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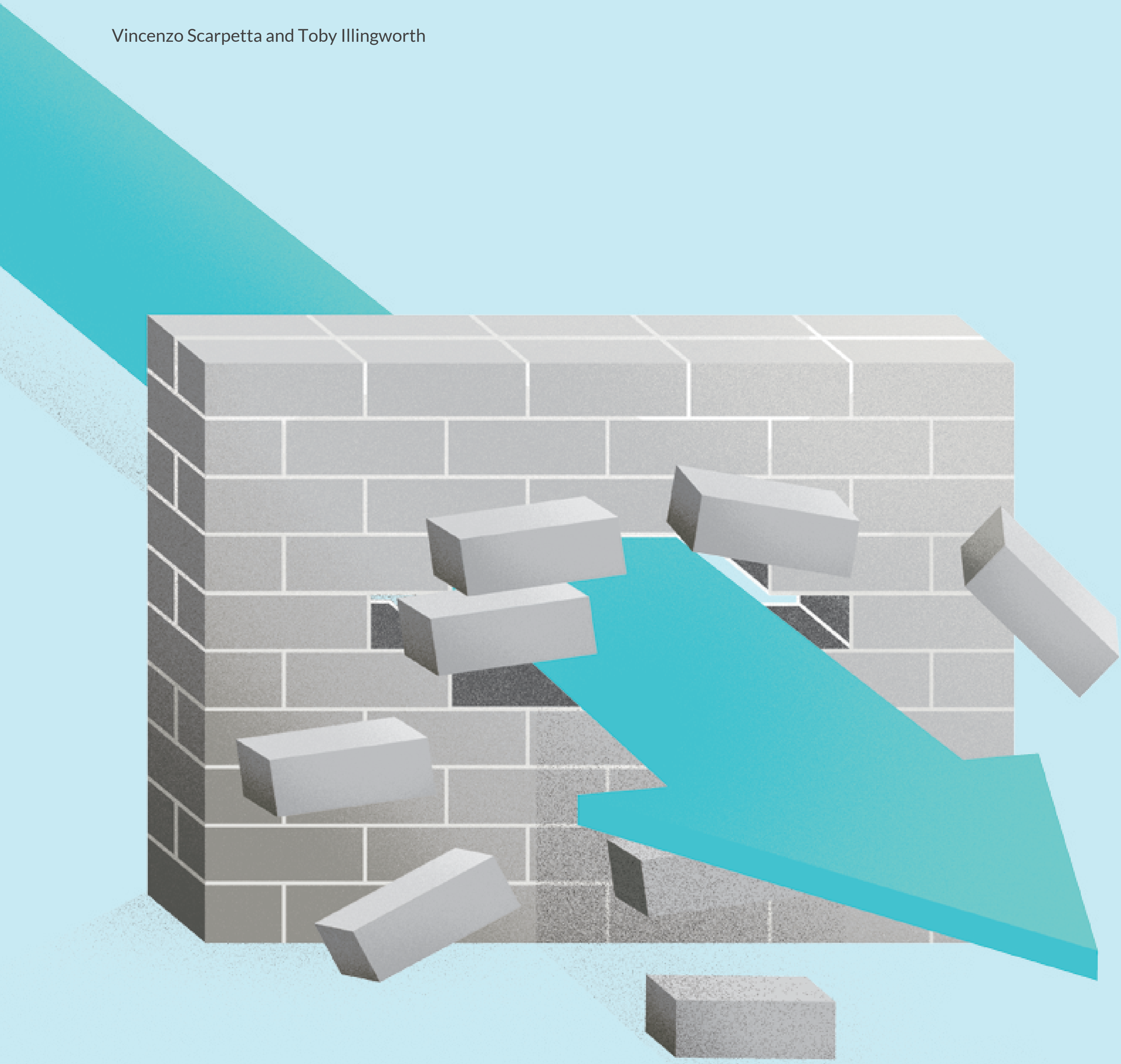
Open Europe in partnership with New City Initiative

Asset management in Europe: The case for reform

Vincenzo Scarpetta and Toby Illingworth



About the Authors

Vincenzo Scarpetta

Policy Analyst, Open Europe

Vincenzo specialises in the politics and economics of Southern Europe and has co-authored policy-changing Open Europe Intelligence on EU financial regulation, social and employment law, free movement and the European Neighbourhood Policy. He is also an expert on the EU institutions and the cost of EU regulation, and is a regular commentator in the print and broadcast media across Europe.

Toby Illingworth

Co-ordinator, New City Initiative

Toby specialises in financial regulation, particularly affecting the asset and wealth management sector. Toby is supported by an experienced policy team made up of practitioners within the industry, compliance experts and members of the NCI board.

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- **Be flexible.** Allow powers to flow back to the member states, and let some countries integrate more than others.

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New City Initiative

New City Initiative is a think tank that offers an independent, expert voice in the debate over the future of financial regulation. Founded in 2010, NCI counts amongst its members some of the leading independent asset management firms in the City and the continent. The NCI gives a voice to independent, owner-managed firms that are entirely focused on and aligned with the interests of their clients and investors.

Over the last decade, an old fashioned 'client-centric' approach has enabled entrepreneurial firms in the Square Mile and beyond to emerge as a growing force in a financial industry dominated by global financial giants. Now, more so than ever, these firms play a key role in preserving the stability and long-term focus of the financial sector, which is of benefit to society at large.

Offices

Open Europe
7 Tufton Street
London
SW1P 3QN

+44 (0)20 7197 2333
www.openeurope.org.uk
info@openeurope.org.uk
@OpenEurope

Open Europe Brussels
113-115 rue du Trône
B-1050
Brussels

+32 (2) 540 86 25

Open Europe Berlin
Oranienburger Straße 27
10117 Berlin
Germany

+49 (0)30 2758 1365
info@openeuropeberlin.de
www.openeuropeberlin.de

New City Initiative
Third Floor Princes Court
7 Princes Street
London
EC2R 8AQ

+44 (0)20 7367 5411
www.newcityinitiative.org
secretariat@newcityinitiative.org
@NCityInitiative

New City Initiative Europe
Place Edouard VII
75009 Paris
France

+33 1 44 94 65 68
fr.newcityinitiative.org

Contents

Foreword

The key trade-off for any business is that of costs versus income. The issues surrounding regulation are very similar – businesses need to operate in a regulated market, but the benefits of regulation need to outweigh the costs. This premise is very relevant for the European Union project. The free trade zone initially created by the European Economic Community (EEC) and the efficiencies (supposedly) generated by a single currency, all should lead to an increase in trade, benefitting all concerned.

However, the investment management community and especially the 'boutique' (i.e. smaller firms) community find that the regulatory burden imposed upon us by the EU (AIFMD, MiFID II, etc.) is so expensive and onerous, that in themselves these regulations are an issue in terms of our business sector prospering. We also find that the implied benefits of an open and free trade zone are largely illusory. As companies trying to sell our products across Europe, we are constantly obstructed by an uneven application of the law, ignorance of the free trade rules, and in some cases protectionism. In this paper, this is clearly illustrated in our case studies of accessing Germany and Slovenia. The costs of the regulations in many instances outweigh the advantages.

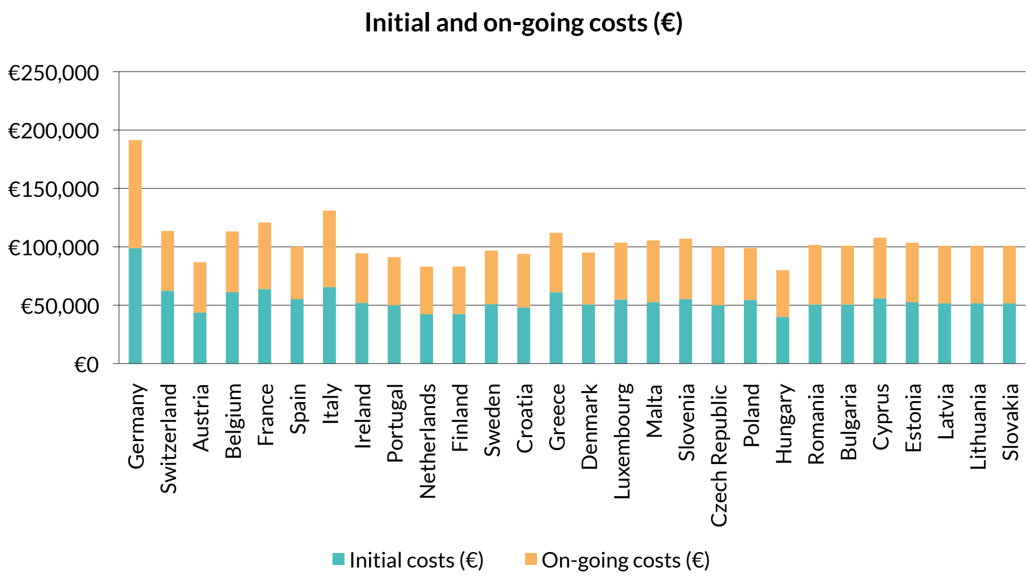
This is a serious situation to find ourselves in, and in collaboration with Open Europe we wanted to bring a positive case for reform in Europe at a time when both the economic and political basis of the principal of Europe are coming under increasing pressure. We have laid out in this paper a clear series of changes we would like to see made, as well as illustrated the barriers we currently experience to a 'proper' free trade zone in Europe. We have specifically avoided trying to make political judgements, leaving that for the politicians, but we do believe that bigger, freer trade zones, properly regulated, are highly desirable for all members of the New City Initiative and we hope that our thoughts here help us achieve this goal.

