AN EXPERIMENT WITHIN THE TECHNICAL COMMITTEE STANDING COMMITTEE ON INVESTMENT MANAGEMENT TO ESTABLISH A FRAMEWORK FOR IDENTIFYING STRATEGIC PRIORITIES

FINAL REPORT

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1. Background

In recent years, financial organizations and regulators have been making increasing use of formalized tools for assessment and prioritization of strategic issues. For instance, as far as prudential risks are concerned, Basel II capital adequacy rules have implemented "more risk-sensitive minimum capital requirements for banking organizations,"[1] and prompted banks to develop risk assessment techniques.[2] In addition, certain risk-based approach frameworks have also been designed and implemented by several financial market regulators (*e.g.*, by the Australian Securities and Investments Commission (ASIC), the United Kingdom's Financial Services Authority (FSA), and the New Zealand Securities Commission).

Against this background, several elements have led the Technical Committee (TC) of the International Organization of Securities Commissions (IOSCO)[3] to consider ways to reduce the complexity of its own decision making process, including:

(a) the wide field of IOSCO's project specifications[4] and domains of activity;

(b) the intrinsically difficult assessment of costs and benefits of financial regulations;

(c) the rising number and complexity of financial risks to be addressed by regulators;

(d) the desire to improve the quality and reach of its consultation exercises.

The TC has agreed that its Standing Committee on Investment Management (SC5),[5] which generally focuses on collective investment schemes (CIS), could conduct a pilot exercise to

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1 *See* http://www.bis.org/press/p040626.htm.

2 *See also*, Financial Services Authority-Risk-Based Analysis to Supervision of Banks-June 1998.

3 The member agencies currently assembled together in IOSCO have resolved, through its permanent structures:

- to cooperate together to promote high standards of regulation in order to maintain just, efficient and sound markets;
- to exchange information on their respective experiences in order to promote the development of domestic markets;
- to unite their efforts to establish standards and an effective surveillance of international securities transactions;
- to provide mutual assistance to promote the integrity of the markets by a rigorous application of the standards and by effective enforcement against offenses.

4 In general, a project specification details particular work to be undertaken by a TC Standing Committee, such as SC5 (as defined below). For instance, the project specification will briefly explain, among other things, the issues that SC5 will consider, and the kind of work product SC5 intends to prepare (*e.g.*, a discussion paper or a consultation paper containing general principles), and the timeline for preparing that work. The TC provides prior approval of the project specifications of the TC Standing Committees.

develop a framework for improving the process of selecting issues to be addressed pursuant to TC project specifications to SC5. In this paper (Report) we refer to those issues as "strategic priorities." Pursuant to the framework, SC5 could identify a strategic priority and then approach the TC for approval of a project specification relating to that strategic priority. The TC could evaluate SC5's proposed project specification in light of the evaluation undertaken pursuant to the framework.

As explained below, the framework combines different processes for identifying strategic priorities.[6] Accordingly, during the spring of 2005, SC5 conducted a preliminary bottom-up exercise, which was updated in June 2006. In the fall of 2005, a top-down exercise was conducted, and the two were combined subsequently. Pursuant to the framework, this Report presents the list of strategic priorities for work that could be undertaken by SC5.

In April 2007, the TC sought comment from investors and market participants on both the form and the content of the framework, and the particular strategic priorities that SC5 has identified pursuant to the framework (April 2007 Paper).[7] The Feedback Statement attached at *Appendix D* to this Report summarizes the comments received and the changes made to the April 2007 Paper in response to the comments.

2. The framework for the identification of strategic priorities

As explained in detail below, the framework mainly consists in comparing views from SC5 members – pursuant to a bottom-up exercise - with systematic reviews of data relating to the global asset management industry – pursuant to a top-down exercise. As a final step, SC5 compared the trends with the bottom-up list of strategic priorities to refine that list.

The Bottom-up Exercise. As a first step in the framework, SC5 conducted a bottom-up exercise. In particular, each SC5 member jurisdiction identified five strategic priorities for SC5 work (note that the strategic priorities offered by each SC5 member jurisdiction are not necessarily reflective of domestic agendas of the SC5 member). SC5 members selected the priorities based upon their own processes, which in some jurisdictions entailed use of a formal "risk-based methodology" (*e.g.*, UK, France), while other SC5 members reviewed, among other things, enforcement actions, and information provided by their personnel in their inspections and supervisions offices. Pursuant to the bottom-up approach, the top five

5 The TC is divided into the following five major functional subject areas: Standing Committee on Multinational Disclosure and Accounting (SC1); Standing Committee on the Regulation of Secondary Markets (SC2); Standing Committee on the Regulation of Market Intermediaries (SC3); Standing Committee on Enforcement and the Exchange of Information (SC4); and Standing Committee on Investment Management (SC5).

