LAUNCH OF THE ECMI-CEPS TASK FORCE REPORT

RETHINKING ASSET MANAGEMENT

From Financial Stability to Investor Protection and Economic Growth

WITH SUPPORT OF CFA INSTITUTE

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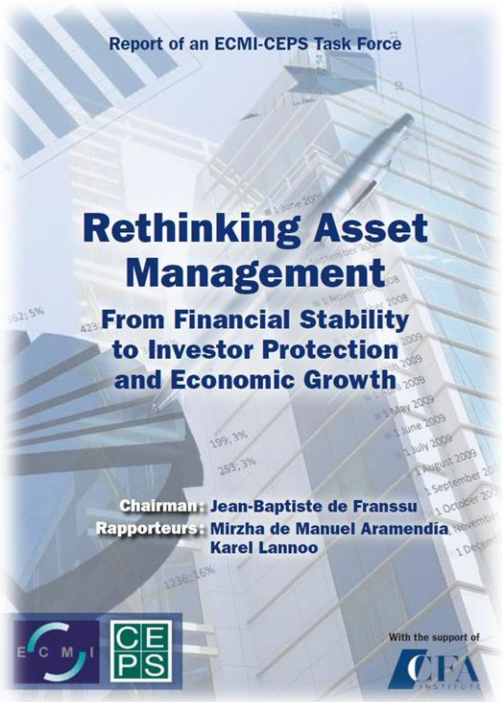

Following the financial crisis, the asset management industry faces a dual challenge: regaining investors trust and coping with the post-crisis regulatory reform. Retail investors require more protection in the sale process to facilitate their access to the best-in-class products in order to save for their future. Distribution is the major stumbling block to competition and the area where substantial reform is needed to serve retail investors' interests. The single market should be exploited to remove inefficiencies and promote competition among providers for product integrity to increase and feeds to decrease. Piecemeal solutions and distinctly national approaches will no longer suffice. We must insist on a holistic (and horizontal) approach across products, players and countries that prevents regulatory arbitrage, preserves financial stability and protects the investor. We must also work to unleash the full potential of the asset management industry to benefit the real economy. The stakes are high to make investment funds and other investment products deliver to European investors.

In view of these imperatives, the Centre for European Policy Studies (CEPS) and the European Capital Markets Institute (ECMI) formed a Task Force to closely examine the functions of the asset management industry, its contribution to the real economy and its regulation in Europe. The Task Force met four times over the course of 2011 with the participation of a wide range of stakeholders, including asset managers, custodian banks, academics, experts and policy-makers, under the chairmanship of Jean-Baptiste de Franssu, Chairman of INCIPIT. The Final Report puts forward the following policy recommendations in seven main areas aimed at strengthening investor protection in the sale process, product integrity in UCITS, the management of non-market risks, long-term and responsible investing and venture capital.

KEY CONCLUSIONS AND RECOMMENDATIONS

1. RETAIL INVESTOR PROTECTION

- **Pre-contractual disclosure should be comparable for all retail investment products.**
  The KIID standard should apply across investment funds, insurance-based investment products, retail structured products and banking saving products — in line with the PRIPS (packaged retail investment products initiative) initiative. Ultimately, uniform standards of pre-contractual disclosure should apply to all retail investments, whether packaged or not, and including pension products, to the benefit of investors.

- **Selling practices should be regulated in the same manner across products and channels.**
  The proposed extension of the rules governing MiFID (Markets in Financial Instruments Directive) to structured deposits is a step in the right direction to stop regulatory distortions. Uniform rules on conduct of business and conflicts of interest should apply across products and distribution channels. MiFID and the IMD should converge in this respect also in their implementation.

- **Investor protection at the point of sale should be clearly distinguished from product integrity and financial stability concerns.**
  It is important to draw a distinction between concerns over financial stability and product integrity, on the one hand, and the protection of retail investors at the point of sale, on the other. Complexity in *product structuring* should be addressed by product regulation to the extent necessary to ensure the integrity of retail investment products. By way of contrast, complexity in the *risk-reward profile* should be addressed by distribution rules.

