Response to the Consultation from the European Commission on Undertakings for Collective Investment in Transferable Securities (UCITS) – Long-Term Investments

Reply of the European Federation of Financial Services Users (EuroFinuse)

18 October 2012

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EuroFinuse has experts participating in the Securities & Markets, the Banking and the Pensions Stakeholder Groups of the European Supervisory Authorities, and the EC Financial Services User Group. Its national members also participate in the national financial regulators and supervisors bodies when allowed. For further details please see our website: www.eurofinuse.org.

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Executive Summary

EuroFinuse, the European Federation of Financial Services Users welcomes this Consultation on UCITS and long-term investments from the European Commission. We will focus our response to the consultation on the part of long-term investments, which is of key interests to individual shareholders and retail investors which we represent.

The broader issue

The promotion of long-term investments is crucial in many ways: for the wellbeing of EU citizens - representing current or future pensioners who have to rely increasingly on the performance of their long-term and pension savings - and for the development of the EU economy and subsequently the creation of jobs. This is why **EuroFinuse believes the solutions for long-term investment envisaged by the European Commission** consultation published on 26 July 2012 on "*Undertakings for Collective Investment in Transferable Securities (UCITS) - Product Rules, Liquidity Management, Depositary, Money Market Funds, Long-term Investments*" **are insufficient to address the current situation**. EuroFinuse therefore proposes in its response to the consultation measures that bear far greater impact.

Individual investors are long-term oriented – "packagers" are not

EU individuals have and will continue to invest for the long-term. The problem is that individual investors have been pushed towards long-term "saving" instead of "investing". They thereby surrender investment decisions into underlying assets to financial intermediaries so called "agency" owners, who by large do not have a long-term vision. **The growing replacement of "economic" end-investors by "agency" investors and their underlying short-term behaviour has been identified in previous reports by EuroFinuse, and lately in the UK's "Kay Review" as one of the key issues that disconnect long-term end-investors from long-term invested assets**. The EU Authorities should not ignore the necessary reconciliation between long-term savings and medium- or short-term "packaged" investment products.

The EU framework for long-term savings announced by the EC five years ago has yet to materialise.

The issue of long-term savings and investments had been rightly identified by the European Commission over five years ago in its Green Paper on retail financial services, concluding that *"the EU framework needs to lay strong foundations for enabling a competitive, open and effective market for long-term savings, retirement and pension solutions that meet consumers' needs"*[1]. Unfortunately, until today the "PRIPs" Directive proposal of the EC excludes those long-

[1] Green Paper on Retail Financial Services in the Single Market, European Commission, April 2007 http://eur-lex.europa.eu/LexUriServ/site/en/com/2007/com2007_0226en01.pdf

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term investment products like shares, bonds and occupation-based private pension products from its scope.

More prominent measures are needed to effectively promote long term investments [2]

- For qualified investors this means back to basics. The discrimination of direct long-term investments such as bonds and shares (especially small and mid caps) at the point of sale should come to an end.

- For non-qualified investors (that make up the majority of investors) a necessary overhaul of incentives of asset managers and of distributors of "packaged" long-term products and provision of long-term value protection is needed.

Box 1 – Eligible Assets

(1) Do you consider there is a need to review the scope of assets and exposures that are deemed eligible for a UCITS fund?

(2) Do you consider that all investment strategies current observed in the marketplace are in line with what investors expect of a product regulated by UCITS?

(3) Do you consider there is a need to further develop rules on the liquidity of eligible assets? What kind of rules could be envisaged? Please evaluate possible consequences for all stakeholders involved.

(4) What is the current market practice regarding the exposure to non-eligible assets? What is the estimated percentage of UCITS exposed to non-eligible assets and what is the average proportion of these assets in such a UCITS' portfolio? Please describe the strategies used to gain exposure to non-eligible assets and the non-eligible assets involved. If you are an asset manager, please provide also information specific to your business.

(5) Do you consider there is a need to further refine rules on exposure to non-eligible assets? What would be the consequences of the following measures for all stakeholders involved?
- Preventing exposure to certain non-eligible assets (e.g. by adopting a "look through" approach for transferable securities, investments in financial indices, or closed ended funds).
- Defining specific exposure limits and risk spreading rules (e.g. diversification) at the level of the underlying assets.

(6) Do you see merit in distinguishing or limiting the scope of eligible derivatives based on the payoff of the derivative (e.g. plain vanilla vs. exotic derivatives)? If yes, what would be the consequences of introducing such a distinction? Do you see a need for other distinctions?

(7) Do you consider that market risk is a consistent indicator of global exposure relating to derivative instruments? Which type of strategy employs VaR as a measure for global exposure? What is the proportion of funds using VaR to measure global exposure? What would be the

[2] See page 19 for a list of suggested measures to be taken

consequence for different stakeholders of using only leverage (commitment method) as a measure of global exposure? If you are an asset manager, please provide also information specific to your business.

(8) Do you consider that the use of derivatives should be limited to instruments that are traded or would be required to be traded on multilateral platforms in accordance with the legislative proposal on MiFIR? What would be the consequences for different stakeholders of introducing such an obligation?