Dominic Johnson
Chairman, New City Initiative
CEO and Founding Partner of Somerset Capital Management LLP

Executive Summary

- At a time when Europe is struggling to find its way back to economic growth, it becomes all the more important to safeguard a sound and vibrant asset management industry.
- As with other parts of the financial services sector, the asset management industry can be susceptible to crises. However, the inherent risks are different and possibly more easily manageable than, for instance, in the banking sector.
- EU membership offers UK asset managers the chance to access a potentially huge pool of capital. However, despite the introduction of a 'passport' that should allow asset managers to do business across the EU once authorised by one EU member state, regulatory and administrative hurdles remain in place at the national level that make it harder to take full advantage of the single market.
- We estimate that a UK-based fund manager marketing and distributing in all the other 27 EU member states plus Switzerland would face total initial costs of over €1.5 million. Total on-going maintenance costs – allowing for the continuation of cross-border marketing – could be near €1.4 million per year.

Total initial costs of marketing/distributing a fund across the EU plus Switzerland	€1.5 million
Total on-going costs of marketing/distributing a fund across the EU plus Switzerland	€1.4 million



- The main EU regulations directly or indirectly impacting the UK asset management industry come with an estimated cost of around £2 billion a year. Furthermore, the UK Government has not quantified the potential benefits of either the AIFMD or UCITS IV, noting that these would largely depend on the asset management industry's uptake of the EU-wide passport.
- If the recommendations set out in this paper (see Page 6 for an overview) are implemented, EU rules are made more proportionate and hurdles at the national level are removed, then the benefits to asset managers and their investors, and to the European economy as a whole, could be significant.

Summary of recommendations

1. National hurdles to the distribution of funds domiciled in other EU countries should be removed, as they contravene the spirit of the single market and the idea itself of a passport. EU-based asset managers would be more willing to bear some regulatory costs if they were guaranteed full and speedy market access to all 28 EU member states.
2. The threshold for the 'de minimis' exemption in the AIFMD should be raised from €100 million to €500 million.
3. UCITS funds that are only distributed to professional investors should not be obliged to appoint local paying agents in member states and should not be required to translate investor information documents in the language of member states where they are marketed. They could also be subject to less strict disclosure and reporting requirements. EU legislation already provides for a clear definition of who can be considered a professional investor.
4. The idea of introducing a Financial Transaction Tax (FTT), even among a limited number of EU member states, should be abandoned. Such a levy would be hugely harmful for the European asset management industry.
5. Proposals to ban the use of dealing commissions for the purchase of investment research should be dropped. A compromise can be found that offers more transparency for investors while ensuring the necessary flexibility for asset managers. An outright ban would have a disproportionate impact on smaller asset managers – and may even force some of them out of business.
6. EU-based asset managers who do not market their funds into other EU countries should be exempted from EU regulations – as they take no advantage from the passport. Asset managers covered by this new exemption would still have to register with the national regulator of their home member state, but would be subject to a lighter regulatory regime.

Methodological note

It has been extremely difficult to find empirical data for our studies. As a result, Open Europe and New City Initiative have consulted extensively with representatives of the asset management industry throughout the preparation of this paper. New City Initiative has also spoken to regulators and lawyers across the EU in order to come up with a solid qualitative estimate of the initial and on-going costs that a UK-based asset manager would incur in order to market in all the other 27 EU member states plus Switzerland. For a more detailed methodology, see Annex I.

1. What is the importance of the asset management industry to Europe?

"The [asset management] industry is a key bridge between end-savers and end-borrowers, between the financial and real parts of the economy. As the banking system continues to de-risk, strengthening that bridge could well strengthen both the financial system and wider economy."

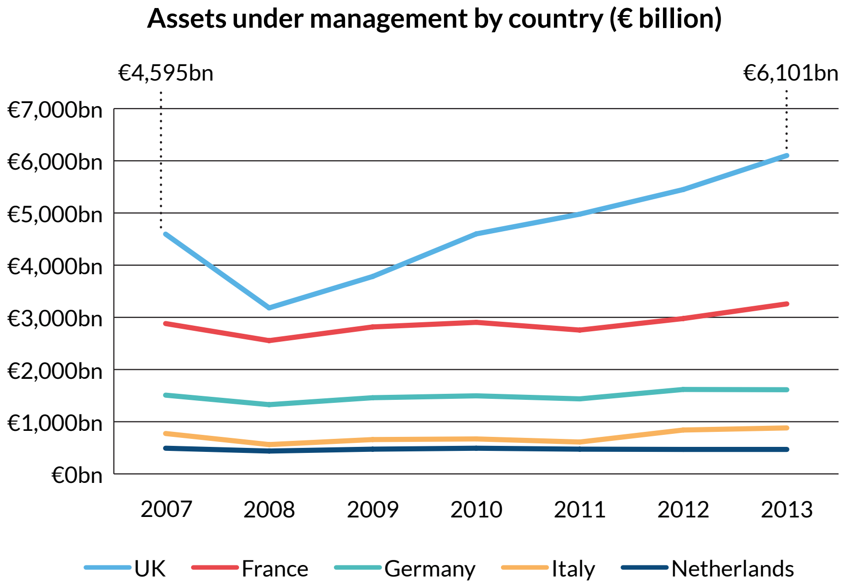
Andrew G Haldane, Chief Economist, Bank of England[1]

Asset managers are financial entities that manage investors' assets through either individual accounts or collective investment schemes – that is, investment funds. The best way to understand the vital role that asset managers can play in helping the recovery across the continent is to look at them as 'intermediaries'. They raise money from investors, and then re-invest it in a wide range of activities. At a time when Europe is struggling to find its way back to economic growth, it becomes all the more important to safeguard a sound and vibrant asset management industry.

1.1 Encouraging economic investment across Europe

It is wrong to think of investment funds as a vehicle for a small number of wealthy individuals to get wealthier in a short amount of time. In fact, it has been estimated that about 22.5 million households in the EU are invested in mutual funds.[2] According to TheCityUK, the EU fund management industry accounted for 29% of global assets under management in 2012.[3]

Graph 1: Assets under management in the five largest EU markets (2007-2013)



Source: EFAMA[4]

[1] Speech at the London Business School, 4 April 2014. Mr Haldane was Executive Director of Financial Stability at the Bank of England at the time when the speech was delivered: www.bankofengland.co.uk/publications/Documents/speeches/2014/speech723.pdf

[2] The estimate is based on 2005-2008 data from six EU member states (UK, France, Germany, Italy, Spain and Austria), see the European Commission's impact assessment of its initial UCITS V proposal, page 11: www.eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52012SC0185&from=EN

[3] *TheCityUK*, 'Key facts about EU financial and related professional services', April 2014, page 5: www.thecityuk.com/research/our-work/reports-list/key-facts-about-eu-financial-and-professional-services/

[4] Data is from EFAMA's annual reviews from 2009 to 2015

With assets under management totalling €6.1 trillion in 2013, the UK is one of the world's largest markets for fund management – along with the US and Japan.

However, in Europe, the industry is far from the sole reserve of the UK. Total assets under management in France and Germany were worth over €3.2 trillion and over €1.6 trillion respectively at the end of 2013.[5] Taken together, the UK, France and Germany account for 67% of Europe's asset management market.

Country	AuM (€bn)	Market share (AuM)
UK	6,101	37%
France	3,258	20%
Germany	1,613	10%
Italy	881	5%
Netherlands	469	3%

Source: EFAMA, Eighth Annual Review

Some organisations believe that the figure for assets managed from the UK is even higher. TheCityUK, for instance, estimates that 50% of EU fund management assets are managed from the UK.[6]

The activities of asset management firms include the purchase of bonds and shares of companies, meaning that investment funds bring liquidity to the market and help businesses finance themselves. According to the European Fund and Asset Management Association (EFAMA), bonds and equities accounted for 43% and 33% respectively of total assets managed by the European industry at the end of 2013.[7]

The benefits for people who decide to entrust part of their savings to asset management firms are numerous. They can get higher returns than if they were to put their money into a bank account, and can also have access to investment opportunities that are sometimes not available to individuals. It is also worth bearing in mind that, nowadays, a significant proportion of assets managed by the fund management industry globally come from institutional investors such as pension funds, insurers, universities and charities.[8]

1.2 Important source of employment

In the City of London alone, over 25,000 people worked in fund management at the end of 2014 – a 4.7% increase from the previous year.[9] Furthermore, the asset management industry helps create jobs across the EU – not only in the UK. An estimated 90,000 people were directly employed by asset management firms in Europe at the end of 2013, while a further 410,000 were employed in functions servicing the asset management industry. This gives a total of around half-a-million jobs directly or indirectly linked to fund management.[10]

