.BVI

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BVI's response to the Call for Evidence on the EU Regulatory Framework for Financial Services

The unprecedented wave of regulatory reforms in the aftermath of the 2008 financial crisis has resulted in many duplications and overlaps between different pieces of EU law and in some cases has given rise to inconsistent or conflicting rules. BVI[1] shares the Commission's view that addressing these weaknesses and remedying the identified shortcomings should significantly enhance the efficiency of financial services and encourage investments, thus further promoting a Capital Markets Union.

In general terms, we would also like to point out that the quality of regulation depends to a considerable extent on the smooth functioning of the underlying regulatory processes. In the last couple of years, the comprehensiveness and complexity of EU regulatory frameworks has significantly increased which should also be reflected in the applicable procedures. Specifically, we think that coordination of work between the ESAs and across different Commission units should be improved in order to identify cross-sectoral links and cross-impacts of various initiatives, and to ensure from the onset consistency of rules under different EU regimes. Also, the timelines for adopting Level 2 measures and implementing new rules at national level should be set with a realistic view on the relevant challenges.

Based on our work and the practical experience of our members, we would like to point to the following problems stemming from the interaction of EU provisions governing capital markets and their participants:

Rules affecting the ability of the economy to finance itself and grow

1. **Unnecessary regulatory constraints on financing:** The following rules can be perceived as obstacles to the ability and willingness of institutional and retail investors to finance the economy:

    - Narrow definition of professional investors under AIFMD/MiFID

    The definition of professional investors under AIFMD which is derived from the MiFID framework does not sufficiently consider certain categories of institutions. In particular, entities such as foundations, charities, national providers of pension schemes, church organisations or family offices are generally not able to qualify as professional clients because they either lack personnel skilled in financial matters or cannot present a sufficient history of direct trading activities significant in size and therefore, do not fulfill two of the relevant criteria in Annex II section II.1. of MiFID II. As a consequence, these investors which generally favour long-term engagements are in most cases deprived of the possibility to exploit investment opportunities available to professional investors. In Germany, these investors have been granted access to professional AIFs at national level on the basis of them being classified as "semi-professional". A similar approach applies in Luxembourg where professional AIFs are open to "well informed investors", a group that does not only comprise professional investors according to MiFID but also other institutions and experienced investors.

[1] BVI represents the interests of the German investment fund and asset management industry. Its 92 members manage assets of some EUR 2.6 trillion in UCITS, AIFs and assets outside investment funds. As such, BVI is committed to promoting a level playing field for all investors. BVI members manage, directly or indirectly, the assets of 50 million private clients over 21 million households. BVI's ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en.

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However, under the current rules, they are not able to benefit from the marketing passport under the AIFMD and to choose from EU-wide suitable investment opportunities e.g. with focus on infrastructure or SME financing which are mainly set up for professional investors. On the other hand, professional AIFs admitting "semi-professional" investors under national law have to struggle with additional burdens such as i.e. the application of the PRIIPs regime and the requirement to produce a PRIIPs KID.

We believe that the introduction of a new EU category of "semi-professional" investors in the AIFMD or ultimately in the MiFID framework could broaden the professional investor base and further diversify the supply of funding to long-term projects in the EU. In our view, such new investor category should be modelled along the lines of EuSEF/EuVECA Regulations which inter alia impose a minimum investment amount for investments by other than professional investors[2]. We also think that introduction of "semi-professional" investors in the ELTIF framework would eliminate the legal uncertainty concerning the treatment of this investor category which up to now has only been reflected in a recital to the Level 1 Regulation[3].

- Unfeasible conditions for marketing of ELTIFs to retail investors

The ELTIF Regulation imposes additional requirements for marketing of units to retail investors. While we understand the general concerns and agree with many of the safeguards to be in the interest of investor protection, we perceive the 10 percent threshold for the aggregated portfolio of retail investors with a portfolio not exceeding Euro 500,000 as a critical impediment to the market success of ELTIFs. It is hardly conceivable how the ELTIF manager or a distributor shall ensure that it obtains full and complete information on the overall financial portfolio of retail investors. Given this uncertainty, the rules bear significant liability risks for the manager or the distributor despite the legislator's intention in the trilogue to reduce such risks, since they will also be subject to interpretation under national civil law. These unresolved issues considerably reduce the attractiveness of retail marketing and may discourage management companies from setting up ELTIFs altogether.

We believe that the mentioned requirement is of no additional value to investors. The ELTIF regulation already provides for sufficient safeguards such as internal governance procedures to assess whether the ELTIF is suitable for marketing to retail investors and rules which require an appropriateness test in cases of direct marketing. In addition, MiFID II strengthens the general standards of investor protection and provides for appropriate safeguards for the whole range of products (including ELTIFs) in case of third party distribution.

- Planned rules regarding investment research under MiFID II

According to the current proposal on treatment of investment research under MiFID II, it is only acceptable for an investment manager to receive research if the asset manager pays for research either (i) out of its own resources (e.g. after accordingly increasing the management fee) or (ii) from a separate research account which is funded by a specific charge based on a fixed budget not linked to the volume and/or value of transactions and allocated as fairly as practicable to the various clients' portfolios.

[2] Cf. Art. 6(1) of Regulation (EU) 345/2013 and Regulation (EU) 346/2013 respectively.
[3] Cf. recital 42 of Regulation (EU) 2015/760.

The proposal raises concerns in terms of potential unintended consequences, i.e. that the amount of research will decrease which will possibly result in reduced research coverage especially of SMEs and impair pricing of financial instruments. In addition, it is unclear how an asset manager could comply with the proposal if some of his clients do not agree to a specific research charge or if in particular non-EU brokers still deliver research without specific prices. Furthermore, the proposal provides for many details – in particular the research payment account – which impose a significant burden but are not required to achieve so-called unbundling. Swedish asset managers have separated transaction costs from research costs without using a research payment account but simply by way of expenses.

We suggest that the envisaged MiFID II delay should be used to consult with market participants on possible solutions regarding bundled payments which allow the market to uphold existing compensation models while addressing the regulatory concerns.