We believe it would be positive to restrict the trade of derivatives for UCITS funds to regulated markets and MTFs and not permitting them to conduct OTC transactions of derivatives. As pre-trade information will probably not be required in the MiFID II, UCITS fund managers should trade with derivatives on the most transparent and objective trading venues in order to guarantee the interest of fund holders.

Box 2 – Efficient Portfolio Management (EPM)

(1) Please describe the type of transaction and instruments that are currently considered as EPM techniques. Please describe the type of transactions and instruments that, in your view, should be considered as EPM techniques.

(2) Do you consider there is a specific need to further address issues or risks related to the use of EPM techniques? If yes, please describe the issues you consider merit attention and the appropriate way of addressing such issues.

(3) What is the current market practice regarding the use of EPM techniques: counterparties involved, volumes, liquidity constraints, revenues and revenue sharing arrangements?

(4) Please describe the type of policies generally in place for the use of EPM techniques. Are any limits applied to the amount of portfolio assets that may, at any given point in time, be the object of EPM techniques? Do you see any merit in prescribing limits to the amount of fund assets that may be subject to EPM? If yes, what would be the appropriate limit and what consequences would such limits have on all the stakeholders affected by such limits? If you are an asset manager, please provide also information specific to your business.

(5) What is the current market practice regarding the collateral received in EPM? More specifically:
- are EPM transactions as a rule fully collateralized? Are EPM and collateral positions marked-to-market on a daily basis? How often are margin calls made, and what are the usual minimum thresholds?
- does the collateral include assets that would be considered as non-eligible under the UCITS Directive? Does the collateral include assets that are not included in a UCITS fund's investment policy? If so to what extent?
- to what extent do UCITS engage in collateral swap (collateral upgrade/downgrade) trades on a fix-term basis?

(6) Do you think that there is a need to define criteria on the eligibility, liquidity, diversification and re-use of received collateral? If yes, what should such criteria be?

(7) What is the market practice regarding haircuts on received collateral? Do you see any merit in prescribing mandatory haircuts on received collateral by a UCITS in EPM? If you are an asset manager, please provide also information specific to your business.

(8) Do you see a need to apply liquidity considerations when deciding the term or duration of EPM transactions? What would the consequences be for the fund if the EPM transactions were not "recallable" at any time? What would be the consequences of making all EPM transactions "recallable" at any time?

(9) Do think that EPM transactions should be treated according to their economic substance for the purpose of assessment of risks arising from such transactions?

(10) What is the current market practice regarding collateral provided by UCITS through EPM transactions? More specifically, is the EPM counterparty allowed to re-use the assets provided by a UCITS as collateral? If so to what extent?

(11) Do you think that there is a need to define criteria regarding the collateral provided by a UCITS? If yes, what would be such criteria?

(12) What is the market practice in terms of information provided to investors as regards EPM? Do you think that there should be greater transparency related to the risks inherent in EPM techniques, collateral received in the context of such techniques or earnings achieved thereby as well as their distribution?

Not applicable to individual end-investors

Box 3 - OTC Derivatives

(1) When assessing counterparty risk, do you see merit in clarifying the treatment of OTC derivatives cleared through central counterparties? If so, what would be the appropriate approach?
(2) For OTC derivatives not cleared through central counterparties, do you think that collateral requirements should be consistent between the requirements for OTC and EPM transactions?

(3) Do you agree that there are specific operational or other risks resulting from UCITS contracting with a single counterparty? What measures could be envisaged to mitigate those risks?

(4) What is the current market practice in terms of frequency of calculation of counterparty risk and issuer concentration and valuation of UCITS assets? If you are an asset manager, please also provide information specific to your business.

(5) What would be the benefits and costs for all stakeholders involved of requiring calculation of counterparty risk and issuer concentration of the UCITS on an at least daily basis?

(6) How could such a calculation be implemented for assets with less frequent valuations?

Not applicable to individual end-investors

Box 4 – Extraordinary Liquidity Management Tools

(1) What type of internal policies does a UCITS use in order to face liquidity constraints? If you are an asset manager, please provide also information specific to your business.

(2) Do you see a need to further develop a common framework, as part of the UCITS Directive, for dealing with liquidity bottlenecks in exceptional cases?

We believe this issue should be tackled either as part of the UCITS Directive or through draft regulatory standards from the ESMA.

(3) What would be the criteria needed to define the "exceptional case" referred to in Article 84 (2)? Should the decision be based on quantitative and/or qualitative criteria? Should the occurrence of "exceptional cases" be left to the manager's self-assessment and/or should this be assessed by the competent authorities? Please give an indicative list of criteria.

We believe that those "exceptional cases" on which UCITS managers can temporarily restrict the redemption capacity of shareholders should be assessed and reviewed on a case-by-case basis by the national securities supervisors. In order to have a single EU-wide interpretation of this notion of "exceptional cases", ESMA should draft guidelines to be implemented by national supervisors. It is more appropriate that national supervisors assume this competency as they have a better understanding of national circumstances and can determine better the "exceptionality" of a case.

