

Shedding Light on the UCITS-MiFID Nexus and Potential Impact of MiFID on the Asset Management Sector

Jean-Pierre Casey*

1. Introduction

There remains considerable confusion as to how exactly the MiFID and UCITS directives will interact in the long run. This uncertainty reflects the growing pains of a regulatory transformation that represents no less than a tectonic shift from intense and prescriptive product regulation to a more flexible, principles-based regulation of management functions. Unlike UCITS, MiFID is a horizontal directive that cuts across the entire financial services industry (except for insurance). Precisely because the two directives are rooted in diverging regulatory philosophies, they are not natural partners, and the exercise of trying to fit the two together will likely be neither effortless nor seamless.

This confusion can be traced to apparently contradictory at first sight, or, in the least, ambiguous, wording in the MiFID as to how its provisions relate to collective investment schemes. In reality, the UCITS-MiFID nexus is a web of dizzying complexity, on which this paper attempts to shed some light. On the one hand, MiFID Recital 15 and Article 2(1)(h) state that collective investment schemes (whether or not coordinated at EU level), their management companies and depositaries are excluded from the scope of MiFID provisions. Since UCITS are collective investment undertakings that are coordinated at Community level, they, their managers and depositaries do not come under MiFID rules.

On the other hand, UCITS are listed in Section C of MiFID Annex I as MiFID financial instruments. Therefore, in their dealings with clients involving transactions in UCITS, all MiFID firms must apply conduct of business rules, which include best execution and suitability.² Yet conduct of business rules do not

apply to eligible counterparties, otherwise known as 'per se financial institutions'. And MiFID Article 24(2) binds member states' competent authorities to recognise as eligible counterparties UCITS and their management companies, meaning that in their transactions with investment firms, they are by default not afforded conduct of business protections. However, investment managers (including UCITS) can request under the same article to have their transactions protected by MiFID's conduct of business rules, including best execution.

In addition, despite the Article 2(1)(h) exemption, MiFID Article 66 brings some UCITS management company functions under the scope of MiFID (see Table 1). Thus, UCITS management companies are subject to both the UCITS and MiFID directives: when providing ancillary investment services (investment advice, individual portfolio management, etc.) they are governed by MiFID, whereas the UCITS directive covers the designation of management companies. Under the original UCITS directive, management companies could only provide collective investment services. But under the 'product directive' component of UCITS III, the services that management companies could provide were extended to cover individual portfolio management, allowing them to compete directly with portfolio managers, who carry out these activities under a MiFID license.³ The decision to apply certain conduct of business rules to UCITS management companies that are undertaking individual portfolio management was a necessary consequence of the wider powers managers of UCITS were given under

exempted from the appropriateness test in Article 19(5) for execution-only transactions.

³ FSA, 2006, DP06/03: Implementing MiFID's best execution requirements, May, p. 20, which cites Article 5(3) of the UCITS Directive, as amended by Directive 2001/107/EC.

² The classification of UCITS under Article 19(6) as a 'non-complex' financial instrument by default means it can be

* Jean-Pierre Casey is a Compliance Manager at Barclays Wealth and Associate Research at CEPS. He was formerly Head of Research of the European Capital Markets Institute. This Policy Brief reflects his personal views only and cannot in any way be taken to represent the views of Barclays Wealth. Comments on this Policy Brief may be sent to: jean-pierre.casey@ext.ceps.eu.



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UCITS III: its purpose was to ensure that a level playing field emerges in the management of individual portfolios, whether by MiFID-authorized investment managers or by UCITS management companies.