6 The framework is not a risk-based methodology to be used at the TC or SC5 level. We note that the TC may use other criteria besides risk, for the prioritization of its work program.

7 *An Experiment Within The Technical Committee Standing Committee On Investment Management (SC5) To Establish A Framework For Identifying Strategic Priorities*, Report of the Technical Committee of IOSCO, April 2007, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD245.pdf.

strategic priorities of each SC5 member were aggregated into a map that weighs equally each priority. The priorities were then ranked in the map according to the number of times they were quoted by SC5 members.

The bottom-up exercise identified potential strategic priorities based on *ex-post* regulatory information that is provided by SC5 members' operational departments, such as supervision and enforcement departments. In other words, the bottom-up exercise looked at a SC5 member's past regulatory experience to determine which issues that have occurred in the past retain present importance.

<u>Example</u>: the departments of some SC5 members which are dedicated to authorizing CIS products indicated that the number of new filings for "structured funds" implementing active strategies were increasing dramatically.[8] This development raised concerns about the ability of retail investors to assess the risk profile of such investment vehicles and of CIS operators to ensure a reasonable level of transparency. In turn, this leads those SC5 members to rank the risk of misselling and marketing related issues high on the SC5 agenda.

The Top-Down Exercise. The top-down exercise is primarily designed to avoid the risk that the bottom-up approach could, for example, overweight specific enforcement cases or, on the contrary, miss important topics not yet addressed by enforcement cases. The framework entailed a second step whereby detailed information pertaining to the asset management industry, on a global basis, was gathered by staff of the French Autorité des marchés financiers (French AMF), with the assistance of other SC5 members and subsequently analyzed with a view to identify various trends in the asset management industry.[9]

The top-down exercise entailed *ex-ante* assessments of market developments and CIS trends, on a macro-economic and long-term basis. These assessments of current developments aimed at early identification of global trends as well as at providing, whenever a relevant statistical basis appeared to be available, economic assessments and quantifications of specific (micro-economic) perceptions. In other words, the top-down reviews were an attempt by SC5 members to anticipate those issues that may be of importance in the future.

<u>Example</u>: the aggregate data on Exchange-Traded Funds (ETFs) show a steep rise of assets under management over the last years. French AMF staff attempted to determine to what extent this phenomenon is likely to keep growing, and to consider whether it generates new kinds of risks for shareholders. As a principal investment strategy, ETFs generally track

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8 For purposes of this Report, structured funds generally are CIS that provide guaranteed returns, or returns that are based on a formula.

9 To enable SC5 to conduct the experiment, the French AMF established the framework, including assembling and analyzing the underlying information, due to its significant experience with formal risk based analyses. SC5 members do not necessarily engage in such a formal process, or follow such a methodology in setting their domestic agendas. Nor did SC5 members independently verify the information or analyses that underlies the methodology set forth herein. The various analyses in the top-down exercise were conducted with respect to particular jurisdictions, due to the lack of time or data, and are therefore not necessarily representative of all jurisdictions (*e.g.*, the US markets). Information concerning those markets may require further analysis in the future.

particular, identified indexes. The quality of an ETF's "tracking" of an index may not be constant, and investors may be confused by subtle differences between funds that "track" and those that do not.[10]

The Refinement of the Bottom-up Exercise Results to Reflect the Top-Down Exercise Results. As a final step, SC5 compared the trends with the bottom-up list of strategic priorities to refine that list.

A systematic confrontation of "*Bottom-up*" exercise with "*Top-down*" exercise enables one to:

- improve the definition of the strategic issues identified (to specify their parameter, their common characteristics in various jurisdictions, etc.);

- put those issues in perspective by relating them to one another and assessing them over time.

The combined bottom-up exercise and top-down exercise can be summarized as determining which issues SC5 members find to be both important and timely.

3. Identification of strategic priorities through the bottom-up exercise

Table 1 generally presents the top five strategic priorities identified by SC5 member jurisdictions. Equal weightings were attached to each quote of a potential strategic priority. Table 1 ranks the potential priorities (in decreasing order) according to the overall number of times they have been quoted by various SC5 members (see column "Total" of Table 1).

The collection of top five priorities from SC5 member jurisdictions was updated continuously between June 2005 and June 2006 for the use of SC5 meetings, and Table 1 represents updates current as of June 2006.

