrative procedures: there will be immediate market access once the authorisation has been granted by the country of origin of the UCITS. The host country will be able to monitor the commercial documents but not to block access to the market.

UCITS IV should also improve investor information by creating a standardised summary information document: ‘key investor information document (KID)’; this should make it easier for the consumer to understand the product. The KID will replace the simplified prospectus of the UCITS III. The supervision of UCITS and of the companies that manage them should be strengthened by means of

[5] Other forms of portfolio management, i.e. management of pension fund portfolios or those of individuals, are presented as a form of derogation from the central objective of the Directive, which is the management of investment funds as authorised under the Directive (Art. 5).

[6] A feeder UCITS is a UCITS or an investment compartment thereof that invests at least 85% of its assets in another UCITS, called the Master UCITS.

enhanced cooperation between supervisors: the Directive encourages the exchange of information between supervisors, harmonises the powers of supervisors and allows for the possibility of on-the-spot investigations, consultation and mutual-aid mechanisms for the imposition of penalties, in particular.

Notwithstanding the recent decline, UCITS is considered as a European regulatory success, a worldwide brand. It started from a limited basis in 1985, covering product rules for equity, bond and money market funds, which are still kept intact in the latest amendments, although the scope of the Directive has been considerably enlarged. The UCITS III product Directive signalled a first expansion, and allowed for funds investing in money market instruments, bank deposits, financial derivatives, index funds, units of other UCITS and non-UCITS funds (funds of funds). The investment limits of the 1985 Directive have been further detailed, depending on the instruments. Overall, the 5/10/40% rule continues to apply. Maximum levels of 10% apply for investments in money market instruments issued by the same entity, and of 20% for investments in one single other UCITS (for funds of funds and index tracker funds or Exchange Traded Funds) and for deposits with credit institutions. Investments in non-UCITS are limited to 30% of the assets of the UCITS.

In 2007, the EU adopted an implementing directive (Directive 2007/16/EC) which details the asset classes eligible for inclusion in UCITS funds. It concerns: asset-backed securities, listed closed-end funds, Euro Commercial Paper, index-based derivatives and credit derivatives. This decision makes use of the limited (and only) ‘comitology’ provisions under UCITS I, which allows for clarifications to the definitions to be made via a simple decision taken in the European Securities Committee (the so-called ‘level 2 Committee’).[7] These changes allowed for the use of hedge-fund based techniques in UCITS, such as the 130/30 funds.

The European Commission also adopted two recommendations in 2004 explaining its interpretation of the information to be provided in the simplified prospectus and on the use of financial derivative instruments in UCITS. The first recommendation sets common interpretations on the presentation and measurement of fund performance, subscription and redemption fees, soft commissions and fee-sharing arrangements (Commission Recommendation 2004/384/EC). The Commission recommended that a total expense ratio (TER) should be disclosed: the expected cost structure, as an indication of all costs applicable; all subscription and redemption charges and other expenses directly paid by the investor; an indication of all the other costs not included in the TER; and the portfolio turnover rate. Equally, it established that the existence of fee-sharing agreements and soft commissions must be disclosed. The second recommendation proposes a uniform understanding of risk measurement methodologies in the UCITS area with regard to derivative products (Commission recommendation 2004/383/EC).

In addition, the European Commission adopted an interpretative Communication in 2007 on the respective powers of the home and the host member state in the marketing of UCITS, which tried to elaborate a common understanding on some unclear provisions of the UCITS III Directive discussed above (COM(2007)112). According to the European Commission’s interpretation, home member states clearly have exclusive responsibilities under UCITS III, on which the host member states should not encroach. The residual host country competences are related to advertising, marketing and the distribution infrastructure as strictly related to UCITS. Host member state rules falling outside the scope of the Directive are in any event harmonised at the EU level under MiFID and various marketing and consumer protection directives, according to the European Commission. This interpretative communication was adopted by the European Commission in March 2007, awaiting the results of the White Paper and the consultation process of the UCITS review, which resulted in UCITS IV.

In response to the Madoff scandal, which broke at the end of 2008, the European Commission started an investigation into the application of depositary safe-keeping duties. Madoff revealed that European asset managers had not properly applied the segregation of fund management from depositary responsibilities, which is an obligation in the EU according to UCITS (but not in the US), but also that the UCITS rule had not been correctly implemented in the EU member states. The problem is, however, that once certain derivative financial instruments are allowed to be used under UCITS, a 100% separation between the fund manager and the depositary is very costly to implement.

