2002 - 2003

ANNUAL REPORT

INVESTMENT FUND PHILOSOPHY

FEFSI MISSION

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Equal opportunities for everybody
in all investment markets

FEFSI MISSION

To maintain a high level of investor protection
and encourage investor confidence

To preserve the integrity
of the European investment fund industry

To promote the highest ethical standards in all areas of the fund business

To contribute to the creation of a real european investment fund market and the opening of national markets

To be the competent and representative business partner of regulators, other associations, the press and the public in and outside Europe

Contents

VOICE FOR A STRONG INDUSTRY IN A SINGLE MARKET

The European investment fund industry in 2002 achieved positive net inflows despite the very unfavourable market climate with stock markets falling for the third consecutive year. We can take this as a result of the industry's strength, in particular with regard to product breadth, and investors' trust in the fund industry.

Net inflows, however, could not compensate the effect of falling market prices on fund assets. Total investment fund assets shrank to €4,251 billion at year-end 2002 from €4,542 billion in 2001.

Against this background it is not surprising, therefore, that the state and future of our industry is undergoing the most fundamental discussion that I personally have experienced in the two decades that I have served in the investment fund industry. "The fun has gone out of fund management" – this recent news headline might be an overstatement but nevertheless reflects the present climate.

When it comes to industry responses to the changed environment I think two aspects are worth highlighting:

- The fund industry has to step up efforts to strengthen and explain its basic value proposition – namely that funds offer the highest degree of transparency, efficiency and customer protection and are the most suitable instruments for savings and pensions provision. Certainly the steps taken in the industry and within FEFSI to preserve the integrity of the industry and to define on a self-regulatory basis professional and ethical standards strongly support this goal.
- I am convinced that a single market for investment management – which means overcoming fragmentation and creating a level playing field – is indispensable to remain competitive. The Lamfalussy report points out that not only customers but also the industry itself – both big and small companies – can benefit from a common regulation and an increased market size. So we have to be active in creating the single market even if it means faster structural change.

PROGRESS TOWARDS THE SINGLE MARKET

The UCITS Directive from 1985 has undoubtedly had a very positive effect. The number of cross-border fund registrations is remarkable, the share of true cross-border flows is rising, and the new UCITS Directive will increase the areas of business that are harmonized and can be passported.

However, cross-border business remains in some aspects costly and complex. Registration procedures, prospectus provision and processing of subscriptions and redemptions can be improved.

Tax measures that discriminate against foreign funds continue to exist in several EU Member States. There are clear signs, however, that awareness of tax discrimination as a serious threat to the achievement of the single market among market participants, governments and regulators has grown. It should also be noted that the Commission finally decided to start a formal procedure against discriminatory tax barriers in December 2002. The industry itself is increasingly alert to discriminatory tax measures and is capable of taking immediate and co-ordinated action if necessary.

FURTHER IMPROVING THE INDUSTRY REPRESENTATION

Current trends in the investment management business and its environment are posing serious challenges to the industry associations. The industry itself is under increasing pressure to be innovative and efficient.

The impact on FEFSI is that the range of issues to be handled is on the increase, as is the need to intensify the dialogue with regulators at different levels. The public profile has to be raised and work on industry standards and best practices beyond current regulatory issues has to be extended.

The election platform of FEFSI's Presidency in May 2002 immediately acknowledged the need for ongoing change and reform within FEFSI, highlighting the following items:

- The need to handle a wider range of issues beyond regulatory themes, including 'business issues' and industry practices, and to involve the management and the expertise of member companies in FEFSI's work.
- The need for FEFSI to integrate issues of 'non-UCITS' and institutional asset management in its prime activities, in view of the enlarged scope of activities of fund management companies and changes in the regulatory environment.
- The need to apply a focused, coordinated and solution-oriented agenda management with regard to the larger and more complex set of topics.

Since the inception of the new Presidency some important steps have been taken. In order to improve the involvement of practitioners at a high level in FEFSI's work, **the establishment of an Advisory Group of Industry Leaders** was accepted. To coordinate the practical work of the Board, committees and working groups within FEFSI more efficiently, new procedures for 'Issue Management' have been adopted and have started to be implemented.

A further challenge is to **unify all relevant forces to strengthen industry representation at European level**. Any fragmentation of the 'voice of the industry' will inevitably weaken the industry representation towards Europe, in particular towards regulators and the public.

FEFSI is therefore committed to call actively for all steps that create progress towards achieving this goal.

Wolfgang Mansfeld
President

Despite declining stock markets in 2002/03 and a steady loss of investor confidence in the markets and market players in general, the European investment fund industry managed to preserve investors' confidence in investment funds. In this rather gloomy climate with an overall decline in total assets in investment funds amounting to 6.4% in the year 2002 and significantly shrinking profit margins, the European industry as represented by FEFSI had to prepare for the future and deal with a multitude of important issues.

The integrity of the industry, the new UCITS Directive, cross-border distribution of funds and the Pension Directive continued to be among the priorities FEFSI dealt with in 2002 and the first half of 2003, in addition to a number of new themes, such as the extension of the Lamfalussy procedure to all financial services and a possible application of International Accounting Standards (IAS) to investment funds.

1. POST-ENRON CRISIS OF CONFIDENCE: PRESERVING THE INTEGRITY OF THE INDUSTRY

In the post-Enron financial environment preserving the integrity of the European investment fund industry and investors' confidence in investment fund products has been paramount. The reason for the loss of confidence in markets and market players worldwide was not so much a result of the 9/11 terrorist attacks as a strong disappointment in equity markets compounded by balance sheet manipulations in the United States and obvious problems with 'Chinese walls' in United States investment banks.

Regulators on both continents were prompted into action. Former SEC Chairman Harvey L. Pitt, for instance, addressing the 2002 US Investment Company Institute's General Membership Meeting summarised investors' worries: " (...investors) *are terribly concerned – they have had their confidence shaken. Are the markets fair? they ask. Do companies tell me what I need to know to invest or do they hide the ball? Can I trust company numbers - are their accounts really accurate? Is anyone who runs a public company, or audits one, or regulates one, really interested in what I think, what I need and how I feel?"* And he added that the real challenge of these times was *"restoring and rebuilding our traditions of integrity, ethical behaviour, fiduciary obligations, basic honesty and decency."*

Before that, the European Ministers of Finance at their Oviedo meeting in April 2002 had discussed what the European Union's response to Enron-related issues should be. Internal Market Commissioner Frits Bolkestein took the message on board and in mid-July at a meeting in Paris declared that financial markets were nervous because of the quantity and magnitude of accounting and corporate governance scandals and that *"only the very foolish would pretend that recent events in America could not or will not happen here* (in Europe)". However, he also underlined that the situation should not be over-dramatised. In contrast to the United States most of the necessary actions had already been on the European Commission's regulatory agenda as part of the Financial Services Action Plan adopted in 1999.

FEFSI statistics show that where the European industry is concerned, funds are not directly concerned by this loss of confidence. Investors are continuing to invest in funds, albeit much less in equity funds than a few years ago. Today, it is a question of safety first and they tend to favour fixed income.

The trust shown by investors is a tribute to the 1985 UCITS Directive, which provides for a uniquely high level of investor protection, further strengthened by its recent modernisation. Thanks to this high level of investor protection, the European industry benefits from an equally high level of investor confidence in investment fund products and those who manage them.

In an attempt to see how the European industry can contribute to re-establishing investors' overall confidence in the markets whilst maintaining their interest in the investment fund as a product, five priorities have been identified:

- To establish pan-European ethical standards;
- To take on more responsibility as shareholders;
- To rebalance the sell- and buy-side research;
- To contribute more to better information and education of investors;
- To take over responsibility for the quality of distribution.

Establishing pan-European ethical standards

FEFSI adopted a first set of standards at the beginning of 2002[1] and is continuing work in this direction, the end target being a complete set of high level pan-European ethical standards covering company management (including structure and organisation), fund managers investment decisions, implementation of the investment policy, and investor information and distribution.

Taking on more responsibility as shareholders

The Statement of Principles for fund managers as fiduciaries of their clients (adopted in Spring 2002) in particular took on a special 'post-Enron' meaning as they urge fund managers to make use of their rights as shareholders and to vote in Annual General Meetings. Fund managers are recommended to develop a clear policy in this respect and particularly take care of companies' commitment to shareholder value and long-term profit orientation. Also, they should scrutinize annual reports and accounts as well as other information given to investors.

Rebalancing sell- and buy-side research

The general feeling that the Chinese walls in investment banks are often too weak is a key issue. Fund managers should consider setting up their own buy-side research and long-term financial analyses in order to gain an informed insight into the quality of assets and the integrity of accounting information. This will no doubt be expensive, but only if investors can trust the industry's capacity to analyse will they have confidence in the fund as a product.

Contributing to better information and education of investors

Selling to investors what they really want is easier said than done. Firstly, investors must learn to define their own investment goals and to be aware of their own risk acceptance. Secondly, they must have more information than in the past about market risks. Investors should for instance be aware that an index tracker fund is

[1] See 'FEFSI Standards' at www.fefsi.org

not necessarily 'safer' than an actively managed fund simply because the risk is not higher than that of the underlying index. Referring to an index is not very helpful in times when nearly all indices are at a low ebb; it might be more useful for an investor to learn that he can 'park' money in a money market fund until times are more settled. The investment fund industry, distributors and advisers can help the investor in this through better education and information.

