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FEFSI FUND FORUM

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"Management of Conflicts of Interest - Is there a 'European Way'?"

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Ladies and Gentlemen,

First of all, I would to thank FEFSI for offering CESR the opportunity to elaborate upon its activities in the field of investment management to date. Following this overview, I will inform you about: the start-up and priorities for our Expert Group in investment management, the need to upgrade the UCITS Directive, a survey on malpractices and conclude with the issue of governing conflicts of interest.

CURRENT STATE OF THE EUROPEAN FUND INDUSTRY

At first I would like to share with you the latest developments in the European fund industry. After some very difficult years and a fall in prices of net assets of the European investment funds by 6.4% in 2002, last year was a strong year of recovery with a growth of 12.3% to all-time high of □4.818 billion. The figures for the first half of this year also show a solid growth of 7.1% to total assets of □5.158 billion. The second quarter was, however, quite difficult with a modest growth of 0.8% reflecting uncertainty in the growth of the global economy following, amongst other things the strong increase in oil prices.

In comparison to last year, the move of net inflows to equity funds and balanced funds instead of fixed-income funds, tells about the still recovering trust of fund investors towards the equity

markets. The stock market recovery and the historically low level of interest rates have undoubtedly encouraged investors to seek better returns in equity-based funds.

Regarding the fund products, I must say it will be very interesting to see how hedge funds, the popularity of which has been increasing significantly during the last few years of bear markets, will cope with the recovering market situation, in comparison to the traditional asset management, especially if the growth of the markets strengthens significantly. In a recent survey on the state of credit risks transfer, based upon a mandate given to CESR, the BSC and CEIOPS by the Economic and Financial Committee, CESR has noted that the involvement of UCITS in the CRT-market is still modest, possibly due to the very recent liberalisation of the regulatory regime.

ESTABLISHMENT OF THE CESR EXPERT GROUP ON INVESTMENT MANAGEMENT

In October 2003 CESR published a consultation paper on the future role of CESR in the regulation and supervision of UCITS and asset management in the EU. The responses to the consultation were all in all very supportive for CESR to start working on this area. The CESR meeting in Dublin in December 2003 decided to set up an expert group on Investment Management. The intention is that this Group should cover the whole so-called "buy side" and not to concentrate solely on investment funds, which explains the name of the Group. This Expert Group will deal with the broad area of investment management, as well as individual asset management and collective portfolio management, the latter one including both harmonised investment funds (UCITS) and non-harmonised funds.

Having taken into consideration the supportive responses of the European asset management industry to our consultation, CESR has now established the infrastructure to work in this area.. In March we strengthened the resources of the CESR Secretariat by recruiting a new permanent member of the Secretariat specialising in investment management issues. In April of this year, the Expert Group on Investment Management, chaired by Mr Lamberto Cardia Chairman of the Italian securities regulator, CONSOB, started its work,. A Consultative Working Group composed of market practitioners and consumers was also appointed to provide technical advice to the Expert Group.

PRIORITIES IN INVESTMENT MANAGEMENT

The CESR meeting in Amsterdam on 3th-4th June approved a mandate and working programme for the Expert Group. It was decided that the short-term priority for the Group will be to focus on ensuring that the single market on investment funds is fully functional. We are well aware of the practical problems the implementation of the so-called UCITS III is causing to the European asset management industry, particularly cross-border fund registrations, because of differing interpretations and practises relating to the transitional provisions of the amendments to the UCITS

Directive. CESR is currently drafting **guidelines for supervisors** to solve these practical transitional problems and questions received from the industry, such as "Can a grandfathered UCITS I management company launch passportable UCITS III funds?", "Can a passportable UCITS I sub-fund be launched in a grandfathered UCITS I umbrella fund?", "Must a UCITS I fund have a simplified prospectus available to maintain its registration?" etc.

In June of this year we published a Call for Evidence, along with the mandate of the Expert Group, to receive feedback on our working programme. The responses were again supportive, but asking us to provide the guidelines before our indicated deadline of March 2005. We will do our best to prepare the guidelines as soon as possible, even though I have to confess that the issues are not easy to solve, taking also into account all the different legal structures of UCITS operating in Europe. We have made good progress, but there is still work to be done. You will have a chance to comment on our draft in the public consultation, hopefully starting in October.