3. Creating an EU regime for non-regular funds

The financial crisis crystallised the consensus that European or global regulation of alternative funds was necessary. Before 2008, the dramatic growth of hedge fund assets was not seen to necessitate a regulatory response. The registration of these funds was considered to be sufficient.

The London G20 summit in April 2009 agreed that “all systemically important financial institutions, markets and instruments should be subject to an appropriate degree of regulation and oversight”. Leaders of the world’s main economies intended to put an end to regulatory arbitrage, seen to be one of the principal drivers behind the crisis. The G20 said hedge funds should be registered and disclose information about their leverage to supervisors. In addition, they should be subject to effective risk management.

The EU’s draft Directive on Alternative Investment Fund Managers (AIFMs), which aims to create a comprehensive and effective regulatory and supervisory framework for AIFM in the European Union. follows the G-20 commitment. The problem was to find a comprehensive way of regulating the sector, of which over 75% is domiciled in

[7] ‘Comitology’ provisions allow changes to be made to an EU measure without going through the formal EU decision-making process, but by the agreement of a specialised Committee. This only applies for those articles of a directive or regulation where this was foreseen in the original text.

offshore jurisdictions.[8] The EU's draft Directive applies to *managers* of alternative investment funds – wherever they are registered – and not only to the funds. In this sense, and by adding a reciprocity provision, the Commission ensures that the whole non-harmonised funds sector that falls outside the scope of the UCITS Directive is covered, including also private equity, commodity and real estate funds. Managers of funds domiciled in third countries will be able to provide services in the EU provided their domestic regulatory regime is considered to be equivalent.

The Commission's proposal follows the provisions of the UCITS and Markets in Financial Instruments Directive (MiFID, see below), on the conduct of business, organisational (including outsourcing), reporting and prudential requirements. The draft added elements that have come up in the crisis, such as the need for appropriate liquidity management, segregation between asset management and the depositary function and additional reporting requirements for highly leveraged funds.

The draft Directive applies some 'generous' thresholds: it will not be applicable to leveraged funds below €100 million, and to non-leveraged funds below €500 million. Such thresholds do not apply to investment advisers and asset managers who fall under the EU's MiFID (brokers) or UCITS rules. The transparency threshold for private equity funds with stakes in non-listed companies is 30%, while it is 3% for listed companies. In addition, 'empty' voting rights (a common tool for alternative funds) will indirectly be included in the threshold set by the proposal.

Although intensely criticised by the industry, which claims it will lead to a flight of fund activities out of the EU, the draft creates a single licence for non-regular funds in the EU, which does not exist at present. More transparency in hedge funds and the private equity sector will be a benefit for users and regulators, and in the end for the industry as well. The Directive is expected to be adopted by mid-2010, and to be applicable by 2012.

4. The interaction with MiFID

Whereas UCITS, strictly speaking, regulates products, MiFID regulates investment services, which also includes asset management, except for the insurance sector. MiFID, which was adopted in 2004 (Directive 2009/65/EC), updates and replaces the 1993 Investment Services Directive. It allows for the free provision of investment services all over the EU with a single licence, subject to detailed conduct of business and organisational provisions. The problem for the asset management industry is to deal with the intersection between both of these regulated activities.

The Market in Financial Instruments Directive (MiFID) is probably one of the most far-reaching and complex EU financial services directives to have been enacted in the EU. MiFID brings more competition to exchanges in equity trading, by abolishing their monopoly, and through the introduction of alternative trading facilities ('systematic internalisers' and 'MTFs'). In return, it imposes much stricter requirements on banks in securities transactions, through best execution, client categorisation (suitability and appropriateness test), conflict of interest and transaction reporting requirements, which have been harmonised to a high degree. These measures should reduce transaction costs and increase transparency to users.

In theory, UCITS are collective investment undertakings that are coordinated at Community level; hence, the funds, their managers and depositaries do not come under MiFID rules. However, UCITS III allowed for discretionary asset management, investment advice and custody and administration, in which case certain MiFID conduct-of-business rules apply. In addition, up to 80% of UCITS are distributed by banks in Europe, which means that the MiFID rules do apply in those cases. The rules that are of the greatest interest to the asset management industry are those governing organisational requirements (Art. 13 of MiFID), in particular regarding conflicts of interest, and conduct-of-business obligations (Art. 19), in particular client suitability and best execution.