[5] *EFAMA*, 'Asset management in Europe – Facts and figures', Eighth Annual Review, April 2015, page 13: www.efama.org/Publications/Statistics/Asset Management Report/150427 Asset Management Report 2015.pdf

[6] *TheCityUK*, Infographics: www.thecityuk.com/research/our-work/infographics

[7] *EFAMA*, 'Asset management in Europe – Facts and figures', Eighth Annual Review, April 2015, page 3

[8] Approximately two-thirds, see *AIMA*, 'The global hedge fund industry: delivering social and economic benefits around the world', 2011, www.aima.org/en/education/the-case-for-hedge-funds/global-hedge-fund-industry-paper-the-value-of-our-industry.cfm

[9] *TheCityUK*, 'London employment survey', January 2015: www.thecityuk.com/research/our-work/reports-list/london-employment-survey/

[10] *EFAMA*, 'Asset management in Europe – Facts and figures', Eighth Annual Review, April 2015, page 3

1.3 Important source of tax revenue

Fund management represents an important component of the UK's financial services sector – and it generates billions in tax revenues. It is hard to find data for the asset management industry alone, but it has been estimated that the UK financial services sector as a whole paid £65 billion in the 2012/2013 tax year.[11]

In proportion, the UK's financial services sector contributes more in taxes than its counterparts in other big EU member states. According to a PwC study from October 2013, the UK's financial services sector generated an average 9.5% of total taxes over the 2006-2010 timeframe. This compares to 6.2% in France, 5.6% in Germany, and 5.5% in Italy. The findings of the study also suggest that the tax contribution of the financial services sector exceeds its economic contribution in all of the four countries considered (see table below).[12]

	UK	France	Germany	Italy
Average financial services sector share of Gross Value Added (2006-2010)	8.8%	4.5%	4%	4.9%
Average financial services sector share of tax generated (2006-2010)	9.5%	6.2%	5.6%	5.5%

Source: PwC

1.4 Helps diversify lending beyond banks

The ability to rely on multiple sources of lending helps better protect an economy against shocks. Contessi et al. have noted that, during the recent financial crisis, bank loans evolved in a far more pro-cyclical way than bond markets. In other words, this means that bank lending contracts during a recession – while liquidity in bond markets may not necessarily do so.[13]

In this regard, asset managers can play an important role in helping businesses raise money from the broader capital markets instead of relying exclusively on banks. This becomes all the more relevant when the economy is struggling and banks become more reluctant to offer loans.

The Eurozone, in particular, is hugely reliant on bank lending. According to data from the European Central Bank, Non-Financial Corporations (NFCs) in the single currency area rely on bank loans for over 85% of their funding – while the figure in the US is less than half this. Furthermore, medium-sized companies in the US get roughly five times as much funding from the broader capital markets as their Eurozone counterparts.[14]

This means that a bigger role for asset managers in helping European businesses secure greater access to capital markets is not only possible, but also desirable – as it could actually help foster economic recovery in the Eurozone.

[11] *PwC*, 'Total tax contribution of UK financial services – Sixth Edition', report prepared for the City of London Corporation, December 2013. The estimate includes both taxes borne and taxes collected by the UK financial services sector

[12] *PwC*, 'An overview of the taxes generated by the European financial services sector', October 2013, page 7

[13] See, for instance, Contessi et al, 'Bank vs bond financing over the business cycle', Federal Reserve Bank of St. Louis, Economic Synopsis No 31/2013

[14] See also *Open Europe*, 'Quantitative Easing in the Eurozone: Limited economic benefits at a high political and legal cost', January 2015: www.openeurope.org.uk/intelligence/eurozone-and-finance/ecb-quantitative-easing/

1.5 Broadens investor base and increases revenue

Thanks to asset managers, individual savers can get the same access to capital markets as large investors. Unsophisticated savers, or savers who just do not want to spend time putting together their portfolio, particularly benefit from more active asset management. Furthermore, collective investment schemes reduce trading costs for investors. This is good news for less wealthy savers, who may otherwise see their returns excessively affected by trading fees because of the small value of their portfolios.

Indeed, this is not to say that the asset management industry is immune from examples of irresponsible behaviour. That needs to be prevented by means of regulation, as in all other types of business. However, the benefits of the asset management industry to the real economy are undeniable – and outweigh the risks involved (see Section 3).

2. Why is asset management different to other financial services?

While asset managers play an important role in connecting savers and borrowers, thereby providing a key source of investment for the wider economy, they do so in a different way to other financial services, in particular banking.

Less complexity
With some exceptions, asset management firms are straightforward businesses – characterised by leaner legal structures and simpler balance sheets compared to other types of financial entities. Furthermore, EU-based asset managers are now required to provide a significant amount of information about their activities.

High substitutability
The threat posed by individual firms to the overall stability of the financial system increases when their activities are so highly specialised that, in the event of a failure, it is difficult for other firms to step in and offer similar services. However, the majority of asset management activities are seen as highly substitutable.[15] This is also due to the global and highly competitive nature of the industry, which makes it a lot easier to move assets between managers and jurisdictions. As a result, although large funds with a dominant position in specific asset classes can indeed create bigger problems, the asset management industry is generally unlikely to pose meaningful systemic risk via this channel.

Limited use of leverage and limited balance sheet risks
Most of the asset management industry employs little or no leverage at all. Only hedge funds tend to use this tool more regularly, and not to the same extent as banks in any case. Furthermore, assets under management are held by custodians and are owned by investors. This means that they are not recorded on the balance sheets of asset management companies. In other words, asset managers tend to have small balance sheets and do not put their own balance sheets at risk when performing their services. This significantly reduces the industry's potential to pose a systemic risk.

No taxpayer-funded bailouts
Unlike banks, asset managers cannot tap national central banks for emergency funding when they face liquidity problems. Nor can they access taxpayer-backed bailouts from national governments in times of crisis. This is an important political point to bear in mind to make sure that regulation of the asset management industry remains proportionate.

[15] See, for instance, Douglas J. Elliott, 'Systemic risk and the asset management industry', Brookings Institution, May 2014: www.brookings.edu/~/media/research/files/papers/2014/05/systemic risk asset management elliott/systemic_risk_asset_management_elliott.pdf

3. What are the risks posed by the asset management industry?

As with other parts of the financial services sector, the asset management industry can be susceptible to crises. However, for a number of reasons, the risks inherent are different and possibly more easily manageable than, for instance, in the banking sector. Nonetheless, given the size of the industry, concern is growing that some funds are becoming 'too big to fail'. This is exacerbated by the concentration of the industry and the dominance of the largest managers. As the IMF put it in its 2015 Global Financial Stability Report,

> "By now, the assets under management of top asset management companies (AMCs) are as large as those of the largest banks, and they show similar levels of concentration."[16]

As such, it is worth considering and exploring some of the risks. These include, but are not limited to, the following:

- While insolvency may not be as big a risk, asset sales and sharp flows of capital can have significant market impacts;
- Following on from that, the industry can be particularly pro-cyclical and exacerbate booms and busts (particularly the potential for fire-sales given the 'first mover' advantage). This is worsened by the benchmarking and herd approach – something which may be more common as investment decisions are delegated to a smaller number of fund managers. This is unfortunate, since as a source of long-term capital the asset management industry could prove useful to smooth out such distortions;
- As with the shadow banking system more widely, some asset managers can suffer from 'liquidity mismatches'. This means they have short-term funding sources, with investors often able to pull cash out at will, but use it to finance longer term investments. This can cause problems in a crunch;
- Disintermediation of banks is good in terms of ensuring healthy diversification of funding sources for economic growth. However, this means asset managers take on a more important role as market makers and have significantly more importance with regards to the functioning of the financial system;
- The asset management industry can become a locus of counterparty risks, but simple prudence on not over exposing to certain entities should not be difficult to achieve. However, this becomes harder when markets are dominated by funds – take for example less liquid emerging market bonds;
- Unlike other parts of financial services, size is not always the best indicator of risk. Some Money Market Funds (MMFs) can be very large but hold only high quality liquid assets. It is more important to judge the type of assets which the fund invests in;
- An important aspect is how interconnected the sector is with the rest of the financial system, particularly the banking sector. These links take a number of forms, some more opaque than others, including ownership of asset managers, funding streams and information sharing.

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[16] See *IMF*, 'Plain vanilla investment funds can pose risks', IMF Survey, 8 April 2015: www.imf.org/external/pubs/ft/survey/so/2015/POL040815B.htm

The recent financial crisis is indicative of these points. The industry was hit hard and saw substantial outflows. There is a case to be made that it did indeed become pro-cyclical and exacerbate certain downturns, as funds were withdrawn from investments. However, the asset management industry was also one of the earliest to recover with funds flowing in early and taking advantage of the long rally in equities and bonds, to help investor returns amongst record low interest rates.