(4) Regarding the temporary suspension of redemptions, should time limits be introduced that would require the fund to be liquidated once they are breached? If yes, what would such limits be? Please evaluate benefits and costs for all stakeholders involved.

We believe that limits should be established to the temporary suspension of redemptions, and the liquidation of the fund should be required if the established time limits are breached. Exceptions should only be authorised by the national supervisor. The last-resort authorization from the national supervisor for additional delay of redemption to shareholders should be a sufficient guarantee for fund managers and for the continuity of the fund itself.

(5) Regarding deferred redemption, would quantitative thresholds and time limits better ensure fairness between different investors? How would such a mechanism work and what would be the appropriate limits? Please evaluate benefits and costs for all the stakeholders involved.

We are in favour of quantitative thresholds and time limits to establish objective limits that ensure fairness between different investors. In order to guarantee non-discrimination of UCITS holders throughout the EU, the ESMA should draft EU-wide technical proposals of guidelines to be implemented by national supervisors based on extensive discussions amongst relevant stakeholders.

(6) What is the current market practice when using side pockets? What options might be considered for side pockets in the UCITS Directive? What measures should be developed to ensure that all investors' interests are protected? Please evaluate benefits and costs for all the stakeholders involved.

Side pockets are a good mechanism to separate liquid from illiquid assets in UCITS funds, consequently reducing the risk of temporary suspension of redemptions. However, they entail a risk of abuse for shareholders if UCITS managers can arbitrarily restrict the capacity of redemption of shareholders. There were problems with side pockets of hedge funds in the USA after the financial crisis. At least, managers should be required to provide information on the existence of side pockets and the reasons for their existence.

(7) Do you see a need for liquidity safeguards in ETF secondary markets? Should the ETF provider be directly involved in providing liquidity to secondary market investors? What would be the consequences for all the stakeholders involved? Do you see any other alternative?

Individual investors are transacting ETFs primarily on the secondary markets. The liquidity of ETFs is therefore key for individual investors. At least two liquidity agreements between the issuer and professional markets makers should be required, and their essential terms (maximum bid/offer spread on which volume) be disclosed in the prospectus.

(8) Do you see a need for common rules (including time limits) for execution of redemption orders in normal circumstances, i.e. in other than exceptional cases? If so, what would such rules be?

Yes, there should be rules on best execution of shareholders' orders of redemption, similarly to those already in place for MiFID products.

Box 5 – Depositary Passport

(1) What advantages and drawbacks would a depositary passport create, in your view, from the perspective of: the depositary (turnover, jobs, organisation, operational complexities, economies of scale…), the fund (costs, cross border activity, enforcement of its rights …), the competent authorities (supervisory effectiveness and complexity …), and the investor (level of investor protection)?

(2) If you are a fund manager or a depositary, do you encounter problems stemming from the regulatory requirement that the depositary and the fund need to be located in the same Member State? If you are a competent authority, would you encounter problems linked to the dispersion of supervisory functions and responsibilities? If yes, please give details and describe the costs (financial and non-financial) associated with these burdens as well as possible issues that a separation of fund and depositary might create in terms of regulatory oversight and supervisory cooperation.

(3) In case a depositary passport were to be introduced, what areas do you think might require further harmonisation (e.g. calculation of NAV, definition of a depositary's tasks and permitted activities, conduct of business rules, supervision, harmonisation or approximation of capital requirements for depositaries…)?

(4) Should the depositary be subject to a fully-fledged authorisation regime specific to depositaries or is reliance on other EU regulatory frameworks (e.g., credit institutions or investment firms) sufficient in case a passport for depositary functions was to be introduced?

We believe that in order to conduct depository functions, firms should go through a specific authorisation procedure as depositaries maintain a key role in the EU financial architecture, and not rely on different regulatory frameworks.

(5) Are there specific issues to address for the supervision of a UCITS where the depositary is not located in the same jurisdiction?

Box 6 – Money Markets Funds

(1) What role do MMFs play in the management of liquidity for investors and in the financial markets generally? What are close alternatives for MMFs? Please give indicative figures and/or estimates of cross-elasticity of demand between MMFs and alternatives.
(2) What type of investors are MMFs mostly targeting? Please give indicative figures.

(3) What types of assets are MMFs mostly invested in? From what type of issuers? Please give indicative figures.

(4) To what extent do MMFs engage in transactions such as repo and securities lending? What proportion of these transactions is open-ended and can be recalled at any time, and what proportion is fixed-term? What assets do MMFs accept as collateral in these transactions? Is the

collateral marked-to-market daily and how often are margin calls made? Do MMFs engage in collateral swap (collateral upgrade/downgrade) trades on a fixed-term basis?

(5) Do you agree that MMFs, individually or collectively, may represent a source of systemic risk ('runs' by investors, contagion, etc…) due to their central role in the short term funding market? Please explain.

