Z E N T R A L E R   K R E D I T A U S S C H U S S

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Comments of the Zentraler Kreditausschuss[1] on the European Commission's Green Paper on the enhancement of the EU framework for investment funds of 12 July 2005

15 November 2005

[1] The ZKA is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks financial group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,300 banks.

I. Introduction

We thank the European Commission for the opportunity to comment on its Green Paper on the enhancement of the EU framework for investment funds. Before replying to the specific questions posed in the paper, we should like to begin by making the following general points:

We share the Commission's view that the **investment fund industry** has grown dramatically in importance in recent years, not least due to the **increasingly significant role** it plays in provisioning for retirement and building up assets.

With this in mind, it is quite correct to analyse the extent to which the existing UCITS legislative framework is able to accommodate these changes and whether some adjustments may be necessary, particularly to allow greater efficiency in cross-border investments.

At the same time, it should be remembered in this context that tougher distribution standards make the required provision of broad sections of the public with suitable longer-term investment products more difficult. The more complicated and more expensive distribution structures are, the less likely it is that the (broad) sections of the public who are not particularly interested in events on, and the workings of, the capital markets will also be able to enjoy the benefits of investing in financial products. This is the conclusion drawn particularly in the Sandler Report on the British distribution system published in 2002. A major criticism in this report was the **"deterrent effect" of a complicated, difficult-to-understand distribution network for financial products**. In response to the Report, the British government announced that it would be introducing changes to support the provision of all sections of the public with longer-term investment products.

May we specifically point out the following:

- In view of the **acknowledged high level of protection** offered by European investment law, we see no need for the Commission to take action concerning new risks associated with managing and administering investment funds. The main **existing safeguards** are as follows: The investment firm is monitored and managed by its corporate governance and regularly examined by auditors. The compliance function ensures that market timing and late trading rules are observed. Firms follow voluntary codes of conduct. In Germany, monitoring functions are exercised by the depositary, which, as a bank, is in turn subject to strict supervision. Finally, potential civil law responsibilities also exist. With all this in

mind, we are convinced that there is no need for further action at EU level to increase investor protection.

- Reference is made several times in the Green Paper and its supporting documents to possible connections between the quality of investment advice, the interests of the customer and distribution architecture (sale of in-house versus third-party products). In the Commission's background paper, for example, the question is raised in Chapter 3.2.1 as to whether advice offered by a distributor operating in an "integrated architecture" is really in the investor's interests or primarily in the interests of the financial services provider. **We firmly reject the notion that customers are only able to invest in the "best" product in an open architecture** and that there is thus a need for regulatory measures to create an environment of this kind. Instead, we support the view expressed by the Commission on page 35 of the background paper – namely that distributors of third-party funds have incomplete and/or slower access to important product information. The more funds or other investment products distributors include in their active portfolio over and above a certain amount, the less knowledge they will have about each individual product. This highlights the **advantage of the practice common in many European countries of limiting the range of products** on which distributors offer active investment advice. Distributors are able to have comprehensive, detailed and up-to-date information about these products. This enables them to supply advice which is in the interests of the investor and will assist him in making his investment decisions.
- As far as **hedge funds** are concerned, any **regulation, if considered necessary at all, should only take place at international level** so that offshore funds can be included. We do not believe that a go-it-alone approach by Europe would serve any useful purpose. On the contrary, it would seriously weaken the internal market for financial services because it would probably trigger a massive exodus of funds from the (then regulated) EU internal market to the (still unregulated) offshore centres. Open-end **real estate funds** should be recognised Europe-wide as a highly secure and stable retail investment product.
- We understand the reference to the **MiFID** on page 6 of the Green Paper to mean that the marketing of UCITS falls within MiFID's scope. This makes good sense since it makes no difference whether a financial services company sells the investor a share, a fixed-income security or a unit in a fund. We see no need for action going beyond this.

II. Specific questions

Question 1: Will the above initiative bring sufficient legal certainty to the implementation of the Directive?

The **approval process and approval criteria** for cross-border distribution **should be the same throughout the EU**. Standards should be introduced (e.g. specifying a uniform list of requirements to be met, short approval processing periods and default approval times). This is the only way to prevent differences between member states at administrative level.

The **use and risk measurement of derivatives and financial instruments** should be based on a binding **harmonised standard**. Restrictions on the definition of authorised instruments which have no basis in the directive should be avoided.