An important issue for the fund management industry is the regime for inducements under MiFID. Inducements are payments by an investment firm of a fee, commission or non-monetary benefit that could place the firm in a situation that is inconsistent with the principle elucidated in MiFID's Art. 19 (1) requiring a firm to act honestly, fairly and professionally in accordance with the best interest of its clients. This means that firms will have to demonstrate that commission charges do not reflect any bias and facilitate an enhanced service for customers.

Conflict-of-interest provisions create difficulties for widely accepted distribution practices in the fund management industry, namely the retrocession of fees from asset managers to distributors. In particular, in some instances, asset managers and intermediaries (which are not the distributor) may consider significant up-front payments to be placed on the distributor's panel or recommended list. These payments are unconnected with, and additional to, conventional commissions which are paid on the sale of particular products. Such introductory payments are incompatible with the fundamental principle that a firm must not conduct business under arrangements that might give rise to a conflict of interest with its duty to customers.

As a result of the financial crisis, some aspects of the MiFID Directive will be opened-up for review in 2010. These would include the extension of the pre-trade price transparency provisions to the non-equity markets, particularly bond and derivative markets, and the clarification of the rules applicable to in-house matching by investment banks ('dark pools'). In addition, action can be expected to reinforce the implementation of the directive, particularly regarding the best execution, client suitability and conflict-of-interest requirements. The new supervisory set-up, discussed below, is expected to contribute greatly to reinforcing MiFID's implementation along these lines.

[8] Data for the top 50 European hedge funds, by number of funds, according to PwC.

5. The impact of the new supervisory set-up

So far, much of the EU's rule-making has been lost at member state level as a result of differences in implementation and enforcement of rules. Under the new supervisory structure, adopted pursuant to the de Larosière report (March 2009), a much tighter control on enforcement and consistent application of rules can be expected. In addition, a new European body will monitor and warn against systemic risk.

The financial crisis revealed serious shortcomings in the oversight of financial markets, which led to the recommendations contained in the de Larosière report, calling for the creation of a European System of Financial Supervisors. The ESFS will comprise three functional authorities covering banking, insurance and securities markets, and a European Systemic Risk Board, administered by the European Central Bank. These new authorities will bring a sea change to financial market regulation and supervision in the EU, as they will assume formal responsibility to enforce EU rules and supervise their application by national supervisors. The end-goal is to have a single rulebook, which will bring about enforcement of exactly the same rules all over the EU.

In the field of asset management, the new supervisory structure will make disputes among member states over how to interpret certain technical aspects of a directive, or what constitutes a host a home responsibility become a thing of the past. The new authorities will formally have the responsibility to mediate between supervisory authorities and the authority to delegate powers in the supervision of fund managers.

6. Towards a horizontal asset management regime

The major challenge for the future is to work out a coherent regime for retail investment products, and to regain investors' confidence after the crisis. Households are now faced with increasingly difficult investment choices that have ever more serious consequences in light of an ageing population and the increasingly obvious unsustainability of the pay-as-you-go pensions regime. Households are often ill-prepared to make informed choices on their own due to a lack of financial literacy.

A comparison of various national regimes within the EU covering retail investment products reveals an immense diversity, with a patchwork of different obligations on distributors regarding disclosure and investor protection, different forms of prudential supervision and a high degree of variation in marketing and advertising rules (see the table in Annex 2). MiFID, with its far-reaching harmonisation of conduct-of-business rules, is triggering a horizontal review, which is being accelerated by the implementation of UCITS IV.

An additional complexity is added to the exercise by the fact that many elements of the retail investment product regime are shared competences between the EU, the member states and the industry, which militates against the emergence of a coherent framework. This problem was clearly stated in the 'rapport Delmas-Marsalet', a study that was commissioned by the French Minister of Finance to examine the issue (see AMF, 2005). The report proposed a charter for the commercialisation of financial products, covering rules on client suitability and appropriateness, the impartiality of investment advice, the need to better educate and target consumers and the creation of a financial ombudsman. Properly addressing these concerns would require an extension of the MiFID regime to cover other investment products (such as unit-linked life insurance), cross-sectoral consistency of national implementation of EU legislation (as opposed to merely at the vertical directive level) and the elaboration of pan-European industry codes of conduct.