Table 1. MiFID provisions that apply to UCITS

MiFID provisions that apply to UCITS management companies	<ul style="list-style-type: none"> ▪ Dealings as counterparty to public authorities (art. 2.2) ▪ Cross-border takeover of a company (art. 10(4)) if it leads to a qualifying holding in that firm ▪ Capital requirements (art. 12) ▪ Organisational requirements (art. 13) (in particular conflicts of interest) ▪ Conduct of business obligations (art. 19) (in particular suitability and best execution) <p><i>These only apply when the following services are provided:</i></p> <ul style="list-style-type: none"> ▪ Discretionary portfolio management ▪ Investment advice ▪ Custody and administration
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The interaction between UCITS and MiFID is further complicated by the Article 3(1) exemption that leaves discretion to the individual EU member states to decide whether to apply MiFID to legal persons that only receive/transmit orders in UCITS, that do not hold any clients' funds, and that only transact with certain counterparties. Because these various options and possible exemptions raise serious concerns for a level playing field at the pan-European level, it would be sensible for the European Commission to clarify to what degree UCITS funds would potentially be affected by the Article 3(1) carve-out.

Table 2. Provisions that apply to UCITS: MiFID or member state discretion

UCITS funds	MiFID	Member state discretion
Fund distribution undertaken by an investment firm	X	
Fund distribution undertaken by fund management company		X
Fund distribution undertaken neither by a UCITS management company nor a MiFID investment firm		X
Investment advice on collective investment scheme given by investment firm	X	
Advice exclusively relating to collective investments given by fund management company		X
Advice on collective investments combined with other instruments given by the fund management company	X	
Advice on collective investment that is part of a package or 'wrap'	X	
Reception/transmission of orders relating to collective investments only		X
Self-managed UCITS, distribution and advice		X (?)

The various layers of interaction, options and carve-outs described above paint a complex picture of the MiFID-UCITS nexus. Its more precise articulation over time will result in a robust learning-by-doing exercise for market participants and regulators alike. It will likely involve hiccoughs along the way. The Asset Management Sector Leader of the FSA, Dan Waters, playing on a phrase coined by the former US Secretary of Defense, has described the interaction between the UCITS and MiFID Directives as being "...full of both known unknowns and unknown unknowns."⁴ His is a not so subtle recognition that regulators just as much as market participants have yet to come to a better understanding of how the two directives will fit together in practice.

At the same time, these differences are in many respects technical, they only touch a few areas, and they do not mean that UCITS and MiFID are fundamentally incompatible. At a very high level, and overlooking some of the technical points where the fit is not perfect, the boundary between UCITS and MiFID is fairly clear. While UCITS governs the constitution, management, administration and process around the launch of a fund, MiFID governs commercial agreements between providers and distributors, as well as services related to distribution (e.g. brokerage and advice). As mentioned above, there are however a few important exceptions from this stylised picture, notably:

1. Where UCITS market their own funds or delegate this activity to an agent;
2. Execution – the boundary between UCITS and MiFID is not explicitly clear with regard to rules surrounding execution: the subscription/redemption of units in UCITS is governed by the UCITS directive, while the reception/transmission of client orders in UCITS is governed by MiFID; and
3. Where UCITS management companies carry out individual portfolio management in addition to their core activity of collective investment management.

The importance of getting these points resolved quickly should not be underestimated. If – as the current legislative framework seems to suggest – UCITS management companies can market and sell their funds cross-border under the UCITS rules, without being subjected to the MiFID regime which applies when MiFID investment firms distribute those same funds, there is a fundamental incoherence in the regulatory architecture governing the marketing and selling of UCITS. In addition, there is evidence that member states are moving to address this disconnect in an uncoordinated manner, which could fragment the UCITS market. While some member states are deciding to impose MiFID rules on their own management

⁴ "Opening up European markets for fund distribution: the impact of MiFID on UCITS distribution", speech by Dan Waters, Asset Management Sector Leader, FSA, City & Financial Group Conference, London, 18 January 2007.

companies or on foreign ones when they sell cross-border into their jurisdictions, others do not.

2. Uneven playing fields?

The degree of confusion prevailing among both regulators and market participants is worrisome to the extent that it could bring about further compliance, administrative and IT costs upon the industry, as well as stifle innovation in both product development and in the evolution of the industry architecture (models of distribution, outsourcing, etc.) through continued regulatory uncertainty. In addition, the same options and exemptions mentioned above, which are the source of the confusion as to how MiFID and UCITS will interact, raise serious concerns about whether a level playing field will exist in the European investment management business post-MiFID.

