

Brussels, 16 November 2006

Frequently Asked Questions (FAQs) on the White Paper on enhancing the Single Market framework for investment funds

(See also [IP/06/1569](#))

Why not also seize the opportunity to tackle fundamental issues regarding the scope and the approach of the UCITS Directive?

The Commission is aware that some parts of the industry have doubts regarding the capacity of the UCITS Directive to respond to continuous evolution in fund management techniques. There are also concerns that some retail funds are denied the benefits of a single market passport. The Commission is giving consideration to those concerns. However, many of the issues regarding the scope and design of the Directive have not yet crystallised sufficiently to allow a considered assessment of the associated benefits, costs or options. A first analysis carried out by Commission services reveals insufficient grounds to undertake a fundamental revision of the Directive at this stage.

Therefore, in line with the better regulation principle, the Commission favours a progressive approach. In a first instance, the objective will be to modernise and complement the Directive in a number of specific and targeted areas. Then, on the basis of a structured review of the need for changes to the scope and regulatory approach of the Directive, further more far-reaching measures could be envisaged. This review will be launched early 2007. It will culminate in a report on this issue to the Council and the European Parliament in 2008.

Haven't product regulation and UCITS legislation in particular passed their sell-by dates?

The Commission does not believe that product regulation and UCITS legislation in particular have passed their sell-by dates. Financial innovation poses big challenges for prescriptive rules on investment fund portfolios. Going forward, regulation may need to concentrate less on the way that fund portfolios are constructed and more on the way that they are managed, marketed and sold. However, rules to ensure the sound structuring, governance and management of funds will remain a staple of our regulatory system. This will particularly be the case for products destined for fast-track access to the retail market. That is why we must persevere in our efforts to modernise the UCITS Directive. The changes that we are proposing in the White Paper are an important step towards simplifying the regulatory overheads for UCITS investment funds and to ensuring the continued relevance of the UCITS 'model' in today's fast-changing market.

Does the Commission still believe that there is no need for EU action on hedge funds?

Firstly, it is a myth that European hedge funds are not regulated. In the European Union, hedge fund managers, administrators and products are subject to wide-ranging national regulatory requirements. There are also regulatory mechanisms in place at EU level (e.g. capital supervision) and ongoing monitoring by banking supervisors to limit bank exposure to hedge funds. There are enhanced market disciplines enforced by hedge fund counterparties such as prime brokers which are EU regulated banks. European rules on market abuse and insider trading apply fully to hedge fund managers intervening on a European financial market. In this respect, the situation is very different from the US where there has been limited regulatory action on hedge funds to date. Our analysis suggests that there are currently no regulatory gaps which call for EU-level intervention to regulate hedge funds above and beyond those measures that are already in place at national and European level. Before taking any action in this area, there would also need to be confidence that any such intervention would actually achieve some useful outcomes. There is a particular danger that hedge fund regulation could stifle the further development of a sector that has thrived on flexibility and a capacity to innovate.

However, we are not turning a blind eye to this asset class. The Commission and other EU and national authorities are carefully monitoring the ways in which growth of the hedge fund industry can impact the EU financial system. The Commission is paying particular attention to the extent to which hedge fund-based investing is being made available to the mass market – including through shares in listed hedge funds and funds of hedge funds.

How does the White Paper relate to the expert group report on hedge fund support services?

The expert group on hedge funds have put forward four recommendations regarding hedge fund support services: appointment of a custodian on a pan-European basis, custodian liability regime, re-hypothecation limits and net asset value (NAV) calculation. These technical recommendations refer to support services for hedge funds which are marketed only to investors capable of self-directed investment decisions. The report analyses the current situation where there is no single market mechanism or framework for hedge funds as well as for the choice of hedge fund service providers. The recommendations are mainly addressed to Member State authorities who are urged to take a flexible and convergent approach with respect to the providers of hedge fund administration services and custody functions.

The Commission welcomes the report's contribution to this debate. The Commission is also of the view that there are currently no clear grounds for action at EU level to create a framework for hedge fund support services. We note that the hedge fund expert group clearly stated that none of its recommendations would warrant legislative action at EU level. Existing competitive forces should prove sufficient to encourage those Member States that want to develop a hedge fund market to tackle, amongst other aspects, the regulatory barriers hindering the provision of strong operational and finance services to their hedge fund industry on a cross-border basis. However, the White Paper does put forward that the Commission will further study the question of non-harmonised funds. In this context, we will also carefully assess regulatory barriers and inefficiencies in support services.

It might be, for instance, appropriate to explore in the context of our reflections on a "private placement" whether hedge fund products proposed only to "eligible" investors could benefit from pan-European operational support and finance services that are subject to specific/lighter regulatory requirements which reflect the sophisticated nature of the investor base.

Is specific action required at EU level in response to the growth and impact of hedge funds and private equity firms?

The Commission recognises that hedge funds, private equity funds and other "activist" investors are increasingly challenging and influencing incumbent management's decision-making and the strategic direction within the portfolio companies in which they invest. Some argue that this investment may occur at the expense of the interests of longer-term shareholders and employees. However, it should be recalled that these investors are doing no more than exercising the rights that they have earned by taking a stake in publicly listed company. Regulatory safeguards exist at European level to ensure that all investors – including hedge funds and private equity firms – publicly disclose their acquisitions and refrain from any abusive behaviour or insider trading.

Should hedge funds be subject to tougher transparency requirements?