This ranking procedure could over-emphasize certain priorities that, although of great importance, are not as timely as other issues. Thus, a comparison of those priorities with available market information seemed appropriate to determine the timeliness of each priority. Thus, the top-down exercise was conducted.

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10 SC5 previously studied CIS that are index funds. *See Index Funds and the Use of Indices by the Asset Management Industry*, Report of the Technical Committee of IOSCO, February 2004, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD163.pdf.

Table 1 - Grid of strategic issues

Jurisdiction / Issues	AU	BR	CH	DE	ES	FR	GB	HK	IE	IT	Jer-sey	JP	LU	MX	NL	CA-Ont-ario	CA-Qué-bec	PT	US	Total
Customers' information (products and fees)	■	■	■	■	■	■		■	■	■		■	■		■	■	■	■	■	16
Distribution and marketing issues		■	■		■	■	■	■	■	■	■			■		■	■	■	■	14
Hedge funds and alternative fund products		■		■	■		■	■			■		■	■	■	■		■		11
CIS pricing and valuation issue	■	■			■							■		■	■	■		■	■	9
Risk management, use of derivatives	■		■	■				■		■				■			■			7
Governance	■						■			■		■	■			■		■		7
Soft commissions and undisclosed agreements		■	■			■				■									■	5
Property funds and private equity funds				■				■	■		■				■					5
Cost of regulation						■			■		■								■	5
Offshoring / Outsourcing				■			■				■		■							4
Best execution			■		■							■								3
Accounting standards													■	■						2
Customers' education						■											■			2
Enforcement									■								■			2
Market timing																				0
Structured funds															■					1
Unit-linked CIS							■													1
Compliance and respect of fiduciary duty												■								1

4. The market trends analysis: a top-down exercise process

In practical terms, a review of the main issues and trends affecting the CIS industry was attempted in order to determine which issues are currently important. A review was conducted of the available CIS data and its methodological limits. A critical review of the data, including statistics on the asset management industry, is set forth in *Appendix A* to this Report. The top-down exercise identified, and focused on the implications of, the global trends present in the CIS industry. A detailed summary of the top-down exercise, including a description of the global trends that were observed, is provided in *Appendix B* to this Report. It focused particularly on global market growth, market fragmentation, the development of new investment products, and investor behavior.

The top-down exercise also focused on a number of non-quantified changes to the global CIS industry, including changes to industry structure and environmental changes in the investment industry.

5. The results in terms of assessment of strategic priorities for the SC5

Against the backdrop of the top-down exercise, the results of the bottom-up exercise contained in Table 1 appear in a new perspective. After identifying and considering global trends in the global asset management industry, a further refinement of the strategic priorities can occur. Further prioritization was performed in a two-stage process, the first one consisting of a comparative assessment of relative importance of each issue (also referred to as a strategic priority) from a regulatory perspective at a particular point in time, the second one consisting of a dynamic approach that is aimed at anticipating prioritization changes over time.[11] At each stage, SC5 attempted to quantify the importance of an issue by assigning an impact on retail markets and probability of occurrence to each issue. In particular, the full extent of possible loss to retail investors from the occurrence of an event that gives rise to a strategic priority is considered in conjunction with the probability of the occurrence of the event.

This combination of approaches can refine and enhance the results produced as part of the bottom-up exercise in a number of ways. For example, the combination could result in general issues (*i.e.*, general strategic priorities) identified by regulators becoming more specific and focused (for instance, a strategic priority of disclosure issues may be focused on disclosure issues for structured funds). In addition, the combination could result in the identification of new strategic priorities, and the merging of previously identified priorities, with due consideration of possible economic effects. The combination could also result in certain issues that were identified by SC5 members as high priority issues being reclassified as lower priority, and vice versa. The combination also could result in confirmation of the priorities that were identified pursuant to the bottom-up approach.

The combination of the top-down exercise and the bottom-up exercise led to the identification and assessment of the following strategic priorities:

1. CIS disclosure at point of sale

Retail investors who buy investment products, particularly interests in a CIS (including a structured fund), may not clearly understand the products or the layers of costs associated with those products.

Accordingly, analyzing the issue of disclosure of information to investors - including information on the functioning of the products, on the related risk-return profile, on fees, and

[11] The application of the list of strategic priorities that SC5 identified pursuant to the bottom-up exercise to the information gleaned from the top-down exercise is set forth in *Appendix C* to the Report.

on the nature of invested assets and investment strategies - appears particularly appropriate.

