16th November 2005

Commission of The European Communities
DG Internal Market
Brussels

Dear Sirs

**Green Paper on the Enhancement of the EU Framework for Investment Funds (SEC(2005)947)**

We welcome the opportunity to respond to the Commission's Green paper on the future framework for investment funds in the EU.

M&G is the UK and European fund management business of the life insurer and pension provider Prudential plc. It has over £111 billion of funds under management, of which £87 billion relates to Prudential's long-term business. As at the end of September 2005 the combined assets under management in our retail investment funds business were £17.4 billion, making M&G the third largest retail fund manager in the UK. M&G has been looking after savers since 1931 when it launched Britain's first unit trust. We now look after investments on behalf of more than 750,000 investors.

In 2001 M&G launched its International Business and is now a major distributor of UK UCITS within the EU and more recently, in Asia. In the year to 31st December 2004 cumulative sales in Europe (ex-UK) amounted to Euros 611.0m and assets under management of Euros 551.9m.

In general, we are supportive of the submissions made by EFAMA and the IMA[1] in that we agree on the UCITS review and the need for effort to focus on the many aspects of the existing Directive that have failed to create the degree of harmonisation intended. Supervisory convergence is a significant component in

[1] Investment Management Association of the UK

this and the Commission's proposals for rapid fixes to the existing framework will, we hope, help to galvanise Member State co-operation in the way needed to implement and maintain a harmonised regime for investment funds in the future.

M&G's priorities, which are discussed in more detail in the attached paper, are:

- Consolidate the UCITS Directive by way of clarifying its provisions
- Protect UCITS as an international brand
- Review distribution issues (via MiFID?)
- Address consumer demand for a wider range of asset classes

Finally, despite significant progress in removing tax barriers to the marketing of funds across borders, tax discrimination in the EU continues to be a major obstacle to the creation of a single market for investment funds and we would encourage the Commission to continue the good effort it has already made in this area.

Yours faithfully

Gary Shaughnessy
Chief Executive Officer
M&G Securities Limited

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**M&G RESPONSE**
**TO THE EU GREEN PAPER ON THE ENHANCEMENT OF THE EU FRAMEWORK FOR INVESTMENT FUNDS**

## SECTION 1: UCITS

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### 1.1 Notification

We strongly support the Commission's proposals with respect to the measures intended to simplify the registration of UCITS within the EU. In particular, we believe agreement on the following will have significant practical importance in delivering an early solution to the obstacles facing firms seeking to register/maintain registration of UCITS in non-domestic jurisdictions:

- <u>clarification on eligible assets</u> for UCITS to provide the certainty needed to establish the notification procedures originally envisaged by the Directive, i.e. for Home State authorisation to establish the passport without further recourse by Host State authorities
- <u>Review the simplified prospectus</u> to achieve its original aim, a simple, user-friendly piece of investor information that draws attention to the key benefits and risks of the product
- <u>Supervisory convergence</u> and clear lines of responsibility to be established for EU supervisors (for example, to eliminate current practice where Home country authorisation is contested)

### (i) Notification within the EU

We have experienced varying degrees of difficulty in arranging to passport our UK UCITS into other EU jurisdictions. To exemplify this, we give a few examples of the types of problems that have arisen during the notification process:

- In one instance a local regulator rejected copies of the UCITS certificates issued by our UK regulator (the "FSA") and instead requested alternative wording relating to the references in the Directive. The original FSA certificate had been perfectly acceptable to several other regulators. This incident resulted in an unnecessary delay in getting our fund to the market.

- Another local regulator rejected as evidence the wording of a letter from M&G to the FSA in which we had requested permission to passport into the country in question. Despite having received written confirmation from the FSA that we could proceed, the local regulator insisted that we draft a new letter to the FSA. This resulted in a significant delay to our marketing plans as well as inflicting an opportunity cost on both M&G and the FSA in dealing with the issue

- The requirement to obtain sworn translations is costly, time consuming and offers no added investor protection. The further requirement to have these documents apostilled only results in extra time and cost for fund managers which in turn results in increased costs to investors.

- Switzerland has introduced a requirement to disclose in the prospectus of a UCITS a breakdown of the annual management charge into the costs attributed to administration, asset management and distribution. Whilst we support the principle of transparency, this approach is not helpful as it is not applicable in other jurisdictions and, as such, there is no consistency or comparative measure for the consumer.

  A non-EU country introducing such a requirement weakens the opportunity for consistency across Europe and works against the ultimate goal of a single market. We believe that an effective way to resolve an issue such as this would be to give Switzerland observer status at CESR to encourage constructive dialogue with EU jurisdictions at am early stage.