The Commission has looked at hedge funds and other institutional investors should be subject to greater transparency of shareholdings or be obliged to disclose their voting policies. These questions were extensively debated during the Commission consultation on its Action Plan on Company Law and Corporate Governance. The Commission's view is that effective initiatives have been undertaken at international level (eg the International Corporate Governance Network), and that such mechanisms not only function satisfactorily but also cater for the flexibility that market participants need.

The Commission sees even less rationale for curtailing the ability of these categories of investor to exercise the voting powers that they acquired in publicly quoted companies. Such restrictions would be a departure from the principle of 'one share, one vote', and would undermine the healthy disciplines that open markets for corporate ownership are starting to impose on European boardrooms. However, the Commission considers that confidence in open markets for corporate ownership requires the respect of good corporate governance by all investors. These requirements extend equally to hedge funds and private equity funds. We look to the industry and its trade associations to contribute to a climate of confidence in respect of their activities.

Which aspects of the White Paper will benefit investors as they come to terms with a more complex range of funds?

Cost savings and new market openings for the industry should translate into tangible improvements for the end investor in the form of lower charges or higher returns, but also in terms of access to continued enhancements in product performance. To achieve this purpose, investors will need improved, understandable and reliable disclosure allowing them to select competitive products offering the most attractive risk-return combinations. They also need to be able to count on the quality and objectivity of the services provided by financial advisors or intermediaries who sell investment funds to them.

The White Paper foresees action on two levels to ensure that market dynamics work to the advantage of the end investor:

Firstly, the White Paper commits the Commission to implement regulatory principles to ensure that fund distributors put the interests of the end investor first when recommending or selling investment funds. Fund selection should not be influenced by the level of commissions paid by fund managers to distributors. The Markets in Financial Instruments Directive (MiFID) provides the necessary framework to manage and disclose conflicts of interest and inducements. The White Paper foresees that the Commission will ensure that these rules are implemented consistently and effectively in ways that ensure that investors can rely on distributors to direct them towards the top-performing and most competitive funds in the market.

Secondly, the White Paper foresees a programme of legislative and non-legislative action to correct the failings of the simplified prospectus: the simplified prospectus was intended to provide the average retail investor with basic information about the product so as to enable him/her to make an informed investment choice. However, extensive consultation with industry, consumers and regulators showed that it is not meeting these objectives. The Commission will therefore undertake radical surgery on the simplified prospectus so that it provides risk, cost and performance disclosures in ways that are intelligible and useful for the end investor. This will be done in close association with national authorities and other stakeholders and will include extensive consumer testing. The result will hopefully be a standardised disclosure document that helps the investor to understand the key features of the proposed fund investment, and to select the fund investment that best corresponds to his/her expectations.

Will the proposed legislative adjustments deliver significant increases in the efficiency of the European investment fund industry?

The adjustments will benefit the industry both directly and indirectly:

Direct effects will result, for example, from the envisaged changes to the notification procedure and the simplified prospectus. Furthermore, the changes regarding mergers, pooling and an effective management company passport will open up opportunities for the industry to reap economies of both scale and specialisation.

Indirect effects are no less important. They should come about primarily through an increase in competition: a simplified prospectus that provides the relevant information in a clear way that is easy to understand for retail investors will increase transparency in the distribution part of the value chain. With investors able to easily assess the costs and investment policies (i.e. success) of poorly performing funds, expensive funds will be put under pressure to improve their operational efficiency and/or investment strategies. In addition, cross-border market integration – brought about through a more efficient notification procedure, amongst other things – will also force fund companies to improve their performance in order to be able to compete with top-class competitors.

How will the Commission ensure that the new provisions for fund managers will not increase cost and complexity and undermine effective supervision?

Effective supervision is one of the conditions for high levels of investor protection, which has been a crucial ingredient in the success of UCITS concept. The strengthening of passporting arrangements and new single market freedoms will entail a reallocation of supervisory responsibilities and more complex cross-border fund structures.

However, these do not have to come at the expense of less effective supervision. An integral part of the White Paper covers new provisions to strengthen supervisory cooperation and establish mechanisms to detect and stamp out instances of cross-border abuse. Similarly, solutions to concerns about effective supervision have been found in other sensitive fields of securities and banking law (such as MiFID, the Prospectus Directive, banking supervision and market abuse).

Will regulated investment funds be undermined by competition from less regulated substitute products?

The Commission is certainly aware of these concerns. We will monitor the developments in this area attentively and assess if there is a need for action at EU level.

Is there is a case for the creation of a single market passport for real estate funds?

The responses to the Green Paper and to the Expert Group report on Alternative Investments have stressed that the Commission should consider whether measures for creating a single market passport for retail-oriented real estate funds should be taken in the coming years. Funds investing in property cannot be authorised as UCITS. However, over the past decade real estate funds have become an important asset class in many Member States, for institutional as well as for retail investors. Open-ended real estate funds in particular are already used widely by retail investors as a product for long-term savings and retirement provisioning.

Due to different regulatory approaches at national level and due to the lack of an EU passport, the European real estate investment market is fragmented and cross-border distribution of real estate funds is marginal. The Commission has therefore decided to set up an Expert Group on retail-oriented real estate funds with the mandate to examine whether real estate funds are suitable for sale to retail investors, and if so, what are the barriers to a single market and how they could be most appropriately overcome, taking into account the costs and risks of EU-level intervention. The Expert Group will present a report to the Commission in 2007, on which stakeholders will be able to comment.