The new UCITS Directive provides an ideal information tool in the shape of the Simplified Prospectus and it is the industry's task to draft this prospectus in such a way as to give investors all essential information in clear, concise and easily understandable terms.

Taking responsibility for the quality of distribution

The Simplified Prospectus allows the industry to deliver the essential product information to distributors and advisers, but more is possible. Fund managers should consider:

- How they can help intermediaries towards a clear understanding of product features. If a fund manager does not understand the product, how can he sell it to the investor?
- How they can contribute towards educating intermediaries;
- Whether minimum standards for qualification for distributing investment funds are needed.

➢ 2. IMPLEMENTING THE NEW UCITS DIRECTIVE

When the new UCITS Directive entered into force on 13 February 2002[2] after more than ten years' discussions, one might have been justified in thinking that the 'UCITS dossier' was closed and that the single market for investment funds had finally been achieved. This, however, is not the case and many new UCITS-related dossiers have been opened, with the realisation that much more is necessary to make the single market work for UCITS.

The implementation of the new Directive is of course a priority for FEFSI and it is putting in a great deal of work to avoid a situation similar to that experienced with the 1985 Directive, where provisions in the national jurisdictions were often subject to varying interpretations, thus undermining the level playing field which it was the Directive's purpose to create. In its efforts to ensure consistent interpretation and transposition of the new UCITS Directive in EU Member States, FEFSI has identified a number of issues to be considered in order to avoid varying interpretations and applications at national level:

- What does 'equivalent level of investor protection' mean when speaking about investment in non-UCITS?
- What does a 'sufficiently diversified' index look like? What is an 'appropriate benchmark'? How is an index 'published in an appropriate manner'?
- What is a 'letter box entity'? What is the necessary minimum substance to avoid such an entity?
- What is the situation concerning the new passport: does a Member State, which has not yet implemented the new Directive, have the right to refuse before 13 February 2004 the benefit of the passport to a fund set up under the new Directive in another Member State, which has already implemented the new Directive?

[2] OJ L 41 of 13 February – with two separate directives amending the 1985 UCITS Directive:
Directive 2001/108/EC ('Product' Directive)
Directive 2001/107/EC (passport for the management company & Simplified Prospectus)

However, the most important factor to implement the Directive, and hence preserve investor confidence, is the new Simplified Prospectus. In order to make it the unique fully harmonised marketing document it is meant to be,

- it cannot differ too much from one country to another;
- it must centre on what investors really need to know to enable them take a serious investment decision;
- it must provide simple and reliable information which is clear, easily understandable and – above all – easily comparable with other funds in the EU;
- it must attempt to answer questions and be educational;
- it must not overwhelm investors with information.

The prospectus has to contain investment information (including a clear description of a fund's investment goal, the investment policy, performance and risk profile), information on all applicable fees (including unitholders' transaction expenses and the fund's annual operating expenses to expressed as total expense ratio), information on how to buy and sell units of the fund and, finally, information about how the fund will be treated in fiscal terms.

In a unique effort FEFSI developed models for the Simplified Prospectus and a User Manual[3] and presented both documents to the European Commission and to supervisors assembled in the UCITS Contact Committee. FEFSI further intensified its efforts to stress its view that the UCITS Contact Committee has a crucial role to play in making the new Directive what it should be, i.e. a further significant step towards a single European market for investment funds.

Another issue where FEFSI tried to assist the UCITS Contact Committee was on the admissibility of the use of derivatives. In a statement answering a number of questions raised by the Commission, FEFSI underlined that:

- Investment funds should not take positions that allow them to lose more than the value of the fund;
- Rules should be adaptable and not be applied in such a way as to stifle innovation, prevent managers from responding to market developments or stopping them from developing products which are beneficial to investors and what investors want;
- Rules should be capable of being applied in a proportionate manner, taking into account the overall context in which they are being applied (experience, expertise of the manager, size of the transaction relative to the fund as a whole, objectives of the fund, what has been disclosed to investors, etc.).

➢ 3. MAKING THE SINGLE MARKET FOR INVESTMENT FUNDS WORK BETTER

Making the single market work for UCITS is a priority for FEFSI, and eliminating fiscal barriers to the cross-border marketing of UCITS, in particular tax discrimination, is one of the key factors in this respect. Another is distance marketing and e-commerce. FEFSI has been active in both areas during the reporting period.

[3] For samples, please go to www.fefsi.org under 'FEFSI standards'

Eliminating tax discrimination

FEFSI in recent months focused on updating the study on tax discrimination it published together with PriceWaterhouseCoopers in 2001[4] and it lobbied actively against possible new discriminatory tax barriers in Germany and Spain.

As Germany is one of the most important markets for foreign fund managers in Europe, because of its size and general 'openness', the introduction in 2000 of new access barriers in the form of discriminatory taxation on dividends caused particular concern to the industry. FEFSI responded swiftly by lodging a complaint with the European Commission in June 2000. The issue gave further cause for concern when the German Government started discussing new (and again discriminatory) taxes in October 2002. Shortly before Christmas of last year, the Commission announced the opening of an infringement procedure against the 2000 tax bill, pointing out that an integrated capital market cannot be established by 2005 if discriminatory tax barriers are maintained. The Commission was particularly concerned by the possible impact of the new legislation, which if adopted, would 'apply the same tax discrimination to capital gains'.

This tough, if somewhat belated (two years after FEFSI's original complaint), stance of the Commission greatly assisted FEFSI in its lobbying efforts against the second new law put forward by the German Government. The battle was finally won in early April of this year when the German Government passed a revised version of the law which no longer contained an introduction of a capital gains tax on investment funds or their investors. The year 2000 case will come to a full conclusion when the new UCITS Directive is transposed into German legislation together with a new tax legislation.

This action was symptomatic of the watchdog role that FEFSI has adopted after the publication of the 2001 PwC/FEFSI Report on tax barriers. FEFSI has contributed to the industry efforts to dissuade the tax authorities of Spain to introduce new legislation that although not discriminatory in itself would have ended up in effect treating foreign investment fund operators more harshly than domestic ones. The differentiated treatment has not disappeared from the law as finally adopted, but it has been reduced to a level that appears widely acceptable to the investment fund industry – domestic and foreign alike.

FEFSI has also galvanised fund managers' attention to instances of tax discrimination in other parts of the global investment funds market, such as in Japan in March 2003.

Distance marketing of financial services

The Directive on Distance Marketing for Financial Services was officially published in October 2002[5] setting out the regulatory framework for the sales of financial services by telephone, fax or other means of distance communication including the Internet.

The Directive aims to provide a high level of investor protection by limiting possibilities for unsolicited service offers and communications ('spamming'), affording statutory rights of withdrawal (from which funds are exempted), and by requiring the financial services provider to inform the customer in advance of the key elements of any potential contractual relation that may follow. For fund managers this means that more investor information requirements must be given on the supplier, the financial service, the distance contract and any possible form of redress. For years FEFSI has strongly lobbied to use the Simplified Prospectus introduced by the new UCITS Directive as the only fully harmonised set of information for investors and the overlap between this Simplified Prospectus and the provisions of the Distance Marketing Directive are high. However, there are gaps, in particular when the fund is distributed via 3rd parties. Member States must implement the EC Directive by October 2004.

[4] The full report is on FEFSI's web site
[5] Dir. 2002/92/EC of 23.9.02 in OJ L271 of 9.10.02

e-Commerce

The adoption of the Distance Marketing of Financial Services Directive has in no way alleviated the legal imbroglio that exists for cross-border marketing of UCITS that resulted from the adoption of the e-Commerce Directive[6], which has permitted the marketing, but not the advertising of UCITS under home country rules. The imbroglio arises from Article 44 (1) & (2) of the UCITS Directive that stipulates that marketing as well as advertising of a UCITS in another Member State can only occur under host country rules.

The European Commission's Communication on e-Commerce and financial services[7] did not clarify this conflict of legal regimes, and thus the situation remains confused and forces UCITS' managers to err on the side of caution i.e. respecting home and host country rules.

For non-harmonised funds (non-UCITS), by contrast, this legal imbroglio does not exist and thus the legal paradox of the e-Commerce Directive does not affect them. Under the e-Commerce Directive non-UCITS will be able to be distributed electronically according to the home country rules. Other Member States will not be able to oppose this, which will have resulted in the remarkable situation that funds subject to a European harmonisation directive will be less well off in cross-border context than funds that are not harmonised. FEFSI has made many attempts at explaining the Kafkaesque effect of the e-Commerce Directive to the Commission and its services but the message would seem to have fallen on deaf ears.

Understandably, Member States' legislators have been dragging their feet over the implementation of the e-Commerce Directive, which should have been completed by January 2002. A full year later the Commission decided to launch infringement procedures against Belgium, France, Greece, Ireland, Italy, the Netherlands and Portugal for failure to implement EU legislation. The other Member States may have implemented the Directive but most have steered around addressing the legal paradox for UCITS in the e-Commerce context.

Only one Member State appears to have implemented the e-Commerce Directive in spirit too, thus leading to the perverse situation that its domestic fund managers are disadvantaged in selling their UCITS into the other Member States, whilst the fund managers from those other Member States can enter the former market - via the Internet - by adhering solely to the well-known rules of the country of establishment ('home country').