In supporting the Commission's recommendation to simplify the notification procedure we would amplify the six key recommendations made in the joint report issued by the IMA[2] and EFAMA[3] which, we understand, could be delivered within the existing framework. In summary:

1) Member States only permitted to request information required by the Directive;
2) Notification should only be required for those sub-funds of an umbrella and those share classes of a fund/sub-fund which are intended to be marketed in the host Member State
3) Changes to a registered fund's prospectus should be notifiable and not subject to delay or approval
4) Only the simplified prospectus should have to be translated into local language for notification purposes
5) It should be possible to start marketing a UCITS one month after filing the necessary information
6) The fees for registering funds should be harmonised and reduced

[2] The Investment Management Association (IMA) of the UK
[3] European Fund and Asset Management Association

### (ii) Registering UCITS outside of the EU

The UCITS label has come to symbolise a well diversified investment vehicle, suitable for retail investors and increasingly recognised well beyond EU borders. Moreover, newer regulatory regimes have developed their own product rules along similar, but no less stringent, lines to UCITS, making its reach very wide indeed.

We believe that greater supervisory collaboration with non-EU jurisdictions is essential to provide continuing opportunities for expanding sales of UCITS outside of the EU. In particular, in the interests of promoting convergence we believe it is vital that CESR and the Commission engage in early discussions with non-EU supervisors on potential regulatory initiatives. The Commission's Green Paper on post-FSAP policy emphasises the importance of international relations but we would argue that it should not be restricted to the US, China, India and Japan.

In Singapore the regulatory framework for domestic retail funds largely reflects the old UCITS provisions and, as a result, a foreign UCITS fund has hitherto enjoyed a reasonably problem-free notification process. However, M&G recently registered UCITS in Singapore where the UCITS III changes came as a complete surprise to local regulators. As a result we experienced a higher than usual degree of scrutiny in registering our funds, despite not having adopted the wider powers.

We feel the delays we experienced in registration could have been avoided if the local regulators had been made aware of the UCITS III changes by the European authorities. We would therefore urge the Commission to keep third-country regulators aware of any legislative changes to allow them sufficient time to consider the regulatory implications and to make amendments to their own rules, as appropriate.

## 1.2 Eligible Assets

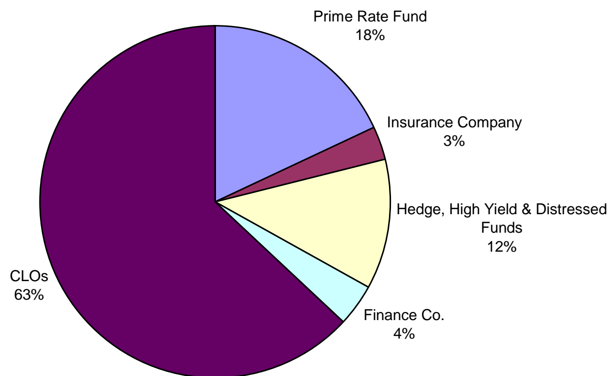
We strongly support the work being undertaken by CESR to reach consensus on the criteria for assessing the eligibility of UCITS assets and, provided robust disclosure is made of the risks involved, we believe there should be no diminution in the scope for investing in derivatives available under UCITS III.

We would, however, welcome clarification on the characteristics of assets that may be contained within the 10% ineligible portion of a UCITS portfolio. In particular, we consider that leveraged loans are suitable for inclusion within retail funds, owing to their complementary and defensive features. For example, we view such instruments as being of particular importance to fixed income funds particularly for diversification purposes, given that these are floating rate assets and, albeit credit instruments, assets with high capital protection features (since they are fully

secured on a company's assets). We therefore consider that the regulations should permit them to be held by retail schemes.

Leveraged Loans are high yield bank loans that are similar to high yielding public bonds but secured against company assets. The floating rate payment structure of these instruments provides complementary features (especially in a rising interest rate environment). In the US, this is a mainstream retail asset class, which takes the form of 'Prime Funds' (mutual funds). For the year to 30 September 2005, prime funds made up some 18% of the $219bn of loan market issuance in the US over the same period, as shown in the chart below:

**Primary Market for Institutional Loans by Investor Type (US) Year to 30 September 2005**
(Source: Standard & Poor's)




Since Leveraged Loans are not traded on an eligible market either in the UK or the US, it would appear that they would only qualify under the UCITS provision that allows no more than 10% of a fund to invest in qualifying assets, subject to their ability to meet the conditions regarding transferability. We believe they meet this latter requirement. In some instances (particularly for European Leveraged Loans) it is necessary for the issuer's consent to be sought prior to sale and purchase. This cannot be unreasonably withheld and has not prevented a ready and liquid market from developing. In our experience, in the majority of cases this requirement to seek consent is little more than a step in the transfer process and is routinely agreed. There is also a growing secondary market to provide greater liquidity.

