European Fund and Asset Management Association

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REGIONAL REPORT ON EUROPE

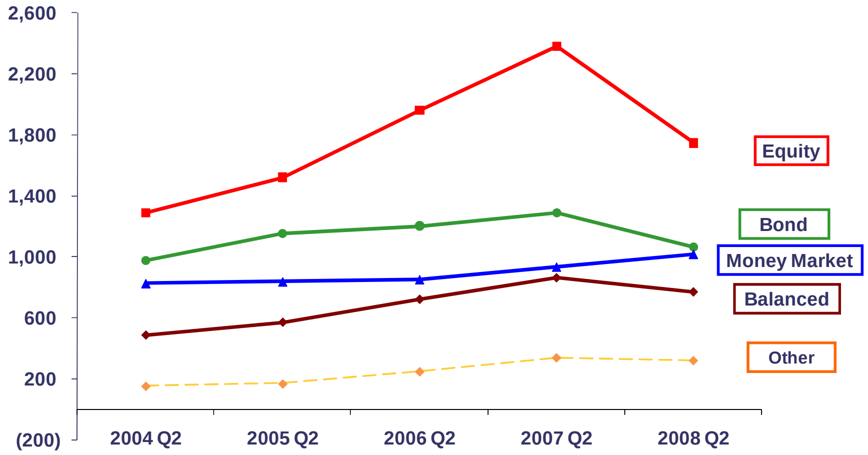
LATEST TRENDS IN THE UCITS MARKET

Since the end of June 2007, total net assets of UCITS fell by 13.5 percent, to reach EUR 5,584 billion at the end of June 2008. All fund categories, except money market funds, experienced a sharp fall in assets, with equity funds being the most severely hit. As a consequence the share of equity fund assets fell from 41 percent at end June 2007 to 35 percent at end June 2008. Money market funds mainly made up for the difference. Since the end of June 2006 total net asset increased by 1.8 percent.

Table 1. Breakdown of UCITS Assets by Category

	30/06/2008		30/06/2007		30/06/2006	
UCITS types	EUR bn	Share	EUR bn	Share	EUR bn	Share
Equity	1,745	35%	2,379	41%	1,958	39%
Balanced	771	16%	863	13%	722	14%
Total Equity & Balanced	2,516	51%	3,242	50%	2,681	54%
Bond	1,066	22%	1,287	22%	1,202	24%
Money Market	1,015	21%	932	16%	851	17%
Other	322	7%	340	6%	248	5%
All Funds	4,918	100%	5,801	100%	4,982	100%
including Ireland	5,584		6,455		5485	

Chart 1. Recent Trends in Assets by UCITS Type (EUR billions)



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As clearly shown in chart 1, total net assets of UCITS grew in all fund categories between June 2004 and June 2007, just before the collapse of the U.S. subprime mortgage market and the spreading of the liquidity crisis.

The developments in UCITS net sales between end June 2007 and end June 2008 illustrate the impact of the financial turmoil on investor demand for UCITS. During the third quarter of 2007, for the first time ever, UCITS registered aggregate outflows, with the trend continuing since. Outflows represented around 26 percent of the asset decline experienced during the period, whereas market depreciation represented the remaining 74 percent. By way of illustration the Dow Jones STOXX 600 index lost 27 percent between end June 2007 and end June 2008.

Chart 2a. Net Sales of UCITS
(EUR billions)

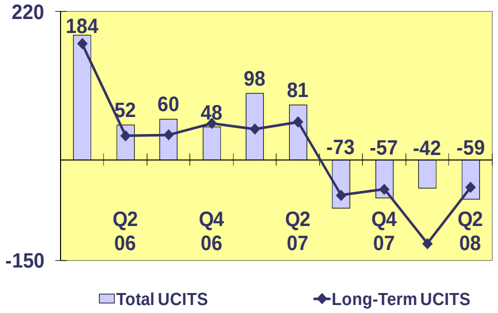


Chart 2b. Net Sales into Equity-Linked Funds
(EUR billions)