Broadly speaking, there are five areas where MiFID impacts most on the asset management business: best execution, outsourcing, product fact disclosures, conflicts of interest and inducements. To the extent that some actors in the UCITS market face MiFID best execution rules that are considerably stricter than those under the UCITS directive governing actors in the same market raises legitimate concerns about a distorted playing field.

Best execution

Concerning best execution, the investment management industry does not come under a harmonised set of rules, since some entities will fall under the light-touch UCITS regime for execution (taken from ISD Article 11 on conduct of business, which only sets out very high level principles), and others will be subjected to MiFID's more detailed rules on execution.⁵ More precisely, management companies executing transactions in the process of managing collective investments do not come under MiFID's onerous best execution rules. They do when providing individual portfolio management services. The European Commission has clearly stated that where a UCITS management company outsources the management of a UCITS to an investment firm under Art 5(g) of the UCITS directive, the investment firm must give the UCITS conduct of business protections and

treat it as a professional or retail client.⁶ However, where the management company retains investment management functions and transacts with investment firms, it is to be considered an eligible counterparty, in line with MiFID Art 24(2).

Broadening the debate beyond UCITS, the French Market Regulator (Autorité des Marchés Financiers), has already declared its misgivings about the uneven application of best execution requirements among management companies: "As regards the best execution requirement, non-uniform treatment of management companies subject to MiFID in respect of all or part of their business and management companies not subject to MiFID (those that manage only non-UCITS or only UCITS, for example), seems hard to justify."⁷

Outsourcing

The emphasis on fund management companies in the various MiFID exemptions and UCITS revision leaves one to wonder where and under what conditions self-managed UCITS fall under the MiFID umbrella. Under the UCITS Directive, both fund management companies and self-managed funds (e.g. SICAVs) may delegate investment management, administration and distribution functions to third party service providers. In the case of delegation of the distribution, which set of rules prevails, those of UCITS or of MiFID?

Fact disclosures

Under UCITS Article 28, UCITS management companies must disclose entry and exit commissions as well as other expenses or fees. The Commission's 2004 Recommendation encouraged Member States to require UCITS to publish in the simplified prospectus total expense ratios (TERs) in order to better reflect the total operating costs of the fund.⁸ However, the non-binding nature of the Recommendation means that Member States have introduced different forms of TERs, making cross-border comparisons of costs difficult. MiFID also requires disclosure of costs and associated charges under Article 19(3). To the extent that Article 34(2) of the MiFID implementing directive⁹ considers the simplified prospectus to be sufficient information for the purposes of MiFID Article 19(3), MiFID firms which distribute UCITS will import the uneven application of disclosure of costs and charges that result from the patchy implementation of the Commission's 2004 Recommendation. In addition, level playing field issues

⁵ Specifically, the requirements to: implement an execution policy and obtain client consent to it prior to dealing with clients and conduct ongoing monitoring of execution quality delivered by the various regulated markets, MTFs and brokers used, based on the execution factors which the firm prioritises. In order to make the review of execution policy effective, firms will have to come up with metrics to quantify, or at least make a credible qualitative assessment of, execution quality. This exercise is particularly difficult for execution factors which are not easily quantifiable, such as likelihood of execution, market impact, etc.

⁶ See the European Commission's FAQ on MiFID, Question 97: http://ec.europa.eu/internal_market/securities/isd/questions/index_en.htm.

⁷ AMF, Consultation on enforcing the best-execution principles in MiFID and its implementing directive, 25 July 2006, http://www.amf-france.org/documents/general/7274_1.pdf.

⁸ Commission Recommendation 2004/384/EC of 27 April 2004.

⁹ Directive 2006/73/EC.

are raised by Recital 55 of the MiFID implementing directive. Notwithstanding Article 34(2) of the same Directive, Recital 55 requires investment firms distributing units in UCITS to additionally inform their clients about all the other costs and associated charges related to their provision of investment services in relation to units in UCITS. It is unclear how these disclosures are to be made, or what information precisely is required, leaving scope for divergent interpretations at the national level.