- **Retail investors should be encouraged to request investment advice for products with a complex *risk-reward profile*.**
  Execution-only services should be reserved for investment products whose *risk-reward profile* may be understood by the average retail investor. Investors should be strongly urged to request investment advice when purchasing an investment product with a complex *risk-reward profile*. Both market and non-market risks (operational, counterparty and liquidity risks) are relevant in understanding the risk profile of a given product.

- **Retail investors need more information about investment advice.**
  Distributors should be completely transparent in describing to investors the character of the services they offer. The Task Force supports the proposal of the European Commission to require distributors to disclose whether advice is provided on an independent basis and whether advice is based on a broad or more restricted analysis of the market. Investors should also be informed about the cost of advice, whether in the form of inducements or up-front charges. Disclosure in these three respects should be meaningful for investors and where appropriate, standardised.

- **Professional standards for advisers should be raised and harmonised.**
  Europe needs a uniform approach to raise the professional standards of investment advisers and distributors, to improve the quality of advice. Ultimately, better advice would improve capital allocation by directing savers to the most adequate and cost-effective product solutions. Ongoing training is also needed to keep advisers up-to-date on market developments.

- **A level playing field is needed to stop regulatory arbitrage.**
  Additional steps are needed to close the gaps that allow the marketing of non-regulated products to retail investors. Two issues are of particular concern: the sale to retail investors of structured products and exchange-traded notes that are not subject to product rules nor the approval of supervisors, and the different standards that apply to regulated products.

2. PRODUCT INTEGRITY

- **UCITS needs to be governed by a single rule book; partial harmonisation can no longer be justified.**
  The UCITS rules are loosely harmonised and implementation diverges across member states with respect to essential aspects, such as eligible assets, concentration limits and investment practices. Insufficient harmonisation also affects key elements of disclosure, such as total expense ratios. To strengthen product integrity and provide clarity to investors, UCITS needs a single rule book.

- **The current rules on derivatives and financial indices should be fine-tuned.**
  The current rules on the use of derivatives and structured financial instruments in UCITS should be revised to strengthen product integrity. It would not be a matter of producing a major overhaul but of closing gaps to reduce the opportunities for arbitrage and deepen harmonisation to improve consistency. Chapter 3 (section 4 and table 7) in the final report provides some ideas in this respect.

- **Legislation should consolidate best practices on collateral management.**
  The Task Force supports ESMA in its work to clarify collateral requirements for UCITS. The same rules should apply, however, to all retail investment products in the form of binding legislation instead of guidelines. Since collateralised transactions are a common practice in financial markets, a horizontal approach is needed, in coordination with international regulators.

- **Legislation should require more transparency on securities lending.**
  EU legislation is needed to bring more transparency into securities lending by UCITS and other retail investment products. Any broader issues related to securities lending in financial markets need to be considered horizontally and in coordination with international regulators.

3. NON-MARKET RISKS AND DEPOSITARIES

- **Non-market risks should be better communicated to retail investors.**
  In a context where market risks are often transformed and repackaged, resulting in novel operational, counterparty or liquidity risks, it is essential to clearly communicate these non-market risks to investors. UCITS are already required to communicate these risks in the KIID, but closer supervision would ensure meaningful compliance. The effectiveness of the current standard of disclosure should be reviewed under PRIPS and extended to all retail investment products.
- **The implementation of depositary rules should make sure that custody risks are managed instead of insured against.**
  The depositary rules in the AIFMD should be implemented in a manner ensuring that custody risks are managed and not insured against. Strict liability should only fall on depositaries for the safe-keeping of instruments over which they have effective control, as recommended by ESMA. Depositary rules for UCITS should be aligned with the AIFMD, but with retail investors in mind.
- **National rules should fully converge before a depositary passport is introduced in Europe.**
  The Task Force would like to see a depositary passport in the future. However, full convergence of national rules should be achieved beforehand, based on the AIFM and UCITS V Directives, to avoid distortions of the kind identified by CESR in 2010. Member states should conscientiously implement these directives and the European Commission should enforce compliance.