- Treatment of investment funds under the CRR/LCR framework

In the Capital Requirement Regulation (CRR) investment funds face some serious operational problems when it comes to the recognition under the Liquidity Coverage Ratio (LCR). Specifically, CRR stipulates that shares and units in investment funds may be treated as liquid assets provided that the fund as such invests solely in liquid assets, namely Level 1 or/and 2 assets ("full liquidity provision"). In practical terms this means that already a small portion of the fund portfolio which is not classified as Level 1 or 2 assets triggers a complete disqualification of a fund under the CRR. The rationale behind the full liquidity provision is that, given the collective nature of a fund, investors in a fund which is not entirely composed of liquid assets may be deprived of the liquidity portion if a co-investor decides to redeem his units. Such scenario, however, cannot happen if and as long as the fund has only one investor, as is the case with so-called "one-investor-funds". "One-investor-funds" are dedicated vehicles such as German "Spezialfonds" tailored to the individual needs of one institutional investor, e.g. a credit institution. They constitute a common and successful product not only in the German investment market. In case of a "one-investor-fund", the liquidity portion in the fund's assets is entirely available to the (only) investor. In our view, this justifies recognition of the liquidity portion for LCR purposes, even if the portfolio is not entirely 'liquid', but also comprises illiquid assets.

The current CRR approach entails the need for significant restructuring of the existing investments. The addition of illiquid assets to the portfolio of a "one-investor-fund" is common market practice in order to enhance both risk diversification and yield opportunities. If such funds needed to be restructured in order to achieve recognition of their liquidity portion, the costs thereof would ultimately have to be borne by the investor. Such costs are likely to be unaffordable for smaller credit institutions, which would hence need to withdraw from a risk diversified and profitable investment.

In order to remedy this situation, the CRR should be modified and should allow for the recognition of high quality liquid assets in a fund portfolio via a "look through" approach even in a case where such fund portfolio consists also of illiquid assets. This exemption should be limited to a scenario where an investment fund has only one investor. Given that the "full liquidity provision" also forms part of the Commission Delegated Regulation to supplement Regulation (EU) 2015/61, we furthermore strongly recommend revising the Commission Delegated Regulation.

2. **Investor and consumer protection:** In our view, the main area of concern is the persisting disequilibrium between the standards of investor protection applying to securities and insurance distribution. In addition, some requirements to be introduced under MiFID II might actually impair effective protection of EU investors:

- Alignment of distribution rules under MiFID II and IMD II

Investors buying securities investment products are already today protected by requirements for cost disclosure and quality standards for distributors remunerated by commissions received from product providers. This regime of investor protection will be significantly strengthened under MiFID II by requiring comprehensive disclosure of all costs and charges and by further tightening the conditions for allowing commission payments to distributors. In the context of the PRIIPs initiative, it has been generally acknowledged[4] by the EU institutions that distribution of all investment products in the retail market, regardless of whether they are sold in a securities or an insurance wrapper, should be subject to equal conduct of business rules in order to effectively protect European investors. Notwithstanding this commitment which has been explicitly enshrined also in the MiFID II legislation[5], the risk that the IDD framework recently agreed by the EU institutions will substantially fall behind the MiFID II standards has still not been banned. IDD redefines the rules for distribution of insurance-based investment products and thus represents a key element of a sound EU investor protection regime. Specifically, there is still uncertainty in relation to the following provisions:

- It is unclear whether legitimacy of inducements will be assessed against the same criteria by financial and insurance distribution channels. The conditions for payment or reception of inducements have been phrased in a different manner under IDD requiring that a fee, commission or a non-monetary benefit "does not have a detrimental impact on the quality of the relevant service to the customer"[6].
- While cost information standards under IDD and MiFID II are pretty similar and apply to all costs and charges at both product and service level[7], it is unclear whether distributors of insurance-based investment products shall disclose third-party payments and other inducements on separate terms as required under MiFID II.

Furthermore, standards for insurance investment advisors marketing themselves as independent have been deleted from the final IDD text and left to the discretion of the Member States which effectively prevents alignment with the MiFID II rules on independent advice.

Against the backdrop of the CMU initiative, we would like once again to call upon the EU institutions to work towards equal standards of investor protection at the point of sale and in particular, to further align these essential standards of good conduct of business in the upcoming work on Level 2 measures under IDD.

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[4] Cf. recitals 1 to 5 of the PRIIPs Regulation (Regulation (EU) No 1286/2014).
[5] Cf. recital 87 of the MiFID II Directive (Directive 2014/65/EU).
[6] Cf. Art. 29 para. 2 (a) of the IDD (text as adopted by the Council). In contrast, MiFID II provides that inducements must be designed to enhance the quality of the relevant service to the client.
[7] Cf. Art. 24 para. 4 (c) and last subparagraph of MiFID II, Art. 29 para. 1 (c) and the following subparagraph of IDD.

- Stronger focus on investor protection in the complex products debate under MiFID II

The MiFID regime classifies certain products as complex in order to prohibit their sales by way of execution-only. However, the notion of complexity has recently been subject of many debates at Level 2 and 3 which overall indicate that complex products shall be burdened with additional requirements for assessing their suitability to investors. Against this background, ESMA's stance to treat all AIFs as complex products without the possibility to assess the individual product's features in a complexity test as manifested in its technical advice on MiFID II from December 2014 is unconceivable from our point of view. The term "AIF" is very broad and also includes highly regulated retail funds. Hence, a consequence of ESMA's position would be that investment funds which are comparable to UCITS in that they observe rules on eligible assets and investment limits, provide for risk diversification and redemption rights for investors, where the issuer is regulated and the product is approved for marketing to retail investors and protected from the issuer's insolvency would be considered complex and subjected to stricter suitability testing whereas other products such as listed shares or bonds would be considered non-complex even though they tend to be less suitable for retail investors as single investments due to the higher concentration and liquidity risk.

Example: *The German fund law permits so-called mixed funds*[8] *which are retail products allowed to invest in units or shares of other retail AIFs in addition to the UCITS catalogue of eligible assets. According to ESMA, these mixed funds would necessarily qualify as complex products, even though their structure and portfolio/liquidity profile is generally very similar to UCITS. In the first place, this means that German "mixed funds" would not be eligible for "execution-only" services. However, "mixed funds" could also be disadvantaged against "simple" products such as shares or plain-vanilla bonds when providing investment advice due to the suitability criteria to be applied by investment advisors as described above even though they offer risk diversification and other relevant features of investor protection.*

Instead of being generally treated as complex products, AIFs should be assessed against the complexity criteria to be endorsed by Level 2 measures under MiFID II in order to avoid an unjustifiable bias in the AIF distribution.