Money Market Funds may represent a source of systemic risk, especially in the short term funding market. However, since the ECB has started conducting a more expansionary short-term monetary policy by easing the access to short-term funding and by accepting a wider range of collaterals, short-term funding market systemic risks probably are or can become much lower.

(6) Do you see a need for more detailed and harmonised regulation on MMFs at the EU level? If yes, should it be part of the UCITS Directive, of the AIFM Directive, of both Directives or a separate and self-standing instrument? Do you believe that EU rules on MMF should apply to all funds that are marketed as MMF or fall within the European Central Bank's definitions?

EU regulation for harmonising MMFs would be positive. However, we believe that regulation for financial products commercialisation should be compiled in one single text in order to ensure the same degree of protection across the different substitutive products available at the point of sale. Any new rules on MMF should be inserted both in MiFID and AIFMD.

(7) Should a new framework distinguish between different types of MMFs, e.g.: maturity (short term MMF vs. MMF as in CESR guidelines) or asset type? Should other definitions and distinctions be included?

Box 7 - Valuation and Capital

(1) What factors do investors consider when they make a choice between CNAV and VNAV? Do some specific investment criteria or restrictions exist regarding both versions? Please develop.

(2) Should CNAV MMFs be subject to additional regulation, their activities reduced or even phased out? What would the consequences of such a measure be for all stakeholders involved and how could a phase-out be implemented while avoiding disruptions in the supply of MMF?

Any extra guarantees for investors would be welcomed especially for Constant Net Asset Value (CNAV) MMFs, provided they are substitute products for bank deposits and are offered at the point of sale as substitute investment products.

(3) Would you consider imposing capital buffers on CNAV funds as appropriate? What are the relevant types of buffers: shareholder funded, sponsor funded or other types? What would be the appropriate size of such buffers in order to absorb first losses? For each type of the buffer, what would be the benefits and costs of such a measure for all stakeholders involved?

(4) Should valuation methodologies other than mark-to-market be allowed in stressed market conditions? What are the relevant criteria to define "stressed market conditions"? What are your current policies to deal with such situations?

Box 8 - Liquidity and Redemptions

(1) Do you think that the current regulatory framework for UCITS investing in money market instruments is sufficient to prevent liquidity bottlenecks such as those that have arisen during the recent financial crisis? If not, what solutions would you propose?

There is room for improving the performance of MMF investing. We think that liquidity constraints are only one of the proposed measures that could work well.

(2) Do you think that imposing a liquidity fee on those investors that redeem first would be an effective solution? How should such a mechanism work? What, if any, would be the consequences, including in terms of investors' confidence?

We oppose the establishment of a liquidity fee to investors willing to redeem. It would prevent investors to invest in MMF and force them to look for other substitute investments. It does not tackle the performance of the managers, currently the main problem.

(3) Different redemption restrictions may be envisaged: limits on share repurchases, redemption in kind, retention scenarios etc. Do you think that they represent viable solutions? How should they work concretely (length and proportion of assets concerned) and what would be the consequences, including in terms of investors' confidence?

Redemption restrictions do not represent a viable solution. The only effect would be to prevent investors from investing in MMFs. MMFs are considered a very liquid instrument, so if obstacles to this liquidity are established investors would turn to other substitutive and more liquid investments.

(4) Do you consider that adding liquidity constraints (overnight and weekly maturing securities) would be useful? How should such a mechanism work and what would be the proposed proportion of the assets that would have to comply with these constraints? What would be the consequences, including in terms of investors' confidence?

Liquidity constraints are the only one of the proposed solution that would contributes to the purpose of guaranteeing MMFs' liquidity. If MMF managers are forced hold more liquid assets, the risks of lack of liquidity of the fund would be reduced.

(5) Do you think that the 3 options (liquidity fees, redemption restrictions and liquidity constraints) are mutually exclusive or could be adopted together?

If the aforementioned 3 options were adopted together the MMF market could collapse, especially if liquidity fees and redemption restrictions are put in place. Only liquidity constraints could contribute to the envisaged objective without the side effect of expelling investors from this market.

Box 9 - Investment Criteria and Rating

(1) Do you think that the definition of money market instruments (Article 2(1) (o) of the UCITS Directive and its clarification in Commission Directive 2007/16/EC) should be reviewed? What changes would you consider?

The CNAV MMFs should be clearly distinguished from other MMFs.

(2) Should it be still possible for MMFs to be rated? What would be the consequences of a ban for all stakeholders involved?

Yes, it should be possible for MMFs to be rated as they provide key information for investors. Investors would not invest in certain types of products without the comparable and easily accessible information provided by credit rating agencies (CRAs). We believe that the current problems of MMFs in relation to CRAs are caused by the inefficient performance of the credit rating market. By improving the functioning of the credit rating market and addressing existing market failures, the systemic risks CRAs can cause in the MMF market should decrease. Possible downgrades of MMFs would be timely and less severe, thereby smoothing the process and decreasing the risk of downgrading vicious circles. We certainly believe that the regulatory technical standards on CRAs proposed by the European Commission are a step in the right direction.