Conflicts of interest

As with best execution, the UCITS requirements on conflicts of interest are lighter touch than those of MiFID. The core duty of care to clients that is the backbone of MiFID conduct of business rules is given in Article 19 (1), which requires investment firms, when providing investment services and/or, where appropriate, ancillary services to clients, to “act honestly, fairly and professionally in accordance with the best interests of its clients”. Similarly, the UCITS Directive sets forth comparable requirements for collective investment management.¹⁰ Notably, Article 5h, Directive 2001/107/EC lists a set of principles a management company shall respect (take from the ISD), i.e.: (i) acting honestly and fairly in conducting its business activities in the best interests of the UCITS it manages and the integrity of the market; (ii) acting with due skill, care and diligence, in the best interests of the UCITS it manages and the integrity of the market; (iii) trying to avoid conflicts of interests and, when they cannot be avoided, ensuring that the UCITS it manages are fairly treated, and (iv) complying with all regulatory requirements applicable to the conduct of its business activities so as to promote the best interests of its investors and the integrity of the market. To give effect to these provisions, a UCITS management company must be “structured and organised in such a way as to minimise the risk of UCITS’ or clients’ interests being prejudiced by conflicts of interest between the company and its clients, between one of its clients and another, between one of its clients and a UCITS or between two UCITS”.¹¹

MiFID, on the other hand, requires firms to “maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest from adversely affecting the interests of its clients”.¹² Where firms are not satisfied that the controls they have put into place around a conflict are sufficient to manage it, they must disclose the conflict to clients. In addition, they must maintain a register of those conflicts of interest, including

potential conflicts, which they have identified as giving rise to potential client detriment. Those registers of conflicts, as well as their attendant controls, must be reviewed occasionally by the firm. This all means that the administrative requirements around the management of conflicts of interest are significantly more burdensome for MiFID authorised firms, as opposed to those authorised under UCITS. While this will not necessarily lead to inefficiencies (given the stylised picture given above of MiFID as regulation distribution and UCITS the manufacturing and management of funds), it could lead to arbitrage where firms conduct activities which are caught in the UCITS-MiFID grey zone.

Inducements

MiFID takes a very strong stance on inducements, with a view to forcing more transparency in the market for the distribution of retail investment products, and to removing biases in investment advice that arise from product providers paying distributors a commission. The starting point is that inducements are banned, unless they meet the strict criteria laid out in Article 26 of the MiFID Level 2 Implementing Directive. Firms can only receive fees, commission or non-monetary benefits in relation to services providers to clients in the following cases:

- when the commissions/benefits are paid or provided to or by the client (or by a person acting on his behalf);
- when the commissions/benefits are paid or provided to or by a third party (or by a person acting on his behalf) if two cumulative sub-conditions are fulfilled: disclosure of such commissions/benefits to the client plus need for enhancing the quality of the service through the payment of the commission.
- when the commissions are necessary for the provision of the services and cannot give rise to conflicts of interest for ensuring acting in the best interests of the client.

These provisions might create difficulties for widely accepted distribution practices in the fund management industry, namely the retrocession of fees from product providers to distributors. In particular, in some instances product providers and intermediaries (which are not in the same immediate parent company) may be contemplating significant up – front payments as a condition for the provider’s products being placed on, or even considered for, the intermediary’s panel or recommended list. These payments would be unconnected with, and additional to, conventional commissions which would be paid on the sale of particular products. Such payments would not be consistent with the standards of conduct for firms – irrespective of whether they will be “whole of market” or “multi-tied”. Such introductory payments are thus incompatible with the fundamental principle that a firm must not conduct business under arrangements that might give rise to a conflict with its duty to customers.

¹⁰ See Article 10 (2), UCITS I Directive 85/611/EEC: “The management company must act independently and solely in the interest of the unit-holders”; and Article 5h, Directive 2001/107/EC.