- Access to professional investment advice

In order to encourage more retail investments in capital markets, we deem it crucial to ensure that European investors retain meaningful access to professional investment advice. Given the complexity and the great variety of product available as investment options in the retail market, we fear that the EU citizens' willingness to invest could further decrease should their ability to obtain professional advice at reasonable cost be curtailed. Shrinking coverage by advice could have negative repercussions for both the level of retirement savings by EU citizens and their engagement in financing the EU economy. Thus, commission-based advice models representing established channels of providing investment advice services to the mass retail market should be upheld under the MiFID II regime in line with the EU legislator's decision for a competition of systems at Level 1. In addition, the regulatory requirements applying to investment advice must remain feasible in the day-to-day retail business. This pertains in particular to the conditions for suitability testing and the statement on suitability to be provided to clients under MiFID II. In light of the German experience with the "advice minutes" (Beratungsprotokoll) which is a national

[8] Gemischte Investmentvermögen, cf. §§ 218 and 219 of the German Capital Investment Code.

equivalent to the suitability statement, we see a serious risk of banks withdrawing from the advice business in case of overly burdensome regulation.

Hence, we call upon the Commission and ESMA to ensure that the regulatory regime for investment advisors at Level 2 and 3 of MiFID II remains practicable and commensurate in view of the need to warrant provision of advice to broad levels of population. This pertains in particular to regulatory provisions governing commission-based advice models and standards for the suitability statement to be provided to clients.

3. **Proportionality/preserving diversity in the EU financial sector:** In terms of proportionality, we see clear deficits in the sweeping definition of alternative investment funds under AIFMD which impedes further differentiation of fund types for regulatory purposes at EU level. The restrictive approach to the reuse of cash from repo transactions under the ESMA Guidelines for UCITS is also disproportionate from our perspective.

- Definition of AIFs hampers reasonable distinction of fund types

The term “alternative investment fund” or “AIF” which determines the scope of application of the AIFM Directive is very broad and covers basically every collective investment vehicle not authorised as UCITS. In consequence, AIFs cannot be perceived as a uniform fund category. On the contrary, the variety of fund solutions formally classified as AIFs is very broad and ranges basically from retail funds regulated and supervised in a UCITS-equivalent manner, but with a somewhat different investment focus (e.g. on real estate) to highly leveraged hedge funds or specialised closed-ended funds investing e.g. in infrastructure or private equity. In Germany, a lion’s share of the open-ended AIF market (roughly 92%) is attributable to “Spezialfonds” which are regulated and supervised investment vehicles dedicated to professional investors. “Spezialfonds” manage mostly funds of institutional investors such as insurance undertakings, pension schemes and other providers of pension solutions and thus are the operational backbone of occupational pensions in Germany. They currently account for over 1.3 trillion of assets under management[9].

Moreover, AIF types vary not only depending on their investment strategy, but also with regard to the level and quality of their regulation. The AIFM Directive which aims at regulation of AIF managers does not prevent product-specific rules for AIFs to be applied at national level. As a consequence, many Member States have retained their national fund rules when implementing the AIFMD. In Germany, for instance, rules governing AIFs and their managers are part of the Capital Investment Code (KAGB) which represents an integrated legal framework for investment funds covering also UCITS. Under the KAGB, open-ended retail AIFs are submitted to UCITS-equivalent rules on investment restrictions and diversification of assets. “Spezialfonds” are generally required by regulation to comply with the UCITS framework concerning eligible assets and investment limits, unless investors request specific modifications due to their particular needs. A large portion of “Spezialfonds” sticks to the UCITS rules in their product set-up.

Notwithstanding these facts, in the public perception AIFs are still being equated with hedge funds. This way of thinking also affects regulatory actions at the EU level. For instance, the proposal for the Banking Structural Reform (BSR) tabled by the Commission aims at prohibiting investments in AIFs based on the argument that systemically important banks could circumvent restrictions on proprietary trading by investing in hedge funds. The draft EBA Guidelines on limiting exposures by

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[9] 1,341 billion as of 31 October 2015; source: BVI statistics (http://www.bvi.de/en/statistics/).

banks to shadow banking entities have been another example of a blanket treatment of AIFs. Under these draft Guidelines, all AIFs regardless of their investment strategies, applied leverage and the level of regulation or supervision were meant to be classified as shadow banking entities.

Practical implications: *A potential consequence of the draft EBA guidelines would have been the withdrawal of small banks from investing in AIFs, because they would not have been able to cope with the risk management approach foreseen for exposures to shadow banking entities. However, small banks such as mutual and savings banks in Germany have generally no sufficient own expertise in capital markets and therefore need "Spezialfonds" investments in order to diversify their risk portfolios which generally bear local risks resulting e.g. from mortgage loans or credits granted to local companies.*

Due to these experiences, we see a clear necessity to facilitate further distinction of the AIF universe based either on investment strategies or on the level and quality of regulation. In our view, this issue should be taken into consideration in the upcoming review of the AIFMD framework to which we will be happy to make substantial contributions in due course.

- Unequal treatment of market participants regarding clearing obligations under EMIR

Pension funds have been granted a temporary exemption from clearing obligations under EMIR due to their perceived lack of liquidity. This exemption has recently been confirmed and extended by the Commission[10]. UCITS' access to liquidity is also severely constrained due to the ESMA Guidelines on ETFs and other UCITS issues. According to these Guidelines, UCITS are prohibited from reusing cash obtained through repo transactions for the purpose of collateralising positions arising from OTC derivative trades[11]. Apart from repos, UCITS' access to liquidity is severely constrained since UCITS are under the contractual obligation towards investors to invest their monies in accordance with the relevant investment strategy. Nonetheless, UCITS do not benefit from a comparable exemption in relation to the central clearing.

In our view, the use of cash from repos for the purpose of collateralising centrally cleared derivative transactions does not entail any additional risk for the fund and its investors compared e.g. to deposits with credit institutions which are admitted as reuse of collateral under the ESMA Guidelines. Therefore, UCITS should be allowed to use cash obtained through repo transactions for the purpose of collateralising other transactions subject to central clearing (cf. also our comments in section 10 below).