(3) What would be the consequences of prohibiting investment criteria related to credit ratings?

We do not think that restricting the possibility of MMF managers to invest only in assets holding a certain credit rating is appropriate. We think that the performance of the credit rating market is far from efficient. Therefore excessive reliance on credit rating should be avoided. The choice of products to invest in should be left to the MMF manager. If any restrictions have to be put in place for MMF asset management, we think that liquidity constraints are more appropriate for the aforementioned reasons.

(4) MMFs are deemed to invest in high quality assets. What would be the criteria needed for a proper internal assessment? Please give details as regards investment type, maturity, liquidity, type of issuers, yield etc.

Box 10 – Long-term Investments

The promotion of long-term investments is vital for the wellbeing of EU citizens as they present current or future pensioners who have and will have to rely increasingly on their long-term and pension savings and on their performance. Additionally, long-term investment is crucial for the development of the EU economy and the creation of jobs (SMEs are by far the biggest job generator in the EU). This is why we believe the solutions envisaged by the EC in this consultation are not of the required depth. We therefore propose significant measures that have a greater impact.

EU individuals have and will continue to invest for the long-term. The problem is that habits have changed as more often individual investors no longer “invest” but “save” for the long-term. They thereby surrender investment decisions into underlying assets to financial intermediaries, so called “agency” owners who by large do not have a long-term vision. The growing replacement of “economic” end-investors by “agency” investors and their underlying short-term behaviour has been identified in previous reports by EuroFinuse, and lately in the UK’s “Kay Report” as one of the key issues that disconnect long-term end-investors from long-term invested assets. The EU Authorities should not ignore the necessary reconciliation between long-term savings and medium- or short-term “packaged” investment products.

• The EU framework for long-term savings announced by the EC more than five years ago has yet to materialise

EuroFinuse would like to point out firstly, that the issue of long-term investments had been rightly identified by the European Commission more than five years ago in its Green Paper on retail financial services:

“Ageing populations and increasing pressure on public finances present clear challenges for consumers and investors, and are a new market for the financial industry. The EU framework needs to lay strong foundations for enabling a competitive, open and effective market for long-term savings, retirement and pension solutions that meet consumers' needs. The Commission has commissioned external research that will report at the end of 2007 on the current state and development of the market for retail long-term savings vehicles to help identify the range of products currently available, the main distribution channels and the influences on consumer choices. Building on this, the Commission will examine developments affecting the marketing of savings and retirement products together with arrangements governing their sale and recommendation.

Due to the nature of long-term savings and pension plans, particular care is needed to ensure that consumers are being offered products that are really adapted to their needs and marketed appropriately. These are major, once in a lifetime, financial decisions for consumers. Therefore, consumers must be in a position to make their choices in full knowledge of the product, correctly assessing their circumstances and needs.”

Unfortunately, an “EU framework” for long-term and pension savings has yet to come. The same fate has fallen upon the Commission’s examination of “*developments affecting the marketing of savings and retirement products together with arrangements governing their sale and recommendation*”, as even today the “PRIPs” Directive proposal of the EC excludes long-term investment products such as shares, bonds and occupational-based private pension products from its scope. Those latter products are also excluded from the Review of the MiFID and IMD Directives addressing sales and “advice” conduct of business rules.

• The growing replacement of “economic” end-investors by “agency” investors and their short term behaviour has been identified by many reports and studies

EuroFinuse’ response to the EC Green Paper on Pensions in 2010, the Public Consultation by the High Level Group on EU Banking Structures earlier this year, and the Kay Review of UK Equity Markets and Long-Term Decision Making commissioned by the British Government published last July all concluded:
- A growing disconnection between real, economic end-investors – individual investors in particular those who generally tend to be long-term oriented – and legal owners of securities (asset managers, professional traders, etc.) who establish a high turnover rate of their portfolios, do not bear the risks and rewards of long-term investments. Their interests are not aligned to those of the end investors.
- This disconnection is in turn magnified by the creation and push of “packaged” investment products in the retail markets over the last four decades, to the detriment of the sale and promotion of pure long-term investment products such as shares and bonds. As a result, the shares of individuals in the ownership of EU listed companies fell from about 50% to about 10%.
- Simultaneously, Solvency II has pushed many European insurers to reduce their investments in equity dramatically, and to push individual investors into highly packaged and commission –rich (sometimes three layers of fees) “unit-linked” insurance products, increasing again the disconnection between “agency” and “economic” owners.

(1) What options do retail investors currently have when wishing to invest in long-term assets? Do retail investors have an appetite for long-term investments? Do fund managers have an appetite for developing funds that enable retail investors to make long-term investments?