2. Distribution of CIS products, commissions and fee sharing arrangements

Retail investors may not clearly understand their intermediary's financial stake in selling those products, including so-called "revenue sharing" arrangements. Therefore, they might end up purchasing a product that they would not have, had they understood the true costs of the product and/or their intermediary's conflicts of interest. The importance of distributors' assessment of CIS product suitability to investors' needs places distribution at the core of a number of current issues.

3. Asset pricing and CIS valuation issue

Technical aspects of the issue of pricing are very important for CIS and their investors, such as in connection with the valuation of illiquid types of assets. CIS increasingly tend to diversify their investments into real estate, private equity, securitized assets (some of them of a synthetic nature), commodities, etc., which may present valuation challenges for CIS.

4. Risk management aspects linked to the use of derivatives and complex strategies within CIS products

Derivatives are tools on which practically all innovative CIS products are based. Their use also explains the rise in the sophistication of asset management techniques.[12]

6. Conclusions

Through the framework, SC5 has attempted to conduct a first attempt at identifying strategic priorities by assessing global trends, considering new products and market trends. The framework has highlighted the need for better and more harmonized statistical data concerning CIS. IOSCO may wish to consider establishing formal relations with international organizations with a view to gaining additional insight into available CIS statistics and their methodologies, and possibly to obtain additional data.

The framework provides a formalized process for identifying strategic priorities that reflects global trends in the CIS and asset management industry. The publication of this Report may further enhance SC5's decision making processes. While the TC might not necessarily authorize SC5 to undertake work in any specific area that is identified in this Report, and SC5 might not necessarily seek TC authorization to undertake such work, this paper provides some insight to investors and market participants about SC5's possible work efforts. The framework may be useful to other groups, task forces and committees of IOSCO in identifying their strategic priorities.

[12] The aggregate level of use of such strategies is not precisely measured, mainly because the lack of statistical basis makes it difficult to aggregate data (related products are often non-regulated, OTC-traded) and for methodological reasons.

Appendices[1]

Appendix A: Critical review of CIS industry statistics

1. Review of information available

With a view to assess the potential contribution of the "t*op-down*" analysis to the exercise, a review of available CIS data and of its methodological limits was conducted during the fall of 2005. Basing on a wide list of indicators, a preliminary data collection exercise was attempted, with the aim to gain additional insight into:

- Aggregate statistics resources available directly from financial regulators;

- Otherwise available macroeconomic, microeconomic and professional sources.

A critical view on the relevance of collected data for the targeted analytical purpose was taken. As part of this assessment, a systematic review of data definitions and methodologies was undertaken.

The main conclusions of those information collection exercises may be summarized as follows:

i) Regulators' resources

From a general point of view, financial regulators possess data (including breakdowns by type of product) on the number of mutual funds, assets under management, and related investment flows. The data are produced for their own regulatory purpose, and may therefore not necessarily be sufficient for conducting fully satisfactory "top-down" analyses as presented hereafter. For example, the data do not always cover non-domestic products and activities (including indicators of foreign activity of investment management firms and data on offshore fund assets), as well as on non-registered products. In several cases considered data do not cover certain investment companies' activities (*e.g.*, hedge funds, pension funds, bank funds, etc.).

To sum-up, the scope of contributed data reflects largely their jurisdictional field. Even though some exceptions may be noted, SC5 members do not systematically compile the statistical information necessary for the process. Accordingly, alternative data sources may be required for conducting "top-down" analyses as described hereafter.

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1 The French AMF established the framework, including assembling and analyzing the information in the appendices, due to its significant experience with formal risk-based analysis. SC5 members did not independently verify the information or analyses contained in these appendices. In addition, any regulatory objectives that are presented in the appendices are not necessarily representative of the regulatory objectives of any single SC5 member.

ii) Relevant, consistent, and up-to-date sets of international data generally appear to be otherwise available to the analyst. Related data consists mainly of:

a) Aggregate macroeconomic information on institutional investors from National statistics (essentially from Central Banks):

National accounts are the main source of aggregate information on institutional investors, namely on insurance firms, pension firms and other investment financial intermediaries, a category that includes investment management firms. Related data are harmonized by the international standards of the United Nations – namely of the System of National Accounts (SNA 1993) – and of the International Monetary Fund (IMF) - the Balance of Payments Manual (BPM5) - and, within Europe, to a further extent, by those of the European System of Accounts (ESA 1995). Most information is provided within the framework of National accounts' financial accounts (flow of funds),[2] whereby a number of limits require that analysts assess precisely the data's methodology in order to obtain accurate cross-border comparisons.[3]

