

Comment Letter on the Regulation of European Securities Markets, August 2000

Questionnaire Response to Committee of Wise Men on the Regulation of European Securities Markets

From your area of expertise, what are the main obstacles standing in the way of an integrated European securities market?

The Investment Company Institute appreciates the opportunity to comment on a number of key issues relating to an integrated European securities market. The Institute is the national association of the US investment company industry. Our membership includes 8,239 open-end investment companies ("mutual funds"), 489 closed-end investment companies, and 8 sponsors of unit investment trusts. Our mutual fund members have assets in excess of \$7.0 trillion, accounting for approximately 95% of total industry assets, and over 83.5 million individual shareholders. Many of our members actively participate in the UCITS market, and our comments reflect their experiences in organizing, advising, and distributing mutual funds in Europe.

With the introduction of a single currency in the European Union, the opportunity to create an integrated European securities market has never been greater. We applaud the efforts by the Committee of Wise Men under the chairmanship of Alexandre Lamfalussy to eliminate obstacles for an integrated European securities market and to seek public consultation on these issues. A single European currency can fuel significant capital market growth in Europe. The structure and regulation of Europe's markets, however, must be able to accommodate this growth and respond to change. One major obstacle for an integrated European securities market is the lack of a single market for mutual funds. It remains difficult for investors in one European Union member state to buy investment funds organized in other member states.

Efforts to create a single market for mutual funds began in Europe with the adoption of the UCITS Directive in 1985. This directive was intended to provide a convenient passport to allow a mutual fund to be sold throughout the member states of the European Union. The Directive was a significant first step in establishing a framework for a pan-European market for mutual funds. It is clear, however, that selling the same mutual fund throughout the European Union under the UCITS Directive remains exceedingly difficult. As discussed below in more detail in response to Question 2, there are three principal problems in marketing UCITS in Europe: (1) the UCITS Directive is interpreted and implemented differently in member states; (2) the marketing rules are left to individual member states; and (3) the highly prescriptive definition of what qualifies as a UCITS impedes innovation. In addition, because it has proven to be extremely difficult to amend the Directive, the Directive does not have the flexibility to accommodate developments in the market.

In your experience, is existing EU securities legislation being transposed and implemented consistently? Do you think that implementation is being carried out in a way which supports or impedes the development of cross-border securities business? What are your main areas of concern? Which market or activities are most adversely affected? What role do you see for self-regulation and market conventions (which may differ between financial centres)?

The UCITS Directive is not being implemented consistently throughout the European Union. This inconsistent application directly

impedes the development of cross-border securities business in Europe. For example, a UCITS fund must register in each member state in which it intends to sell its shares, and member states administer the provisions of the UCITS Directive differently. Some member states impose burdensome requirements for registering a UCITS fund for sale that routinely delay the 60-day waiting period set forth in the Directive. For example, in Italy, registering a non-Italian UCITS fund for sale typically takes up to six months.

In addition, because host countries have jurisdiction to set marketing requirements, funds are subject to varied and conflicting requirements relating to advertising and disclosure or are required to incur the cost and delay to file, and await approval of, detailed information about their marketing plans. For example, in Spain, authorities require an official translation of the prospectus, which is quite costly. These overlapping, duplicative, inconsistent and ever-changing requirements make it difficult to sell the same mutual fund throughout the European Union. In fact, as reported by Moody's Investor Services in August 2000, only 30% of the 12,000 registered UCITS are sold truly cross-border.

The structure of the UCITS Directive also restricts the ability of the directive to respond to market changes. The UCITS drafters defined UCITS to be a subset of mutual funds in existence in 1985. This approach creates a regulatory scheme that cannot accommodate innovation. In order to meet investor needs, the mutual fund industry must be able to adapt to changes in markets and investor interests. To illustrate, the current directive does not permit money market funds or any exceptions to its strict fund of funds prohibitions, let alone other types of funds that may be desirable to meet investor needs. Proposals to amend the Directive would add other specified securities, such as money market instruments, to the permissible investments. Although the proposed amendments would be helpful, they will not help the Directive accommodate changes in the future. Because it is difficult to enact amendments to the Directive and difficult to anticipate the future asset classes that should be permissible investments for UCITS funds, consideration should be given to creating a more flexible standard for permissible UCITS investments, such as a liquidity standard. Requiring UCITS to invest a certain level of their assets in liquid investments would be more flexible than listing the currently acceptable investments. This approach would accommodate developments in new types of assets without compromising investor protection goals. It also would benefit the economy more generally, and the mutual fund industry can be a source of funds for important segments of capital markets and thus contribute to overall economic growth in Europe.