Unnecessary regulatory burdens

4. **Excessive compliance costs and complexity:** In these terms, we can point to several areas in the need of regulatory attention:

- Duplication of reporting/disclosure requirements for asset managers under SRD II

The SRD II proposal adds another layer of regulation (e.g. reporting / disclosure requirements) for asset managers although similar rules are already included in the AIFMD and UCITS frameworks.

[10] http://europa.eu/rapid/press-release_IP-15-3643_en.htm?locale=en.
[11] Cf. para. 42, 43 letter j) of the ESMA Guidelines on ETFs and other UCITS issues as amended on 1 August 2014 (ESMA/2014/937).

For instance, the SRD II proposal requires asset managers to set up an engagement policy for their relationship with investee companies. This requirement, however, partly duplicates the existing duties of asset managers under AIFMD and UCITS Directive particularly in relation to the exercise of voting rights and the management of conflicts of interest. The same applies to the proposal to include reporting requirements for asset managers to specific institutional clients where both the AIFMD and UCITS Directive require client reporting on the same or similar subjects such as investment activities and portfolio turnover costs, but with different content in detail.

If further rules regarding asset managers are necessary, these should be integrated in the AIFMD and UCITS framework. Any rules for asset managers within the SRD II should be aligned with the AIFMD and the UCITS framework in terms of wording and identical duties should be incorporated by reference. In addition, asset managers should be allowed to integrate information to be disclosed and reported according to SRD II within the existing reports according to AIFMD and the UCITS Directive.

- <u>Procedural difficulties for refunding of withholding tax in cross-border situations</u>

It has been widely acknowledged that claiming withholding tax relief under Double Taxation Agreements and/or a country's domestic tax laws especially for investment funds is in practice often cumbersome and time- and resource-intensive for governments, financial institutions and foreign portfolio investors. As a result, end investors are often effectively forced to forego the tax relief due to them which has adverse effects not only for the investor, but also for the source country (due to its reduced ability to attract investments) and the residence country (due to its lack of information about the income of its residents or the excessive foreign tax credits it may have to provide). In our experience the process for claiming withholding tax relief has deteriorated over time in many countries, resulting in increased costs and protracted delays for cross-border portfolio investors to obtain tax relief. The types of burdensome procedures being increasingly faced by investors include:

- extensive, non-standardised documentation requirements, often for each income payment;
- the need to hire local counsel to pursue relief procedures;
- requirements for residence country tax administrations to provide certificates tailored to requirements of the source country;
- unclear or unreasonably complicated requirements for withholding tax relief on payments to investment funds, contrary to the OECD's recommendations; and
- lack of effective refund procedures.

Where the complexity and cost of obtaining the tax relief to which an investor is legally entitled are too great, full withholding at the maximum tax rate is often the outcome. Even though financial intermediary have access to accurate customer information and are subject to high compliance regulation standards, obtaining tax relief to which its customers are entitled is often not practicable. This outcome discourages cross-border investments and thus undermines the objectives of the CMU initiative. In addition, it can also contribute to the erosion of the investor's residence country tax base in the absence of mechanisms ensuring that information about the investor's income is conveyed to his home country tax administration.

In 2011 the Commission already consulted on taxation problems that arise when dividends are distributed cross border to portfolios and individual investors and asked for possible solutions. Due to specific problems for investment funds to achieve cross border treaty relief

(unknown investor base), our favoured solution to solve the problem - also presented as one possible option by the Commission - was to generally abolish withholding tax (WHT) on cross border dividend payments. An alternative approach was to impose an EU-wide limit on the WHT-rate equal to the rate foreseen in double taxation treaties which is 15%. These options should be again considered in the context of the CMU initiative.

- <u>Doubled burden for UCITS as regards investor information</u>

The PRIIPs Regulation stipulates a temporary exemption from scope for UCITS and other retail investment funds which provide a UCITS-like KIID according to national rules[12]. The underlying reason for this exemption has been the EU legislator's intention to spare these funds from additional costs after the efforts of introducing the UCITS KIID only a few years ago[13].

Nevertheless, under the current ESAs' drafts for regulatory technical standards to the PRIIPs Regulation, UCITS will be effectively required to produce investor information conforming to the PRIIPs rules. This is due to the fact that the ESAs expect insurance undertakings offering multi-option investment products such as unit-linked insurance contracts to produce specific PRIIPs KIDs on each individual investment option. Since the insurance undertaking offering a unit-linked insurance contract will not be capable of producing such information on each underlying fund, it will refer to the fund provider for assistance and request delivery of the relevant information elements. As a consequence, many fund management companies will be effectively compelled to set up internal projects in order to provide their business partners from the insurance sector with PRIIPs-compliant figures on the synthetic risk indicator, performance scenarios and costs.

Such elements should in principle be delivered well ahead of the entry into force of the PRIIPs Regulation in order to enable insurance companies to produce PRIIPs KIDs on unit-linked insurance products by 31 December 2016. Since the specific standards for multi-option PRIIPs (so-called MOPs) were not discernible before publication of the draft RTS in November 2015, most fund providers have not yet assigned specific budgets and set up no business projects for PRIIPs implementation. If needed to be made up in the short term, such projects would probably entail disproportionately high costs. **In any case, it is utterly inappropriate to assume that of all things fund providers shall be ready for the PRIIPs regime going live well ahead of its formal implementation date even though they manage the only sort of PRIIPs for which a temporary exemption from scope applies.**

Furthermore, we deem it questionable whether such outcome was envisaged by the EU legislators or even is covered by the Level 1 text. Article 6(3) of the PRIIPs Regulation stipulates that in case of MOPs "the key information document shall provide at least a generic description of the underlying investment options <u>and state where and how more detailed pre-contractual information documentation relating to the investment products backing the underlying investment options can be found</u>." In our view, this wording does not imply provision of a PRIIPs KID on each underlying investment option. On the contrary, when combined with Article 32 it should be read as allowing the provision of the UCITS KIID as pre-contractual information on any UCITS or AIF benefitting from the exemption under Article 32.

Therefore, we urge the Commission and the ESAs to reconsider the proposed approach to the treatment of multi-option PRIIPs under the PRIIPs Regulation having regard to the EU

[12] Article 32 of the Regulation (EU) No 1286/2014 (PRIIPs Regulation).
[13] Cf. recital 35 of the PRIIPs Regulation.

legislator's deliberate choice to spare investment funds providing a UCITS-like KIID from the duty to implement new information standards by end 2016. Should the approach remain unchanged, we request postponement of the entry into force of the PRIIPs Regulation in order to facilitate practical implementation of the PRIIPs standards for investment funds.