Such harmonization of the data and inference of global comparisons of institutional investors' activity are periodically conducted by international organizations such as the Organisation for Economic Co-operation and Development (OECD) and the IMF.[4] They subsequently enable one to gather a view, over time, of the importance of assets managed as well as of portfolios' structures.

b) Investment fund product information from international investment managers associations:

Those professional sources – namely the ICI/IIFA[5] and EFAMA[6] mutual fund data[7] - are important sources of information for analysts conducting international comparisons. The comprehensive domicile-based (ICI/IIFA includes 41 jurisdictions) quarterly data covers indicators including the number of domiciled funds, net assets

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2 Other data provided by National Central Banks may provide additional detail but generally does not provide harmonized categories. A noticeable exception is provided by the launch of "Euro area investment fund statistics" (http://www.ecb.int/stats/money/funds/html/index.en.html) by the European Central Bank in April 2006. A valuable innovation of this database consists in implementing new international statistical standards for investment funds. One may however regret the lack of publication of underlying national data (only "total assets" are provided).

3 Other data provided by National Central Banks may provide additional detail but do not provide internationally harmonized categories.

4 OECD's Institutional Investors Statistical Yearbook is in the process of being updated. The IMF's Global Financial Stability Report, Sep. 2005 reviews both global trends of institutional investors and more specific insight into the investment management industry and trends.

5 Investment Company Institute and International Investment Funds Association.

6 European Fund and Asset Management Association.

7 Although data in this area remain incomplete, EFAMA has started publishing statistics on non-mutual funds.

(both aggregate and broken down into fund subcategories) and was extended to include net sales.

Despite a number of limits to the data, time series are compiled and methodological shortcomings are to a large extent acknowledged and documented. Above-mentioned limits of national account information for analyzing the investment fund management sector make this professional source of data a valuable alternative.

c) Market Information on Investment Funds Trends and Performances

Commercial providers, offer a range of alternative sources. These different sources, with the varying levels of analytical value added that they provide, enable a clearer picture of short-term market dynamics to emerge. They are updated quickly and regularly, so they can be used to gain an accurate understanding of market structure, product releases and innovative advances. They also make it possible to estimate net inflows to individual products.

In addition, it is noted that information provided by such data vendor may in some cases extend to information on fees and the pricing of CIS products. A methodical use of the aforementioned data seems likely to improve IOSCO's assessments.

2. Shortcomings in the data

Numerous limits to the use of those sources of international data are noted, among which:

- Limits due to institutional differences across jurisdictions:

  - Institutional differences generate differences in coverage (perimeter of the data), generally due to differences in the field covered by financial regulators.
    Example: Central bank data do not cover all CIS products -notably discretionary accounts (mandates), hedge funds, US investment trusts, etc.

  - Differences in the nature of distributed products may have an impact on the comparability of the various product categories.
    Example: such differences arise when products are jurisdiction specific (UK listed investment trusts, etc.) or when the same concepts cover dissimilar products (ETFs may or not refer to commodity or real-estate products, to actively managed products, etc.)

- Against this background, a general lack of common definitions (nomenclatures) and methodologies[8] limits the use of the various sources available:

8 In practice, conducting comparative exercises, it appears necessary to question the legal status of entities under review. OECD (2001), or EFAMA Statistical Yearbook 2005, for example, provide detailed methodological country notes.

- o <u>National financial regulators data</u>
  Detailed jurisdiction data often remains jurisdiction specific, particularly with regard to the definitions of product categories.[9]

- o <u>ICI/IIFA data</u>
  - Does not take into account a significant part of the industry's activity,[10] namely funds sold to the general public (closed-end funds and funds of funds as separate categories, etc); special funds (funds sold specifically to institutional investors); discretionary accounts (or mandates); other types of non mutual funds CIS (real estate funds, hedge funds, etc.);
  - Lacks of explicit/detailed methodology on the data's perimeter.[11] Data collection depends largely on national members of the IIFA and may sometimes be incomplete;[12]
  - Based on a "product domiciliation view" which does neither take into account where products are effectively managed (localization of supply side economic activity) nor show where products are effectively commercialized (demand side). Cross-border sales are thus not specifically accounted for.

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9 The French AMF's statistics, for example, are based on the following nomenclature of UCITS: "Money market," "Fixed Income," "Equities," "Balanced," "Alternative funds," "Guaranteed funds," "Formula funds."