Given the introduction of new debt structures, while not frequent, is nevertheless a feature of evolving capital markets, we would urge the Commission to add clarity to the UCITS rules to allow such assets to gain qualification under the 10% non-

qualifying provision either through direct investment or indirectly through a collective investment scheme. We provide, in appendix I to this response, further background to the Secondary European Loan Market.

### 1.3 Simplified Prospectus

We both welcome and strongly support the Commission's recommendation to review the simplified prospectus. We are aware that the content and presentation varies considerably from one Member State to another and believe it to be a significant lost opportunity in creating one concise, comparable and easily readable document for investors. In this respect, we would echo the view from Wolf Klinz MEP (ALDE, Germany), expressed at the UCITS Hearing in October, that instead of a simplified prospectus, investors would benefit from a simple factsheet. Indeed, we would link this to the concerns that have arisen in relation to the wider investment powers available under UCITS III and believe that enhanced disclosure is the most effective way to address issues of investor understanding of risk. In this sense, we believe that it is important to provide a clear description of the range of outcomes the product offers together with clear disclosure of the risk(s) that those outcomes may not be achieved. This communication should be contained in a succinct document that draws the consumer's attention to key information which explains what it is the product purports to deliver and, as such, provides more of a user's guide than a detailed description of the inner workings of the fund.

We therefore believe that fresh agreement on the form and content of a harmonised document that provides investors with "simple reliable and comparable information" before they buy, is essential if the UCITS framework is to achieve the original aim of enhancing effective investor information.

## SECTION TWO: BEYOND UCITS

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In this section we discuss areas that cannot be addressed within the UCITS framework but which, in the absence of appropriate legislation, place undue restrictions not only on the scope of the market in investment funds, but also on the extent to which it can realistically offer consumers a diversified range of competitive investment products. We believe there may already be appropriate European legislation in place to support these issues (eg MiFID) and would therefore urge the Commission not to delay consideration of these matters but to address them in parallel with the work being undertaken to achieve consensus on aspects of UCITS.

The key issues are:

- Distribution
- Meeting consumer demand for a wider range of asset classes

### 2.1 Distribution Issues

#### (i) Separation of asset management from distribution services

The nature of the distribution landscape in many EU jurisdictions means that consumers are not getting the best choice, nor are they being offered the most competitive products. There are, as we see it, two key factors in this. Firstly, there is, in many jurisdictions no clear distinction between asset management services and distribution so it is possible for one firm to offer both without disclosing the proportion of costs attributable to the product and those relating to advice. Secondly, the fact that there is no obligation on the part of the distributor to demonstrate 'best advice' (across a range of products) serves to create the illusion that its own products are the best and most competitive. In short, the consumer has no way of knowing otherwise.

#### (ii) Commission Disclosure

We believe that there should be a clear distinction between product costs and the cost of advice so that the consumer can compare the costs of different products (offered by different providers) and the services of one distributor with another. To achieve this, we believe that there should be a regulatory requirement placed on the distributor to (a) demonstrate 'best advice' and (b) clearly disclose commission/sales costs in a consistent and verifiable way to the customer at point of sale.

We do not believe that it will be possible to create a truly competitive single market in investment funds unless this regulatory requirement is imposed. Without this, the consumer has no way of comparing one firm's products and services with those of another and is therefore effectively denied the opportunity to shop around. We would urge the Commission to consider the potential for MiFID to deliver the regulatory framework necessary to achieve this aim.

## 2.2 Private Placement

We believe the UCITS product rules are an important element of what retail investment funds symbolise and should be retained. However, there is a growing market in non-UCITS funds with varying levels of diversification and risk to which, in the absence of a harmonised regulatory framework, consumers are generally denied access. We therefore consider a harmonised private placement regime as essential to the growth of the cross-border market. However, its scope must extend beyond the alternative investment market ("AIM") assets as defined in the Green Paper, to any assets not currently available within a retail fund. In this respect we refer not only to particular asset classes but to any fund structure whose investment and borrowing terms fall outside of UCITS; the important point being that any legislation to support this initiative must be sufficiently flexible to embrace new and emerging asset classes/fund structures as they are introduced to the market.

Our experience is that there is an increasing demand for non-harmonised funds from both private (including high net worth) and professional investors (for example, firms offering discretionary portfolio management services or investing for an existing portfolio construct) and, therefore, a pressing need to establish uniform private placement rules within the EU. In the UK, the regulations place no limits on the number of investors to whom an "unregulated" fund may be promoted but impose strict rules regarding the conditions and recipients to whom promotional material may be issued.