- Use of share classes by UCITS should not be inhibited

Share classes are essential tools for cost-efficient fund management in the European and global context. They allow fund managers to respond to the varying investors' needs relating to e.g. maximum/minimum investment amounts, types of fees and charges, denomination of currency, allocation of revenues etc. in a prompt and cost-efficient manner while maintaining a common management solution and offering the expertise of a particular fund manager to the whole fund. In particular, it is worth noting that creation of new share classes does not require new authorisation and thus involves no supervisory fees and lower set-up costs as compared to launching a new fund. Also, operating costs of large funds with different share classes are generally lower than costs of funds with low levels of assets under management (e.g. in terms of transaction costs). These efficiency gains in fund operations should not be curtailed without the evidence for misuse or other type of misconduct. Thus, while welcoming a common approach to the use of share classes by UCITS as envisaged by ESMA in its recent discussion paper[14], we caution against hampering the use of share classes for the efficient management of various investors' demands. In particular, we do not support the notion to ban the use of share classes offering additional hedging against certain types of market risk such as interest rate or volatility risk[15]. In our view, such restrictive approach is disproportionate in view of the high segregation and risk management standards prevailing in the market with regard to such separate hedging operations and the negative implications of a new fund launch as an alternative to setting up a share class.

***Example:** Provider of a UCITS investing in long-dated EU government bonds receives increased requests from investors/intermediaries for investment solutions offering protection against interest rate risk. The most efficient response to this request in terms of both costs and time-to-market would be to establish a new share class within the existing fund which would provide for duration hedging by means of a systematic risk overlay in addition to the general UCITS portfolio. In contrast, creation of a new fund with these features would trigger an authorisation process which can last for two months even in case of a complete application and an additional notification period of 10 working days should the fund be distributed cross-border.*

Therefore, we think that UCITS managers should be allowed to respond to their investors' requests for different degrees of protection against some elements of market risk such as interest rate or volatility risk by setting up customised share classes of a UCITS instead of being required in each case to launch a new fund.

[14] Cf. ESMA Discussion Paper "Share classes of UCITS" from 23 December 2014 (ESMA/2014/1577).
[15] Cf. ESMA Discussion Paper "Share classes of UCITS", para. 9-11.

5. Reporting and disclosure obligations:

- Streamlining of reporting requirements in terms of definition of data standards and formats

In the aftermath of the financial crisis several new or enhanced reporting requirements have been imposed upon asset managers and the broader financial sector. These pertain to individual transaction data on the one hand and to positions and their inherent risks on the other hand.

The applicable and pending requirements for **transaction-level reporting** under EMIR, MiFID II/ MiFIR and SFT Regulation display considerable differences in terms of reporting details, reporting channels, data repositories and applicable IT standards. The same pertains to the **regulatory reporting** on positions and risks required under AIFMD, UCITS Directive and the future MMF Regulation as well as to **reporting obligations for institutional investors** under Solvency II/CRR which require delivery of data and further support services by asset managers. In addition, reporting is often insufficiently standardised which causes significant problems in the collection of data as currently experienced under AIFMD and EMIR.

The threatening jumble of different data standards and formats presents a huge burden for the industry in both operational and financial terms and impedes efficient supervision concerning in particular systemic risks. Enhancing consistency of regulatory reporting is therefore badly needed in order to enable the regulators to use the stored data for the purpose of detecting systemic risk and to keep the administrative burden for market participants at a reasonable level. Moreover, there is also an urgent need for stronger integration in technological terms. The use of common reporting channels and standardised IT formats would enable regulators to better utilise the loads of submitted information for supervisory purposes, especially for the prompt detection of systemic risk, and might entail cost savings for market participants such as fund management companies which may run into millions of Euros.

As a starting point of discussion, data standardisation along the whole value chain should be based generally on ISO 20022. Overall we believe that ISO 20022 offers the best potential for cost-effective and future-proof implementation. It has a strong methodology and model for defining and structuring financial data, and an open governance process that ensures a level playing field for standardisers and users. It also offers expert international scrutiny of submitted content. ISO 20022 is now being implemented in a growing number of markets, which results in increasing opportunities for automation and interoperability (e.g. MiFID II/MiFIR).

Furthermore, we urge the EU-Commission to ensure that regulatory reporting requirements are accompanied by practical implementation deadlines which allow all market participants to implement new regulatory obligations on time. Lessons should be learned from the practical experience with EMIR reporting obligations where the lack of sufficient implementation time combined with legal and operational uncertainty due to undefined ESMA standards have significantly hampered the ability of the market to timely implement the relevant technical specifications. We fear that the MiFID II/MiFIR implementation will suffer from similar shortcomings given that the technical details of the reporting provisions are still being contentiously debated by the EU institutions and ESMA.

In consequence, we would welcome a stronger and efficient integration of regulatory reporting obligations relating to both transaction and position data. In our view, the Commission should launch an initiative for stocktaking of the existing reporting rules, including those awaiting implementation under the pending EU initiatives, and on this basis,

should develop a regulatory approach to streamlining of the reporting requirements in terms of data standards and formats.

- Provision of UCITS KIID to professional investors

The UCITS Directive requires UCITS management companies to produce a key investor information document (UCITS KIID) for each managed UCITS regardless of whether the specific fund is meant to be distributed to retail investors. Similarly, the obligation to provide a UCITS KIID is not limited to retail distribution, but applies to any fund marketing activity. As a consequence, UCITS managers are under the obligation to produce a KIID for funds set up for professional investors only and/or to provide the KIID to professional investors wishing to buy fund units even though it contains simplistic information designed for the retail public. In our view, these requirements are excessive since professional investors have generally no interest in the concise product factsheet which is the KIID, but require more detailed information which often needs to be tailored to their specific needs. The PRIIPs Regulation takes these circumstances into account by making the duty to produce a key information documents (PRIIPs KID) conditional upon the product being made available to retail investors[16]. Furthermore, the obligation to provide the PRIIPs KID applies only in case of advice or sale services to retail investors[17].

Therefore, we suggest aligning the UCITS rules on production and provision of the KIID with the new standards introduced by the PRIIPs Regulation.