10 For its European members' countries, EFAMA, however, has already started computing statistics on non-mutual fund categories.

11 Although very detailed methodological information is provided on a wide range of issues (notably definitions of categories of funds, inclusion or not of funds of funds, coverage of foreign/international funds, inclusion or not of sales outside home jurisdiction in total assets, treatment of share classes, master-feeder structures, umbrella funds in counting the number of mutual funds), IIFA does not provide an explicit definition of mutual funds. The US definition of "mutual funds" –"open-end funds registered for public sale under the Investment Company Act of 1940 and the Securities Act of 1933"– is used as a proxy.

The World Bank (Policy Research Paper 3055 of May 2003 on the Global Growth of Mutual Funds) - provides insightful views on "Differences (that) relate, *inter alia*, to the inclusion or not of closed-end funds, unit-linked funds operated by life insurance companies, and retirement funds that operate on mutual fund principles (such as the AFP system if Chile or the defined-contribution pension plans that have proliferated in Australia, New Zealand, South Africa and the United States)." An additional source of discrepancy may also arise between mutual funds in the United States and European UCITS (as taken into account by EFAMA): all European funds eligible to the UCITS status are actually not all effectively "passported" (and do thus not all have the UCITS status).

Conversely, ICI/IIFA provides detailed methodological information.

12 Australia and The Netherlands, for example, provide only a limited number of indicators.

- Flow of fund data
  - Nomenclatures of financial assets provide a heterogeneous level of detail: data cover a perimeter mostly limited to regulated products, and thus exclude a large field of investment management activity (hedge funds, discretionary accounts,[13] etc.). The data rarely enables one to distinguish precise product categories such as holdings of corporate debt, non-listed shares, unit-linked life insurance contracts, etc. Derivatives are not covered;
  - The norms of the SNA 1993 do not enable one to identify investment management firms as separate economic agents in national accounts data. They indeed remain included in a broad category of "Other Financial Intermediaries," which includes among others securitization vehicles, financial holdings, etc. This limits considerably the use of national accounts for analyzing this sector of activity[14];
  - The lack of separate information on pension funds and life insurance, or on unit-linked and monetary contracts within life insurance assets and/or the fact that mutual funds are not provided as a separate asset category for all types of institutional investors translates in some double counting of assets. Pension funds investment in life insurance or mutual funds, as well as life insurance investments in mutual funds, cannot be identified specifically and thus tend to be counted not only as insurance or pension fund assets, but also separately as investment funds. Estimated growth in total institutional investors' assets is probably somewhat overstated by the rise in so-called "re-intermediation";
  - Detailed financial accounts are available for the main jurisdictions (in terms of assets under management), but still lack in a number of jurisdictions.

- Data Vendor Systems

  The primary function of these systems is to compare the performances of individual products, not to enable a historical analysis of aggregate statistics. As a result, these systems offer historical data on products, but no demographic information, *i.e.*, on funds that have been discontinued, fund mergers, etc. Aggregate historical data compiled in this way have thus suffered until now

13 One may note, that the United States Federal Reserve ceased considering "Bank and Personal Trusts" as a separate economic sector in its last quarterly release. As a result, related holdings of financial assets are from now on considered as directly held by trust clients.

14 ESA 95 defines Other financial intermediaries – or OFIs - (excluding insurance corporations and pensions funds) as "financial corporations and quasi-corporations which are principally engaged in financial intermediation by incurring liabilities in forms other than currency, deposits and/or close substitutes for deposits from institutional units other than monetary financial institutions, or insurance technical reserves." Sub-categories of OFIs include investment funds (except money market funds); financial vehicle corporations created to be the holder of securitized assets; financial corporations engaged in lending; security and derivative dealers; financial holding corporations and other OFIs. See above-mentioned "Euro area investment fund statistics" for more detail.

from survivorship bias. Aggregate assets under management (AUM) for past dates cover only those funds that are still operational at the present date, meaning that growth of aggregate AUM is probably overestimated.