It is clear that the current EU framework governing retail investment products remains primarily vertical, which will be strengthened by the coming into force of the AIFM Directive. The level of mandatory fiduciary care afforded retail investors as well as the level of supervision undertaken by regulatory authorities may vary depending on the distribution channel through which they access investment products, even if, in terms of the outcome or payoff profiles, the products are broadly similar. MiFID provides a detailed framework for ensuring a coherent approach to disclosure and point-of-sale regulation by investment firms for all financial instruments, including all funds and structured notes. In addition, it includes rules on inducements, which influence the remuneration structures that are permissible in the distribution of financial instruments. Nothing comparable exists today at European level for other products, although it may exist at national level. As regards insurance products, the Insurance Mediation Directive only sets out some very basic requirements for insurance intermediaries to deliver advice, taking into account the demands and needs of the policy-holder. For other listed securities, the prospectus Directive sets out detailed disclosure rules, but addresses marketing rules only to a very limited extent (e.g. the language regime). For private placements, the MiFID rules will apply, to the extent that the products are sold via banks, brokers or financial advisers licensed under this directive. For professional investors and large undertakings, a lighter regime applies.

Table 1. EU regulatory framework for retail investment products (long-term)

Product / Regime	UCITS	Non-UCITS (i.e. hedge funds)	Life-insurance products (and UCITS distributed by insurers)	Listed security	Un-listed security/ structured products
Marketing rules	UCITS/local rules	(AIFM)/ MiFID	Insurance mediation Directive	Prospectus Directive (part)	–
	Distance Marketing of Financial Services Directive				
Disclosure	UCITS/MiFID	(AIFM)/MiFID	Life insurance and insurance mediation Directive	Prospectus Directive	MiFID
Asset allocation rules	UCITS	(AIFM)	Life insurance or solvency II Directive/ (UCITS)	–	–
Prudential rules	UCITS/MiFID/ CRD	(AIFM) CRD	Life insurance or solvency II Directive/ (UCITS)	–	–

In view of the highly heterogeneous situation sketched out above, elaborating a more coherent regime will be a complex exercise. Some products are be tightly regulated at EU level, whereas for others, there is only general service level regulation. The problems raised by the interaction of a product directive (UCITS) with a services (MiFID) directive provide evidence that many questions remain to be answered.

Conclusion

A well-developed regulatory framework is in place for the asset management industry in the EU. With the arrival of UCITS IV, further consolidation of the EU fund business is in the cards, which should increase its efficiency. More regulation is also expected for the alternative investment fund sector, which will level the playing field for the traditional fund business. The implementation of the new EU supervisory structure will lead to a stricter enforcement of rules, most notably with regard to the conduct-of-business rules enshrined in MiFID.

In the post-crisis era, the dual challenge for the industry and policy-makers is to restore confidence and allow a re-diversification of the savings of households. As a consequence of the financial crisis, the increase in the protection offered by deposit guarantee schemes and the government bail-out of the banking system, savings have concentrated in the banking sector. This is, however, an unhealthy situation, for households, as for the economy, as it hinders a proper transfer of savings to productive investments.

In a longer-term perspective, the objective should be to create a more coherent framework for the retail investment product regime across sectors. Too many differences remain in the rules applicable to the fund business and other asset managers. This creates distortions of competition, but also leads to inefficiencies and maintains the vertical structure of the financial industry as we know it today. A more open architecture of the financial industry should be the imperative across the board, in the interest of consumers, regulators, central bankers and the public at large.

References and selected bibliography

AMF (Autorité des Marchés Financiers) (2005), Rapport relatif à la commercialisation des produits financiers (rapport Delmas-Marsalet).

Casey, Jean-Pierre and Karel Lannoo (2008), *Pouring Old Wine in New Skins: UCITS and Asset Management in the EU after MiFID*, CEPS-ECMI Task force report.

Cinquegrana, Piero (2008), Summary of the open hearing on “retail investment products”, June (available from www.eurocapitalmarkets.org).

European Commission (2009), Communication from the Commission to the European

Parliament and the Council on packaged retail investment products, April.

European Commission (2009), Update on Commission work on packaged retail investment products, December.

Lannoo, Karel (2009), *The Road ahead after de Larosière*, CEPS Policy Brief, August (available from www.ceps.eu).

Loehr, Jean-Michel (2009), “Towards the Next Generation: Moving from UCITS III to UCITS IV”, Guide produced by RBC Dexia, May.

Annex 1. The US investment fund regime

In the US, investment funds that are comparable to UCITS are known as 'mutual funds'. The legal regime for mutual funds was laid down about half a century prior to the adoption of European legislation, and is mainly based on federal statutes: the Investment Company Act of 1940 (hereinafter: the 1940 Act) and the Investment Advisers Act of 1940, and in additions to or interpretations of the core securities laws, the 1933 Securities Act and the 1934 Securities Exchange Act.