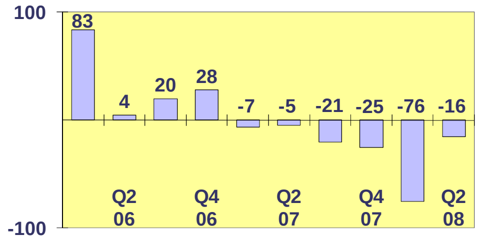


Chart 2c. Net Sales into Balanced Funds
(EUR billions)

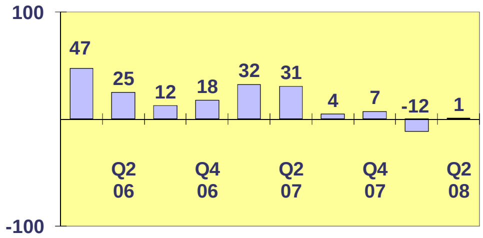


Chart 2d. Net Sales into Bond Funds
(EUR billions)

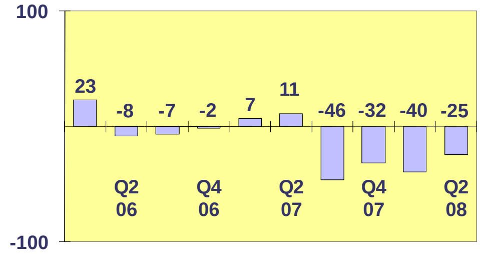


Chart 2e. Net Sales into Money Market Funds
(EUR billions)

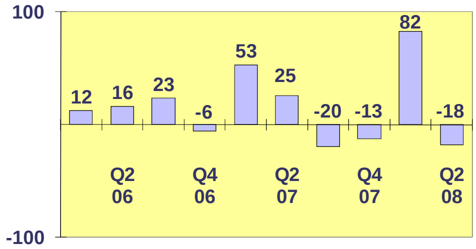
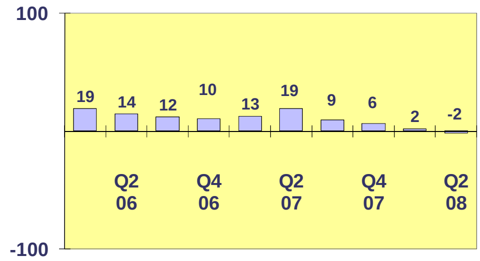


Chart 2f. Net Sales into Other UCITS
(EUR billions)



As shown in the charts above, long-term funds experienced outflows during the period, but outflows slowed down during the second quarter of 2008: EUR 41 billion in the second quarter compared to EUR 125 billion in the first quarter.

Outflows from equity funds reached EUR 138 billion between end June 2007 and end June 2008, with a peak in the first quarter of 2008. The prolonged volatility in stock markets against the background of increased risk of economic slowdown dampened investor demand for equity funds. Bond funds also suffered from severe outflows, which were driven by inflationary pressure, competition from bank saving products as well as investor concerns about the exposure of bond funds to asset backed securities. Balanced funds were also affected by the crisis, albeit to a lesser extent. Following the start of the subprime crisis, money market funds also witnessed outflows, resulting from contagion effects and, even more so, from enhanced competition from banks issuing debt securities at higher rates than money market fund returns in order to cope with the liquidity crisis. The strong inflows recorded in the first quarter of 2008 marked a reversal which was partially offset during the second quarter. [1]

Overall, UCITS funds suffered aggragate ouflows for EUR 231 billion between end June 2007 and June 2008. A key difference between this period and previous years is that the adverse developments on the worldwide stock markets and the resulting outflows from equity funds could not be offset by favourable conditions in fixed-income markets and inflows in bond funds.

[1] At this point in time EFAMA statistics do not include net sales of stable NAV money market funds domiciled in Ireland; these funds have recorded strong inflows since the start of the credit crunch.

MAIN REGULATORY DEVELOPMENTS: UCITS IV BACK ON TRACK

On 16 July, after months of uncertainty, the European Commission presented the new UCITS IV legislative proposal [COM(2008) 458/3] including new regulation regarding the notification procedure, fund mergers, master-feeder structures, key investor information – replacing the "old" simplified prospectus – and supervisory cooperation.