In some member states – such as Germany – **high standards on cost transparency** have already become established. Such standards, like the total expense ratio (TER), for example, could be used as a **basis for a common European standard**. This would also help to create a level playing field for European suppliers. We understand that the EFAMA (European Fund and Asset Management Association) is already working on a European standard of this kind.

Question 2: Are there additional concerns relating to day-to-day implementation of the Directive that need to be tackled as a priority?

The **time to market** is in **need of improvement** compared to that for rival products. Uniform standards should be established and short approval processing times (e.g. three weeks) prescribed for plain vanilla products. **Approval processing times** of this kind, **after expiry of which approval may be deemed to have been granted**, should cover the above products.

Question 3: Would an effective management company passport deliver significant additional economic advantages as opposed to delegation arrangements? Please indicate sources and likely scale of expected benefit.

We would welcome an effective European passport for management companies. Along with the international distribution of funds, this would open up a further opportunity of establishing and marketing corporate funds in the home state or in a new market swiftly and

efficiently. It must be borne in mind, however, that the cost-effectiveness of such an opportunity depends very much on harmonisation of the supervisory criteria. Only if all administrative requirements are defined unequivocally can it be assumed that fund managers will concentrate on a single location and use it as a base from which to launch their products directly in other member states. The main reasons for establishing bases in various jurisdictions were, and are, the continual changes in administrative practices and the legal environment relating to approval criteria and eligible products. Only consistent and reliable standardisation is likely to result in cost savings for fund management companies, which can then also be passed on to investors. More important than an effective European passport for management companies is, however, in our view an improvement in the viability of the European passport for investment funds by, for example, introducing uniform standards and short approval processing periods (see our reply to question 1).

Question 4: Would the splitting of responsibility for the supervision of the management company and the fund across jurisdictions give rise to additional operational risks or supervisory concerns? Please describe sources of problem and steps that would have to be taken to manage such risks effectively.

If administrative requirements and the legal framework are harmonised, the risks will be low. We believe it is possible to make a sufficiently clear distinction between rules relating to companies and those relating to products to avoid overlaps and thus unnecessary costs. A very important point will be to ensure that corporate funds are permitted to delegate totally all administrative responsibilities to a management company.

Question 5: Will greater transparency, comparability and attention to investor needs in fund distribution materially enhance the functioning of European investment fund markets and the level of investor protection? Should this be a priority?

Chapter 2.2.2 of the Green Paper states that investors are faced with increasingly complex products and thus need better and user-friendly disclosure of performance and charges. In chapter 2.3.2 of the background paper, the question is raised as to whether existing disclosure makes all the relevant charges associated with funds sufficiently visible to investors. With this in mind, we assume that the transparency referred to in question 5 relates first and foremost to cost transparency.

We can only confirm the Commission's statement in the background paper that **member states sometimes apply a differentiated approach to the issue of how much information is supplied to investors**. As far as fund distribution in Germany is concerned, we would like to stress that investors are supplied with comprehensive information irrespective of the size of the investment, so that small investors, in particular, can always be sure of having a complete picture of the characteristics of the fund and the associated costs. The **MiFID** and its planned technical implementing measures contain extensive rules which also cover fund units. These are subject to the same requirements as those applying to all other financial instruments. There is no need for any additional rules and regulations aimed specifically at funds. It would be extremely problematic if the MiFID's provisions were called into question before they have even entered into force and been implemented in practice. **We therefore firmly reject any proposals leaning in this direction such those in Chapter 2.3.3 of the background paper**.

As far as the other questions raised in Chapter 2.3.2 of the background paper are concerned, we advocate implementation on the basis of a standard European code of conduct, which could be developed by EFAMA, for example. We understand that EFAMA is already working on pan-European standards of this kind. The Commission should wait until these are finalised and can be evaluated before considering a legislative solution.

Along with such pan-European standards, which should also cover classification, nomenclature performance measurement, etc., competition and generally accessible media will also ensure that the investor, as a responsible consumer, is able to make an effective comparison of products.

Reference is made several times in the Green Paper and its supporting documents to possible connections between the quality of investment advice, the interests of the customer and distribution architecture (sale of in-house versus third-party products). In the Commission's background paper, for example, the question is raised in Chapter 3.2.1 as to whether advice offered by a distributor operating in an "integrated architecture" is really in the investor's interests or primarily in the interests of the financial services provider. **We firmly reject the notion that customers are only able to invest in the "best" product in an open architecture and that there is thus a need for regulatory measures to create an environment of this kind.** The key point is that firms have an obligation to supply customers with "suitable" advice and that this is implemented in practice. There is no indication that this obligation is not being complied with. In the absence of firm evidence of abuse, interference in distribution structures would not be compatible with the Commission's "better regulation"

approach. Instead, it should be left to the market to decide which is the preferred distribution structure.