4. LONG-TERM INVESTING

- **Investment horizons should be better communicated to retail investors.**
  Pre-contractual disclosure and investment advice should more carefully consider investment horizons. While UCITS may mention any 'minimum recommended holding period' in the KIID, investors would nevertheless benefit from consistent and more positive disclosure in this respect. Advisers should be expressly required to consider the investment horizon of their clients.
- **A new long-term vehicle for retail investors should be introduced in Europe.**
  Retail investors would benefit from having access to relatively illiquid asset classes to channel part of their long-term savings, including part of their retirement savings. A harmonised regulatory framework for long-term retail funds (LTRFs) should therefore be considered. Chapter 5 (box 6) in the final report offers some initial ideas in this respect.
- **Prudential rules should not hinder the ability of institutional investors to make long-term investments.**
  The importance of long-term investing cannot be sufficiently stressed both to foster sustainable growth and to generate the returns needed to meet pension liabilities. In this respect, prudential rules should be reconciled with long-term investing.

5. RESPONSIBLE INVESTING

- **Institutional investors should consider engagement in their investment mandates.**
  Environmental, social and governance (ESG) indicators are useful tools to mitigate risks and potentially increase returns. Policy-makers should actively support the development of integrated reporting

standards for non-financial corporations. Institutional investors should pay more attention to engagement and ESG criteria in their investment mandates and voting policies.

- **Harmonised rules are needed for funds that present themselves as responsible.**
  Responsible investment funds have the potential to combine attractive returns for investors with the achievement of ESG objectives. Europe needs a harmonised framework for retail funds presenting themselves as responsible, including responsible UCITS. This framework should be robust and ensure that the funds are indeed invested in a manner consistent with the ESG goals they purport to seek.
- **The industry should commit to the success of the EU initiative on social entrepreneurship funds.**
  Forthcoming legislation on social entrepreneurship funds is a useful instrument to promote impact investing. The Task Force invites the asset management industry to commit to the success of this initiative aimed at small and medium enterprises whose primary goal is to achieve positive and measurable social impacts.

6. VENTURE CAPITAL

- **The proposed rules on venture capital should be flexible enough to unleash its full potential.**
  The proposed regulation on European Venture Capital Funds (EVCFs) is of key importance for the economy, given the role of venture capital in financing entrepreneurship and innovation. Sufficient flexibility should be extended to qualifying funds and qualifying investments so that the passport becomes truly attractive for managers. Beyond building the single market, additional incentives will be needed to boost the 'venture capital ecosystem' in Europe, as considered in the final report (chapter 5).

7. THE SINGLE MARKET

- **The standard of harmonisation should be upgraded to complete the single market.**
  Completing the single market is essential to foster growth and competitiveness in Europe. As highlighted recently by several heads of state and government, "The single market must be brought to its next stage of development, by reinforcing governance and raising the standards of implementation". The single market for asset management products and services is of particular importance, given its role in financing the economy and providing retirement income. Divergent national rules on investor protection risk reversing the single market for retail investment products.
- **Beyond issuing new rules, Europe needs better implementation and supervision of existing rules.**
  The Task Force found that some of the rules recently reviewed, while not flawed, were ineffective due to the lack of appropriate implementation and supervision. More resources should be made available to make legislation work in practice. The role of ESMA should become more central, and the body should be endowed with adequate resources to carry out its tasks.
- **The single market would benefit from promoting competition but also its competitiveness.**
  Resolving the distribution conundrum is essential to foster competition, rationalisation and lower fees in retail markets. The European Parliament and member states should step-up their efforts to find a satisfactory solution in this respect. Next to fostering competition, policy-makers should also strive to promote the competitiveness of the EU in global markets for investment funds and asset management services.

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These recommendations reflect a general consensus reached by Task Force members, although not every member agrees with every aspect in each recommendation.
Refer to the Final Report for a full disclaimer.

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