Although most in the European investment management industry would have preferred a proposal including provisions for the Management Company Passport (MCP) introduced in the UCITS Directive by Directive 2001/107/EC of 21 January 2002[2], EFAMA welcomed the proposed modification of the 1985 UCITS Directive, in particular as at the same time a mandate was sent to the Committee of European Securities Regulators (CESR) asking for advice *"that will help the Commission to develop provisions permitting the introduction of a management company passport under conditions that are consistent with high level of investor protection."*

The European investment management industry hopes the package will be adopted by the European Council and Parliament in the second quarter of 2009 allowing that both the present Directive and its implementing measures could enter into force by mid-2011. EFAMA is committed to support fully all European legislative parties to achieve this goal.

The proposed measures were, of course, fully supported as they are very much in line with what the industry has since 2004 considered as an absolute necessity to increase the efficiency of the European investment management industry and to strengthen its global competitiveness.

NEXT STEPS

As the time left to adopt UCITS IV before the end of this European Parliament's term is extremely short, all legislative bodies have set themselves a very tough agenda:

- The European Council started discussing the legislative proposal in early September and the EU French Presidency aims for the final vote at the Finance Ministers' (ECOFIN) meeting of 2 December;

[2] The so-called « Management Company Directive »

- The same day the European Parliament's ECON Committee (Rapporteur, Wolf Klinz MEP) intends to adopt its report and the Plenary vote is foreseen for mid-2009;

- Regarding the Management Company Passport, CESR started working immediately after having received the above-mentioned request for advice from the Commission on 16 July and it hopes to deliver in time before November 1st.

Depending on CESR's advice, Level 1 rules on the Management Company Passport will be introduced in the procedure probably beginning of next year.

As all European legislative bodies seem willing to bring UCITS IV to a positive conclusion, expecting adoption of the proposal by Council and Parliament in the second quarter of 2009 is still realistic. This would also mean that both the present Directive and its implementing measures could really enter into force by mid-2011.

THE PROPOSAL

The UCITS IV proposal represents the last step in a long process of revision of the 1985 UCITS Directive. The Asset Management Experts Group set up by the Commission in 2004 recommended a list of actions needed to improve the efficiency of the European funds industry.[3] These recommendations were embodied in the Commission's 2005 Green Paper.[4] As a follow-up to this Green Paper, the Commission contracted two studies: one on the potential cost savings in a fully integrated European fund market, the other on current trends in the European asset management industry. Also, the Commission set up two industry Expert Groups, one on investment fund market efficiency, the other on alternative investment funds.

The reports of the two groups were published in July 2006. The European Parliament commented the Commission's Green Paper in a report adopted in April 2006 (the so-called "Klinz Report"[5]). Concluding this discussion, the Commission issued in November 2006 a "White Paper on Enhancing the Single Market Framework for Investment Funds"[6] concurrently with the results of the two studies it commissioned.

3 See: www.efama.org
4 COM(2005) 314 final of 12 July 2005
5 A6 – 0106 / 2006
6 COM(2006) final of 15 November 2006

The Commission's proposal aims to overcome administrative burdens as well as increase market efficiency, investor protection and the global competitiveness of the industry. In order to achieve this, it includes five measures to:

- Ensure the smooth functioning of the product passport by eliminating administrative obstacles;
- Set out clear and common requirements and procedures for fund mergers;
- Allow so-called master feeder structures to provide for asset pooling;
- Ensure that product disclosures made by fund managers provide relevant and meaningful information to investors;
- Strengthen the current UCITS provisions on supervisory powers and cooperation.

The sixth set of measures, i.e. amendments to the UCITS Directive needed to make the Management Company Passport effective, was left out for the time being. Instead, the European Commission asked CESR for advice on the structure and the principles which should guide potential future regulation. After CESR's advice is received, the necessary legislative pieces should be included in the regulatory procedure at a later stage.