➢ 4. CREATING A LEVEL PLAYING FIELD FOR SECOND-PILLAR PENSIONS

Dating back to the European Commission's 1997 Green Paper on 'Supplementary Pensions in the Single Market'[8], the pensions issue has been at the top of the European agenda. FEFSI too has made it one of its priorities to lobby all European legislative instances for an open and modern regulation creating a level playing field for all financial institutions capable of offering occupational pension schemes. FEFSI is convinced that investment can – and indeed must – play a far more important role in second-pillar retirement provision than it does today.

The European Parliament on 12 March 2003 voted the Pension Directive, but missed the opportunity of creating a level playing field in the second-pillar pensions market. As a result of a complex political compromise, the Directive only covers pension funds and life-assurance companies, but no other providers of occupational pension schemes. Neither the Commission nor the Council was willing to extend this possibility to other financial entities with the consequence of restricting the choice of occupational pension schemes and making the structure of the occupational pension market less competitive.

Nevertheless, because the European Parliament agreed with FEFSI's view that the Directive should create a true level playing field for all occupational pension service providers, we have obtained that the Commission will '*carefully monitor the situation in the occupational pensions market and assess the possibility of extending the optional application of this Directive to other regulated financial institutions*'.

[6] Dir. 2000/31/EC of 8.6.2000 in OJ L 178 of 17.7.2000
[7] COM(2001)066 of 7.2.2001
[8] COM(1997)283 final

This said, fund management companies could benefit from the adoption of the Directive in different ways:

- They could benefit from the potential growth in pension assets that is likely to spur growth in the volume of investment funds sold to pension institutions;
- They could use their experience in fund design to create investment funds that could be used to pool into a single vehicle the assets held by pension institutions operating on a cross-border basis;
- They could be appointed as investment managers of the investment portfolios of pension institutions, including from pension institutions established in another State;
- They could set up investment funds specifically dedicated to occupational retirement provision.

5. EXTENDING THE LAMFALUSSY PROCEDURE

FEFSI has always been a firm supporter of the European Commission's efforts to make financial market regulation faster, better and more efficient. So naturally FEFSI welcomed the new rule-making process for securities markets based on the 'Lamfalussy Report' when it was approved by the European Parliament in February 2002.

FEFSI welcomed a further significant step towards achieving an integrated European market in investment funds when in early Summer 2002, discussions were launched about the extension of the Lamfalussy procedure to other financial services. And again, when on 3 December 2002, Ministers of Finance and Economy endorsed the extension in line with the arrangements in force since February 2002 '*based on existing inter-institutional agreements, whilst also recognising sectoral specificities*'.

But the Council agreed to only four separate sectoral committees each at Levels 2 and 3 of the Lamfalussy procedure. They are:

- for banking;
- for insurance, including pensions;
- for securities, including pensions in the insurance pillar and UCITS in the securities pillar;
- and lastly, for financial conglomerates.

FEFSI concerned itself with the preservation of the specificity of the fiduciary duty to manage investors' financial assets in the proposed framework. It would have preferred a 'separate pillar' for investment management (comprising asset, fund and pension fund management disciplines). This is why it will now be crucial for the success of this undertaking to determine the conditions under which it will take place.

Three key issues must be considered before any further decision is taken:

- a segregated working sphere within the securities pillar;
- an institutionalised industry participation;
- an efficient work procedure until the end of the UCITS Contact Committee.

In summary[9] this means:

[9] Please see FEFSI's full statement *"FEFSI welcomes the extension of the Lamfalussy Procedure" at www.fefsi.org*

A segregated working sphere within the securities pillar

Fund management is unique in its kind, singled out for its high level of investor protection, based on two European passports, one for the 'UCITS' product and another for the management company. Furthermore, the UCITS Directive requires the fund manager always to act in the sole interest of the share/unit-holders, which means that the manager must always act as the investor's fiduciary and thus has a very specific responsibility.

The European investment fund industry has always adhered to the strong tie between the investment fund on the one hand and investor protection on the other, and it believes that this was one of the reasons for the unique economic success of this product. It is also the reason why the industry strongly committed itself not only to serve investors in their best interest but also to preserve its long-held tradition of integrity by setting pan-European standards for good behaviour, in particular with respect to the industry's structure and independence.

In line with this, regulators throughout Europe have always regarded investment funds not just as a 'security', but as the 'output' of an investment management process which implies an ongoing fiduciary relation with the client and as such is subject to extensive regulation. Also, the implementation of best practice standards plays an extremely important role for the European investment fund industry, an issue acknowledged expressly in Article 5h of the new UCITS Directive. Important industry initiatives both by FEFSI and at national level are the consequence.

To take into account these particularities of the fund industry and to clearly separate the 'buy-side' from the 'sell-side', the industry management industry should not, as proposed by the Council, simply be incorporated into the securities pillar, but should consist of independent working spheres both at Levels 2 and 3 of the Lamfalussy procedure.

An institutionalised industry participation

As the successful forging of revised and improved supervisory structures depends on an efficient collaboration of market practitioners and industry experts, such participation must be organised in an adequate, well-structured and institutionalised manner at both Levels 2 and 3.

The industry should be given the opportunity to communicate its point of view on any subject before any policy decision is taken. To achieve this one could – for example - set up a kind of permanent structured dialogue as a link between the industry and the various Lamfalussy/comitology bodies. The current Lamfalussy procedure and the transparency policy undertaken by the Committee of European Securities Regulators (CESR) is a first step in this direction.

Efficiency until the 'end' of the UCITS Contact Committee

Notwithstanding the general agreement over the extension of the Lamfalussy procedure, with the UCITS Directive taking effect on 13 February 2002, the current key issue for the European investment fund industry is its implementation and consistent and coherent transposition into national law. As any transferral of Contact Committee's authority to other bodies (under a Lamfalussy procedure) would need another legal act and thus time (and can almost certainly not be achieved before the two UCITS III implementation deadlines), the existing UCITS Contact Committee has a crucial role to play both in terms of a body with regulatory as well as advisory powers.

The UCITS Contact Committee must continue to operate as the forum through which a harmonised implementation of the new UCITS Directive[10] is to be achieved and this in its two functions, ie Consultation (Art. 53) and Regulation (Art. 53a) with respect to clarification of definitions and alignment of terminology.

Under the Council principles on comitology as defined in Council Decision 1999/468, the UCITS Contact Committee must set its own internal rules of procedure with regard to its regulatory powers. Any transferral of the UCITS Contact Committee's authority to other bodies may very well take place in the future and a further modification of the UCITS Directive is already a distinct possibility as the European Commission must present a report on the investment fund industry by 13 February 2005. This approach also coincides with the position of the European Parliament's Economic and Monetary Affairs Committee, which seems more amenable to the Commission extending the Lamfalussy procedure to new Community legislation (directive or regulation) when there is a clear need for new legislation.

Notwithstanding the procedural niceties, it would be very helpful if the UCITS Contact Committee would, without actually falling under the Lamfalussy procedure, be enabled to work as much as possible as if it were. In other words, as a regulatory committee it would work 'like' the European Securities Committee (ESC) and as a consultation committee 'like' CESR.

➢ 6. OTHER ISSUES OF INTEREST

Capital requirements and operational risk

In November 2002, the European Commission launched a public consultation on a new framework on capital requirements for banks and investment firms. Even if UCITS are not directly concerned because of their special capital regulation under the new UCITS Directive, the issue is of some significance to the European investment fund industry because any regulation for investment firms (under the Investment Services Directive or ISD) might later become a 'model' for a new UCITS regulation.

This is why also FEFSI commented on the issue[11]. The main points can be summarized as follows:

- Operational risks in asset/fund management are significantly lower than in other business lines in banking activities, such as retail and commercial banking. Consequently, asset/fund management should benefit from lower operational risk capital charges;
- For investment funds (UCITS and other funds equivalent to UCITS), the capital requirement for operational risk should also be lower because regulatory requirements applicable to investment funds, notably with regard to the monitoring role of depositaries, play an important role in reducing operational risk in investment fund management;
- As operational losses result from inadequate or failed internal processes, people and systems or from external events, the most direct approach to limit operational risk is to implement carefully monitored risk management systems;
- Insurance should be allowed as risk mitigation tool because the use of insurance would have the desirable implication of encouraging institutions to implement sound monitoring systems for operational risk in order to benefit from lower insurance premium;
- The capital requirements to meet operational risk should not have any anti-competition effects.

To support these arguments and contribute to the future work of the Basel Committee on Banking Supervision and the European Commission, FEFSI commissioned an independent analysis on the merits of capital regulation to control operational risk in investment fund management. This study was undertaken by the University of Toulouse under the leadership of Professor Bruno Biais and was published in January 2003[12].

[10] Directives 2001/107/EC and 2001/108/EC

[11] For the full statement please go to www.fefsi.org

[12] For the full study please go to www.fefsi.org

The study, in broad terms, reinforced FEFSI's position on the regulation of operational risk and one of its conclusions is that there is only limited justification for capital requirements in investment fund management. One of its key contributions is to highlight that the prudential regulation of operational risk should rely primarily on market discipline, disclosure rules and insurance, essentially because these tools tend to create incentives for investment fund management companies to implement sound monitoring systems for operational risk. It also confirms the view that investment fund management poses low operational risk.