## 2.3 Meeting consumer demand for a wider range of asset classes

(i) <u>Property</u>

It has, for many years, been possible to establish retail property funds in the UK and the FSA's[4] regulations for such schemes apply a UCITS-equivalent corporate governance framework together with principles of diversification, liquidity and other risk mitigation measures appropriate to the asset class. As such, these

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[4] Financial Services Authority of the UK

schemes can be promoted to retail investors in the UK in exactly the same way as a UCITS. On the basis of its low correlation to other asset classes, commercial property within a collective investment scheme offers retail investors the opportunity to diversify their investment portfolios with exposure to a low volatility asset class that provides a secure and stable cashflow for investors seeking income rather than growth. As such, we strongly believe that retail investors should not be deprived access to the benefits of commercial property, provided these can be delivered within a product framework that delivers the same safeguards available to UCITS schemes.

M&G has recently launched a UK authorised commercial property fund for retail investors which has been designed in such a way as to provide the liquidity necessary to meet redemption requests by offering a share class that meets the same standards as a UCITS, without penalty or condition. This means that UK investors can diversify their portfolios by investing in an asset class that has no correlation to bonds and equities. Moreover, the UK Government is actively considering the inclusion of retail property funds as an eligible asset for its Individual Savings Account wrapper, a tax efficient scheme designed to encourage retail investors to save.

In addition to the issue of liquidity, we realise that property has unique characteristics and that concerns have been raised around the ability to provide accurate (fair) and frequent valuations and, of course, liquidity. The following key provisions apply to retail property schemes in the UK:

- The Fund/Manager must, with the approval of the trustee, appoint a standing independent valuer ("SIV")

- The SIV must be independent from both the Manager and the trustee

- A full valuation with physical inspection must be carried out by the SIV, at least once a year and reviewed at least once a month

- Up to 20% of the value of the property assets held by the fund may be mortgaged up to 100%

- The ability to hold non-immovable investments

We strongly believe that property is an important asset class for the retail market and that provided investors are given unconstrained redemption rights, is one that is entirely appropriate for a UCITS-type product offering.

If it is not possible to achieve this within the existing framework we would nevertheless urge the Commission to consider ways in which property could be

brought to the retail market, including within a private placement regime which we discuss below.

## SECTION THREE: RESPONSES TO PARTICULAR QUESTIONS RAISED

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*Would an effective management company passport deliver significant additional economic advantages as opposed to delegation arrangements? Please indicate sources and likely scale of expected benefit.*

We agree that this is an important initiative and strongly support the Commission's proposal to establish a working group to examine the requirements for a management company passport.

*Would the splitting of responsibility for the supervision of the management company and the fund across jurisdictions give rise to additional operational risks or supervisory concerns? Please describe sources of problem and steps that would have to be taken to manage such risks effectively.*

We are not aware of any reason why there should be any issues arising from split supervisory responsibility of the funds/management company but a successful outcome on this initiative must be dependent on collaboration across EU supervisors.

*Do you think that safeguards – at the level of the management company and depositary - are sufficiently robust to address emerging risks in UCITS management and administration? What other measures for maintaining a high level of investor protection would you consider appropriate?*

Yes. In particular, we believe that the separate ownership of a fund's assets by the trustee/depositary is sufficient to safeguard the interests of investors.

**Appendix I**

## Background to the Secondary European Loan Market

The European Loan Market is some EUR 640 billion in size of which leveraged finance comprises over 25%[5]. Though it is an 'over-the-counter' market, the size, history and number of participants has led to growth and standardisation of trading practices. In addition, the loan market benefits from a 'trade body' – the Loan Market Association (LMA) – to which all leading banks and institutional investors belong.

The LMA was established almost 10 years ago with the objective of 'fostering an environment that would facilitate the constructive development of a secondary market for loans'. Activities include the establishment of standardised trading and settlement procedures as well as the issuance of template loan agreements, including transfer certificates (the instruments by which secondary trades are commonly effected). The LMA also disseminates weekly secondary price information on loan assets, garnered from a wide group of banks. An average of quotations received on a particular loan asset is posted each week on its website.

Trading in the European loan market has steadily increased in recent years as the number of active investors grows. Standard & Poor's (which regularly compiles data on the European market) considers that there are currently over 100 funds regularly buying leveraged loans in Europe- an increase of over a third since 2004. Secondary trading volume in 2004 was approximately EUR 65 billion equivalent according to statistics compiled by the LMA from its monthly surveys of members.[6]

As an illustration of the maturity of the European Leveraged Loans market, the existence of two indices may be mentioned: the CSFB Western European Leveraged Loan Index and Standard & Poor's European Leveraged Loan Index (ELLI). The CSFB index was launched in January 1998 and its frequency is monthly. S&P's index tracks returns from January 2003.

[5] Source: Barclays Capital

[6] Source: Loan Market Association