¹¹ UCITS Directive 2001/107/EC, Article 5f (1) (b).

¹² See MiFID, Article 13 (3).

Where UCITS are distributed by MiFID firms, the latter will have to comply with the rules on inducements. Because UCITS management companies are allowed to distribute third party funds under the Management Company Directive (at least according to CESR's interpretation), it was considered necessary to extend MiFID rules on inducements to cover the remuneration agreements struck between UCITS management companies and the fund management groups whose funds they may distribute in addition to their own, precisely in order to ensure that the playing field would be level.

How exactly the complex interaction between the UCITS and MiFID Directives plays out in practice will therefore have an important impact on the European fund industry, not least because UCITS constitute the vast majority of funds in the EU. This interaction is further complicated by the very real possibility that MiFID will be applied and interpreted differently in the various EU Member States, meaning that the way MiFID and UCITS interact is also likely to vary from Member State to Member State. In reality, the potential impact of MiFID on the asset management industry, especially on distribution, could well reach far beyond what anyone had anticipated, or indeed, the European Commission intended.

3. Further impact of MiFID on asset management sector

The practical consequences of the application of the MiFID regime to UCITS might become very burdensome for UCITS management companies: as soon as they develop the MiFID services mentioned above, they will have to comply with a comprehensive set of rules regarding their organisation and functioning, and will still have to comply with the UCITS Directive provisions regarding their core activity of UCITS fund management. One can at least identify six areas of impact for those services apart from collective portfolio management.

1. Many functions have to be organised in an independent way (e. g. compliance function; risk management; internal audit). Although the MiFID provides that this requirement can be softened or exempted with a proportionality test (i.e. for SMEs in particular), some of these exemption cases will be offered only if the management company is able to prove that it fulfilled the conditions to be exempted.
2. The restrictions and internal disclosure of personal transactions of management companies' staff is regulated in detail by the MiFID. This might raise concerns as for instance the scope of relevant persons is now extended to relatives (including partners for instance) and professional relations. Regarding relatives, we do not know yet how Member States will be able to strike the right balance between this requirement and the European and national obligations on data protection (which have to be applied for the MiFID transposition – see Recital 43 of Level 1 MiFID). In addition, those transactions

will have to be disclosed 'promptly' (Art. 12 (b)), which might create some difficulties of organisation in the daily work of compliance officers of management companies.

3. The management companies will have to deal not only with actual conflicts of interest but also with potential ones (Art. 21 Level 2 MiFID). It might raise difficulties as by nature some potential conflicts of interest are not always easy to anticipate.
4. The files of clients of management companies will have to be reclassified as the MiFID introduces a distinction between eligible counterparts, professional clients and retail clients. But the question of a grand-fathering clause for the treatment of existing clients' files (requiring or not new information today for already existing clients' files) is not answered by the MiFID.
5. Regarding best execution, even though this full requirement is only imposed on investment firms executing the transactions themselves (in general, the brokers), management companies will have to comply with it in the following way. When management companies provide individual portfolio management services or for the service of reception/transmission of orders, they have to transmit the orders to brokers for execution. The MiFID requires that the management companies have to provide for a 'transmission policy' which ensures that brokers have been selected by the management companies among those presenting the objective criteria of offering a high probability of best execution of orders. It means that management companies will not be responsible for the best execution of orders in practice as those orders are executed by the brokers, but that they will have to justify the way they have established their 'transmission policy'.

Box 1. Substantive references to UCITS and collective investments in the MiFID directive (2004/39/EC) and implementing directive

Recital 15 and Article 2(1)(h) – collective investment undertakings, whether coordinated at the EU level (i.e. UCITS) or not, together with their managers and depositaries do not fall under the scope of MiFID.

Article 3(1) – Member States can decide whether or not to apply the MiFID to legal persons that only receive/transmit units in collective investment undertakings and that do not hold any clients' funds and that only transact with certain counterparties.

Article 10(4) – Cross-border acquisitions by UCITS management companies that would result in a 'qualifying holding'¹³ are subject to Article 60¹⁴ subject to certain conditions.