The European Commission's study on depositaries

Part of what may be termed as the Council's 'deal' over the new UCITS Directive was the obligation for the Commission to present within one year from date of entry into force of the Directive a report on the regulation of depositaries. To prepare this report, the Commission launched in September 2002 a public on-line consultation to review the regulation of UCITS' depositaries, collect views on a potential need to amend the respective rules of the UCITS Directive and collect basic economic data. Attention was drawn to four key issues relating to the duties and responsibilities of depositaries as dictated by the 1985 UCITS Directive:

- Conflicts of interest;
- Duties and responsibilities of the depositary;
- A passport for depositaries?
- Remuneration of depositary services.

FEFSI in November 2002 issued a statement on the subject[13] underlining that *conditio sine qua non* for any liberalisation of a UCITS depositary's services must be that the interests and the protection of investors be properly safeguarded, supervised and controlled.

Whilst the European investment fund industry recognises the potential benefits of a possible passport for cross-border depositary services, it also underlines the need to recognise the difficulties in achieving this. As a first step, FEFSI has identified areas where a more precise formulation of depositaries' duties and responsibilities seems not only desirable but also possible.

With respect to possible conflicts of interest, FEFSI can only underline that the effectiveness and robustness of procedural safeguards established by the continental European universal banking system will enable bankers and fund managers in case of a conflict of interest to offer solutions that are fully in line with the principle of at all times acting in the sole interest of an investment fund's unit-(/share)holders.

Finally, the remuneration of the services of depositaries depends on a number of factors, which vary not only from country to country but also from contract to contract. These circumstances make any cross-border comparison of cost structures meaningless.

Future revision of the UCITS Directive

The new Directive also calls for a general review three years after entering into force. FEFSI has committed itself to assisting the Commission in this task. In a first step FEFSI member associations organised a series of workshops to study the market for, and the structure of, real estate funds, protected ('guaranteed') funds, hedge funds, master-feeder funds and exchange-traded funds (ETFs).

[13] The full text can be found on the FEFSI site www.fefsi.org under FEFSI documents

Real estate funds

The workshop was hosted by the German national association, the BVI, and brought together about 30 real estate fund managers, association representatives and representatives of the Commission. The following conclusions were drawn:

- Real Estate Funds (REF) are an important segment of the European fund market. They allow retail investors in particular a risk diversified participation in the real estate market. Investments in real estate are important for their particular risk and return characteristics which are distinct from those of bonds and equity. REFs therefore can play an important role in adding an element of diversification to the individual asset allocation;
- REFs invest predominately in direct real estate holdings and property rights as well as participation in real estate management companies. A fund which exclusively invests in quoted real estate companies is a stock fund and not an REF. At least in a retail context an REF should be a regulated and supervised vehicle;
- There are wide differences in structures of REFs across Europe. REFs come as closed-end funds (often listed on the Stock Exchange), and semi-open or open-end investment funds with various redemption dates. Capital structures (fixed or variable capital) and legal structures (corporate or contractual) also vary in Europe;
- As is the case with UCITS, in order to grant a 'European passport' to retail REF products certain minimum, and preferably 'principle-based' standards on the structure and investments of REF, are necessary.

Protected ('guaranteed') funds

The workshop was hosted by the Belgian national association, the ABOPC-BVICB, and assembled about 100 participants from the fund industry. It identified different national regulatory and marketing contexts. It assisted the subsequent FEFSI working group in focusing more clearly on key aspects that culminated in a position paper to be found on FEFSI's website[14]. These were the main points:

- Clarification as to the distinctive protection offered – a legally binding guarantee or a promise of capital preservation;
- Recognition of the quality of any guarantor;
- Arguments for UCITS compatibility of protected ('guaranteed') funds in terms of the former's key characteristics (risk-spreading and open-ended nature);
- Acknowledgement of an enhanced duty for fund managers to disclose the essential qualities of protected ('guaranteed') funds;
- Transparency of information to the investor is crucial.

Hedge funds

The workshop was hosted by the Irish national association, the DFIA, attended by some 65 participants from 8 jurisdictions and made the diversity of national regimes clear, with in some cases closed country perspectives limiting any cross-border marketing of hedge funds. Although generally speaking the European Union could be characterised as having a certain degree of regulation in the field of hedge funds, many EU countries were seen to be debating the adoption of rules regarding the marketing of such funds. Envisaging a 'passport' was considered elusive at this stage.

The workshop's main conclusion was that no conclusion could be drawn from the variety of regimes and approaches. Further work would be welcome and could focus on finding a definition and a regulatory regime

[14] see www.fefsi.org/ Documents/Investment funds issues

and product types. Administrative capabilities, reporting, fee transparency and, last but not least, the feasibility for the retail market.

Master-feeder funds

The workshop was hosted by Luxembourg's national association, ALFI, and brought together about 40 participants from industry and supervisors. Main points of the discussions were:

- Funds of funds and master-feeder funds are two structures that respond to completely different exigencies: funds of funds are structures for more efficient asset allocation, whereas master-feeder funds are established largely for marketing reasons;
- The attitude of the industry towards the concept of master-feeder funds and any concerns existing in the past have changed. National supervisory authorities are willing to work closely with the industry on this issue, to ensure that the necessary steps are taken in order to enhance investor protection and to facilitate free movement of capital;
- Harmonisation is not always necessary;
- Contractual relationship between master and feeders must be applicable to avoid problems concerning the protection of the investor of the feeder and to guarantee that the essential information concerning the master is also made available for the investor of the feeder;
- ALFI will set up a working group with the task of reporting on master-feeder funds in the following years and FEFSI will work closely with regulators in order to assess their point of view and their expectations on the issue.

Exchange Traded Funds

The workshop was hosted by the BVI and was attended by approx. 60 participants representing ETF providers, exchange and market makers from across Europe as well as the European Commission, the ECB and German regulators. The following conclusions were reached:

- A comprehensive regulation of ETFs in the EU is not required;
- Concerning the need for change in existing regulation, a duplication of listing prospectuses and fund prospectuses for ETFs should be avoided and a clarification of the Prospectus Directive[15] would be helpful;
- Clarification of the rules of the new UCITS Directive on index funds with respect to investment limits (application of the 40%-rule) would be necessary;
- Most other impediments need to be clarified with national regulators and exchanges;
- Under the tutorship of FEFSI, a committee will be set up to monitor further developments with respect to ETFs.

International Accounting Standards (IAS)

The adoption of IAS by the EU for European exchange traded companies preparing consolidated financial statements will have significant effects for all EU entities. The impact on accounting and reporting procedures will be considerable not only for the targeted companies, but also for European investment funds, which may be caught as some countries may decide to include in the net all entities quoted on a stock exchange and/or selling to the public.

Against this background FEFSI established a working group with the wide participation of experts including major auditing firms (PWC, KPMG, Ernst & Young, Deloitte & Touche). Its main task is the preparation of the

[15] Proposed Directive on Prospectuses of 30. 05. 2001 [COM(2001) 280]

industry's position with regard to the possibility of a future application of IAS rules to European investment funds.

The group of experts achieved significant progress in the course of past months, as it managed to identify the necessary conditions that would allow for an efficient implementation of IAS to investment funds. Several factors had to be taken into consideration throughout this effort, the most important one being investors' interests and the need for coherent and meaningful information, as the main purpose of accounts for an investment fund - be they in corporate or contractual legal form - should be to inform investors.

The group's experts examined IAS rules in their entirety, identified existing problems related to the application of IAS to investment funds, exchanged views with respect to accounting/reporting methods used in the various counties and prioritised the problems discussed.

Investment Services Directive (ISD)

FEFSI continued to follow the debate surrounding the revision of the Investment Services Directive after the European Commission issued its 2nd consultation paper in March 2002. The European Parliament held its 2nd open hearing on the ISD in April and CESR a seminar on market transparency in May of that year. FEFSI commented on the Commission's paper with particular importance attached to the coherent and consistent interaction between the ISD and UCITS Directives, esp. since in future UCITS managers will be allowed also to conduct selected ISD activities.

The European investment fund industry welcomed the changed scope of the ISD to cover investment advice, but was keen to learn what regulatory regimes (in terms of applicable business conduct rules, levels of capital, standards of qualifications/competency, ...) would accompany this extension. FEFSI could not reach a common position over the proposed ISD architecture and transparency obligations as membership remained split over the respective merits.

In November 2002, and after a thorough consultation process, the Commission issued its proposal for a directive to amend the ISD[16]. The European Parliament and the Council are to review the proposal under the co-decision procedure and it will be a tough timetable to adopt and implement within the Financial Services Action Plan deadline given the transparency considerations that accompany the internalisation of trade executions by ISD firms.

FEFSI issued its position paper with a view to raising the profile of the 'buy-side' concerns in seeking clarifications on the precise application to investment managers of the best execution rules and the business conduct rules in situations where it is not the fund manager who conducts the actual trade on the market. The possibility of continuing to be able to accept 'execution-only' business without any provision of advice was a key concern for many investment managers. The uniform treatment across the European Union of UCITS and their management companies as eligible counterparties being allowed to waive the statutory conduct of business rules in favour of more tailored inter-institutional agreements was also called for by FEFSI.

On investment advice, it was also felt that the particularities of a highly regulated product like an investment fund were not adequately recognised in the proposed ISD as they were frequently treated on the same footing as lesser regulated investment activities and products. The introduction of product differentiation into the ISD may provide solace whilst the option of a separate measure dealing with the distribution of investment fund products was also raised. In essence the coherence and consistency between the future ISD regime for financial advisers and that of the Insurance Mediation Directive[17] is essential for the distribution of investment products to retail investors.

