alfi association of the luxembourg fund industry

Luxembourg, 23 February 2015

Response to IOSCO consultation on cross-border regulation

Introduction

The Association of the Luxembourg Fund Industry (ALFI) is the representative body of the Luxembourg investment fund community. Created in 1988, the Association today represents over 1300 Luxembourg domiciled investment funds, asset management companies and a wide range of service providers such as custodian banks, fund administrators, transfer agents, distributors, legal firms, consultants, tax experts, auditors and accountants, specialist IT providers and communication companies.

We thank IOSCO for the opportunity to participate in this consultation on cross-border regulation.

We support the submission of the European Fund and Asset Management Association (EFAMA).

Response to the consultation

Cross-border regulation and the various tools described in IOSCO's consultation report are of particular importance for the Luxembourg fund industry because it is the largest fund domicile in Europe and a worldwide leader in cross-border distribution of funds. Over time, the experience and services offered in the area of cross-border fund administration and distribution emerged as key factors explaining the choice of Luxembourg for the domiciliation of global fund houses. Today, Luxembourg-domiciled investment structures are distributed on a global basis in more than 70 countries with a particular focus on Europe, Asia, Latin America and the Middle East.

Unilateral Recognition

The success of Undertakings for Collective Investment in Transferable Securities (UCITS) as well as the brand recognition they have were not achieved through mutual recognition outside the European Union, but rather through unilateral recognition aiming to facilitate cross-border activities in financial services. However, distribution in this sense is simply impossible if a country is not willing to open its market to foreign investment vehicles, no matter how high e.g. the product standards or level of investor protection really are.

Non-UCITS do rarely benefit from the same recognition, although the Alternative Investment Fund Managers Directive (AIFMD) in Europe has recently introduced a harmonised framework for managers of alternative investment funds (regulating indirectly the funds themselves) which could lead to a rethinking.

UCITS in particular were able to develop to a true brand, as they are allowed for distribution by many jurisdictions worldwide. The same success is hoped to become a reality for European alternative investment funds and their managers due to the high quality standards that have lately been introduced.

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We think the most significant obstacle in terms of cross-border marketing of collective investment schemes in non-European countries is the overlapping of responsibilities of regulators involved; especially, the respective definitions, scope of activity, eligibility of investors and the tax environment are not harmonised and inevitably create costs and regulatory conflicts or cause duplications that undermine the efficiency of cross-border distribution.

Mutual Recognition

In case of mutual recognition, competences and responsibilities belong only to the regulator of the jurisdiction in which the collective investment scheme or its manager is domiciled. Therefore, we believe a certain level of regulatory convergence is a pre-requisite (in fact for both mutual recognition and passporting). The respective national bodies consequently need to be equipped with equivalent rights and powers to achieve sufficient harmonisation. Moreover, existing unclear investor protection rules and the absence of a thorough investor compensation scheme, as well as the danger of not having put into place a mandatory sanction regime in case of breaches give cause of concern. Considering investment funds, it would be important to ensure that depositaries in jurisdictions involved were subject to broadly equivalent responsibilities. Otherwise, liability issues to the detriment of investors could emerge.

In the context of investment funds, there are to the best of our knowledge limited examples of mutual recognition:

a) The securities regulators of Singapore, Malaysia, and Thailand have signed a Memorandum of Understanding to establish the ASEAN CIS Framework for the cross border offering of Collective Investment Schemes ("CIVs") to retail investors. Only CIVs which qualify for the Framework will be allowed to take advantage of the passport.
b) The Asia Region Funds Passport is a second initiative led by Australia, New Zealand, Korea and Singapore which should become operational in 2016.
c) Finally, the European Commission and the Chinese national regulator are at a very early stage of discussions on a possible mutual recognition, but we understand that negotiations are currently stalled.

Passporting

As further described by IOSCO's consultation report, the marketing and management passports introduced for UCITS on the one hand and managers of alternative investment funds on the other hand are good examples for operating on a harmonised basis when national borders are crossed. As far as UCITS are concerned, the passport is in operation within Member States of the European Economic Area ("EEA") whereas as described in the previous section on "Unilateral Recognition", other jurisdictions may have accepted UCITS for distribution in their home market on the basis of a unilateral decision.