The risks of course vary across the various types of asset managers. The inherent risks in leveraged hedge funds are higher and widely known but are borne privately by institutional investors and rarely result in significant market disturbances. Indeed, the experience of Long Term Capital Management (LTCM), which needed a Wall Street-backed bailout in 1998, provides a warning that we should not be complacent of the risks. However, LTCM was leveraged at 25:1 at the time of its failure. Nowadays, such leverage at hedge funds is rare – with the UK's Financial Conduct Authority (FCA) 2015 hedge fund survey finding that the median gross leverage per fund was 3.9 times their Net Asset Value (NAV) in September 2014, down from 4.2 in March 2014.[17]

Similarly, certain MMFs are known to suffer from vulnerabilities due to their structures and the ease/speed of redemptions. This was demonstrated during the crisis when a number of funds 'broke the buck', causing the US Department of the Treasury to issue a guarantee to maintain the value of MMFs (similar to deposit insurance). Regulatory steps are being taken in Europe to address these risks, although it is proving tough to balance protection against risk with the very fine margins which MMFs are working in due to the very low interest rate, inflation and growth environment.

On the whole, during the recent financial crisis, while there were examples of different types of asset managers getting into trouble and even becoming insolvent, these seem to be largely isolated incidents rather than systemic flaws.

4. Key pieces of EU legislation impacting the asset management industry

In the aftermath of the 2008 financial crisis, the European Commission has tabled more than 40 proposals for financial services laws – many of which are already in force.[18] In this section, we provide a brief overview of the main EU regulations with either a direct or an indirect impact on the asset management industry.

4.1 Alternative Investment Fund Managers Directive (AIFMD)

The Alternative Investment Fund Managers Directive (AIFMD) was adopted in 2011 and came into effect in 2013. It covers managers of all types of investment funds – hedge funds, private equity funds, real estate funds, etc. – that are not covered by the UCITS Directive (see below). It applies to any fund manager who manages total assets worth €100 million or more.[19] The AIFMD creates a 'passport system' for EU-based managers of alternative investment funds, mirroring the one introduced by the UCITS IV Directive.[20] Managers authorised by the national regulator of one EU member state can market their funds to professional investors in any other EU member state. Managers that do not wish to make use of the pan-EU passport can market to institutional investors through national private placement regimes – although the latter can vary markedly across jurisdictions.

The AIFMD requires fully compliant fund managers taking advantage of the pan-EU passport to appoint a single depositary for each of the funds they manage. The depositary is responsible for safe-keeping of assets, oversight of activities, and management of cash flows of the fund. Depositaries are subject to strict liability for the loss of assets, although many discharge or indemnify themselves against this

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17 See *Financial Conduct Authority*, 'Hedge fund survey 2015', page 22: www.fca.org.uk/static/documents/hedge-fund-survey.pdf

18 *European Commission*, 'A reformed financial sector for Europe', Communication COM(2014) 279, 15 May 2014: www.ec.europa.eu/internal_market/finances/docs/general/20140515-erfra-communication_en.pdf

19 The threshold is raised to €500 million if the funds are not leveraged and investors have no redemption rights for at least five years since the initial investment in each fund

20 Directive 2009/65/EC: www.eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0032:0096:en:PDF

liability in certain circumstances following agreements with their sub-custodians. EU-based managers of non-EU funds are allowed to appoint a 'depositary-lite' – an entity that provides depositary services, but is excused from strict liability. Importantly, the depositary must be located in the same EU country as the fund.

As regards non-EU managers, at the moment they can still market their funds in the EU via national private placement regimes. This means they do not have to comply in full with the AIFMD, and are notably exempt from rules on depositary liability – although they are only granted access to one EU country at a time.[21] However, private placement could be abolished across the EU after 2018.[22] Some EU member states (notably Germany) have actually already de facto scrapped private placement unilaterally.[23] Non-EU fund managers are currently awaiting an imminent decision on which third countries will have the pan-EU marketing passport made available to them.

4.2 Undertakings for Collective Investment in Transferable Securities (UCITS) Directive

The latest update to the UCITS Directive, known as UCITS V, was adopted in July 2014 and needs to be transposed into national law by March 2016. UCITS V primarily focuses on two aspects: the role of depositaries and the remuneration of UCITS managers. As regards depositary liability, UCITS V largely echoes the rules set out by the AIFMD (see above). The main difference is that UCITS depositaries cannot limit or discharge their liability by agreement with their sub-custodians.

When it comes to remuneration, UCITS V establishes that managers must have at least half of their bonus paid in units of their own funds – while at least 40% of it will have to be deferred over a period of at least three years, again mirroring the rules laid out in the AIFMD. Furthermore, UCITS V establishes that bonuses "shall generally be considerably contracted" in case of poor performance. This includes the possibility of not paying out bonuses that UCITS managers have already earned.[24] UCITS V also sets out a number of administrative sanctions for managers found in breach of EU rules.

4.3 Markets in Financial Instruments Directive II (MiFID II)

The upgraded Markets in Financial Instruments Directive (aka MiFID II) was adopted in May. The deadline for transposition into national legislation is July 2016, although the new rules will come into effect in January 2017. MiFID II covers a wide range of investment activities and products, including high-frequency trading and commodity derivatives.[25]

The entry into force of MiFID II will have several implications for asset managers, mostly stemming from stricter investor protection rules. As usually happens with EU financial services legislation, MiFID II is a framework law that has yet to be complemented by a number of more detailed implementing rules. As part of this process, the EU looks set to tighten the rules on asset managers' use of dealing commissions to pay brokers for investment research (see Section 6).

4.4 European Market Infrastructure Regulation (EMIR)

The European Market Infrastructure Regulation (EMIR) was adopted in July 2012 and entered into force in February 2014.[26] Under EMIR, financial institutions – including asset managers – are required to report every derivative contract they enter into to a trade repository based in the EU and registered with the European Securities and Markets Authority (ESMA), the EU's financial markets watchdog. They also need to inform the repository every time a contract is modified, or if it is terminated. EMIR also

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21 See the FCA's website for further details: www.fca.org.uk/firms/markets/international-markets/aifmd/nppr

22 By means of a European Commission delegated act, based on advice from ESMA. See Articles 67 and 68 AIFMD

23 See White & Case, 'AIFMD in Germany: Strategies for non-EU AIFMs marketing alternative investment funds', July 2013: www.whitecase.com/files/Publication/d89e842b-4e95-4360-9b3e-eb2de263b2e9/Presentation/PublicationAttachment/d8d49155-2713-433d-ab59-ecad7ad794dd/GER0713007_Insight_Capital_Markets_July_2013_FINAL.pdf

24 For further details, see the new Article 14b introduced by Directive 2014/91/EU (UCITS V)

25 Directive 2014/65/EU: www.eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065&from=EN

26 Regulation (EU) No 648/2012: www.eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32012R0648&from=EN

establishes that a significant portion of over-the-counter derivative contracts – that is, derivative contracts not traded on an exchange – need to go via a clearing house if their value exceeds a certain threshold. The clearing thresholds range from €1 billion to €3 billion, depending on the different types of derivative contracts.[27]

4.5 Solvency II

The EU's Solvency II Directive sets out new stringent capital requirements for the European insurance sector.[28] It was adopted in 2009 but is only due to enter into force in January 2016 – a few years later than initially envisaged. Solvency II is primarily addressed to the insurance industry, but it does have implications for asset managers.

First, the Directive forces insurers to hold more capital if they invest into products that are seen as riskier by regulators – with hedge funds included in the highest-risk band, corresponding to a 49% 'capital charge'. This could discourage insurers from investing into hedge funds. Second, insurers are required to provide national supervisors with a significant amount of information about their investment and assets. This will require fund managers to supply a substantial amount of data to their insurer clients – an additional operational burden that should not be underestimated.[29]

4.6 European Long-Term Investment Funds (ELTIFs)

The European Commission tabled its proposal for European Long-Term Investment Funds (ELTIFs) in June 2013.[30] The idea was to have a dedicated scheme for long-term investment projects in areas such as infrastructure, new technologies and sustainable energy. The ELTIF Regulation was adopted in April and will apply from December.[31]

The new ELTIFs will have to be run by fund managers authorised under the AIFMD and will be required to invest at least 70% of their capital in long-term investment projects. The remaining 30% can be used for trading in UCITS-eligible securities. It will be possible to market ELTIFs to retail investors, but with some restrictions – not least because these new long-term funds are supposed to invest in illiquid assets, meaning that investors would not be able to redeem their money at short notice.[32]

4.7 Securities Financing Transactions Regulation (in the pipeline)

The European Commission tabled its draft Securities Financing Transactions Regulation (SFTR) in January 2014. The proposal is part of the Commission's drive to tighten up regulation of so-called 'shadow banking' activities.[33] The SFTR would require fund managers to report details of their securities financing transactions – such as securities lending and borrowings – to trade repositories. The new rules would bear some similarities to EMIR, and would also require UCITS and AIFMs to rigorously document their re-hypothecation practices at prime brokers.