¹³ As defined in MiFID Art. 4 (27).

Article 19(6) – Because UCITS is qualified as a non-complex instrument, investment firms do not need to apply the appropriateness test mentioned in Article 19(5) when on an execution-only basis.

Article 24(2) – UCITS and their management companies must be recognised as eligible counterparties by member states' regulatory authorities, which means MiFID's conduct of business rules do not apply for these transactions. However, this does not preclude them from requesting to opt-down (higher standard of investor protection) to a lower classification for the purposes of seeking protection under conduct of business rules.

Article 66 – Certain MiFID articles will apply to UCITS management companies, including capital requirements, organisational requirements and conduct of business rules (see Table 2 above).

Recital 55 (Implementing directive 2006/73/EC) – Although Article 34 of Directive 2006/73/EC states that the simplified prospectus is enough for the purposes of directive 2004/39/EC, investment firms distributing units in UCITS should additionally inform their clients about all the other costs and associated charges related to their provision of investment services in relation to units in UCITS.

Article 34(2) (Implementing directive 2006/73/EC) – The simplified prospectus is sufficient information for the purposes of MiFID Article 19(3) on disclosing costs and charges associated with investing in a fund.

4. MiFID and the distribution of non-harmonised products

Much of the debate surrounding the Commission's work on the Green and White Papers has focused on eligible assets – i.e. which instruments could eventually be regarded as suitable for inclusion in a UCITS portfolio and which can not. The advantage of having a product that is harmonised at the European level like UCITS is that these funds can be marketed across the EU on the basis of a single offering document, the simplified prospectus, and under a single set of rules, which is not the case for non-harmonised funds.

With the proliferation of financial instruments, there has been significant pressure on the Commission (and CESR by extension) to widen the definition of eligible assets (which is the only way to widen the range of products that can be included in a UCITS without necessitating changes to the existing legislative framework). This pressure also arises from the fact that the market for UCITS, while originally designed essentially for retail investors, is today permeated with institutional players who seek to piggy-back on the passport for a 'retail' product as the only means to efficiently market a fund cross-border, even in the institutional space. In this respect, there have been and continue to be attempts to shoe-horn various alternative products into UCITS, even

though they may not be a particularly good fit for retail investors. This reality will necessitate a careful balancing act for regulators between on the one hand preserving the standard of investor protection for which UCITS is known, and on the other hand making the brand flexible enough to respond to ever greater competitive pressures in the global fund market – at least until a pan-European private placement regime or a light-touch harmonised regime for the treatment of unregulated funds, is in place.

The problem with trying to 'shoe-horn' different products into the UCITS framework is that the exercise of defining eligible assets for UCITS is outdated. It is neither sustainable given the existing institutional framework, nor does it adequately take account of the lessons of modern portfolio theory.¹⁵ Critics will contend however that it is precisely this measured consideration of eligible instruments that has contributed to the reputation of the UCITS brand as ensuring a high degree of investor protection.

On the other hand, from an industry perspective, the accelerated pace of financial innovation means that the exercise of reconsidering which instruments are suitable for UCITS is handcuffed by the slow legislative machinery and therefore not conducive to facilitating a competitive EU fund market. The industry sees a distinct possibility in MiFID to by-pass this bottleneck. The Commission's expert groups on alternative investments have recommended that alternative investment funds (e.g. hedge funds) be distributed to retail investors on a cross-border basis on the basis of MiFID's distribution framework without imposing any additional product or management regulation at EU level.¹⁶ In other words, this suggestion would amount to a pure mutual recognition regime for alternative investment funds without any minimal level of harmonisation at EU level of the product. This is rather wishful thinking in light of the 40 years' EU experience with single market legislation (historical precedent shows that without a minimum degree of harmonised legislation at EU level, a single market cannot emerge).