According to the 1940 Act, fund managers can register four types of investment companies: open-end investment companies (i.e. mutual funds), closed-end investment companies, exchange-traded funds (ETFs) and unit investment trusts (UITs). The vast majority of funds fall in the first category, both in terms of numbers and assets under management – over 90% of total assets, in fact, are in mutual funds. In comparison to the 1940 Act, the UCITS Directive applies only for open-ended investment funds, as UCITS funds must allow the redemption of their units by the investors at any time.

While the UCITS Directive is identified as a product regime, the 1940 Act is more of a horizontal legal regime that regulates the registration, structure and operations of investment companies through a combination of disclosure requirements and other structural and operational requirements, including capital structures, custody of assets, governance, conflicts of interest and fiduciary duties. Moreover, the 1940 Act includes provisions related to the enforcement of the Act, including public (by the Securities and Exchange Commission) and private (through civil actions) enforcement.

Another important difference distinguishing the legal regime in Europe from that in the US relates to the purpose set by the lawmakers when enacting the rules. European regulation, i.e. the UCITS Directive, aims at allowing the cross-border provision of European investment fund services, whereas US regulation, i.e. the 1940 Act, seeks to protect investors from misrepresentation by fund managers and advisers, and ensure that those managers comply with their fiduciary duties and abstain from misusing their powers.

The differences in approach are reflected in the application of the rules in Europe and the US. In this regard, UCITS is based on a 'voluntary' registration by the fund promoters/managers who are interested in acquiring the so-called 'European Passport' to allow them to distribute their funds across the EU. In contrast, the US 1940 Act is based on an obligatory registration for every company that falls under the statutory definition, unless exempted by the Act.

Unlike the EU, the registration of investment companies in the US is done both under state and federal law. A fund can be licensed as a corporation, business, trust, partnership or limited liability company under state law. It is also registered with the SEC as an investment company pursuant to the 1940 Act, and authorised to sell its units to the public pursuant to the Securities Act of 1933. In addition, a fund must make a separate filing and pay certain fees in each state (except Florida) in which the fund's shares will be offered to the public. In Europe, no central authority is responsible for licensing and monitoring the activities of investment companies. Instead, the licensing of investment funds is done by national authorities in each member state, combined with a notification procedure that applies whenever funds are distributed in another member state from the one where it is registered (defined by the UCITS Directive as 'Host Member State'). Therefore, the US investment companies regime is considered to be less flexible than the EU regime: in the EU, the national law implementing the UCITS Directive applies, whereas in the US, there is direct application of the federal rules.

The EU is currently considering bringing together all non-regular funds under an EU-wide regulatory umbrella in the so-called 'Alternative Investment Fund Managers Directive'. This would make subject the entire fund sector to EU rules, with some exemptions for small funds.

Annex 2. Basic rules for capital adequacy and asset allocation under the EU's financial services directives