3. Elements of bibliography, sources and methodology

"Euro area investment fund statistics," European Central Bank

"Factbook 2006," EFAMA

"Global Financial Stability Report," IMF, September 2005

"Green Paper on the Enhancement of the European Union Framework for Investment Funds," European Commission, 12/07/05

"Green Paper on the Enhancement of the European Union Framework for Investment Funds-Background Paper," European Commission, 12/07/05

"Incentive structures in institutional asset management and their implications for financial markets," Committee on the Global Financial System, March 2003

"Institutional Investors Statistical Yearbook," OECD, 2001

"Risk-Based Analysis to Supervision of Banks," UK Financial Services Authority, June 1998

"Risk-Based Regulation: The FSA's Experience," 13 February 2006 speech to ASIC of FSA Chairman, Mr Callum McCarthy

"European System of Accounts 199," Eurostat, European Commission

"Global Growth of Mutual Funds," Policy Research Paper 3055, World Bank, May 2003

"Flow of Funds Accounts of the United States," Federal Reserve Board

"Worldwide Mutual Fund Assets and Flows," ICI/ IIFA

Appendix B: Detailed Summary of the Top-Down Exercise

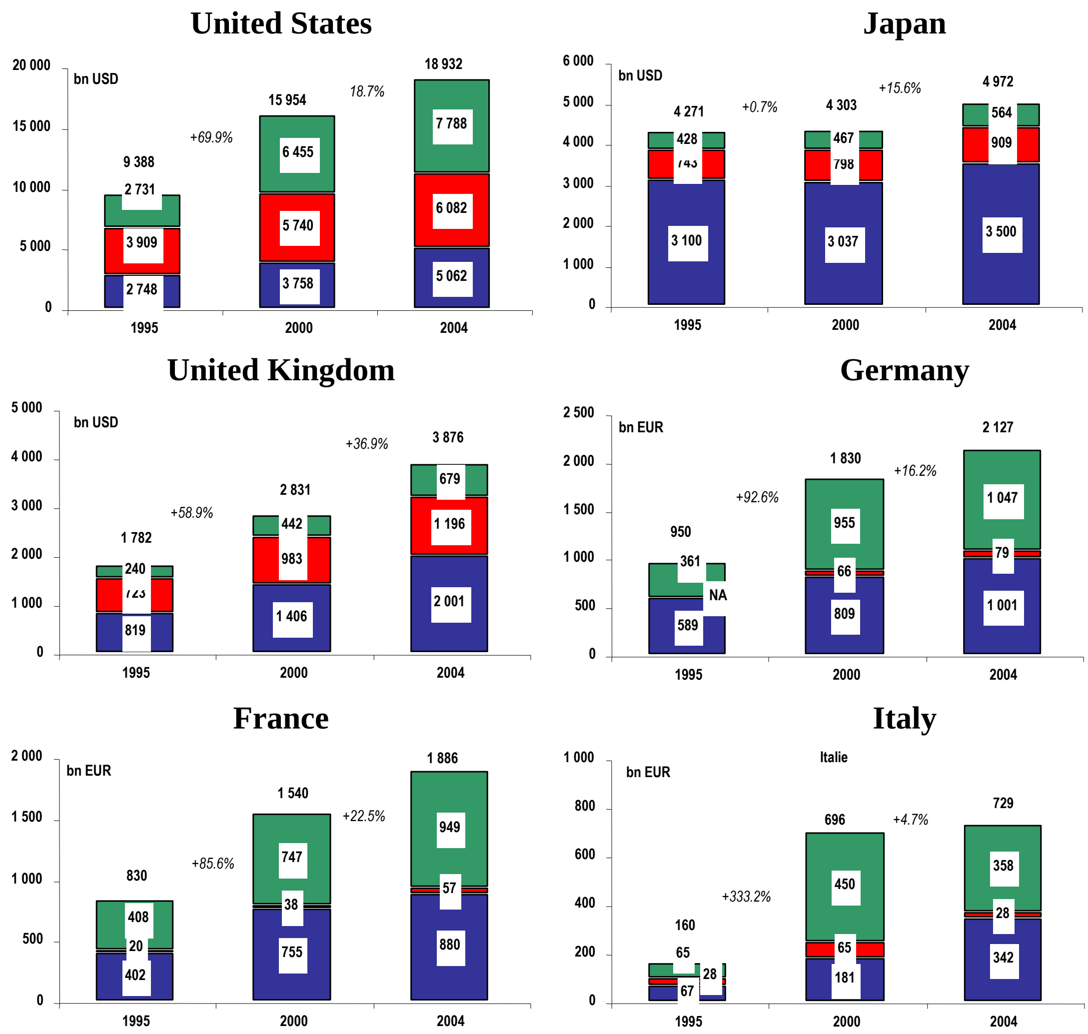
The top-down exercise identified the following trends.