On the other hand, the AIFMD will introduce a new dimension in passporting. In a first step and similar to the UCITS legislative framework, a passport is now in operation among EEA Member States. In a second step, this passport might be extended to non-EU alternative investment funds and/ or non-EU alternative investment fund managers, subject, as the case may be and depending on the final decision of the European Commission, to some form of reciprocity (in effect a mutual recognition) between these non-EU jurisdictions and EEA Member States.

The AIFMD sets out the minimum rules that non-EU investment managers may abide by and in essence it offers a passporting opportunity which is conditioned by some form of regulatory convergence.

Fund of Funds

Technically speaking, there is another somewhat “limited implied” passport for fund of funds structures: a UCITS fund of funds may invest up to 30% in funds of non-EU jurisdictions, subject to specific conditions; however, this is not an “active” passport but rather an indirect placing of funds in the context of investment management.

Benefits of Passporting

The advantages of passporting in the investment funds sector are significant. Thanks to harmonised rules (e.g. enhanced disclosure requirements towards the investor and reporting obligations towards the respective national regulator) a high level of investor protection is achieved. A clear split of responsibilities between management companies, depositaries, auditors and other service providers avoids not only liability issues but also allows parties involved to achieve considerable economies of scale (e.g. in terms of human and technical resources, and by streamlining processes and controls).

This should logically translate into lower fees for investors. Moreover, investors have a single point of contact and regulators are able to efficiently supervise the vehicles or managers.

Despite this undoubtedly positive perception which is valid for many aspects resulting from passporting, certain obstacles or areas where improvements are needed remain. For example, during the 2008 financial crisis many legislative and regulatory initiatives were launched at the same time, and this on national, European and international level. As a result, certain areas within the fund sector seem now to be overregulated and need to be aligned (e.g. disclosure requirements towards investors set by the UCITS Directive, the AIFMD, the Markets in Financial Instruments Directive and the Regulation on Packaged Retail and Insurance based Investment Products; another issue for smaller practitioners are the complex reporting requirements towards regulators in the context of funds or the diverging approach taken by US regulators and the European Commission for reporting on OTC financial derivative instruments). On the other hand, compared to fund products some other sectors are in our view still regulated to a lesser extent, which leads to a non-level playing field within retail products. It is also true that despite the introduction of the aforementioned passports certain national barriers remain or become more stringent (for example, the requirement to appoint a centralising agent for marketing funds in another EU Member State). Moreover, institutional clients feel increasingly supervised by their national regulators through minimum requirements set for own funds (including Basel II/III, CRD IV and Solvency II); as a consequence, they must have access to comprehensive data in order to be able to report on their investment funds positions (QMV, KSA, VAG, GroMIKV). Further issues from a European fund’s perspective are the partially long time periods until authorisation for cross-border management is granted, existing tax barriers or uncertainties (again in particular with regard to cross-border management of funds) and fees imposed by national regulators for marketing funds abroad.

Outlook

Considering the cross-border regulatory toolkit IOSCO’s task force is mandated to develop, we think two aspects are key for collective investment vehicles:

1. No matter whether recognition or passporting applies, similar rules (in other words: regulatory convergence or equivalence) are at least needed in terms of transparency and investor protection, regarding both products and service providers.

2. A minimum of regulatory convergence or equivalence is also a key factor to ensure that all stakeholders will operate under broadly equivalent terms, hence the cost of doing business should be comparable between jurisdictions with mutual recognition.

3. The various options should not be discussed without considering the progress and outcome of other global initiatives, namely the negotiations on a Trade in Services Agreement at the level of the World Trade Organisation, the OECD's action plan on Base Erosion and Profit Shifting and discussions led by certain countries within the EU on implementing a tax on financial transactions.

Last but not least, we think consideration should be given to the option of interconnecting not only national but rather regional initiatives, such as the UCITS and AIFMD passport in Europe, the ASEAN framework for cross-border offering of collective investment schemes and the intended mutual fund recognition between Hong Kong and mainland Chinese fund products. This would take global fund distribution to a new level. The consequences and details of how this could work in practice would have to be analysed thoroughly by both practitioners and regulators.

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