Another priority issue for CESR is the **clarification of some key definitions** of the UCITS Directive. It is anticipated that in October CESR will receive a so-called Level 2 mandate in this area from the European Commission asking CESR to advise the Commission on the implementing measures to be included in the UCITS Directive. This task will be to clarify in which financial instruments UCITS can invest their assets. The main open issues include: investments of UCITS to money market instruments, structured securities, index funds and non-harmonised funds.

CESR observed earlier this year with great interest the work of the Asset Management Forum Group, which evaluated, for the European Commission, the status of the European regulation on asset management. The CESR Expert Group took on board many issues raised in the report in its working programme on investment management, naturally within the limits of the competences granted to CESR. One example of this is the **simplification of the registration procedure** for UCITS, which the Forum Group identified as one of the key barriers to efficient cross-border fund distribution. CESR therefore intends streamlining fund registration procedures of national regulators by developing consistent standards for the registration requirements foreseen by the UCITS Directives.

A further example of the work foreseen relates to **non-harmonised funds** which at present are not able to benefit from the single market. CESR hopes to contribute here by making an inventory of the non-harmonised collective investment schemes marketed throughout Europe and then drafting a common approach to non-harmonised funds (hedge funds, real estate funds, private equity funds and also in relation to the specificities of closed-end funds).

By the end of the year 2005 CESR will also work on the **conduct of business rules in collective investment management and outsourcing**. As you know the consultation period for our first draft advice under the MiFID Directive ended last week. On the basis of this advice we will consider at a

later date whether it is necessary to develop specific rules for collective investment management on Level 3, so in co-operation among the regulators.

CESR will also work on the clarification of the **interaction between the several relevant EU Directives** (UCITS, MiFID, E-Commerce, Distance marketing) to facilitate cross-border marketing of UCITS, and will prepare draft guidelines for supervisors by early 2006. In addition we will work to ensure the convergence of supervisory systems in the different jurisdictions aiming to have more efficient and effective communication between regulators and also to have a more consistent regulatory response to issues that might arise.

So you see we have a very ambitious agenda for our work on investment management. This also means that in the near future we will have continuous dialogue with the industry via CESR consultations on the various projects in their various stages. I encourage you to continue giving us feedback on our proposals, it is vital to guarantee the quality of our work.

UPGRADING THE UCITS DIRECTIVE

Regarding the institutional aspects of CESR's work on investment management I have to confess that we faced difficulties in structuring our work because of the framework of the current UCITS Directive. This Directive, as it stands, even after the latest amendments, is not yet a real Lamfalussy Directive. It includes a number of rigid details and the scope of comitology is very limited. Due to these limitations the outcome of CESR's work on UCITS will mainly be of Level 3 nature, while regarding the content of our work it should normally be on Level 2 of the Lamfalussy process, so that CESR would be advising the Commission when it is preparing implementing measures.

From the positive experience of the adoption of the implementing measures under the first two directives following the Lamfalussy process, the Market Abuse and Prospectus Directives, and from our initial activities in the field of investment management, we believe that the sector of investment management would significantly benefit from adjusting the UCITS Directive to the Lamfalussy process.

CESR has therefore suggested to the Commission to initiate, as soon as possible, a full review of the structure of the UCITS Directive to adapt it to the Lamfalussy process. This would allow the regulatory system to exploit the full flexibilities offered by the process to address, in particular, the requirements of financial innovation and market changes. The revision of the UCITS Directive should also ensure full consistency with the rules applicable to the provision of investment services.

The Commission noted that a formal response to these suggestions can only be supplied by the new Commission after November 2004. Hopefully, the Commission's Regular report on the application of

the UCITS Directive in early 2005 will shed some light on this issue. In addition, the Commission noted that in case of a full "re-engineering of the UCITS Directive", other structural challenges facing the investment funds industry, like the facilitation of cross-border fund mergers and the removal of discriminatory tax barriers, should be taken into account as well, which have been for example addressed by the Asset Management Expert Forum Group and participants at the recent high-level conference on European Financial Integration.

In order to achieve a single market for asset management, the Asset Management Forum Group also suggested modifying the existing regulation so as to create a stand-alone pillar for asset management. CESR considers that the new legislation should aim at progressively dismantling inconsistencies in rules covering the products that serve the same economic functions across different market sectors which inhibit a real level playing field. An example may be perceived in asset management functions performed by insurance companies, pension funds, asset management companies and investment firms, which are all subject to different regulations at the moment. This means that all various legislative measures in the securities field markets of FSAP, which include in particular the Market Abuse Directive, Prospectus Directive, Transparency Directive, Market in Financial Instruments Directive, and after adjustment to the Lamfalussy process, the UCITS Directive, be brought together in one codification. In this respect, attention should be paid to the articulation between sectoral and horizontal directives in the field of customer protection. Past (E-Commerce Directive) and recent experiences (proposed Regulation on Consumer Protection Cooperation and proposal for the Directive on Unfair Commercial Practices) show how difficult and problematic it is to extend general provisions for consumer protection purposes to the financial services where the directives already provide for corresponding rules.