[16] COM(2002)625 of 19 November 2002
[17] Dir. 2002/92/EC of 09.12.02; *(OJ L 9 of 15.01.03)*

Taxation of savings

FEFSI continued to follow developments on the proposed Taxation of Savings Directive with a highly critical eye whilst repeatedly drawing attention to the discriminatory aspect of the Council's *idée fixe* given that the deliberate exclusion of insurance and pension products from the scope of the Directive installs a decidedly unlevel competitive playing field for the fund industry in Europe.

To add insult to injury, the practical implications of the implementation of the Directive – should it ever come to be adopted – have not been fully grasped, or at least woefully underestimated, by Council representatives. A case in point came to the fore after FEFSI called on the authorities to determine the nature of a fund-of-funds by the investment policy of the fund prospectus as opposed to the actual composition of the funds.

The Council decided otherwise, thus obliging the fund industry to ascertain the actual composition of each sub-fund. If this is not done or is impossible – as FEFSI argued – then the entire revenue of that fund-of-funds falls within the Directive, even if it is predominantly made up of equity funds... And so the saga of this debate that has already covered 13 years continues to steam roller ahead.

In January 2003, ECOFIN Ministers came to a political agreement on the Taxation of Savings Directive although the final deadline of adoption in March 2003 did not materialise. The original deadline of implementation by 1 January 2004 looks increasingly unrealistic, certainly for the economic operators that will carry the weight of the exchange of information and/or withholding tax duties. The application date for these latter entities will no doubt be postponed by a year. FEFSI will continue to monitor developments closely, and a first exchange of opinions among member organisations on the impact of the Directive seems to point increasingly to a measure that will come back to haunt the European Commission as 'Guardian of the Treaties' when the perverse effects of the Taxation of Savings Directive will dismantle some of the single market building ambitions of the UCITS III Directives, and erode Treaty freedoms.

Meeting the United States Securities and Exchange Commission

As in previous years, FEFSI representatives met with SEC officials to discuss issues of mutual concern such as TER and investor protection.

The method to calculate TER agreed by FEFSI does not differ much from the methodology used in the United States for the calculation of the Annual Fund Operating Expenses. The main difference lies in the terminology used.

Concerning Investor protection with respect to products, which are or seem to be very similar to funds, there are two such cases in the United States, ie folio baskets and separate accounts. The SEC is keeping a close watch on the matter, whilst holding back from intervening at this point.

Meeting the Investment Company Institute's International Committee

Continuing a long-standing tradition, FEFSI members held a meeting with members of the ICI's International Committee to discuss a number of issues of mutual interest, such as investment fund industry developments in Europe and the United States, the impact of the USA Patriot Act on the investment fund industry, the use of the term 'investment fund' or 'mutual fund' to describe products that are unregulated or are not investment funds.

GATS and international market access

Since the launch of the new Doha Round of multilateral negotiations in 2001, FEFSI has focused primarily on the GATS services negotiations, although other peripheral aspects that deserve to be monitored and, where appropriate, supported, such as WTO work done on '*domestic regulation*', '*emergency safeguard measures*' were also considered. In addition, the contentious negotiations on agriculture, which are crucial in view of the Doha Development Agenda negotiations being a '*single undertaking*', which means that no element of the negotiations will be agreed until all areas are agreed, need to be watched carefully.

The Guideline and Procedures for the Negotiations on Trade in Services as adopted by WTO Members in March 2001 set out the remit of and the procedures for the services negotiations, which are conducted under a '*request-offer*' approach. Accordingly, WTO Members have agreed to submit their requests for market access by late June 2002, which the EU did. FEFSI had transmitted its priority list of target countries to the relevant European Commission services in time for these to be taken into consideration, which they duly were.

Late March 2003 was the next key date as WTO Members had agreed to submit their initial offers of market access. Accordingly, FEFSI will evaluate the nature of these offers and communicate to the EC's trade negotiators any additional or improved commitments that the European investment fund industry may seek from other WTO Members in the area of investment funds. Special attention will of course be given to the USA's offers of market access to EU funds.

With the submission of an increasing number of initial offers, the process of multilateral negotiations is likely to gather pace increasingly and FEFSI will continue to monitor and push for better trading conditions for EU funds until the scheduled conclusion of the Doha Round by the end of 2004.

The FEFSI Fund Forum 2002 (Stockholm)

The 2002 FEFSI annual conference took place on 30-31 May in Stockholm and had as central theme 'Customer Focus – the Road to Success'. Some 180 industry participants from Europe, Canada and the United State listened to presentations and exchanged views on questions such as:

- How do other industries integrate customer orientation in their business model;
- What do customers expect from the industry;
- What new products does the customer want;
- The customer search for advice;
- The fund manager's search for customers.

Interestingly, FEFSI's model for a Simplified Prospectus was mentioned on several occasions as a key instrument for better information and education of investors and advisers.

Other highlights of the conference included the Gala Dinner speech by Mr Urban Bäckström, the Governor of the Swedish Central Bank and the Closing Address by Sweden's Minister for Consumer Policy, Ms Britta Lejon.

The 16th International Investment Funds Conference

The 2002 Conference was hosted by the German national association, the BVI, and took place in mid-October in Berlin. It was attended by 72 delegates from 31 countries. The conference closed with a final declaration, which underlined the responsibility for fund managers towards their investors at a time of uncertain market conditions and the need for high levels of integrity within the industry. Fund managers should actively involve themselves in discussion about the proper functioning of the market for the benefit of fund investors.

7. OUTLOOK ON 2003

Most of the issues at the top of FEFSI's agenda in 2002 will continue to be so in 2003, with the addition of some new themes.

On the integrity of the industry

FEFSI will of course continue to promote the image and integrity of the European investment fund industry. In particular it hopes to finalise the work on high-level pan-European ethical standards, which will place special emphasis on:

- The corporate structure and good governance of the management company;
- Fund managers as shareholders and their corresponding duties;
- The independence of the 'buy-side';
- Quality of distribution.

Net asset value calculation and dealing with errors will also figure on the agenda.

The FEFSI discussions have a very topical character in view of the continued global debate and the presentation of the EU Corporate Governance Action Plan. It is expected that the FEFSI Fund Forum of September 2003 on the theme of fund managers and corporate governance will provide an important impulse to the industry discussions on this issue.

On the implementation of the new UCITS Directive

Working on the consistent transposition of the UCITS Directive is and remains at the core of FEFSI's activities. Here three points are particularly important:

- A truly harmonised Simplified Prospectus. In order for investors to have the full benefit of this ideal information tool, it will be essential to ensure that the prospectus does not differ too much from one country to another and that it contains information that is clear, easily understandable and easily comparable. FEFSI will furthermore continue to stress the responsibility of the UCITS Contact Committee in this respect;
- Agreement among supervisors on the use of derivatives. Here too, the UCITS Contact Committee has an important role to play;
- 'Co-operation' between the Commission, the UCITS Contact Committee and the industry. Working efficiently can only happen if and when the UCITS Contact Committee demonstrates greater transparency and openness towards a permanent dialogue with the industry. That FEFSI can substantially support the work of the Contact Committee has been proved with its contributions to the debate on the Simplified Prospectus and the Use of Derivatives.

On the single market for investment funds

FEFSI's commitment to making the single market work better for investment funds remains the other main priority on its agenda. Eliminating tax discrimination continues to be top of the list in this pursuit. As such, FEFSI will continue careful monitoring of national tax legislators and the activity of the European Commission.

FEFSI monitoring will also include the Commission's activity in regard to problems linked with the e-Commerce Directive for the fund industry and its implementation at national level.

FEFSI will continue to lobby for the suppression of administrative barriers to the marketing of UCITS, at EU level where the Commission is concerned and at national level with the relevant national authorities. A specific issue in this context is the work on a 'harmonised' format for cross-border registration.

Finally, FEFSI will start to look more closely into the possibilities and impossibilities of merging funds across borders including the tax component of this issue.

On pensions

It was an interesting point that in the course of the discussions on pensions in recent years, the European Parliament was alone in its support of a level playing field. The Commission has always been opposed to this approach, a position which is difficult to comprehend against what is set out in its Communication 'Financial Services: Building a Framework for Action'[18] :
"*Broadly substitute products such as pension funds, life assurance and UCITS are subject to different forms of regulatory requirement and tax treatment in each Member State. This can lead to arbitrary differences between products and unfairly tilt the balance in favour of some asset managers. The Commission will strive to achieve greater policy coherence whilst enhancing transparency for consumers and effective competition*" (...) "*To ensure a level playing field for financial operators is one of the key elements of an integrated single market for financial services*".

So the questions now are 1) why the European Commission and the Council of Ministers seem to be favouring life assurance over other pension or savings products, 2) why the level-playing field argument is absent in this context and 3) why the Commission seems so keen to freeze this historic situation rather than be forward-looking and open the second pillar pension market to 'new' products and services.

The European investment fund industry's challenge for the near future will be to explain to European and national legislators that the discrimination against certain savings products and the preferential treatment of others constitute a serious impediment to the functioning of the single market for financial services. There is no valid argument for preventing employees to benefit from the unique combination of advantages offered by fund-based occupational pension schemes in terms of security, efficiency, flexibility and transparency.