Another impediment to the efficient operation of UCITS funds in Europe relates to fund administration. Because the current UCITS Directive does not speak to this issue, some member states require fund administration to be located in the fund's domicile. Therefore, a fund complex with funds domiciled in several member states is not able to centralize its administrative operations. Consolidating back office operations of funds would achieve economies of scale and cost efficiency, which could be passed on to investors.

Do you think the current arrangements for co-operation and mutual assistance between national supervisors are sufficient to deal with cross-border market developments? If not, what are the main shortcomings (e.g. lack of expertise or insufficient powers, deficient channels for co-operation, duplication of supervisory control, excessive cost, lack of regulatory resources etc, why?

We are not aware of any particular concerns relating to supervision of the securities markets across the European Union. We would like to comment, however, on the need for greater coordination among supervisors of member states in dealing with cross-border market developments and issues for UCITS as demonstrated by the examples provided in answer to Question 2. The myriad regulations set by the various authorities in the different member states impose cumbersome and costly burdens on funds that prevent efficient cross-border sales and administration of funds throughout the European Union.

Looking forward in your area, what do you see as the key structural, technological or regulatory developments that will affect European securities markets in the future and what will be the main implications of European regulation and supervision?

We believe that technology and more emphasis on long-term savings will have significant effects on the European securities markets. With further developments in and greater use of the Internet, individual investors will seek to invest even more across border through the Internet. Investors focusing on individual savings also will demand access to a greater range of investments than currently

available within their national borders. The UCITS Directive has the potential, as yet unfulfilled, to meet these needs of individual investors without jeopardizing the important regulatory goal of investor protection.

To accomplish this task, European Union regulation and supervision need to make strides to facilitate an integrated European market that provides the diversity of mutual funds that investors want and supports the investors' ability to purchase funds across Europe within a system that ensures the protection of investors. The proposals for amendments to the UCITS Directive currently under consideration should be adopted as soon as possible. Moreover, further amendments to the UCITS Directive are necessary to facilitate a single market for mutual funds in Europe. For instance, the marketing rules for UCITS funds also should be harmonized. A single standard for advertising and marketing would not only ensure a uniform level of investor protection but also assist sales of fund shares cross-border, especially via the Internet. Further liberalization of what qualifies as a UCITS also would allow greater range of funds to be provided to individual investors.

Moreover, there should be a single standard permitting management companies to delegate certain functions to their parent company or to affiliates outside the home country provided that the affiliate submits to regulation and jurisdiction by the appropriate authorities of the home country. Permitting management companies to delegate the management of a portion of a portfolio to an affiliate would allow mutual funds to benefit from an affiliate's particular expertise.

The greater emphasis on long term savings also will inevitably create the need to address issues raised by the current pension systems in the EU. Many member states of the EU currently are considering reforming their pension systems. To adequately provide for individuals at retirement, member states must permit managers of pension plans to maximize returns subject to diversification and prudence standards and not prohibit certain types of investments. Specific restrictions on how pension assets can be invested have an adverse impact on pension plan investment performance and also impede the full development of European securities markets.

In order to create an integrated European securities market, what type of regulatory/supervisory arrangements will be ultimately needed to underpin it? What is the right sequencing to follow? Do you have any views on timing and transitional arrangements? How should it be organized?

The creation of FESCO, the organization of competent national authorities, was a laudable effort in facilitating coordination and cooperation among the regulators of member states. Because FESCO does not include all of the national regulators responsible for UCITS, however, we would recommend immediately encouraging greater coordination among the member state authorities and creation of uniform interpretations for provisions of the UCITS Directive and member state mutual fund laws and regulations. The development of more uniform standards should be achieved by a process that is transparent and provides for input from the affected industry and other interested parties. Finally, we also recommend immediate action to eliminate restrictions that prevent the investment of pension assets on the basis of prudence and diversification.