The currently offered range of long-term investment products for retail investors is in our view, unsatisfactory. Indeed, retail investors do have appetite for long-term investments because of the growing need to complement the occupational pension income. In general, all individual investors according to consumer surveys consider retirement as the main incentive for saving. The problem is that the range of products offered and “advised” by financial intermediaries is usually inappropriate:

- Those products entail an usually high portfolio turnover rate (typical for long active funds), and their long-term track record is most of the time non-existent or not communicated or communicated with bias[3];

- Those products are heavily invested in bonds instead of shares. This is typical for life insurance products which for example, is the number one private pension saving product in France and counts for about € 1400 billion in assets, of which more than 90% is invested in bonds (sovereign European bonds in particular). This is partly due to the obsolete risk weightings of Solvency II;
- Tax policies often favour short-term savings products, and penalize long-term and/or risky products ("livret A" sight savings accounts are fully tax exempt in France versus more than 100% taxes on real returns for life insurance income or long-term capital gains)
- Small and mid-cap investment has been increasingly discouraged by recent EU policies

a) Direct investments in enterprises/development projects

Pure and simple mid- and long-term investment products such as shares and bonds are no longer actively proposed or "advised" by financial intermediaries. The last four decades have seen the creation and development of "packaged" products in the retail investment markets. Nowadays, they are widely sold and advised to individual investors to the detriment of pure, simple products that connect directly individual investors to the issuers. While packaged products most often provide diversification and professional portfolio management, they are heavily charged with fees and commissions that harm their performance. Many reports[4] show that on average these products underperform the capital markets performances in the long run. The eviction of individual investors from long-term capital markets over the last four decades has very damaging consequences on the corporate governance of listed businesses: They hand over the legal share ownership to "agency" owners who are not the economic owners and who hold the shares for less than a year on average (turnover rate of EU domiciled long equity funds excluding index funds is over 100%). In turn, the average holding period of investment funds by individual investors is about three years at best. These practices have estranged EU citizens from their economy and enterprises.

It is very difficult to find funds with track records that are long enough to match retirement horizons (minimum 10 years, preferably 20 or 30). EuroFinuse has already

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[3] The "survivor" bias in particular : the only and few investment funds able to show a long term track record are those that survived, i.e. mostly if not only the best performing ones, the others having been dissolved or merged.

[4] For a very recent example please check Financial Times' article from 14th October 2012, "Fund selling is a 'rip off' – consumers"
http://www.ft.com/intl/cms/s/0/d3785f72-0e22-11e2-8d92-00144feabdc0.html#axzz29NUKdWKH
EuroFinuse's response to the European Commission's Green Paper on Pensions compares the performance and fees to clients of two UCITS funds (see pages 8 to 10)
http://eurofinuse.org/upload/positions/EuroInvestors%20reply%20to%20the%20Green%20paper%20towards%20adequate,%20sustainable%20and%20safe%20European%20pension%20systems1289909049.pdf

published ample analysis and evidence on these problems (e.g. our reply to the European Commission's Green Paper on Pensions[5], or our Reply to the Consultation from the High-Level Group on EU banking structures[6]).

We are concerned that this trend will increase further through the PRIPs Directive proposal from the EC, which excludes shares and bonds from the scope of retail investment products. By excluding them from the PRIPs scope they are not required to have a comparable, short Key Investor Document written in plain English. The current "summary prospectus" in the Prospectus Directive for shares and bonds is useless as a "key investor document". It is long, does not provide for comparison with other investment products and is not written in lay man's English. The PRIPs Directive as currently proposed is giving a further boost and a sort of "EC label" to the financial industry sponsored, commission – laden and short-term oriented "packaged" products.

We ask for:

1. **Shares and bonds** – which are real mid and long-term investment products to the direct benefit of the economy and job creation – **to be included in the scope of the "PRIPs" Regulation.**
2. **Increased dividend to be mandatorily granted by Law to shareholders holding their shares for two years or more**. This must go hand in hand **with a requirement for custodians to track the real owners of shares** (on this issue please consult our 2012 Report on Barriers to Shareholder Engagement). This should help getting individual investors back to the capital markets and reduce the importance of "agency owners" in General Meetings and Board rooms.
3. Some of our member organisations would even propose to **grant double voting rights to shareholders holding their shares for two years or more** in order to emphasize their role in General meetings in relation to "agency" owners. But other member organisations would prefer to stick to the "one share one vote" principle.
4. Some of our member organizations also propose to **set a record date well before the GA Meeting date** (for example up to one year) **to ensure only engaged shareholders can vote**, and to make it more difficult for shares' borrowers to vote (as typically they would borrow the shares for a very limited time).
5. **EU and national regulators should reduce the barriers to initiatives** similar to that by our Swedish member organisation Aktiespararna's, which has created

[5] http://eurofinuse.org/upload/positions/EuroInvestors%20reply%20to%20the%20Green%20paper%20towards%20adequate,%20sustainable%20and%20safe%20European%20pension%20systems1289909049.pdf

[6] http://eurofinuse.org/upload/positions/Liikanen%20Group%20Consultation%20EF%20reply%2030%2005%2020121338453136.pdf

investment funds **where the fund holder votes on the shares of the fund's portfolio**.