6. Rules outdated due to technological change:

- Increasing efficiency of investor communication

In view of the technological progress and the increased use of electronic communication devices, we believe that the legal requirements for providing information to investors should be put under closer scrutiny. For example, the UCITS Directive and the PRIIPs Regulation still consider provision of the investor information document in paper as the standard case while requiring additional safeguards for the use of a website as an information tool[18]. Provision of the key information with interactive features or in a more interactive way, e.g. by means of a mobile app, is generally considered not sufficient to meet the legal requirements, even in cases the investor agrees and even though it would be more engaging for the younger generation of investors used to deal with their personal matters on mobile devices.

Moreover, the UCITS Directive gives Member States significant leeway in determining how relevant information needs to be provided to investors. Under AIFMD, conditions for informing the existing investors are not at all specified and generally determined by the national product regimes. As a result, different standards and practices can be observed at national level. In Germany, for instance, fund providers are in many events required to inform investors by means of a durable medium. This applies in particular in cases of suspensions of redemptions of fund units or shares, terminations of fund administration, amendments to the fund rules which (1) relate to fees and expenses, (2) are not compatible with the present investment principles or (3) otherwise affect substantial rights of the unit holders[19]. However, information via a durable medium is very expensive and onerous, since the fund

[16] Cf. Art. 5(1) of the PRIIPs Regulation.
[17] Art. 13(1) of the PRIIPs Regulation.
[18] Cf. Article 38(2) of Regulation (EU) 583/2010 (UCITS KIID Regulation, Article 14(5) of the PRIIPs Regulation.
[19] Cf. §§ 298 para. 2 for UCITS, 299 para. 5 for AIFs marketed in Germany to retail investors.

manager is generally not able to identify investors in a retail fund and needs to rely on banks administering the securities accounts to comply with the information requirements.

Example: *A UCITS which is domiciled in Luxembourg and marketed in Germany, France, Belgium, Austria and some other Member States makes amendments to its investment strategy. In these circumstances, the fund manager needs to establish in each jurisdiction (1) which requirements the applicable national law imposes on the respective information of investors and (2) what interaction with the local distributor network is necessary in order to fulfill these requirements. Since provision of a durable medium to several thousands of investors involves significant costs, the issue of cost reimbursement is also quite relevant.*

The EU Commission should investigate how the increased use of electronic communication tools could be utilised in order to ease the financial and administrative burden of providing information to investors. As a prerequisite, legal provisions governing investor information should be harmonised at least under the UCITS Directive which is generally used as a model for national regimes applicable to retail AIFs.

7. **Barriers to entry:** The following weaknesses of the EU regulatory framework for financial services and markets have the potential of inhibiting cross-border investments in the EU.

   - Insufficient harmonisation of shareholder transparency rules

   The EU Transparency Directive still allows for national divergences regarding information about major shareholdings and related sanctions. In Germany, for instance, the initial threshold for notification of major holdings is set at the acquisition of 3% of voting rights[20], even though the mandatory initial threshold at EU level is set at 5%. Other Member States have adopted similar or even more radical modifications to the EU transparency regime. For asset managers and institutional investors with an EU-wide investment perspective, such inconsistencies in the notification rules amount to a clear impediment for investing cross-border, since they must fear to be temporarily deprived of their voting rights and in some countries such as Germany of their entitlement to dividend payments in case of non-compliance[21]. In addition, the applicable jurisdiction depends on the home member state of the issuer. Where the information on the home member state is available, however, differs between member states. Hence, the process to access this information is complex.

   The EU rules on shareholder transparency should provide for a coherent regime without any room for local deviations. Further, ESMA should set up databases for both the thresholds applicable in each member state as well as the home member state of issuers.

   - Lack of harmonisation in relation to marketing requirements for investment funds

   In order to facilitate cross-border fund distribution, it is very important to introduce smooth and standardised processes and to avoid as much as possible national regulations gold-plating the EU rules on marketing. This is of particular importance in relation to the functioning of the EU passports since additional requirements in this regard act as deterrents for middle-sized and smaller fund managers to offer their products cross-border. Currently, the modalities of UCITS marketing and

[20] Cf. § 21 para. 1, first sentence of the German Securities Trading Act (WpHG).
[21] In Germany, persons are not only deprived by law of their shareholder rights for the period of non-compliance in case of incorrect or omitted notifications but also of their entitlement to dividend payments, cf. § 28 WpHG.

dealing with redemption requests/other payments to investors are subject to diverging national requirements under Art. 91(3) of the UCITS Directive. In this regard, some Member States require identification of a local financial institution as a paying agent who satisfies redemption requests and makes other payments to investors. This requirement which is not foreseen by the UCITS Directive significantly increases marketing costs of UCITS in the relevant jurisdictions. An extensive harmonisation of product-related marketing rules and further bundling of supervisory competences at the fund manager's home Member State authority has also the potential of reducing costs and thus should enhance the economic appeal of cross-border distribution. Similar issues pertain to the marketing of AIFs which is also generally submitted to the rules of the relevant host Member State[22].

As regards UCITS, it is generally questionable why they should at all undergo the notification process for cross-border marketing. If a UCITS has been authorised in one Member State in accordance with the harmonised rules of the EU UCITS regime, it would be only consequent to allow for its marketing in the entire EU without the need to transmit further documentation to the home authority which in turn has to submit this information to the national authority of the home member state. This process necessarily delays any marketing activities by at least two weeks[23]. In addition, fund managers should not be required to notify the host member state authority of any changes to the fund documentation prior to their implementation[24].

In consequence, we see the case for further harmonising the marketing standards for investment funds making use of the EU passports for marketing their units cross-border. In terms of UCITS, the possibility of waiving the notification process altogether should be investigated with the perspective of introducing a truly unified Single Market in the longer term.

Interaction of individual rules, inconsistencies and gaps

8. **Links between individual rules and overall cumulative impact:** We see multiple interactions especially in the remuneration rules introduced under different pieces of EU law which overall amount to a huge practical burden for the affected market participants. There are also detriments arising from interactions between the clearing requirements under EMIR and the restrictive approach to repos under the UCITS Directive.