Hence, FEFSI will continue to push for the creation of a true level playing field between all pension providers. FEFSI and its national member associations will also have to monitor closely the implementation of the new Directive at national level to ensure that the possibilities offered to the investment fund industry by the Directive will be taken on board.

On the extension of the Lamfalussy procedure

The extension of the Lamfalussy procedure to other financial services will be top of the European Commission's agenda and a legislative proposal will probably be tabled in early Summer.

However, as the European Parliament has been open in expressing its reluctance, feeling that its democratic scrutiny powers are being eroded further and that the extension is being rushed needlessly, it does not seem very probable that this extension is to happen soon. All the more so as a new Parliament will be elected next Spring. More probably the Parliament will wait for the outcome of the IGC in 2004 before it changes its view on the Lamfalussy rule-making powers.

FEFSI will nevertheless continue in the dialogue it recently engaged with CESR on future developments.

[18] COM(1998)625 final

On capital requirements and operational risk

The New Basel Accord is due for completion by the fourth quarter of 2003, with implementation to take effect in member countries by year-end 2006. To meet this deadline, the Basel Committee has issued a third consultative paper in April for comments due by end July 2003. The European Commission's services will also publish a third and final consultative document in late Spring/early Summer 2003. The Committee also expects a proposal for the new framework to be adopted by the Commission in the first part of 2004 with a view to allowing national implementation to be achieved in time for the global implementation data of the end of the year 2006.

This tight time frame will not make it easy for FEFSI to participate in the various consultation exercises carried out by the Basel Committee and the European Commission. Such participation is nevertheless necessary to ensure that the concerns of the European investment fund industry regarding future legislation on capital adequacy are taken into account.

On depositaries

The Commission is expected to table its (delayed) report on depositaries in the early Summer and FEFSI's subsequent comments might have to include a new discussion about the passport for the services of depositaries.

On IAS

Upon completion by FEFSI's Experts Group and adoption by its Board of Directors, the report 'Conditions for the Application of International Accounting Standards for Investment Funds in the European Union' will serve as a basis for discussions with the services of the European Commission and various IAS bodies. The report might also assist national associations in discussions with their authorities about a possible application of IAS standards at national level.

On the taxation of savings

As soon as the final text of the Directive will be adopted formally – details of the agreement with Switzerland are still unknown - discussions will start on its implementation and it is easy to predict that they will be anything but simple. Many Member States appear to be mistakenly confident that transposition is easy, but they will probably come up against a series of obstacles when drafting the administrative rules and considering mechanisms for implementing the Directive. They will for instance find that certain definitions 'for the purpose of this Directive' might be different compared to their existing definitions. The definition of 'interest' in particular is unlikely to be the same as that under any existing domestic tax regime.

FEFSI has always warned of the technical problems linked with this Directive and must now closely monitor its transposition in order to avoid too many differences in the process, which would significantly increase the existing problems. Also, the number of choices in the interpretation given to Member States might create additional difficulties for cross-border distribution.

On GATS

From March 2003 onward, WTO member countries have been submitting their 'offer' packages and the process of proper negotiations offers will gradually gather pace as the deadline of late 2004 looms larger. It is important that FEFSI maintains a strong interest in the matter and accompanies the EU trade negotiators with up-dated assessments of the interim results of the Doha Rounds in terms of improved market access for EU fund managers in other countries.

Irrespective of the multilateral process, FEFSI will support the bilateral dialogues that the Commission is involved in, esp. the ongoing EU-US regulatory dialogue.

On the support to the accession countries on the absorption of the EU 'funds' acquis'.

As the accession countries will enter the Internal Market in the course of 2004 FEFSI felt compelled to continue to offer a helping hand towards these countries with a view to fostering a high level of understanding of critical UCITS issues and to equate standards as much as possible. In particular the absorption of the UCITS III is as topical for current EU Member States as it is for accession countries.

The addressees of this initiative will continue to be the regulatory authorities of these countries as well as the member associations.

8. CONCLUSION

Neither the new UCITS Directive nor the very ambitious Financial Services Action Plan will complete the creation of the single European market for investment funds. A great deal still needs to be done by the European Commission, regulators and the industry.

Commission and regulators on the one hand must provide for:

- A common interpretation of the UCITS Directive and a more harmonised supervisory practice;
- A coherent tax system;
- A coherent regulation on cross-border distribution based on the country of origin approach;
- Abolition of administrative constraints.

The industry on the other hand has to:

- Take a more active part in the development towards the single market;
- Ensure the integrity of the industry and responsible fund management companies;
- Enhance customer orientation by putting customers first.

The European Union in 2004 will have a new Parliament and a new Commission with new people and new ideas. The industry should prepare itself for the change by wasting no time in putting its agenda on the European table.

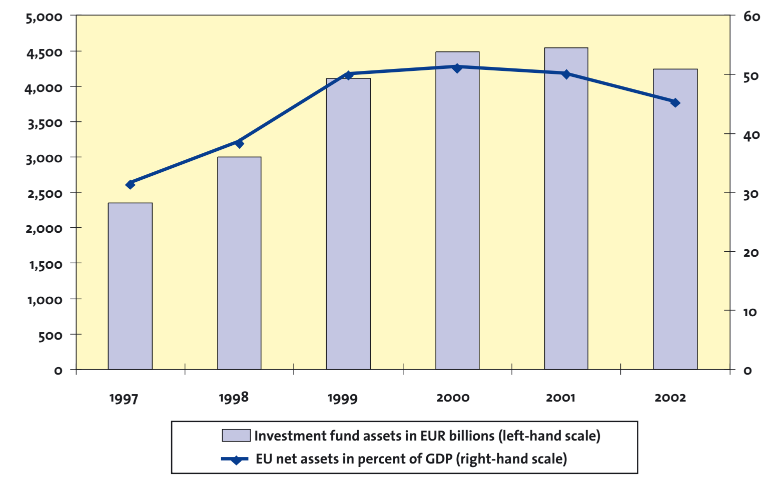
Brussels, 22 May 2003

➢ TRENDS IN INVESTMENT FUND ASSETS

Against the backdrop of a decline in broad stock markets indices ranging from 20 to 45 percent, total assets in the European investment fund industry fell by 6.4% in 2002 to €4,251 billion. With €3,304 billion invested in UCITS, this segment of the business accounted for 78 percent of the fund market.

Thanks to an average growth rate of 12.6 percent over the last five years, investment funds remained an important part of the European economy at end 2002, whether measured in relation to GDP or to the European savings market. For the European Union as a whole, the ratio of investment funds relative to GDP grew from 31 percent in 1997 to 45 percent in 2002 (Chart 1). This development translated into an increase of the amount of investment fund assets per inhabitant, from €6,100 in 1997 to €10,800 in 2002.

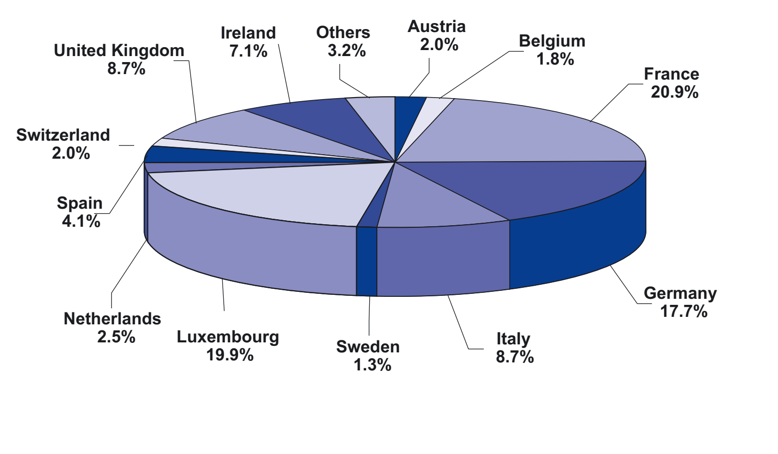
Chart 1. Trends in Investment Funds in Europe



Source: FEFSI, European Commission

Three countries – France, Luxembourg and Germany – continue to dominate the industry with a global market share of 58.5%. Italy and the United Kingdom follow in fourth and fifth place in this ranking (Chart 2).