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[27] The clearing threshold is set at €1 billion for credit and equity derivatives, and at €3 billion for all other types of OTC derivatives, see the European Commission's Delegated Regulation (EU) No 149/2013: www.eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:052:0011:0024:EN:PDF

[28] Directive 2009/138/EC: www.eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:335:0001:0155:en:PDF

[29] For further details, see *New City Initiative*, 'What is Solvency II?', 2 February 2015: www.newcityinitiative.org/news/what-is-solvency-ii/

[30] *European Commission*, European Long-Term Investment Funds: www.ec.europa.eu/finance/investment/long-term/index_en.htm

[31] Regulation (EU) 2015/760: www.eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:JOL_2015_123_R_0010&from=EN

[32] Retail investors with a portfolio of up to €500,000 will only be allowed to invest an aggregate amount of up to 10% of their portfolio into ELTIFs: www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/146140.pdf

[33] See European Commission, 'Proposal for a Regulation of the European Parliament and the Council on reporting and transparency of securities financing transactions', 29 January 2014: www.eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:52014PC0040

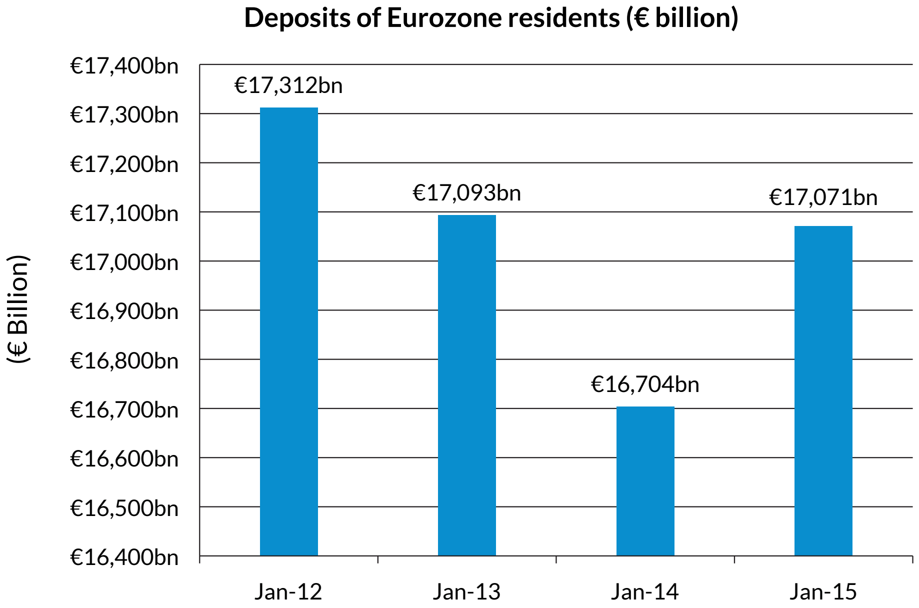
5. The advantages of EU membership for the asset management industry

5.1 EU membership potentially opens up a huge market to asset managers

The EU has introduced a 'passport system' for asset managers. If implemented properly, the passport system can be beneficial for both investors and managers. It means greater choice for the former, and more business opportunities for the latter. Easier access to investors in other EU member states should be good news for UK-based asset managers, particularly given the current challenges of raising capital.

The EU passport potentially means also gaining access to a huge pool of liquidity, at least part of which may be invested. To give an example, although deposits of Eurozone residents have decreased slightly compared to three years ago, they were still worth over €17 trillion at the end of January.[34]

Graph 2: EU passport means potential access to a huge pool of liquidity



Source: European Central Bank

In this regard, the UK could especially benefit from the City of London being traditionally seen as the 'gateway' to the rest of the EU. In other words, a growing number of non-EU investment funds may want to establish a branch in London and then gain access to other European markets thanks to the passport.

5.2 The importance of UCITS

Between 2009 (when the UCITS IV Directive was adopted) and 2013, almost every EU member state has seen a rather substantial increase in the number of registrations of UCITS funds. In the UK, the number of registrations of UCITS funds jumped from 3,482 in 2009 to 5,144 in 2013 – a 48% increase over the period.

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34 ECB, 'Aggregated balance sheet of Euro area monetary financial institutions, excluding the Eurosystem – Deposits of Euro area residents': www.ecb.europa.eu/stats/money/aggregates/bsheets/html/outstanding_amounts_L20.A.U2.0000.en.html

Country	Number of UCITS registrations in 2009	Number of UCITS registrations in 2013	% growth 2009-2013
Germany	5,329	7,403	39%
Austria	4,282	5,382	26%
France	3,671	5,261	43%
UK	3,482	5,144	48%
Netherlands	3,678	4,986	36%
Spain	3,559	4,297	21%
Italy	3,081	4,232	37%
Sweden	2,538	3,628	43%
Finland	1,904	3,027	59%
Belgium	1,927	2,477	29%

Source: PwC[35]

More generally, the sharp growth in the number of registrations shows that UCITS have become increasingly attractive – primarily because they are seen as ensuring high levels of transparency and investor protection. It is also undeniable that UCITS have gained recognition across the world over the past few years as *the* global standard for mutual funds. Asset managers in the UK and elsewhere in the EU benefit from the reputation of the UCITS brand to attract non-EU investors.

5.3 Increased transparency shores up investors' confidence

In principle, the disclosure requirements introduced at the EU level can have a number of positive side-effects. They can shore up investors' confidence and provide a boost to the asset management industry's reputation, for instance. They can also help prevent market abuse and make the industry more understandable for the media and the public. However, it is also essential to strike the right balance between ensuring the necessary transparency and keeping the compliance costs at a reasonable level – especially for smaller asset management companies.

5.4 Influence over the design of EU rules

It is beyond doubt that, in the aftermath of the 2008 crisis, EU financial regulation has become increasingly focused on ensuring financial stability and protecting investors, while paying less attention to opening up the markets and facilitating cross-border trade.

However, thanks to its reputation as a global financial hub, the UK has been able over the years to influence the design of legislation adopted at the EU level and make it less prescriptive. The first Market in Financial Instruments Directive (MiFID I) is a clear illustration of how a key piece of EU legislation has been influenced by UK thinking – notably as regards the ways MiFID I required financial firms to categorise their clients and some of the forms of trading that had to be allowed throughout the EU following the adoption of MiFID I.[36]

As regards the asset management industry more specifically, it was an amendment brokered by a UK MEP that stopped the European Parliament adopting an outright

[35] *PwC Ireland*, 'Fund distribution: UCITS and Alternative Investment Funds (AIFs)', May 2014: www.download.pwc.com/ie/pubs/2014-pwc-ireland-distribution-knowledge-12-05-2014.pdf

[36] For further details, see *Open Europe*, 'Continental shift: Safeguarding the UK's financial trade in a changing Europe', 2011: www.openeurope.org.uk/Content/Documents/Pdfs/continentalshift.pdf

bonus cap for managers of UCITS funds.[37] These examples show that, provided that it has a clear negotiating strategy and makes a move sufficiently early during the law-making process, the UK can make its voice heard when it comes to drawing up EU rules. More generally, the UK has had – and still has – an important role to play in giving a more pro-free trade steer to EU financial regulation.

5.5 EU keen to encourage non-bank lending

The EU deserves some credit for actively trying to encourage non-bank lending as a way to speed up economic recovery. The creation of ELTIFs, which we discussed in Section 4.6, is a clear example and a positive step – as well as the wider plans for a Capital Markets Union (CMU) unveiled by EU Financial Services Commissioner Lord Hill.[38]

The exact magnitude of the benefits is hard to predict at this stage. ELTIFs could, for instance, turn out to be not particularly attractive for retail investors – given that they would usually not be allowed to get their money back until the end of the life of the fund. As regards CMU, the public consultation phase only ended in May. This means the road ahead is still quite long, as negotiations between national governments and the European Parliament have yet to start.

However, the direction of travel seems to be the right one. The EU looks increasingly keen to boost alternative sources of funding for businesses across Europe – potentially opening up a whole range of new opportunities for the asset management industry.

5.6 More choice for investors

Being part of the EU's single market is also beneficial for investors across Europe, since they can choose from a much larger pool of asset managers. Investors have the option of spreading their money across a number of funds operating in different countries, with different approaches and exposures. This ultimately means they can reduce investment risk further.

6. The drawbacks of EU membership for the asset management industry

Although, as we noted in the previous section, the asset management industry can benefit from the UK being a member of the EU, it is also true that EU regulation poses a number of challenges to asset managers.

6.1 One-size-fits-all approach to regulation

Arguably the biggest problem with EU financial services regulation is the one-size-fits-all approach in the design of new rules. This is true on two different levels:

a. Different industries within the financial services sector need different regulatory approaches;

b. Big asset managers are not the same as small ones.

a. The financial services sector is no monolith

The financial services sector is not a homogeneous bloc. The asset management industry has its specificities and poses different types of risks compared to other industries – banking, insurance, etc.

This means that different industries need different types of regulation. However, the EU institutions seem to think that measures envisaged for one industry can just be replicated across the financial services sector. The bankers' bonus cap is a good example. The rationale for its introduction was basically that bankers had to be dissuaded from taking excessive risks in order to avoid a repeat of the 2008 financial

[37] For further details, see *Open Europe Blog*, 'MEPs reject plans for controversial fund managers' bonus cap', 3 July 2013: www.openeuropeblog.blogspot.co.uk/2013/07/meps-reject-plans-for-controversial.html

[38] See *Open Europe Blog*, 'Capital Markets Union – Good idea, bad name', 18 February 2015: www.openeurope.org.uk/blog/capital-markets-union-good-idea-bad-name/

crisis and the subsequent taxpayer-backed bailouts.