	Capital requirements Directive (Basel II)	Insurance Directives (& Solvency II)	Pension funds Directive	MiFID	Investment funds Directives (UCITS III and IV)	Alternative Investment Funds Managers (EU Commission draft)
Initial capital	Minimum €5 million	Minimum €3 million guarantee fund (€2 million for some classes of non-life insurance) Solvency II will introduce models based measures	Where the institution itself underwrites the liability, the rules of the life insurance directive apply	Minimum €125,000, may be reduced to €50,000 for local firms or €25,000 for investment advisers (Directive 2006/49/EC)	Minimum €125,000 plus 0.02% of total assets (as soon as assets exceed €250 million), with maximum of €10 million (UCITS III)	Minimum €125,000 plus 0.02% of total assets (as soon as assets exceed €250 million),
Additional capital requirements	Minimum 8% of risk-weighted assets (Basel Accord) *or* VAR for trading book (under review)	Solvency margin must be three times the guarantee fund, and a proportion of technical provisions (in general 4%)	(idem)	Function of trading book (Directive 2006/49/EC, under review)	Capital requirement shall never be less than required under Art. 21 of Directive 2006/49/EC. Special rules for position and foreign exchange risk (see annex I Art. 47-56 of Directive 2006/49/EC)	Capital requirement shall never be less than required under Art. 21 of Directive 2006/49/EC. Special rules for position and foreign exchange risk (see annex I Art. 47-56 of Directive 2006/49/EC)
Permissible activities (non-exhaustive, only when related to asset management)	Portfolio manage-ment, safekeeping and administration of securities, trading in and underwriting of securities	Life insurance (including group insurance) Non-life insurance (large and mass risk)	Management and investment of funded occupational pension schemes	Individual portfolio management, securities brokerage and order execution activities	Management of investment funds *Non-core:* Discretionary asset management (including pension funds) Investment advice Safekeeping (custody) and administration of UCITS	Management of alternative investment funds (not covered under UCITS) including hedge funds, funds of hedge funds, private equity, real estate and commodity funds Administration Marketing
Asset allocation	Holdings in non-financial institutions limited to 60% of own funds, and 15% for a single holding. Large credit exposures to single clients are limited to 800% of own funds and 25% for a single exposure	Harmonised minimum rules: < 10% single holding of real estate < 5% non-listed securities < 10% of assets in single security, except for public debt, and < 40% for total large exposures of blocks of 5% < 20% in other currency than liabilities. These quantitative restrictions are abolished by Solvency II	Prudent man rule Member states may set more stringent rules for institutions active on their territory, but within certain limits; Investment in sponsoring undertaking are limited to 5% of the technical provisions	Rules on large exposures	< 10% of assets in single security, except for public debt, and < 40% for single investments of 5% < 10% non-listed securities < 10% of same body for money market instruments, and < 20% for investments in single other funds and deposits with credit institutions - Special rules for master-feeder structures	- Qualitative rules - liquidity requirements
Conduct of business	Host country rules on advertising and 'general good'	Host country rules on advertising and 'general good' provisions	Host country social and labour rules	Harmonised, but host country in charge of enforcement of rules for branches	Host country conduct of business rules (unless subject to MiFID rules for non-core); Host country advertising and marketing rules	- Conflict of interest provisions - Risk and portfolio management subject to separate review - rules on outsourcing - rules on remuneration (Council) - rules on valuation
Disclosure	Pillar III	Limited	Disclosure of investment policies, risk and accrued benefits to fund members	Extensive, full price transparency (for equity securities), unbundling of cost of transactions	Key Investor Information (KII)	Annual report, disclosure of investment strategy, risk management, depository, fees and charges Reporting to authorities Controlling stake notification rules
Investor compensation	Deposit guarantee Directive	Insurance guarantee fund		Investor compensation schemes Directive	Investor compensation schemes (depending on national implementation)	n.a.
Final date for implementation	2007-2008	New framework (solvency II) by 2012	2004	November 2007	August 2003 (UCITS III), July 2011 (UCITS IV)	(2012)
Technical adaptations	European Banking Committee (EBC), limited	European Insurance and Occupational Pensions Committee, limited	European Insurance and Occupational Pensions Committee, limited	European Securities Committee (ESC), extensive	European Securities Committee (ESC), limited	European Securities Committee (ESC), extensive

Source: Updated from Casey & Lannoo (2008).

About ECMI

The European Capital Markets Institute (ECMI) was established as an independent non-profit organisation in October 1993, in a collaborative effort by the European Federation of Financial Analysts Societies (EFFAS), the Federation of European Securities Exchanges (FESE) and the International Securities Market Association (ISMA), now the International Capital Market Association (ICMA). ECMI is managed and staffed by the Centre for European Policy Studies (CEPS) in Brussels. Its membership is composed of private firms, regulatory authorities and university institutes.

European capital markets have experienced rapid growth in recent years, corresponding to the gradual shift away from relationship banking as a source of funding and at the same time, have had to absorb and implement the massive output of EU-level regulation required to create a single market for financial services. These developments, combined with the immense challenges presented European financial institutions by the globalisation of financial markets, highlight the importance of an independent entity to undertake and disseminate research on European capital markets,.

The principal objective of ECMI is therefore to provide a forum in which market participants, policy-makers and academics alike can exchange ideas and opinions concerning the efficiency, stability, liquidity, integrity, fairness and competitiveness of European capital markets and discuss the latest market trends. These exchanges are fuelled by the publications ECMI regularly produces for its members: quarterly newsletters, annual reports, a statistical package, regular commentary and research papers, as well as occasional workshops and conferences. ECMI also advises European regulators on policy-related matters, acts as a focal point for interaction between academic research, market sentiment and the policy-making process, and promotes a multidisciplinary and multidimensional approach to the subject.

European Capital Markets Institute
c/o Centre for European Policy Studies (http//:www.ceps.be)
Place du Congrès 1 ▪ 1000 Brussels ▪ Tel: 32(0) 229.39.11 ▪ Fax: 32(0) 219.41.51
Website: http//:www.eurocapitalmarkets.org ▪ E-mail: info@eurocapitalmarkets.org