Chart 2. The European Investment Fund Market (Breakdown of nationally domiciled funds at end 2002)



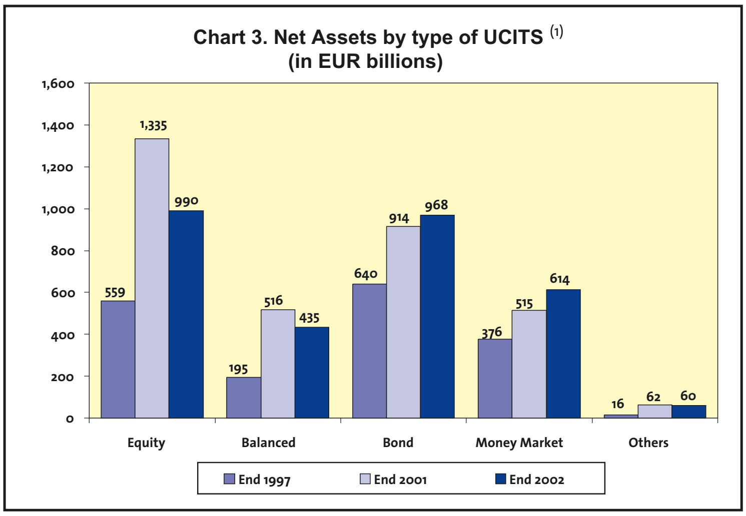
Source: FEFSI

DEVELOPMENTS IN THE UCITS INDUSTRY

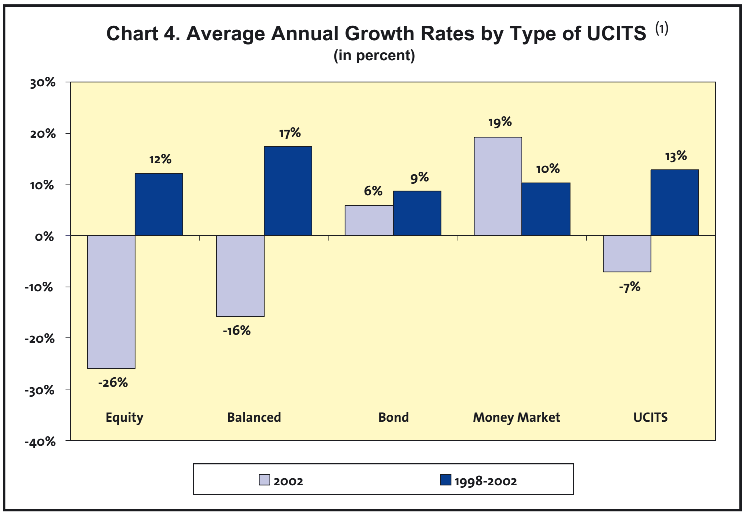
Total assets in the UCITS market[1] declined by 7.1 percent to reach €3,305 billion. The decline in assets in 2002 principally reflected the downward movement in stock prices. By way of illustration the Dow Jones pan-European Broad Index recorded a 28 percent decline in 2002. The market downturn and investors' reduced appetite for investment risk resulted in a fall in equity fund assets from €1,335 billion at end 2001 to €990 billion at end 2002 (Chart 3). Also reflecting the decline in stock prices, balanced funds posted a drop of 16 percent in assets.

Against the background of volatile stock markets, money market funds scored for the second year in a row double-digit growth rate (+19%) and by the end of 2002 reached an all-time high of €614 billion. Bond funds also continued to grow, albeit at a smaller pace compared to 2001.

Looking at the developments over the past five years, total assets in the UCITS industry grew at an annual rate of 13 percent, with the highest growth rates recorded by balanced and equity funds (Chart 4).



(1) Excluding Ireland for which no asset breakdown by type of funds is available.
Source: FEFSI



(1) Excluding Ireland except for growth rate of UCITS.
Source: FEFSI

[1] UCITS is used in this section in the sense of publicly offered open-ended funds investing in transferable securities and money market funds.

For the group of countries reported in Charts 5a-5c, which controlled 85 percent of total UCITS assets at end 2002, the net flow of cash to all UCITS funds was €163 billion in 2002, down from €257 billion in 2001. For 2002 as a whole, equity funds recorded a net inflow of €42 billion, despite a third-quarter outflow. This outflow, which was caused by stock market weakness and volatility in the Summer, however, amounted to only 0.3 percent of equity funds assets. The net flow to money market funds remained high in 2002, with the inflow for the year totalling €91 billion compared to €113 billion in 2001. Bond funds received a net inflow of €42 billion, down from €86 billion in 2001.

Chart 5a. Net Cash Inflows to Equity Funds in 2002 (1)
(In EUR millions)

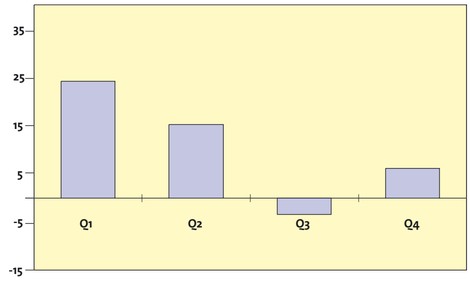


Chart 5b. Net Cash Inflows to Balanced Funds (1)
(In EUR millions)

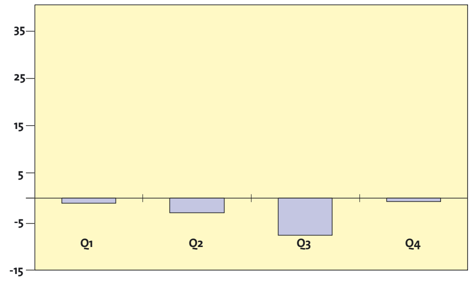


Chart 5c. Net Cash Inflows to Money Market Funds in 2002 (1)
(In EUR millions)

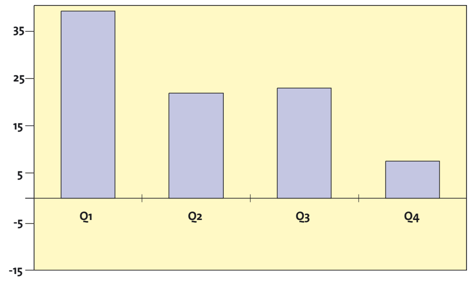
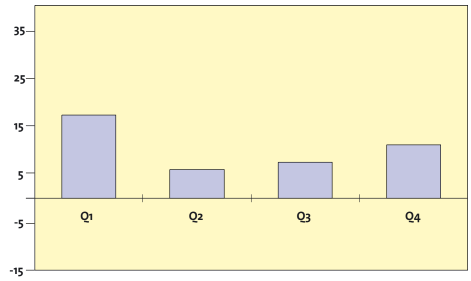


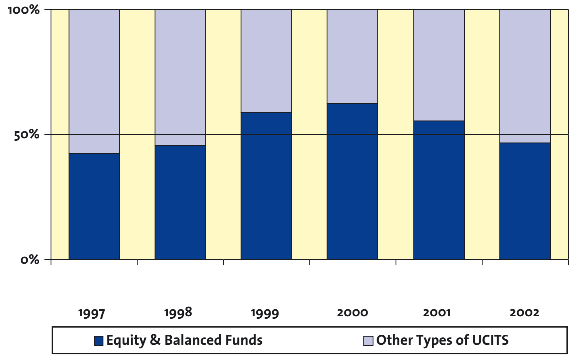
Chart 5d. Net New Cash Inflows to Bond Funds in 2002 (1)
(In EUR millions)



(1) For Austria, Czech Republic, Denmark, Finland, France, Germany, Greece, Italy, Luxembourg, Norway, Portugal, Spain, Sweden and UK.
Source: FEFSI

As a result of the decline in stock prices, the share of assets held in equity funds slipped back from 40 percent in 2001 to 32 percent in 2002. When balanced funds are taken into account, the proportion of fund assets with an equity exposure was 46 percent – a percentage slightly higher than in 1997 (Chart 6).

Chart 6. Share of Equity and Balanced Funds in Total UCITS Assets
(in percent)



Source: FEFSI

CHANGES IN THE UCITS INDUSTRY ACROSS EUROPE

Looking at the geographical developments in the UCITS market, equity market exposure acted as the main asset driver across Europe, i.e. Sweden, the United Kingdom, Germany and Norway suffered from the relatively high proportion of their equity fund assets whereas countries like the Czech Republic, Poland, Portugal, Austria and France managed positive growth in 2002 thanks to their relatively small exposure to stock market gyrations (Table 1). The relationships between the changes in total UCITS net assets and equity exposure is illustrated in Chart 7. The good performance of Finland and Denmark reflected strong asset growth in the bond and/or money market segments of those countries' fund industry (Chart 8).

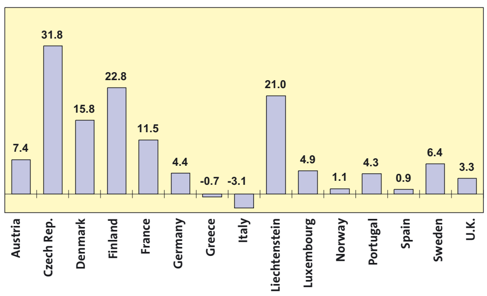
Table 1: Net Assets and Sales of Nationally Domiciled UCITS
(millions of euros)

Members	Assets end 2002	% chg [1]	Sales [2] 2002	Members	Assets end 2002	% chg [1]	Sales [2] 2002
France	805.9	0.7%	92.0	Sweden	55.3	-24.8%	4.7
Luxembourg	766.5	-9.9%	39.2	Denmark	38.3	0.8%	6.0
Italy	360.7	-10.6%	-12.6	Greece	25.4	-5.3%	-0.2
United Kingdom	275.5	-22.9%	11.6	Portugal	19.0	2.1%	0.8
Ireland	238.5	10.8%	n.a.	Finland	15.7	8.5%	3.3
Germany	199.5	-16.8%	10.5	Norway	14.8	-11.1%	0.2
Spain	170.8	-4.0%	1.6	Poland	5.2	56.5%	n.a.
Netherlands [3]	88.8	--	n.a.	Liechtenstein	3.7	-2.0%	0.8
Switzerland	78.8	-7.3%	n.a.	Hungary	3.8	37.1%	n.a.
Austria	63.8	3.0%	4.6	Czech Republic	3.1	59.0%	0.6
Belgium	71.5	-7.2%	4.6	Total	3,304.6	-7.1%	167.7

(1) End 2002 compared to end 2001; (2) Net sales of equity, bond, balanced and money market funds; (3) as of end 2001.
Source: FEFSI

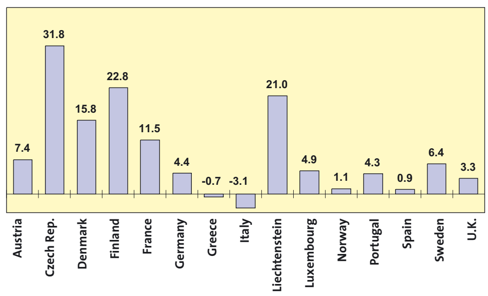
The changes in net assets also reflected the geographical distribution of net sales across Europe. With the exception of Italy, all the UCITS industry's leading countries recorded net cash flow from investors, with France capturing 56 percent of the total net sales of UCITS reported in Table 1. The fund industry in Luxembourg, the United Kingdom and Germany also received positive inflows but these were insufficient to cancel out the negative impact of the poor stock market performance in 2002. Chart 8 also shows that the relatively good performance of UCITS in the Czech Republic, Finland, Denmark and Liechtenstein reflected the rather high level of net sales when measured as a percentage of assets. In all likelihood, the same pattern was also observed in Poland, Hungary and Ireland – the three countries that recorded the highest growth in UCITS assets in 2002.