Furthermore, the preference for open architecture is based on a totally unrealistic premise. No bank or financial services provider is in possession of sufficient analyses of the past or potential future performance of all funds available on the market. There are currently 2,353 funds open to the general public operated by German investment firms alone.[2] To these must be added the foreign funds which are open to the general public in Germany as well as restricted-access funds – not to mention the large number of other financial products that would also have to be taken into account when giving appropriate investment advice. **Neither banks nor financial services providers are in a position to monitor the performance and quality of all these funds and other investment products.** Whilst it is true that information about funds is also available from data providers, these normally disclaim all liability for errors.
Nor is it possible to access any reliable central and independent compilation of all product information that would allow the "best fund" or the "best investment product" to be determined. **What is more, any decision concerning the "best fund" or the "best investment product" would inevitably relate to past performance.** But there is no guarantee that today's "best fund" will also be tomorrow's. This is why, in the context of the MiFID, the Commission quite rightly requires a description of past performance to "contain a prominent warning that the figures refer to the past and that past performance does not provide a reliable indicator of future results"[3]. Finally, differences in the investment needs of different types of investors entail placing a different emphasis on the various product requirements. Such an analysis can only be made on a case-by-case basis. So a standardisation of product evaluation, which references in the Green Paper and background appear to be leaning towards, would be neither appropriate nor feasible, in our view.

We therefore support the view expressed by the Commission in Chapter 3.2.1 of the background paper, namely that distributors of third-party funds have incomplete and/or slower access to important product information. There is a danger of giving misadvice, in our view, if the evaluation of a product fails to consider all the necessary information. The more funds or other investment products distributors include in their active portfolio over and above a certain amount, the less knowledge they will have about each individual product. It

[2] BVI, Investment 2004, Daten Fakten, Entwicklungen, Übersicht, p 82.

[3] Cf. Article 3(e)(iv) of the Commission's Working Document ESC/23/2005-rev. 2 of 29 September 2005. There is even discussion as to whether a description of past performance should be permitted at all. This view is totally at odds with the notion of designating a "best fund" or "best product".

can consequently be argued that the quality of the advice will decrease in inverse proportion to the number of products included in the portfolio. **This highlights the advantage of the practice common in many European countries of limiting the range of products on which distributors offer active investment advice. Distributors are able to have comprehensive, detailed and up-to-date information about these products. This enables them to supply advice which is in the interests of the investor and will assist him in making his investment decisions.** These are not normally – as the background paper suggests – "in-house products"[4], where conflicts of interest may be assumed to be associated with their distribution. We therefore see no basis for the background paper's criticisms, particularly on page 34, of integrated architecture. On the contrary, we believe the above arguments underline the need to confine distribution structures to familiar and reliable partners – which constantly have a name and reputation to lose in the stiff competition on the market.

Question 6: Will clarification of "conduct of business" rules applying to firms which retail funds to investors contribute significantly to this objective? Should other steps (enhanced disclosure) be considered?

Please see our replies to questions 5 and 7.

Question 7: Are there particular fund-specific issues that are not covered by ongoing work on detailed implementation of MiFID conduct of business rules?

The **MiFID and its planned technical implementing measures contain comprehensive rules**, which also cover fund units. These are subject to the same requirements as those applying to all other financial instruments. They include the information requirements under Article 19(3) of the MiFD, the suitability test for advice and asset management under Article 19(4) of the MiFID, rules on inducements and best execution. **There is no need for any further rules or regulations aimed specifically at funds.** It would be extremely problematic if the MiFID's provisions were called into question before they have even entered into force and been implemented in practice. Any proposals leaning in this direction such as those in Chapter 2.3.3 of the background paper are therefore to be firmly rejected.

Question 8: Is there a commercial or economic logic (net benefits) for cross-border fund mergers? Could those benefits be largely achieved by rationalisation within national borders?

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[4] Commission Staff Working Paper, Annex to the Green Paper on the enhancement of the EU framework for investment funds; Background Paper (Com(2005)314 final), pp. 6, 34.