The Fund Passport/Notification Procedure

The Commission is proposing a fast regulator-to-regulator procedure whereby:

- A UCITS seeking to market its units in another Member State informs its home authority of its intention and sends them the notification documents;
- The home authority checks the completeness of the file within 1 month and, if complete, transmits it to the host authority;
- The home authority informs the UCITS about the transmission date and the latter can start marketing its units in the host country immediately after the transmission;
- The host authority checks *ex post* that marketing is conducted in accordance with national rules.

If realised as proposed, this proposal would reduce the regulatory burden significantly and create "near Schengen" conditions, even if the 1 month period for the funds home authority simply to check the completeness of the file [Article 88 (3)] seems rather long and should, as most in the industry think, be reduced to the 3 days of the Prospectus Directive.[7]

[7] See : Article 18 of Directive 2003/71/EC

Fund Mergers

The proposal – largely based on an analysis carried out by IOSCO in November 2004 - introduces a legal framework for both national and cross-border mergers applicable to all UCITS (and their compartments) irrespective of their legal form. All currently used methods are allowed: merger by absorption, by creation of a new fund and by amalgation. The approval process is clear, the competent authority is that of the merging UCITS and prior authorisation is necessary. The proposal provides for long lists of information to be provided to the competent authority and clearly describes the rights of unit/ shareholders. In this context, it is of particular importance that possible approvals by shareholders are limited to no more than 75% of the votes actually cast.

The biggest problem with this proposal is that the Commission seems still to be of the opinion that issuing a Communication on Taxation clarifying the applicability of the existing ECJ case law to cross-border fund mergers would be sufficient to achieve the necessary tax neutrality of such mergers on a cross-border basis. Many in the industry question this approach because of the non-binding nature of such a Communication even if the Commission were to envisage backing it with infringement procedures. This is why the Commission should at least try to go for a Directive.

Pooling & Master-Feeder Structures

For years, both forms of asset pooling – virtual and entity pooling – have been high priority issues for many in the industry. For a number of reasons, the Commission is limiting its proposal to the introduction of so-called master-feeder structures, which are very similar to what exists in the U.S. under the denomination “hub-and-spoke funds”. This approach is broadly supported, even if many in the industry think that the proposal looks rather “overloaded”, at least for Level 1 legislation and includes a number of unnecessary provisions.

The main difference between hub-and- spoke and master-feeder structures is that the latter must only invest 85% of their assets in the master; the remaining 15% can also be invested in financial derivatives and this not only for currency hedging purposes.

The Simplified Prospectus/Product Disclosure

For about 15 years the European fund industry is discussing how to improve product information for investors. When in 1997 the Commission took on board EFAMA’s (or “FEFSI” as the association was then called) proposal for a Simplified Prospectus, it seemed to be heading in the right direction. Indeed, the Simplified Prospectus should be:

> "*A short notice allowing investors to compare product features across borders through a harmonised document informing investors in an easily understandable language about the key features of a fund, thus enabling them to make well considered investment decisions as well as a document simplifying cross-border distribution.*"

EFAMA's model for a Simplified Prospectus published in 2002[8] aimed to reach this goal, but it was implemented by many Member States in such a way that the contrary was achieved.

Already in its *White Paper* the Commission had accepted this issue as a serious problem and the new approach entitled "Key Investor Information" (KII) goes in the right direction, in particular as:

- It will be a maximum harmonised document, which cannot be altered by host Member States;
- It will not raise civil liability provided it is consistent with the prospectus;
- The proposal strikes the correct balance between framework principles and implementing measures.

Already last year CESR received from the Commission a request for advice on the planned KII or KID ("Key Information Document" as it is now called) and is since then working on possible Level 2 implementing measures. Two issues are top of CESR's agenda in this respect: risk-reward indicators and fee disclosure.

Supervisory Cooperation

The proposals to strengthen existing provisions of the Directive are aimed to:

- Ensure equivalence of powers for competent authorities;
- Develop existing mechanisms relating to exchange of information;
- Put in place mechanisms to carry out on the spot verification of information and investigation;
- Grant certain rights in case of a breach of Directive provisions;
- Provide for the possibility to adopt by way of comitology implementing measures with respect to exchange of information.

Indeed, had these proposals already been included in the original Directive, many problems could have been avoided.