   - Multiple and diverging remuneration rules for asset managers

   Management companies offering services and products under different sectoral remuneration requirements such as UCITS Directive[25], AIFMD[26] and MiFID[27] are legally required to comply with

[22] Cf. Annex IV h) of Directive 2011/61/EU (AIFM Directive).
[23] Cf. Art. 93 (3) subpara. 2 of the UCITS Directive.
[24] Cf. Art. 93 (8) of the UCITS Directive.
[25] Management companies licenced as UCITS managers fall under the remuneration requirements set out in Article 14a and 14b of the UCITS V Directive and under the proposed ESMA guidelines on sound remuneration policies under the UCITS Directive.
[26] Management companies licenced as AIF managers fall under the remuneration requirements set out in Article 13 and Annex II AIFMD and under the ESMA guidelines on sound remuneration policies under the AIFMD (Ref.: ESMA/2013/232).
[27] UCITS management companies or AIFM providing MiFID services of individual portfolio management or non-core services such as investment advice (within the meaning of Article 6 paragraph 3a and b of the UCITS

three different sets of rules with regard to remuneration of their personnel. In particular, it is a common practice that all of these services are provided jointly within an entity by specialised management teams. Thus, it is very common for management companies to have management teams for e.g. European corporate bonds, North American or South-East Asian equities which then provide their services to all AIFs, UCITS and individual portfolios focusing on these markets. In Germany, we are not aware of any management company which separates employees by legal structure of the managed products, e.g. UCITS employees and AIF employees. In most situations the affected employees need to be remunerated according to AIFMD, UCITS and MiFID rules in parallel. Applying all these rules within one employment contract is barely possible. Therefore, we expressly support ESMA's proposed approach to align the guidelines for remuneration of both UCITS and AIF managers[28]. It is important that consistent remuneration requirements apply to investment management companies which manage both UCITS and AIF. Moreover, we are in favour of the approach that only the AIFMD/UCITS remuneration guidelines should apply or should be qualified as more effective for aligning the interest of the relevant employees with those of the clients in case of management companies performing MiFID services such as individual portfolio management or investment advice.

In this context, we are concerned about EBA's interpretation that certain staff members of subsidiaries not subject to the CRD (such as management companies within the meaning of the AIFMD or the UCITS Directive) should also be required to fulfil the CRD remuneration requirements which significantly differ from the remuneration requirements under the AIFMD and UCITS Directive. AIF or UCITS management companies neither perform services regulated under CRD, nor are they bound by remuneration standards applicable to the banking group.

MiFID services provided by investment firms which directly fall within the scope of the CRD such as portfolio management, investment advice or execution of orders on behalf of clients must be legally distinguished from the services provided by management companies. MiFID investment firms are required to comply with the remuneration rules under CRD and MiFID II. These investment firms can be also appointed as managers under a delegation agreement with regard to the portfolio management of these investment funds in full or in respect of certain segments (e.g. European corporate bonds, North American or South-East Asian equities) of an investment fund. Since the services provided by such investment firms are comparable to the services provided by management companies within the meaning of the AIFMD or UCITS Directive, it is important that also an equal remuneration regime applies to these investment firms. In particular, there is a need for a close cooperation between ESMA and EBA in drafting the future guidelines on sound remuneration policies under Article 74(3) and 75(2) of Directive 2013/36/EU and disclosures under Article 450 of Regulation (EU) No 575/2013 presented by EBA in its consultation paper (Ref.: EBA/CP/2015/03).

We are in favour of applying only one single and consolidated set of remuneration guidelines to all asset managers, irrespective of whether they are management companies licenced under UCITS Directive or AIFMD, or investment firms holding a MiFID licence.

Directive and Article 6 paragraph 4a and b of the AIFMD) are required to comply also with the MiFID remuneration rules stated by ESMA in its guidelines on remuneration policies and practices (MiFID) (Ref: ESMA/2013/606).

[28] As suggested by ESMA in its draft Guidelines on sound remuneration policies under the UCITS Directive and AIFMD from 23 July 2015 (ESMA/2015/1172).

- UCITS guidelines limit access to cash for collateralisation of centrally cleared transactions

UCITS' access to liquidity for the purpose of collateralising derivative transactions is currently gravely inhibited due to the ESMA Guidelines on ETFs and other UCITS issues. According to these guidelines, the purchase price of a repo contract shall be treated as collateral in itself and may not be reused or reinvested by the fund[29]. Since clearing banks accept only a limited range of non-cash collateral (not included in the portfolios of all UCITS), liquidity demand in UCITS will increase with the broader application of EMIR. However, the ESMA Guidelines deprive UCITS of the main liquidity source, as short-term borrowing is only allowed up to 10% of the fund's NAV and generally being used for handling fund redemption requests. Moreover, UCITS are generally not able to use cash inflows from investors as collateral, since they are contractually obliged to invest these inflows in accordance with the relevant investment strategy.

In our view, the use of cash from repos for the purpose of collateralising centrally cleared derivative transactions does not entail any additional risk for the fund and its investors compared e.g. to deposits with credit institutions which are admitted as reuse technique under the ESMA Guidelines. Therefore, UCITS should be allowed to use cash obtained through repo transactions for the purpose of collateralising other transactions subject to central clearing.

9. Definitions:

- Diverging concepts of marketing/private placement in the EU financial services frameworks

The current Prospectus Directive[30] as well as the proposed Prospectus Regulation[31] require a prospectus in case of a public offer while allowing for certain specified exemptions (e.g. an offer to fewer than 150 non-qualified investors). In contrast, the AIFMD requires a marketing notification for any offering or placement of fund units at the initiative of the AIFM[32] and provision of information similar to a prospectus before investors invest in fund units[33]. This disequilibrium in marketing opportunities discriminates against AIFs especially when it comes to a non-public offering to a limited number of professional investors. Moreover, depending on their structure, closed-ended funds might need to comply with both EU frameworks and hence deal with different understandings of placements for the same marketing activity.