6. EU Authorities should explore the most cost effective means for individual investors to hold shares directly on an electronic register, as it is the case in certain Member States like Slovenia for example. This is also a recommendation of the Kay Review for the UK.

b) Investments via "packaged" long-term products

Regarding the majority of individual investors who do not have the financial literacy to directly buy shares or bonds, the market does not provide investment options that comply with what we believe is a basic requirement for long-term investment products for individual, small and not financially literate investors (i.e. the vast majority of EU citizens): at least protecting the value of their long-term savings against inflation. This need has been identified by the Australian Government[7].

<u>We ask for:</u>

1. **All private pension products to be included in the scope of this PRIPs Directive**. Currently, all non-mandatory occupational-based private pension products are excluded despite the above-mentioned EC commitments from 2007 to create a single framework for long term savings;
2. The EC, the ESAs and the national supervisors to **enforce MiFID rules on**:
   - **mandatory disclosure of "inducements"**; and
   - **a ban of inducements** as they evoke conflicts of interest (article 26 of MiFID I implementation Directive).

   For national supervisors, any intermediary not proposing shares and bond issues or any other long-term investment product without or with little inducements like ETFs in parallel to commission-based and supposedly "long-term" packaged products should raise suspicions of biased financial "advice" and illegal inducements.
3. **Extend these same rules to insurance and pensions sales (IMD and IORP)** which drive the majority of long-term and pension savings in Europe.
4. **Ban the practice of shared commissions between asset management firms and their custodians** (widespread in France) which are an incentive for asset managers

[7] The Australian Superannuation Guarantee; an occupational-based, defined benefits pension fund providing protection against inflation to the pension fund holders. For more information check Bateman,H and Piggott, J.: "Mandatory Retirement Saving in Australia". Annals of Public and Comparative Economics, Vol. 69 n.4, 1998 http://info.worldbank.org/etools/docs/library/76548/march2000/proceedings/pdfpaper/preliminary/bateman.pdf

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to increase the turnover of their portfolios.

5. **EU regulators should allow UCITS funds with non-daily requirements in terms of NAV and of subscriptions/redemptions specialised in long-term assets**. The KIID of these funds should clearly mention the minimum recommended holding period in addition to the risk level. The fund should commit to a low maximum turnover rate, and behave like an engaged investor (no "comply or explain" just "comply").
6. As previously proposed in our position paper on Shadow Banking, and as recommended by the UK's "Kay Review" **all income from stock lending should be disclosed and rebated to investors**.
7. **Taxation of savings and investments as a positive function of the duration and risk of real investment income** not the reverse.

c) Problems of one of the key long-term investment categories: private pension funds

1. **Lack of accurate information on funds' returns**. Past performance is not disclosed after inflation, and unlike for US mutual funds not disclosed after tax.
2. **Non-transparency of investment strategies of the pension funds** and other corporate governance related problems.
3. **Abuse of management and commercialisation fees**. This is one of the rare industries where the long-term growth and multiplication of products (there are currently about 35,000 investment funds in the EU) has not been accompanied with any significant reduction of fees and commissions.

Asset management has often no real incentives for developing long-term investment strategies, as their remuneration is not aligned to that purpose. **We welcome the approach of the European Commission's UCITS V proposal which tackles managers' remuneration issues**. We believe that asset managers' salaries should be aligned with the funds' long-term, risk-adjusted performance.

(2) Do you see a need to create a common framework dedicated to long-term investments for retail investors? Would targeted modifications of UCITS rules or a stand-alone initiative be more appropriate?

We believe in the need of distinguishing between short-term, speculative investment and long-term, engaged and responsible investment. It is the latter that has a bigger contribution to the economy in terms of bridging the gap between financial markets and the real economy.

We believe that integrating long-term distinction in regulatory frameworks that are currently in place is more appropriate. Creating a stand-alone initiative would probably bring more uncertainty for investors in a changing investment environment in Europe. It would be better to promote longer holding of currently established investment products, especially those that could be appropriate, for example UCITS funds.

The consideration of long-term investment for pension funds should come together with the harmonisation of taxation which is another demand of retail investors' advocates. This is especially important as EU savers today are facing the creation of new taxes and their rise in many Member States. This further discourages investors from making long-term investments for retirement provision.

(3) Do you agree with the above list of possible eligible assets? What other type of asset should be included? Please provide definitions and characteristics for each type of asset.

We believe the list of eligible assets (direct investments into unlisted companies, infrastructure projects, «real assets" and third-party managed funds making investment in unlisted companies) is much too narrow. It does not reflect the reality of retail long-term investment products or of the needs of a real European economy (see for example the financing of SMEs in Poland currently). The list should at least include listed shares and bonds in particular small and mid cap shares, which have been quite neglected by European Authorities in the recent years (for example the impact of the MiFID induced capital markets fragmentation on SME listings and transactions). If we want to develop retail investments in long-term assets, we need to have a minimum of standardization, transparency and liquidity.

Besides the mentioned list of assets, it is crucial to include private pension funds into the definition of "long-term investment". It would does not make sense to exclude those products typically held by the average retail investor for more than a decade. Other substitute retail investment products that are commonly used by retail investors in many Member States for the same purpose e.g. life insurance products, should also be covered under the definition of "long-term investment".