8 See: www.efama.org under "Standards"

The proposed measures seem sufficient to overcome concerns of supervisors regarding issues such as cross-border distribution of funds or the management company passport. However, CESR will probably use its advice on the Management Company Passport asked for by the Commission to complete this package of measures.

CESR AND THE MANAGEMENT COMPANY PASSPORT

As said above, on 16 July 2008 the European Commission asked CESR for advice on the structure and the principles which should guide potential future amendments to the UCITS Directive needed to make the Management Company Passport (MCP) effective.

In a *Call for Evidence* issued by CESR on 17 July, all interested parties were invited to submit their views by 22 August and despite the time constraints, a public Hearing on this issue is scheduled for 13 October.

The Goal

A functioning MCP would allow a fund manager to set up a fund – independent of its legal structure - in another jurisdiction than that where the Management Company is situated. This is in fact not only one of the basic rights in a Single Market and a goal of the Lisbon agenda, but it would also provide for significant cost savings and add legal certainty.[9]

CESR's advice should help the Commission to draft provisions making the MCP work under conditions which preserve the globally recognized UCITS brand and the current high level of investor protection of UCITS funds and it should include:

- A clear and systematic allocation of regulatory responsibilities between the competent authorities for all relevant entities;
- Conditions needed to ensure that the respective competent authorities have the means necessary to verify, monitor and enforce the regulatory requirements for which they are responsible;
- Obligations incumbent on competent authorities to provide information and other assistance to partner authorities or other entities having responsibilities for the oversight of the fund/ Management Company;

9 From a practitioners point of view probably the most important benefit of the passport should emerge for the new UCITS IV feeder funds. Local feeder funds that invest in pan-European master funds are nearly the perfect instrument to combine local investor needs with efficient collective portfolio management.

- Conditions needed to ensure that all relevant entities are subject to effective enforcement action for breaches of the law governing the fund or fund rules.

One of the main concerns of the industry, namely that the outcome of this discussion might end up with such complex procedures that the advantage of the MCP would be outweighed, was advanced by the Commission. Indeed, the Commission underlines in its mandate that "*CESR's advice should be mindful of the need to minimize compliance costs and complexity for business operators of the supervisory framework. The advice should, where consistent with the goal of underpinning the current high level of investor protection, avoid duplication of controls and excessively cumbersome administrative procedures*."

The Content

The Call for Evidence identifies five "areas" where legislation might be necessary:

- Definition of the fund domicile;
- Applicable law and allocation of supervisory responsibilities;
- Authorization procedure for UCITS funds whose Management Company is established in another Member State;
- On-going supervision of the management of the fund;
- Dealing with breaches of rules governing the management of the fund.

Impact of the liquidity and credit market turmoil

The global financial market turbulence triggered by the U.S. subprime crisis is more than a year old and significant weaknesses persist with serious consequences for the financial system and the global economy.

While the direct impact of the financial turmoil on asset management companies can be qualified as limited – no direct exposure on the asset management balance sheets, very few fund closures, few temporarily suspended redemptions – the crisis had two main indirect impacts:

- firstly on revenues: market conditions have generated outflows for the last 4 quarters, and
- secondly on operational procedures.

EFAMA realized very soon that its top priority for 2008 and the following years would be to restore confidence in markets and to uphold the integrity of the industry. Consequently, three initiatives are being pursued by EFAMA:

- The creation of a guidance for the classification of money market funds;

- The issuing of a practice note on the guidance of fund valuation;
- The elaboration of an industry paper on risk management procedures.

Market developments over the last 12 months also shed light on a number of potential challenges to the industry, in particular that some product categories did not perform as anticipated, as was for example the case with regard to strongly promoted fund types such as enhanced money market or absolute return funds.

Finally, the subprime problems have put pressure on distributor banks and this has resulted in a wholesale shift of client monies out of funds and into deposit accounts. The switching of client money from one financial product to another is not a new story but it now serves as a warning. Some clients may well be best served by holding their money in cash right now but one cannot assume that when confidence returns, distributors will switch their money straight back into funds. Structured notes are gathering an important head of steam and may offer a more profitable option for bank distributors, which of course, also own the production of notes.

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