In addition to the unrealistic ambition of a pure mutual recognition regime (i.e., one where there is no minimal product harmonisation at EU level), one has to consider whether regulators would really accept to passport an alternative investment fund across the EU without any form of (at least minimally) harmonised pan-European product regulation. The answer from CESR is very clear: impossible.¹⁷ CESR's objections are based upon two

¹⁵ See Casey (2006).

¹⁶ See Recommendations 1 and 4 of the Report of the Alternative Investment Expert Group: Managing, Servicing and Marketing Hedge Funds in Europe, European Commission (2006).

¹⁷ For a more detailed view, see: CESR (2006), CESR's reaction to the reports of the Commission expert groups on market efficiency and on alternative investment funds, CESR/06-461d.

¹⁴ MiFID Article 60 relates to the consultations among the different competent authorities of the member states prior to the authorisation of cross-border business.

grounds. First, retail investor protection: in CESR's view, distribution rules are simply too lax under MiFID for alternative investments to be marketed to retail investors without any further product regulation. Second, the competitive effect: if alternative investments can be marketed to retail clients only on the basis of MiFID suitability/ appropriateness tests, the playing field in the European fund market would be severely distorted to the advantage of alternative funds.

UCITS is widely seen to be a major success story in Europe, the only example of a truly successful pan-European retail market for financial services to date. Today, it is a globally-recognised brand that is synonymous with investor protection and sound product quality. This success should be built upon, rather than undermined. No doubt markets move fast and the existing regulatory framework ought to reflect these changes. It is necessary, for example, to examine whether the quality of UCITS is indeed consistently superior on average (in terms of risk-return profiles) to that of alternative investment funds, on which no clear-cut answer has been given so far, although inclusion of some portion of derivative instruments seems to have got a positive impact (European Commission, 2008). If not, there would be little reason to object to the wider inclusion of complex instruments in UCITS. But at the same time, one must be aware that confidence in the widely-recognised UCITS label could be easily destroyed: building the trust and confidence of (international) investors in certain products takes years, and clumsy action by regulators could destroy this confidence overnight.

The continuing uneven playing field between various savings products is therefore very worrying. Relying on MiFID alone for the distribution of alternative investment funds to a retail market audience without any additional product regulation would only exacerbate the problem. Indeed, the possibility for distributors to market an alternative investment fund across the EU under the MiFID distribution passport but without the attendant UCITS product passport would undermine the very *raison d'être* of the UCITS brand – a high level of investor protection through a combination of product regulation and management regulation – effectively driving UCITS out of the market. As a consequence, vigilance and careful reflection are required on the part of regulators as they determine how exactly the MiFID distribution passport will apply to alternative investment funds, and whether this application is compatible with the UCITS Directive.

Currently, there is significant confusion in the marketplace as to how alternative investments will fit into the already tense MiFID-UCITS interaction. Under MiFID, it is not sure that a product has to be harmonised at the European level to enjoy pan-European distribution. All that is required for the (advised) sales of MiFID financial instruments is the suitability test and an appropriateness test for execution-only transactions (except under certain conditions). This looser regulatory

framework (in the sense that MiFID does not regulate products) might apply not only to alternative investment funds, depending on how MiFID is ultimately interpreted, but also to structured product wrappers around these investments.

The probability that cross-border sales of alternative investment funds be done under MiFID without any kind of pan-European sales framework is less probable than for structured products. This is because structured products are already widely available in the retail market in many European countries, mostly due to the capital protection at maturity built into many of them. As a result, even if some national regulators in the EU were to prevent the cross-border distribution of non-harmonised funds into their jurisdictions under a MiFID distribution license only, it is well possible that investment firms could offer structured notes around a portfolio of hedge funds to retail investors cross-border under MiFID. To the extent that structured products, or a portfolio which includes complex financial instruments such as options and other derivatives, might successfully replicate the risk-return profiles of UCITS funds, and might be marketed cross-border under MiFID without any form of product regulation, they will have a significant advantage over UCITS in terms of the regulatory framework. So long as these products can be considered 'transferable securities' under MiFID, they qualify for pan-European distribution under a MiFID license.