The same rationale certainly does not apply to asset managers, who cannot expect governments to come to the rescue if they run into difficulties. Nonetheless, the European Parliament tried to extend an outright bonus cap to asset managers during the negotiations over UCITS V. This approach does not always appear to take into account the specificities of the different financial industries.

b. Big vs small asset managers

Regulation should take into account the size of asset managers and be applied proportionately. This is not always the case with EU regulation. The AIFMD, for instance, imposes the same requirements on any fund manager who manages total assets worth €100 million or more – meaning that it captures a number of fund managers that presumably have very little, if any, impact on global financial stability.[39]

Another example is MiFID II, particularly with regard to how asset managers should pay for investment research. Asset managers rely on brokers to execute trading operations, and pay them what is known as a 'dealing commission'. The cost of the commission is then passed on to investors, as part of the services the asset manager is providing them. It is quite common, especially among smaller asset management firms, to also ask brokers to carry out research on specific investment opportunities – and pay them higher commissions in return for what is, in substance, a 'bundle' (trading execution plus investment research).

However, according to ESMA, this practice should be forbidden. Investment research should be 'unbundled' from trading execution. More transparency on the use of dealing commissions and the purchase of investment research can help boost the reputation of the asset management industry. In addition, ESMA is not suggesting that asset managers pay for research themselves as the only option – which is encouraging.[40]

Yet, the new rules under consideration could prove quite burdensome and would still unnecessarily limit asset managers' ability to rely on high-quality research – thereby resulting in them missing potentially profitable investments. The unintended consequences of forcing asset managers to pay for research from their own pocket would be significant. An outright ban on the cost of research being passed on to investors would clearly favour larger asset management companies – especially those that can afford their own in-house research services. Smaller firms tend to be heavily reliant on external research, and would find it a lot more difficult to face this extra cost. A number of smaller managers may even be forced out of the market.

The Financial Conduct Authority (FCA) – the UK's financial supervisor – is itself very supportive of 'unbundling' research from dealing commissions. In a recent discussion paper on this issue, the FCA argued:

> **"We believe unbundling would drive price transparency and a focus on value for money by investment managers, and more effective competition in the supply of research services [...] We expect significant benefits from unbundling research from dealing commissions, which would outweigh costs to industry or potential negative effects on the market."[41]**

However, the FCA should avoid gold-plating EU rules on investment research and instead make sure that any new measures do not overburden smaller asset managers.

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[39] The threshold is raised to €500 million if the funds are not leveraged *and* investors have no redemption rights for at least five years since the initial investment in each fund

[40] See, for instance, *ESMA*, 'Technical advice to the European Commission on MiFID II and MiFIR', 19 December 2014, page 133: www.esma.europa.eu/system/files/2014-1569_final_report_-_esmas_technical_advice_to_the_commission_on_mifid_ii_and_mifir.pdf

[41] *FCA*, 'Discussion on the use of dealing commission regime: Feedback on our thematic supervisory review and policy debate on the market for research', discussion paper DP14/3, July 2014, page 11: www.fca.org.uk/static/documents/discussion-papers/dp14-03.pdf

6.2 EU regulations come with substantial cost for the UK asset management industry

Based on figures from the UK Government's Regulatory Impact Assessments (RIAs) available at this stage, it turns out that the EU laws we briefly presented in Section 4 come with an estimated cost of around £2 billion a year.[42] Admittedly, this cost does not fall entirely on asset managers – Solvency II is mainly addressed to the insurance industry, for instance, and MiFID II will apply to many different areas and products, just as its predecessor MiFID I.

However, it is worth bearing in mind that the AIFMD alone costs an estimated £1.5 billion a year – and it is specifically addressed to fund managers. Furthermore, the total figure does not include the estimated cost of UCITS V and MiFID II. Both have been adopted at the EU level, but have yet to be transposed into UK law – meaning that the UK Government has not published an impact assessment for either of them to date. The same goes for the other EU regulations in the pipeline.

RIAs usually also carry estimates of the benefits of new regulations. However, the UK Government has not quantified the potential benefits of either UCITS IV or the AIFMD – while stressing that both would improve competition, market efficiency and investor protection. The main reason cited was that it was virtually impossible to forecast how many fund managers would decide to make use of the passport.

The distribution of regulatory costs and benefits is not uniform across the industry. For example, asset managers that make little or no use of the passport see reduced benefits from EU regulation. Similarly, compliance costs are proportionally higher for smaller asset managers compared to their larger counterparts. According to a survey conducted by BNY Mellon at the end of 2013, for instance, a typical asset manager was expected to pay approximately $300,000 in initial AIFMD compliance costs.[43]

6.3 Global regulation vs regional regulation

The EU does not legislate in a vacuum, meaning that it is essential to always take into account the global regulatory environment. This is all the more true for the asset management industry, given how fluid it is and how easily managers can move across firms, countries and continents. Unilaterally regulating certain aspects of the industry means potentially losing some of the best talents to other non-EU big financial centres.

New EU rules on remuneration of UCITS managers – which broadly mirror those introduced by the AIFMD in 2013 – are a good example in this regard. Although these rules stop short of an outright cap on UCITS managers' bonuses, they still amount to unilaterally introducing restrictions on pay that do not exist in other parts of the world.

6.4 Approach to financial regulation has shifted away from Anglo-Saxon liberalism after the crisis

The latest global financial crisis has led to a change in attitudes towards financial services regulation. At the EU level, this has led to proposed laws gradually becoming less focused on boosting cross-border trade and increasingly aimed at extending the scope and bite of regulation instead.

This shift away from Anglo-Saxon liberalism inevitably means that the UK has lost some of its influence over the design of EU rules. This change of tack is not entirely unjustified. The Anglo-Saxon regulatory framework did show some clear weaknesses leading up to the crisis – as did other systems. As a result, the new regulatory approach at the EU level has reflected the idea that the financial sector was enjoying too much freedom during the pre-crisis years.[44] However, it may well be that, in the near future, the UK and EU approaches to financial regulation begin to converge again.

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[42] The figure is in 2014 prices, and is the sum of the estimated recurring cost of AIFMD, UCITS IV, Solvency II, EMIR and MiFID I

[43] BNY Mellon, 'AIFMD: The risks of non-compliance', survey conducted from 10 December to 29 December 2013: www.bnymellon.com/ global-assets/pdf/foresight/aifmd-the-risks-of-non-compliance.pdf

[44] For a more detailed discussion, see *Open Europe*, 'Continental Shift: Safeguarding the UK's financial trade in a changing Europe', December 2011, pages 14-16

6.5 Protectionism

Due to the high cost of complying with the various EU regulations, some non-EU fund managers may simply give up on doing business in the EU. This would be bad news for the UK in particular, since London is seen as the gateway to the EU market. Furthermore, a number of non-EU countries could decide to adopt more protectionist measures – ultimately leading to limited choice for investors.

7. Recommendations

Below, we set out a number of recommendations to improve the business environment for European asset managers by making sure that the industry is not overburdened by disproportional EU regulation.

7.1 Remove national barriers to distribution of funds based in other EU countries

At least in principle, the 'passport system' is arguably the main benefit of EU membership for asset managers. However, there are a number of examples showing that the single market for EU-based fund managers is not working as smoothly as envisaged by UCITS IV and the AIFMD. Imposing additional requirements on top of what is laid down in EU legislation contradicts the idea itself of an EU-wide passport.

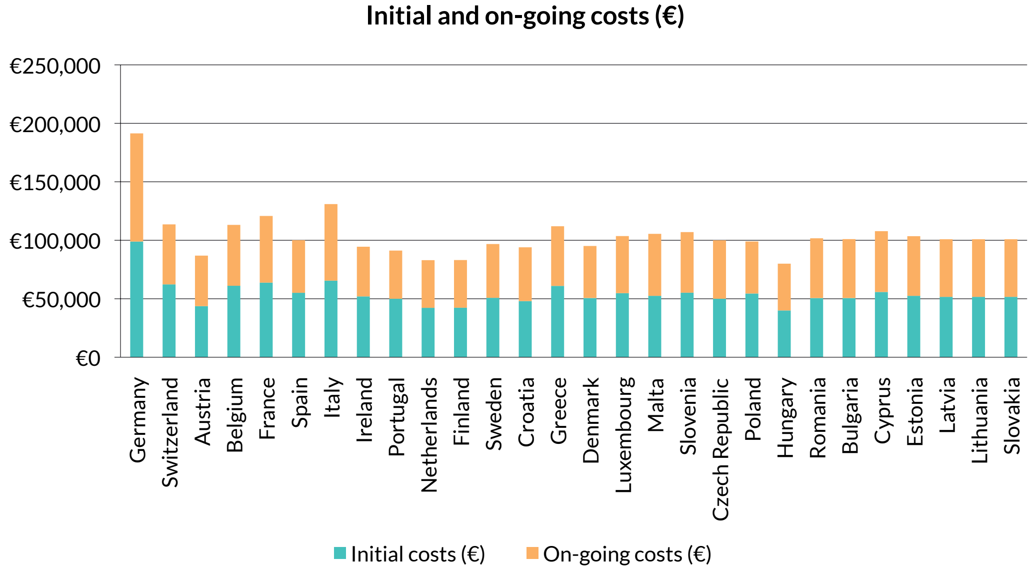
Therefore, we recommend scrapping such barriers. EU-based asset managers would be more willing to bear some regulatory costs if they were offered the prospect of higher returns thanks to full and speedy market access in all 28 EU member states.