REPORT ON MALPRACTICES

I take this opportunity to inform you that CESR has decided to publish a summary report in October on the actions its members have taken to investigate the possibility of late trading or market timing type of abusive mispractises in the European investment fund industry. I can inform you that, broadly speaking, the conclusion is that CESR members have not at this stage found major evidence of mispractices concerning late trading or market timing. The investigations conducted have nevertheless revealed some issues for regulatory concern. The findings of the investigations relate, however, in most of the cases to failures and inadequacies in internal processes of some management companies rather than to the existence of major mispractices. In the Netherlands for example, no indications of market timing or large-scale late trading have been found but other shortcomings were revealed. Therefore, the AFM has set up a 'Committee for Modernising Collective Investment Schemes' headed by Jaap Winter as independent chairman. The Committee will issue an advice to the AFM by the end of 2004. The advice will hopefully bring forward various recommendations to rectify the shortcomings

in the Netherlands which may relate to the responsibilities of the market players, the supervisor and the legislator.

GOVERNING CONFLICT OF INTERESTS

The shortcomings revealed by the investigations of CESR members brings me to the issue of governance, and especially the governance of conflicts of interest in the investment funds industry. To my delight, FEFSI has recently published a Code of Conduct for the industry, stating the principles with regard to the integrity of the market. The Code of Conduct reflects clearly the objectives i) protection of investors and ii) ensuring that markets are fair, efficient and transparent which are of great importance for the financial market as a whole. In order to achieve these objectives, it is of great importance that situations of potential conflicts of interest are avoided as much as possible and, if not avoidable, properly managed and disclosed to investors.

Conflicts of interest or a lack of transparency in that respect can severely harm overall investor confidence in the transparency and the integrity of the market. It is prevalent to assess where conflicts of interest may arise and which kind of measures should be applied. The application of these measures should preferably be done on a cross-sectoral basis which will have the benefit of clarity, consistency, accessibility and immediacy. In this respect, we should keep in mind the important steps made concerning conflicts of interest in the field of the Market Abuse Directive.

In addition to these legislative measures, self-regulatory initiatives like the Code of Conduct of FEFSI are warmly welcomed. However, the conflicts of interest clause no. 12 in this code is of a general nature. The recommended rules and procedure with regard to conflicts of interest, but also on delegation, fund trading and investor information may not have the desired effect of governing conflicts of interest and equivalent issues in a better way. These principles lack specification as to which kind of conflicts need to be avoided, which conflicts need to be managed and in what form disclosure of conflicts is required. For example, in CESR's draft advice for consultation on the MiFID, it is stated that if conflicts of interest cannot be prevented by internal structural arrangements, the firm should disclose its conflicts of interest. This requires an assessment of the question what role can and should Chinese walls play within investment firms in addressing conflicts of interest. Taking into account the problems of analysts "crossing over the walls" in the past years, it can be questioned whether Chinese Walls substantially improve the prevention of conflicts of interest in full-service investment firms.

It is important to bear in mind as well that these issues need to be resolved in the broader spectrum of questions relating to the regulation of the integrity of the industry, the proficiency requirements for the management company and the role of investor education in addressing conflicts of interest. In addition, this means that the industry should elaborate on the effectiveness of the disclosure, for example the distinction between actual and potential conflicts and the disclosure of structural

arrangements within the firm. Furthermore, it requires further development of rules on trading, whereas the FEFSI's Code of Conduct principle now "discourages frequent trading, it should preferably answer the question what kind of trading is appropriate in what situation.

At the same time, regulators within CESR and IOSCO are thinking about similar questions, for example with regard to Credit Rating Agencies where maintaining the independence of Credit Rating Agencies vis-à-vis the issuers they rate is vital. Notwithstanding my comments, the work of FEFSI is highly appreciated and the Code of Conduct will be a useful tool for the further development of the rules for conduct of the investment funds industry on which, as I said earlier, CESR will work on by the end of 2005.

In the meantime, a continuous dialogue with you is essential to fulfil our ambitious agenda on investment management. So I hope we will meet again in the near future. Thank you.