There are most certainly **benefits** to be gained from cross-border fund mergers. This will enable international suppliers to offer their range of products throughout Europe.
A **fundamental prerequisite** for such mergers, however, is that investment units receive the **same tax and supervisory treatment** throughout Europe. The differences between national tax regimes are probably the greatest obstacle at present.

Question 9: Could the desired benefits be achieved through pooling?

We doubt whether there is any need for regulation at all on virtual pooling. Progress in this area depends on establishing appropriate technical standards and processes, in our view.

The approval of master-feeder funds, on the other hand, would require amendments to the existing UCITS Directive. We believe **master-feeder funds offer considerable potential for rationalisation** and possibly represent an alternative to cross-border fund mergers. In our opinion, neither general principles of investment law nor investor protection concerns should stand in the way of introducing master-feeder funds. However, we see **potential problems here, too, owing to the heterogeneous nature of tax and supervisory rules** in member states.

Question 10: Is competition at the level of fund management and/or distribution sufficient to ensure that investors will benefit from greater efficiency?

Competition between distributors and managers of funds which are open to the general public is extremely well developed. This is due, first, to the number of products on offer and companies offering them. A second reason is the lively rivalry to innovate existing both among fund management companies and with competing issuers of securities (e.g. certificates). This requires all involved constantly to keep abreast of new developments. Germany is currently experiencing a strong influx of large foreign funds onto the market, which is stepping up competition still further. Finally, distribution structures are changing more and more rapidly. Funds are now offered on Internet platforms, traded on exchanges, sold from fund supermarkets, etc. All this demonstrates that there is **no need, either in the area of fund production or fund distribution, for regulatory action by the Commission to increase competition.**

Question 11: Which are the advantages and disadvantages (supervisory or commercial risks) stemming from the possibility to choose a depositary in another Member State? To what extent does delegation or other arrangements obviate the need for legislative action on these issues?

The idea of being able to choose a depositary in another member state is in principle to be welcomed in the interests of greater competition. **It will only make good sense to allow such a possibility, however, when the rules governing depositaries have been harmonised at a high level** so that an equally high level of investor protection, which the depositary serves by exercising the functions assigned to it particularly under Article 7 of the UCITS Directive, can be ensured. Harmonisation must, above all, cover the depositary's monitoring function. As things stand, there are big differences in the role and responsibility of depositaries from one member state to another. **Opening up the market without prior harmonisation would lead to regulatory arbitrage, to the detriment of investor protection.** It would not be acceptable if funds were able to opt for the most inexpensive depositary service, for example, without having to ensure that high security standards, such as those existing in Germany, were in place. In our view, the depository function should be performed solely by banks in order to ensure the high level of investor protection required. To preserve the independence of the depositary function, we feel that personnel and company-law sovereignty, which does not preclude membership of a group, is sufficient.

Question 12: Do you think that on-going industry-driven standardisation will deliver fruit within reasonable time-frames? Is there any need for public sector involvement?

We see no need whatsoever for legislation at either European or national level in the area of standardisation. **Standardisation should be left to the industry itself**, in line with the principle of subsidiarity. Whilst the industry's successful ongoing efforts to standardise the clearing and settlement of share certificates should be supported, there is no need for additional European regulation.

Question 13: Does heavy reliance on formal investment limits represent a sustainable approach to delivering high levels of investor protection?

We make a distinction between investment limits due to issuer diversification and those imposed by defining eligible instruments. As far as investment instruments are concerned, the focus should be on the overall risk, not on their composition. Only a material approach can take proper account of the increasing complexity and innovation in this area. Issuer

diversification should be maintained as a principle of investment law. Generally speaking, suppliers which invest in transparent and efficient risk-measurement systems should be rewarded. As soon as a supplier meets a certain (previously) defined standard, it should be allowed to manage funds with more freedom from formalised investment limits. These should be replaced with risk measures that reflect the overall risk of the fund. This will tell investors exactly how much risk is associated with the product they have acquired and will protect them more effectively than would excessively formalised investment limits.

Question 14: Do you think that the safeguards – at the level of the management company and depositary – are sufficiently robust to address emerging risks in UCITS management and administration? What other measures for maintaining a high level of investor protection would you consider appropriate?

Given the existing and acknowledged high level of protection, we see **no need for action by the Commission in this area**. To mention just a few of the safeguards already in place: the investment firm is monitored and managed by its corporate governance and regularly examined by auditors. The compliance function ensures that market timing and late trading rules are observed. Firms follow voluntary codes of conduct. In Germany, monitoring functions are exercised by the depositary, which, as a bank, is in turn subject to strict supervision. Finally, potential civil-law responsibilities also exist. With all this in mind, we are convinced that there is no need for further action at EU level to increase investor protection.