(4) Should a secondary market for the assets be ensured? Should minimum liquidity constraints be introduced? Please give details.

A secondary market for the assets is always desirable and would naturally appear after a new category of financial product is generalised among investors. MiFID promoted the fragmentation of capital markets and the proliferation of small and numerous trading venues (such as MTFs) which rarely quote small and mid caps, and to which retail investors do not have access.

(5) What proportion of a fund's portfolio do you think should be dedicated to such assets? What would be the possible impacts?

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(6) What kind of diversification rules might be needed to avoid excessive concentration risks and ensure adequate liquidity? Please give indicative figures with possible impacts.

(7) Should the use of leverage or financial derivative instruments be banned? If not, what specific constraints on their use might be considered?

(8) Should a minimum lock-up period or other restrictions on exits be allowed? How might such measures be practically implemented?

We do not believe in further restrictions on capital withdrawal to investors, as we believe this would only hinder their confidence in those newly established products. We believe in incentives for retail investors rather than punishment for early withdrawal except if the lock-up period is inferior or equal to the recommended holding period (see our proposal 1.b 4). A retail investor may be forced to withdraw a long-term investment for serious reasons such as illness or death within the family, something no one should be penalised for. Decreasing tax rates for longer holding periods is a solution already implemented for certain saving products in some Member States. A very reasonable approach if targeted at long-term portfolio assets. Harmonised legislation at EU level on savings tax has been the major request from retail investor advocates. This could be a good opportunity to tackle the issue although we are very aware that tax legislation is a matter of national law.

Box 11 - UCITS IV Improvement

(1) Do you think that the identified areas (points 1 to 4) require further consideration and that options should be developed for amending the respective provisions? Please provide an answer on each separate topic with the possible costs / benefits of changes for each, considering the impact for all stakeholders involved.

(2) Regarding point 5, do you consider that further alignment is needed in order to improve consistency of rules in the European asset management sector? If yes, which areas in the UCITS framework should be further harmonised so as to improve consistency between the AIFM Directive and the UCITS Directive? Please give details and the possible attached benefits and costs.

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ANNEX: EUROFINUSE DETAILED PROPOSALS TO PROMOTE LONG-TERM INVESTMENTS

a) Direct investments in enterprises/development projects

We ask for:

1. Shares and bonds – which are real mid and long-term investment products to the direct benefit of the economy and job creation – **to be included in the scope of the "PRIPs" Regulation.**

2. Increased dividend to be mandatorily granted by Law to shareholders holding their shares for two years or more. This must go hand in hand **with a requirement for custodians to track the real owners of shares** (on this issue please consult our 2012 Report on Barriers to Shareholder Engagement). This should help getting individual investors back to the capital markets and reduce the importance of "agency owners" in General Meetings and Board rooms.

3. Some of our member organisations would even propose to **grant double voting rights to shareholders holding their shares for two years or more** in order to emphasize their role in General meetings in relation to "agency" owners. But other member organisations would prefer to stick to the "one share one vote" principle.

4. Some of our member organizations also propose to **set a record date well before the GA Meeting date** (for example up to one year) **to ensure only engaged shareholders can vote**, and to make it more difficult for shares' borrowers to vote (as typically they would borrow the shares for a very limited time).

5. EU and national regulators should reduce the barriers to initiatives similar to that by our Swedish member organisation Aktiespararna's, which has created investment funds **where the fund holder votes on the shares of the fund's portfolio**.

6. EU Authorities should explore the most cost effective means for individual investors to hold shares directly on an electronic register, as it is the case in certain Member States like Slovenia for example. This is also a recommendation of the Kay Review for the UK.

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b) Investments via "packaged" long-term products

We ask for:

1. **All private pension products to be included in the scope of this PRIPs Directive**. Currently, all non-mandatory occupational-based private pension products are excluded despite the above-mentioned EC commitments from 2007 to create a single framework for long term savings;

2. The EC, the ESAs and the national supervisors to **enforce MiFID rules on**:

- **mandatory disclosure of "inducements"**; and
- **a ban of inducements** as they evoke conflicts of interest (article 26 of MiFID I implementation Directive).

For national supervisors, any intermediary not proposing shares and bond issues or any other long-term investment product without or with little inducements like ETFs in parallel to commission-based and supposedly "long-term" packaged products should raise suspicions of biased financial "advice" and illegal inducements.

3. **Extend these same rules to insurance and pensions sales (IMD and IORP)** which drive the majority of long-term and pension savings in Europe.

4. **Ban the practice of shared commissions between asset management firms and their custodians** (widespread in France) which are an incentive for asset managers to increase the turnover of their portfolios.

5. **EU regulators should allow UCITS funds with non-daily requirements in terms of NAV and of subscriptions/redemptions specialised in long-term assets**. The KIID of these funds should clearly mention the minimum recommended holding period in addition to the risk level. The fund should commit to a low maximum turnover rate, and behave like an engaged investor (no "comply or explain" just "comply").

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