Various national regulators, for instance, charge fees on fund managers based in other EU member states, in some cases for the mere processing of their passport notification. This can make it quite expensive to passport funds into multiple host countries, especially for smaller asset managers. In addition, these supervisory fees usually apply to individual funds – something which drives the cost further up because it means a manager has to pay multiple times if it wants to passport multiple funds.

New City Initiative consulted with lawyers in several EU countries and fund managers distributing into a number of EU markets to estimate what the real costs of distributing a UK-domiciled Open-Ended Investment Company (OEIC) UCITS fund would be.

Total initial costs of marketing/distributing a fund across the EU plus Switzerland	€1.5 million
Total on-going costs of marketing/distributing a fund across the EU plus Switzerland	€1.4 million

Graph 3: Initial and on-going costs of marketing in other EU member states and Switzerland



Source: New City Initiative calculations[45]

The graph above reflects the initial and on-going costs of legal fees, added regulatory and tax requirements, local agents and management time of a UK-based fund manager distributing into EU markets and Switzerland.

The initial costs include initial management costs (which we put on average at €40,000 for all EU countries), initial regulatory costs and additional initial costs – legal costs, paying agent costs, translation costs, and so forth. The latter two vary from one country to another.

Similarly, on-going costs include management costs (same average as above), on-going regulatory costs and additional on-going costs. Again, the latter two vary from one country to another. For a more detailed methodology, see Annex I.

We estimate that a UK-based fund manager marketing and distributing in all the other 27 EU member states plus Switzerland would face total initial costs of over €1.5 million. Total on-going maintenance costs – allowing for the continuation of cross-border marketing – could be near €1.4 million per year. However, on-going costs tend to become less of an issue as firms begin to manage capital on behalf of EU investors.

[45] New City Initiative attained its estimates through consulting documents such as Global Funds Registration (GFR) data and speaking with regulators and lawyers in the referenced EU member states (plus Switzerland). New City Initiative also spoke with fund managers distributing fund vehicles across the EU

Case Study 1: Austria and Germany

Perhaps one of the biggest challenges facing asset managers surrounds the tax laws in a handful of jurisdictions – most notably Austria and Germany, which have strict interpretations of tax transparency. A paper published by PwC explores this issue.[46]

Taxation is and should remain a national competence. This case study is not a suggestion for tax harmonisation at the EU level, but gives a good idea of the difficulties asset managers face when trying to market their funds outside their home EU member state. In that sense, it is an example of the need for tax simplification and increased clarity.

According to the PwC paper, foreign funds in Austria are obliged to hire a local tax representative alongside a fund administrator to calculate and provide in a timely fashion information on distributed income, net interest income and information on the taxable portions of the distributions paid to investors to the Österreichische Kontrollbank (OEKB). Appointing tax representatives and a fund administrator is not cheap, and adds to the costs of doing business.

Germany is equally challenging from a tax perspective. As with Austria, foreign funds must demonstrate to German tax authorities that they are tax transparent, and fully compliant with German tax law. This forces the fund to adhere to a number of reporting requirements and obtain confirmation from tax authorities in Germany that the fund's German tax reporting is compliant with local tax legislation. This must be verified by an auditor and published in the German Electronic Federal Gazette within four months of the financial year-end. "In addition to annual reporting Germany requires daily reporting for certain parts of the fund's income", adds the PwC paper.

The additional costs of this should not be underestimated. One long-only equity fund manager in London highlights that his organisation spends approximately €30,000 in audit fees for its six share classes, and notes that "€30,000 is a lot of money before an investment vehicle has commenced marketing. This does not take into account other additional costs such as translating documents, for example. In total, net of regulatory, local agent and legal fees, it costs around €45,000 to begin distributing in Germany."

He adds, "German tax transparency is a very challenging proposition. The authorities in Germany want specific figures pulled out, and the data from financial statements on income, dividends and distributions must be formatted according to these specific requirements. This all costs a huge amount of money through audit fees, which can rise to thousands and thousands of pounds. Again, this is another stumbling block to distributing funds in Europe." He concludes, "Once firms have raised meaningful capital in Germany, these charges are not an issue. But it is a challenge for smaller managers hoping to market across the EU. If you are marketing into Germany, France and Switzerland – which tend to be core investor markets, it can cost up to €150,000 before firms have even started to distribute or raise money."

Other examples of hurdles to the correct functioning of the EU passport include:

- The AMF, the French national regulator, requires that managers of alternative investment funds appoint a 'paying agent' *(agent centralisateur)* based in France before they can start marketing in the country. However, while having a paying agent based in the host member state is mandatory for UCITS funds, the AIFMD makes no mention of it.
- As noted by the Law Society of England and Wales in its response to a recent ESMA consultation, different EU member states have adopted different

[46] *PwC Ireland*, 'Fund distribution: UCITS and Alternative Investment Funds (AIFs)', May 2014: www.download.pwc.com/ie/pubs/2014-pwc-ireland-distribution-knowledge-12-05-2014.pdf

approaches with regard to what 'marketing' means for the purposes of the AIFMD. More specifically, some countries consider preliminary promotional activities (that is, for instance, when fund managers approach potential investors in a country) as marketing – meaning that asset managers cannot engage with potential investors without going through the passport notification process. In practice, this imposes a cost, which in some cases includes a fee for the processing of the passport notification, at a stage when asset managers do not know yet whether investors in a specific country will be interested in buying their fund. The Law Society notes that – in other EU countries – 'marketing' occurs when a fund is actually made available to investors.

In order for the EU passport to express its full potential, national regulators of EU member states need to boost coordination to make sure that such additional requirements are scrapped as soon as possible. The same should apply at least to the fees that some national regulators charge to simply process the passport notifications they receive from their counterparts in other EU countries.

7.2 Raise threshold for 'de minimis' exemption in AIFMD

Currently, the AIFM Directive does not apply to fund managers with total assets under management worth less than €100 million. However, this means that the Directive still covers a number of fund managers that are unlikely to pose a threat to global financial stability. We recommend that the threshold for 'de minimis' exemption from AIFMD be raised to €500 million. This would be unlikely to increase systemic risk, and can be done by amending the AIFM Directive.

Statistics showing in a clear-cut fashion how many fund managers would fall within this new exemption are not immediately available. It is worth bearing in mind that the 'de minimis' exemption in the AIFMD applies to individual managers, not individual funds. In practice, this means that a fund manager running several funds – whose total size in terms of assets under management is larger than €500 million – would not be eligible for the exemption.

7.3 Less paperwork for UCITS only marketing to professional investors

EU rules establish that,

> **"UCITS shall, in accordance with the laws, regulations and administrative provisions in force in the member state where their units are marketed, take the measures necessary to ensure that facilities are available in that member state for making payments to unit-holders, repurchasing or redeeming units and making available the information which UCITS are required to provide."[47]**

As a result, UCITS funds are forced to appoint a 'paying agent' based in each host EU member state where they want to sell their units. In practice, paying agents are a one-stop shop for investors who put their money into a UCITS fund based elsewhere in the EU. However, they also represent an extra cost to asset managers.

The prices of local agents can vary significantly. For example, fund managers are obliged to pay a fixed agency fee of 0.3% of the total UCITS fund assets for each UCITS established in Croatia, the EU's newest member state. While the registration costs in Bulgaria appear markedly low, the appointment of a local agent can be a very expensive proposition. According to one Bulgarian-based lawyer, "Based on our experience, local agents charge fees in the range of 20 basis points of the Net Asset Value of the relevant shares. However, such fees are subject to contractual arrangements and may vary depending on the specific agent used and the UCITS fund and manager."

The UCITS IV Directive also establishes that asset management companies need to

[47] Article 92 of Directive 2009/65/EC: www.eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0032:0096:en:PDF

translate a certain amount of information for investors – the so-called Key Investor Information Document (KIID) – into the official language of the host member state before they can start marketing there. This can be regarded as another additional cost.

While these costs may appear trivial if taken individually, they can be quite burdensome if added together across multiple markets. Managers often have to appoint lawyers and tax consultants, and translators to translate various documents. All of this adds to the cost of doing business when operational costs are rapidly mounting and returns are increasingly hard to come by.

Case Study 2: Slovenia

Another stumbling block is the varying degrees of expertise and familiarity with the asset management sector in different EU member states. One compliance expert explains the contrasts, "We have assisted fund groups with obtaining registration in Slovenia and it can take up to one year to obtain authorisation. The regulatory registration process in itself is not painful. Ensuring we meet the compliance standards and rules in advance of seeking registration can be an issue. The key challenge is appointing a local bank as an agent, and this is a time-consuming process. It is not a regulatory stumbling block but a market issue as it takes a long time for an agent bank to on-board funds. If we contrast that with Ireland – a jurisdiction that is well-versed with UCITS – the registration process happens in a matter of weeks because the service provider community is very experienced at getting firms up to speed."

The compliance expert concludes, "These newer EU markets like Slovenia simply need time to familiarise themselves with UCITS. Over time this will undoubtedly happen, and local regulation and service providers will adapt and make it more straightforward for foreign funds to distribute."