Question 15: Are there instances resulting in a distortion of investor's choice that call for particular attention from European and/or national policy-makers?

In Chapter 3.3. of the Green Paper and chapter 4.2 of the background paper the Commission discusses a possible lack of a level playing field between UCITS and other investment products. The discussion culminates in the above question and suggests there is a need for action when revising the UCITS directives. Irrespective of whether or not there is really a lack of a regulatory level playing field between UCITS and the investment certificates and unit-linked insurance products specifically mentioned by the Commission, we believe it should first be discussed whether there is a need for European regulation of these particular alternative products at all. As far as investment certificates are concerned, it is clear that specific European regulation of this product group would not reflect market realities. The Commission itself

states that certificates are traded primarily in Germany, Switzerland and Hong Kong.[5] **Quite apart from the questionable need for regulation at European level, certificates – which, legally speaking, come under the category of bonds – are covered by the MiFID and the Prospectus Directive and thus already subject to extensive European regulation.**

In some member states, the fact that different investment products receive different national tax treatment has led, and continues to lead, to possible distortions of the investor's choice. Distortions based on tax treatment cannot, however, be eliminated by regulation geared towards particular products. Against this background, it is above all national policymakers in the member states who need to take action regarding the lack of harmonisation in tax law.

Question 16: To what extent do problems of regulatory fragmentation give rise to market access problems which might call for a common EU approach to a) private equity funds; b) hedge funds and funds of hedge funds?

The treatment of **private equity funds** under company law, tax law, supervisory law and investment law differs from one member state to another. This makes cross-border distribution complicated and gives rise to many uncertainties. We would welcome a common EU-wide solution which made it possible to sell private equity products across borders.

Hedge funds are now regulated in several member states, including Germany. European harmonisation might, at first glance, seem a logical way of creating a level playing field in Europe. It must be borne in mind, however, that, even today, most hedge funds are located in unregulated or only lightly regulated offshore centres. A purely European approach would merely heighten this effect. What is needed, therefore, is a solution at international level.

Open-end **real estate funds** should be recognised Europe-wide as a highly secure and stable retail investment product. Now that they have been accepted well by private investors in the member states, a European framework for open-end real estate funds would be desirable.

[5] Commission Staff Working Paper, Annex to the Green Paper on the enhancement of the EU framework for investment funds; Background Paper (Com(2005)314 final), footnote 127 on p. 52.

Question 17: Are there particular risks (from an investor protection or a market stability perspective) associated with the activities of either private equity or hedge funds which might warrant particular attention?

In the case of private investments offered on the so-called “grey” market, a well-known problem that has existed for some time now is that these are distributed under largely unregulated and uncontrolled conditions. Adequate transparency of such investments would facilitate management companies’ investment decisions.

Question 18: To what extent could a common private placement regime help to overcome barriers to cross-border offer of alternative investments to qualified investors? Can this clarification of marketing and sales process be implemented independently of flanking measures at the level of fund manager etc.?

In our view, a common European private placement regime is not necessary, as private placement customer groups differ greatly in the member states and national regulation thus makes more sense.

Question 19: Does the current product-based prescriptive UCITS law represent a viable long-term basis for a well-supervised and integrated European investment fund market? Under what conditions, or at what stage, should a move toward principle-based, risk-based regulation be contemplated?

We welcome the Commission’s basic approach of focusing initially on exhausting the possibilities offered by the existing legislative framework. Prior to publication of the Green Paper, the Expert Group on Asset Management discussed a thorough overhaul of EU legislation which would consolidate all areas of law relating to asset management. This project should be scheduled for the medium term at the earliest and after a cost-benefit analysis of all the implications of such an approach has been carried out. At this stage, a move towards a more principle and risk-based – and thus more flexible – approach could be contemplated.

Dissenting opinion of the Bundesverband deutscher Banken (BdB):

In our view it is doubtful whether the Commission’s basic approach of focusing initially on exhausting the possibilities offered by the existing legislative framework is adequate. It may

indeed be possible to realise all the planned improvements within the current legal framework (which remains to be seen in practice, given past experiences especially with the notification procedure). However, the existing Directive will still cause a competitive disadvantage for the fund industry, compared to comparable investment products governed by different European rules. Due to limitations in the production of new kinds of funds, it will also limit the choice for European investors.