This possibility will *require a review by the Commission into the definition of 'transferable securities'*, which currently could be taken to mean various structured products under Article 4(1)(18)b, which mentions 'bonds or other forms of securitised debt'. This definition could potentially include CDOs, CLOs, and various derivatives thereof. *For the reasons stated in the paragraph above, without a more precise definition of the term 'transferable securities', the UCITS market faces a severe threat from a new range of structured products with alternative investments as underlying.*

Another important question in the debate on the 'MiFIDisation' of alternative investment funds and products relates to whether financial advisors are truly competent enough to handle complex instruments and non-harmonised funds without the end-investor enjoying any kind of additional protection in the form of product regulation. There are good reasons to doubt this to be the case. Additionally, one must consider whether Independent Financial Advisers or ill-trained personnel at the point of sale in bank branches will really be capable of keeping pace with and understanding the vast influx of complex new products sufficiently well to act as the ultimate safeguard of investor well-being in a world devoid of product regulation. Will there not likely be a significantly enhanced risk of mis-selling under such circumstances? For this reason, any move away from product regulation must be accompanied by rigorous exercises to ensure sales forces are trained and competent to advise these products and are treating customers fairly.

In the view of this author, MiFID should not be seen to grant a passport to the cross-border distribution to retail investors of any or all non-harmonised collective schemes and structured products with alternative investments as underlyings. But as it currently stands, it remains very unclear whether or how regulators will prevent alternative investments from being distributed cross-border to a retail audience under MiFID. It is therefore essential that a proper articulation of how MiFID applies to the cross-border sales of non-harmonised products be developed as soon as possible. How broad a reading of MiFID is adopted by the Commission and national regulatory bodies will be critical to determining the future success of UCITS as a brand.

It is also useful to highlight how insurance products, some of which (e.g. unit-linked) can compete directly with UCITS without a similar degree of harmonised regulation, also (currently) enjoy a skewed playing field. One of the main causes of the unequal playing field between products is the differing conditions for the oversight and control over marketing documents for ‘financial products’ and ‘insurance products’.¹⁸ In view of the above discussion, the exclusion of insurance products from the scope of MiFID does not make any sense, and should be urgently addressed. The comparable rules under the EU’s insurance mediation directive (2002/92/EC) are not comparable to the regime that MiFID has brought in place.

In this vein, the conclusions of the May 2007 EU Council of Finance Ministers are very welcome. The Council emphasised the importance of consistency between MiFID and UCITS, and insisted “to ensure, in the context of retail distribution of, and advice on, UCITS, that all steps are taken by the Commission and the Member States in enforcing the conduct of business rules provided for in the MiFID, (...) and stresses the need for clearly ensuring the coherence of application of the MiFID and the UCITS directives.” The Council further invited the Commission “to review the consistency of EU legislation regarding the different types of retail investment products (such as unit-linked life insurance, investment funds, certain structured notes and certificates), so as to ensure a coherent approach to investor protection and to avoid any mis-selling possibilities.”¹⁹ The European Commission has opened a consultation on the subject, but it is clear that, in view of the foregoing discussion, the answer will not be easy.²⁰

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¹⁸ Delmas-Marsalet Report on the marketing of financial instruments (AMF, 2005, p. 18).

¹⁹ Casey & Lannoo (2008), p. 28.

²⁰ See European Commission (2007).

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European capital markets have experienced rapid growth in recent years, corresponding to the gradual shift away from relationship banking as a source of funding and at the same time, have had to absorb and implement the massive output of EU-level regulation required to create a single market for financial services. These developments, combined with the immense challenges presented to European financial institutions by the globalisation of financial markets, highlight the importance of an independent entity to undertake and disseminate research on European capital markets.

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European Capital Markets Institute

c/o Centre for European Policy Studies (<http://www.ceps.eu>)

Place du Congrès 1 • 1000 Brussels • Tel: 32(0) 229.39.11 • Fax: 32(0) 219.41.51

Website: <http://www.eurocapitalmarkets.org> • E-mail: info@eurocapitalmarkets.org