One fund manager estimates the initial costs in management time of distributing a fund in Slovenia to be around €40,000 – excluding regulatory and legal costs. On-going costs are approximately €6,000, according to the fund manager – although one must remember Slovenia remains a small investor market.

While such requirements are justifiable for UCITS funds that are sold to retail investors, they make less sense for UCITS funds that are only marketed to professional investors – which could therefore be given an exemption. UCITS funds that are only sold to professional investors could also be subject to less strict disclosure and reporting requirements – the rationale being that professional/institutional investors would be doing their own due diligence before putting money into a fund.

According to the EU definition, laid down in MiFID II, a professional investor "possesses the experience, knowledge and expertise to make its own investment decisions and properly assess the risks that it incurs." This includes "entities which are required to be authorised or regulated to operate in the financial markets" – banks, insurance companies, pension funds, and so forth. National and regional governments, as well as "large undertakings" meeting certain size requirements, are also considered as professional investors under EU rules.[48]

It should be straightforward to apply this criterion – which is already set out in existing EU legislation – to UCITS funds in order to establish whether their clients are professional investors or not.

[48] The definition of 'professional client' was laid down in MiFID, and has been carried over to MiFID II. Large undertakings are considered as professional investors if they meet at least two of the following requirements on a company basis: their total balance sheet is at least €20 million; their net turnover is at least €40 million; their own funds are at least €2 million. See Annex II to Directive 2014/65/EU (MiFID II): www.eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065&from=EN

7.4 The Financial Transaction Tax is a bad idea: just drop it

A Financial Transaction Tax (FTT) would be hugely harmful for the European asset management sector. In 2012, EFAMA put the estimated annual cost of the FTT to the European UCITS industry at a mind-boggling €38 billion – of which €15 billion would have been paid by investors on the sales and redemptions of UCITS shares, and €23 billion would have been paid by UCITS managers on trading of securities.[49]

The Commission has since withdrawn its initial proposal, and put forward a revamped one in 2013. The latter is supposed to be adopted by only some EU member states via so-called 'enhanced cooperation'.[50] Decisions on taxation matters need unanimity in the EU, and the UK and others have made it clear that they would not sign up to the FTT. Yet, the levy would still hit investors and fund managers in the participating EU member states. Therefore, we suggest that the FTT be dropped altogether.

7.5 Dealing commissions: More transparency for investors and flexibility for asset managers

Forcing asset managers to pay for broker research from their own resources rather than using dealing commissions would be disproportionate and could have serious unintended consequences. Nonetheless, further transparency on this issue can be beneficial to the reputation of the industry. We believe that a compromise can be found building upon the existing Commission Sharing Arrangements (CSAs), whereby the asset manager agrees with a broker that it will be paid the trading component of the commission when the trading is executed – but the research component will be put into a separate account held by the broker (on behalf of the asset manager). Periodically, the asset manager can then decide to pay out the money set aside for research to the broker who holds the account or to any other research provider.[51]

CSAs give asset managers more control over research payments, while providing for clearer separation between money spent on trading execution and money spent on investment research. The basic principle here is that investors should be put in a condition to always be able to understand how much their asset manager is paying for research in proportion to their returns – so that they can judge for themselves whether their money is being put to good use. A balance has to be struck that ensures transparency while not unnecessarily restricting asset managers' ability to run their funds and maximise the returns for their clients.

7.6 New exemption for EU-based fund managers doing no business with rest of EU

EU-based fund managers who make no use of the passport should be granted an exemption from either the AIFM or the UCITS Directives – depending on which one applies to them. This could be achieved through the creation of a special trade zone within EU member states, which would exempt from EU regulation their asset managers that do not market to other EU countries. This would be a fair compromise, since these fund managers take no advantage from what is arguably the most beneficial aspect of EU financial regulation. Therefore, it makes sense not to burden them with the higher compliance costs of EU rules.

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49 The estimate was worked out by assuming that the FTT, as initially proposed by the European Commission, was applied at the start of 2011, see *EFAMA*, 'Impact analysis of the Commission's proposal for a Council Directive on a common system of financial transaction tax', 28 March 2012: www.efama.org/Publications/Public/FTT/EFAMA impact analysis on Commission proposals on FTT.pdf

50 *European Commission*, 'Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax', 14 February 2013: www.ec.europa.eu/taxation_customs/resources/documents/taxation/com_2013_71_en.pdf

51 For further details, see *IMA*, 'The use of dealing commission for the purchase of investment research', February 2014, page 7: www.fsc.org.au/downloads/file/FSCNewsFile/IMA_DealingComm_20140218.pdf

We suggest the following criterion: the new exemption applies to a fund manager or an asset management firm if their investors are based either outside of the EU or in the home member state of the fund manager/management company. This can be done by amending the AIFM and the UCITS Directives.

Such an exemption should be fairly straightforward to apply in practice. Compared to other economic sectors, the existence of an EU passport makes it easy to identify fund managers who wish to operate in other EU member states and those who do not. It could be argued that this new exemption would give an advantage to local funds vis-à-vis foreign ones. However, local funds tend to be smaller – meaning that the exemption could potentially help reduce the risk of concentration in the asset management industry. Managers of smaller funds would see their regulatory compliance costs reduced, and would therefore have less incentive to merge with bigger funds. Furthermore, the benefits of this new exemption would be evenly distributed across the EU – as smaller local funds are also present in other EU member states, not just the UK.

In any case, fund managers and asset management companies covered by this new exemption would still have to register with the national regulator of their home member state, but would be subject to a lighter supervisory regime – which could be modelled on the one currently envisaged for sub-threshold fund managers in the AIFMD.[52]

[52] Sub-threshold fund managers have to "regularly provide the competent authorities of their home Member State with information on the main instruments in which they are trading and on the principal exposures and most important concentrations of the AIFs that they manage in order to enable the competent authorities to monitor systemic risk effectively." National supervisors are also free to impose stricter requirements on sub-threshold fund managers if they wish to do so, see Article 3 of Directive 2011/61/EU: www.eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF

Conclusion

EU membership offers UK asset managers the chance to access a potentially huge pool of capital. However, this paper has shown that regulatory and administrative hurdles remain in place at the national level that make it harder for asset managers to do business across the EU and take full advantage of the EU-wide passport. We also noted that, as any other part of the financial services sector, the asset management industry is not immune from examples of irresponsible behaviour. That needs to be prevented by means of regulation. Nevertheless, the EU needs to move away from its one-size-fits-all approach to financial regulation and avoid placing an excessive regulatory burden on smaller asset managers – particularly those who do not wish to make use of the passport and market to other EU member states.

If the recommendations set out in this paper are implemented, EU rules are made more proportionate and hurdles at the national level are removed, then the benefits to asset managers and their investors, and to the European economy as a whole, could be significant.

Annex I – Methodology

Estimated distribution costs

New City Initiative attained its estimates through consulting documents such as Global Funds Registration (GFR) data and speaking with regulators and lawyers across EU member states (plus Switzerland). New City Initiative also spoke with fund managers distributing fund vehicles across the EU.

New City Initiative assumed that the management costs of distributing inside an EU member state would be around €40,000. This was based on conversations with fund managers distributing into the EU and compliance consultants helping fund managers distribute into the EU. Admittedly, €40,000 may be too low in some countries, such as Austria, where there are a number of additional impediments to distribution – such as the strict tax requirements. Simultaneously, it may be too high a figure in less economically developed EU member states, where there is limited investor appetite for funds. However, conversations with managers distributing into some Eastern European economies did reveal that there were challenges surrounding the appointment of service providers which could make attaining regulatory compliance challenging and time-consuming.

New City Initiative then undertook a qualitative assessment of other costs such as initial/on-going regulatory costs, paying and local agent costs, legal costs, documentation costs (i.e. translation costs) through data from GFR and conversations with lawyers in the majority of EU markets. For Lithuania, Latvia and Slovakia, where there was limited data available, the estimate was obtained by averaging out the costs in similar neighbouring markets: Croatia, Slovenia, Bulgaria, Romania, Poland, Estonia and the Czech Republic.

Please note that the UK is not included in the relevant graph because New City Initiative worked on the assumption that the hypothetical fund manager is based in the UK.

Estimated cost of EU regulations

Open Europe added up the estimated recurring cost of the AIFMD, UCITS IV, Solvency II, EMIR and MiFID I. The estimated cost figures are taken from the UK Government's Regulatory Impact Assessments (RIAs) of the UK laws transposing the relevant EU directives and regulations. The total figure was then inflated into 2014 prices by using the GDP deflators available on the website of the UK Government.[53]

Please note that the UK Government has yet to produce RIAs for EU laws that have been passed but have yet to be transposed into national law (e.g. MiFID II) and for EU laws that are still under negotiation. Therefore, these regulations have not been included in the final cost estimate.

[53] *UK Government*, 'GDP deflators at market prices, and money GDP', June 2015: www.gov.uk/government/collections/gdp-deflators-at-market-prices-and-money-gdp

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www.openeurope.org.uk
@openeurope

www.newcityinitiative.org
@NCityInitiative

Open Europe. 7 Tufton Street, London, SW1P 3QN

New City Initiative. Third Floor Princes Court, 7 Princes Street, London, EC2R 8AQ