> ***Example:*** *A structured note on the S&P 500 index may be offered to investors on a cross-border basis without the need to produce a prospectus as long as the offer reaches no more than 150 non-qualified investors in each EU Member State. In contrast, an AIF investing in the S&P 500 securities is bound in any case to undergo a marketing notification and to produce a prospectus-like information document. This applies also to non-public offering to a limited number of professional investors.*

European law should provide for a coherent concept of a private placement regime throughout all regulation related to offers or placements of financial instruments. The proposal for a Prospectus Regulation tabled by the Commission acknowledges that in

[29] Cf. para. 42, 43 letter i) and j) of ESMA Guidelines on ETFs and other UCITS issues (ESMA/2014/937).
[30] Cf. Art. 3 para. 1 and 2 prospectus directive (Directive 2003/71/EC).
[31] Cf. Art. 4 para. 1 and 2 in connection with Art. 1 para. 3 of the draft prospectus regulation.
[32] Cf. Art. 4 para. 1 lit (x) in connection with Art. 31 para. 2 of the AIFMD (Directive 2011/61/EU).
[33] Cf. Art. 23 para. 1 of the AIFMD (Directive 2011/61/EU).

certain circumstances the regulatory requirement of a prospectus is disproportionate. This should equally pertain to investor information required under AIFMD in case of fund unit placements especially in light of the strict regulation applicable to the product provider.

10. **Overlaps, duplications and inconsistencies:** Potentially detrimental overlaps, duplications and/or inconsistencies can be found in the following areas of the EU financial services framework:

- Duplication of reporting/disclosure requirements for asset managers under SRD II

The SRD II proposal adds another layer of regulation (e.g. reporting / disclosure requirements) for asset managers although similar rules are already included in AIFMD and UCITS framework. For instance, the SRD II proposal requires asset managers to set up an engagement policy for their relationship with investee companies. This requirement, however, partly duplicates the existing duties of asset managers under AIFMD and UCITS Directive particularly in relation to the exercise of voting rights and the management of conflicts of interest. The same applies to the proposal to include reporting requirements for asset managers to specific institutional clients where both the AIFMD and UCITS Directive require client reporting on the same or similar subjects such as investment activities and portfolio turnover costs.

If further rules regarding asset managers are necessary, these should be integrated in the AIFMD and UCITS framework. Any rules for asset managers within the SRD II should be aligned with the wording within the AIFMD and UCITS framework and identical duties should be incorporated by reference. In addition, asset managers should be allowed to integrate information to be disclosed and reported according to SRD II within the existing reports according to AIFMD and the UCITS Directive.

- Transparency standards for benchmark providers do not match the information needs of benchmark users

The level of transparency in relation to benchmarks as determined in the final compromise on the EU Benchmark Regulation achieved in the trilogue negotiations[34] is not sufficient for investment funds and other users of indices to comply with their obligations under EMIR and MiFID/MiFIR. Asset managers are themselves subject to extensive transparency requirements and conditions if using financial indices as benchmarks especially under the ESMA Guidelines on ETFs and other UCITS issues[35]. In light of the growing importance of indices and growing transparency requirements, including the regulatory reporting on an underlying index by the end users as foreseen in the EMIR and MiFID/MiFIR transaction reporting, it is necessary to impose corresponding transparency requirements upon index providers in order to enable index users to comply with the regulatory requirements. This pertains in particular to the availability of clear summary information on the index objectives and its key construction principles, complete information on the index construction and calculation methodology and historical data on constituents and weights. In this context we strongly support the ESMA assessment[36] related to the transparencies for alternative indices that index providers have to provide investors with a tool box of methods, data, constituents and weightings allowing the investor to replicate both the index construction and also the simulated/historical performance.

[34] http://data.consilium.europa.eu/doc/document/ST-14985-2015-INIT/en/pdf.
[35] Cf. para. 56 to 62 of the ESMA Guidelines on ETFs and other UCITS issues (ESMA/2014/937).
[36] Cf. http://www.esma.europa.eu/system/files/2015-esma_rd_01_2015_527.pdf.

In view of the final compromise, we urge the EU institutions to review and - if possible - reinstall Article 16 on data transparency in the final Level 1 text or alternatively, to provide for a possibility to introduce the necessary transparency standards by Level 2 measures.

- Problematic approach to the target market definition under MiFID II

  The MiFID II regime requires the definition of a target market by product manufacturers and distributors taking into account the risk and reward profile and charging structure of a product[37]. Similar obligations will be imposed on insurance undertakings and distributors under the new IDD[38]. Currently, there is significant uncertainty relating to the specific criteria for identifying the target market of a product and different industry initiatives have been launched at national level in order to develop a common understanding on the concept of the target market.

  Current discussions within the industry on a national level show that the target market concept has the potential to significantly change the retail distribution landscape. In order to avoid unintended consequences and additional barriers for cross-border distribution, the following actions are essential:

  - Overall, a common approach to identification of the target market would be necessary since (1) many products are distributed cross-border and by different distribution channels which should be able to rely on the same description of the target market by the product manufacturer and (2) the target market specification at the manufacturer's level shall be disclosed in the PRIIPs KID according to the draft RTS currently consulted by the ESAs[39].
  - The approach to determining a target market has to be feasible in practice and should allow for implementation by all distribution channels legitimated by MiFID II, including execution-only distribution. Any attempts to introduce target market criteria which effectively anticipate a suitability test on a client incumbent only in case of investment advice must be rejected as impracticable in terms of non-advisory distribution. In particular, for non-complex products eligible to be sold via execution-only services, the target market must be set very broadly in order not to hamper the provision of these services which in accordance with MiFID II do not require any information on personal circumstances to be collected from the client.

  In addition, it should be clear that the manufacturer of a specific financial product cannot provide for a target market definition which takes into account investors' portfolio structures comprising many different investments.

Example: *A UCITS (say, a bond or an equity fund) can be sold to investors on their initiative through execution-only services. When using the execution-only channel, the distributor are not obliged to obtain any information from the potential client, but is allowed to proceed with the purchase order as requested. If the target market criteria were to imply collection of personal information e.g. on the investment objectives, knowledge and experience or risk tolerance of a client, distribution of non-complex products via execution-only would be no longer possible.*

Therefore, we urge the Commission to work together with the ESAs and the market participants towards a viable concept of the target market which should allow for straightforward implementation. For financial instruments that are deemed non-complex for

[37] Cf. Art. 24 para. 2 of the Directive 2014/65/EU.
[38] Cf. Art. 25 of the IDD (as adopted by the Council).
[39] Cf. Joint Consultation Paper on PRIIPs Key Information Documents from 11 November 2015, Article 4(3) of the draft RTS.

the purpose of execution-only services, the target market should be defined as the mass retail market in order to account for the effective lack of personal information in the execution-only distribution as admitted by the MiFID II legislator.