Chart 7. Net Cash Inflows to UCITS in 2002 [1]
(In percent of total assets at end 2001)



Source: FEFSI

Chart 8. Net Cash Inflows to UCITS in 2002 [1]
(In percent of total assets at end 2001)



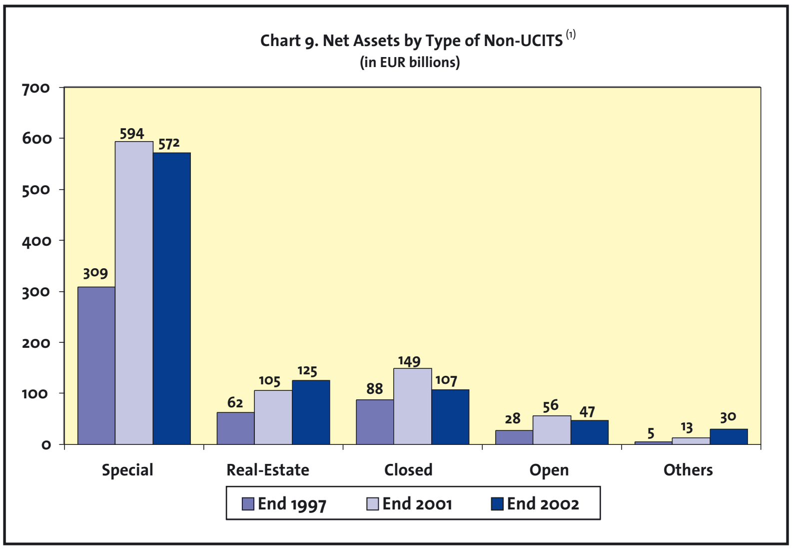
(1) Net flows into equity, bond, balanced and money market funds.
Source: FEFSI

➢ DEVELOPMENTS IN THE NON-UCITS INDUSTRY

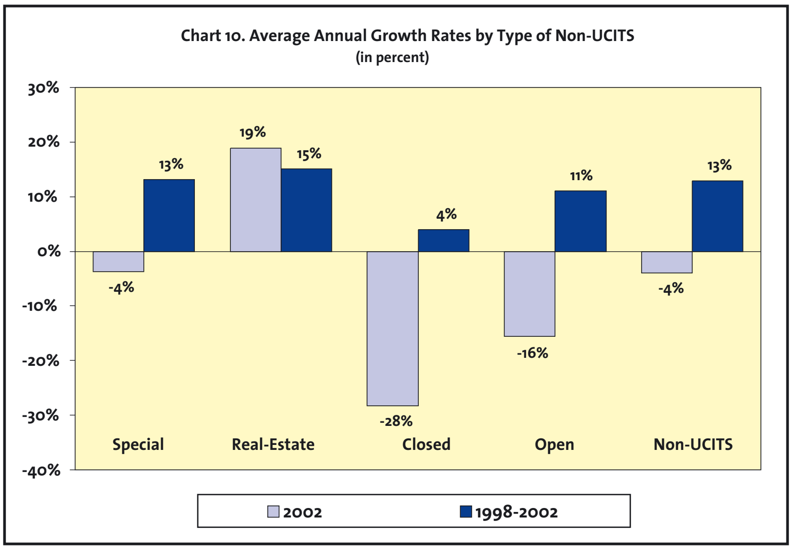
Total assets in the non-UCITS market fell by 4.0 percent in 2002 with German special funds dedicated to institutional investors declining by 4.0 percent to €480 billion, British closed-ended investment trusts 34.0 percent to €73 billion, and French open-ended employees saving funds 14.9 percent to €47 billion. Those declines were largely attributable to the fall in prices on worldwide stock markets.

On the other hand, and unsurprisingly, real-estate fund assets recorded a 19.0 percent increase to €125 billion, with total assets rising to €71 billion at end 2002 in Germany, or 27 percent.

Taking a longer perspective, non-UCITS assets grew at an annual rate of 13 percent over the last five years, from €515 billion at end 1997 to €950 billion by year-end 2002 (Charts 9 and 10).



(1) Excluding Ireland for which no asset breakdown by type of funds is available.
Source: FEFSI



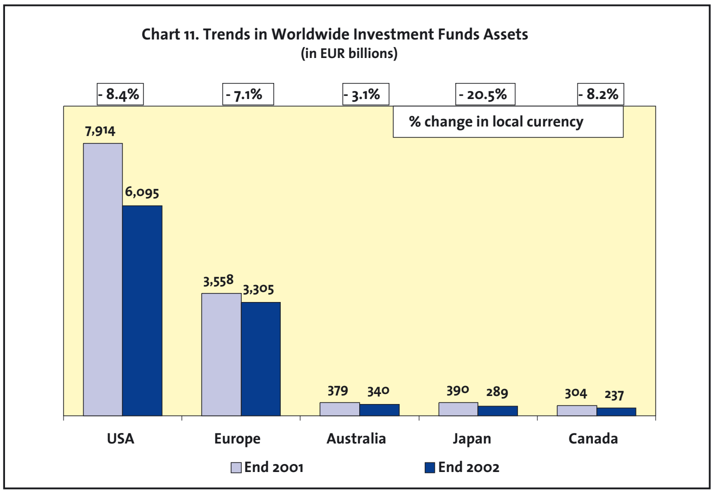
(1) Excluding Ireland except for growth rate of non-UCITS.
Source: FEFSI

DEVELOPMENTS IN WORLDWIDE INVESTMENT FUND ASSETS

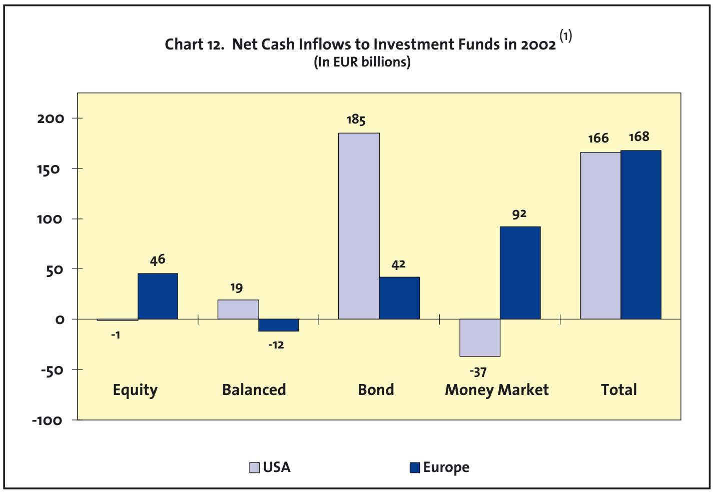
Investment fund assets worldwide fell by 18.0 percent in 2002 from €13.1 trillion to €10.7 trillion. A weak dollar alleviated the decline, as many countries experienced much lower asset decreases measured in local currencies (Chart 11). Measured in dollar terms, worldwide assets dropped 3.6 percent.

Reflecting the global weakness in equity prices, mutual fund assets declined by 8.4 percent in the United States in 2002 with equity funds falling by 22 percent in dollar terms. In contrast, bond funds were up 22 percent thanks to a record net cash flow of $175 billion (€185 billion). These strong inflows were in part associated with the attractive returns of bond funds, as well as households seeking to place assets outside the equity market. In Europe, bond funds also benefited from those factors but investors moved more money towards money market funds. Overall, net cash flow turned stronger in Europe than in the United States as the data reported in Chart 12 do not include net sales of Irish domiciled UCITS, which reported a 10.8 percent increase.

Looking at the worldwide distribution of investment fund assets, the United States and Europe dominated the global market, with a share of 57.0 percent and 30.9 percent respectively. Australia, Japan, Canada, Hong-Kong and Brazil follow in this ranking. Taking into account non-UCITS assets, the market share of Europe reached 36.5 percent at end 2002, and that of the United States 52.3 percent.



Source: FEFSI, ICI



(1)Data for Europe are for the 14 countries referred to in Charts 5a-5c as well as Belgium and Liechtenstein.
Source: FEFSI, ICI

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2002 - 2003

ANNUAL REPORT

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