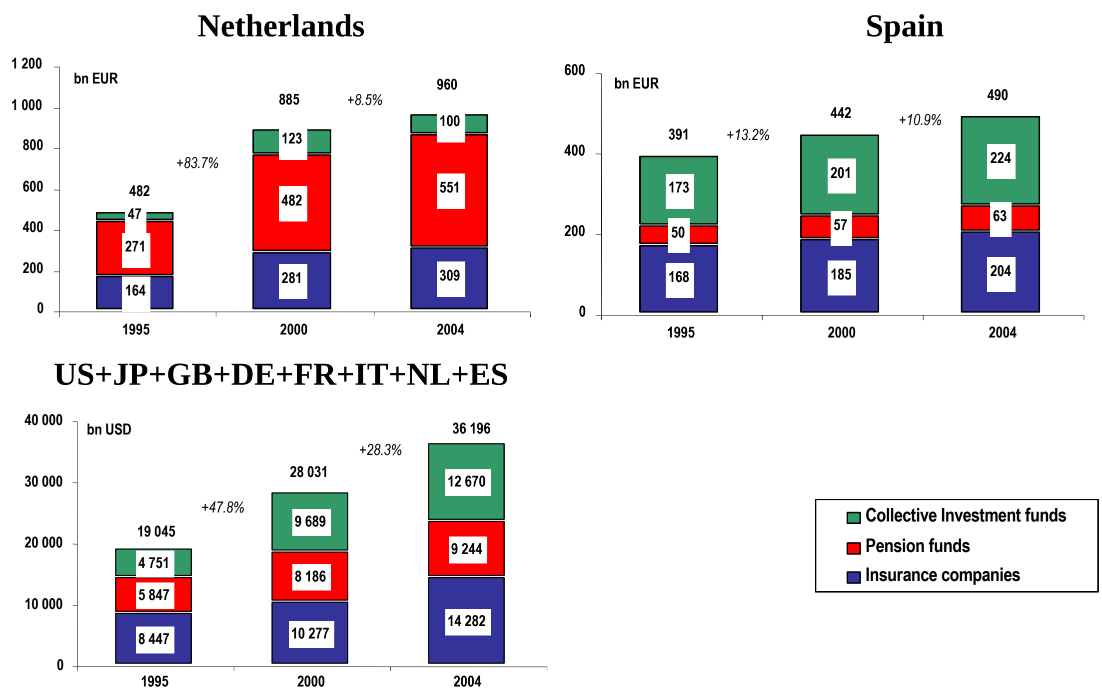
1. Global Market Growth

A global trend in growth in the amount of assets managed (assets under management or AUM) that is by institutional investors was observed, and could be attributed to growth in assets managed by UCITS.

- Over the last decade, assets under management of institutional investors – a general concept that includes insurance firms, pension fund schemes and other investment management firms - grew at a significant growth pace. In nominal terms, assets under management almost doubled between 1995 and 2004, thus reaching 90.1% growth in a sample of eight major jurisdictions (in terms of assets, see *Appendix B* Chart 1 and Table 1).

Chart 1 – Aggregate statistics on institutional investment - 1995-2000-2004





Source: National Accounts, French AMF calculations

- The CIS industry had particularly strong growth in AUM:

Table 1 - The rising weight of investment management in institutional asset management

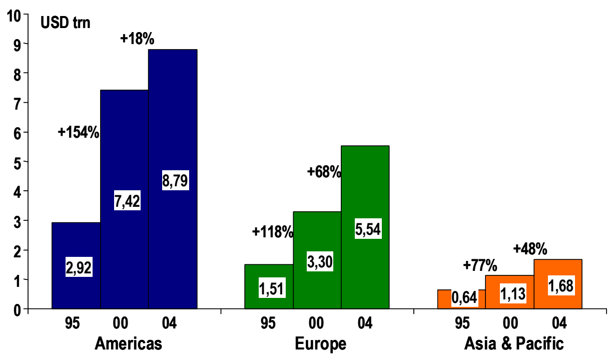
	Assets under Management (2004, bn USD)		**Growth in Assets under Management** (1995 to 2004 in % and in national currency)	
	CIS	**Total Institutional Asset Management**	**CIS**	**Total Institutional Asset Management**
Italy	487.0	990.8	447.1	353.5
France	1,289.7	2,562.9	132.7	127.3
Germany	1,422.7	2,891.5	189.9	123.9
United-States	7,787.7	18,931.7	185.1	101.7
Netherlands	135.5	1,304.7	110.3	99.2
United Kingdom	679.5	3,876.0	128.8	75.9
Japan	563.8	4,972.1	30.8	15.6
Spain	304.0	666.6	29.3	25.5
Total	12,669.9	36,196.3	166.7	90.1

Sources: National Accounts, IOSCO calculations.

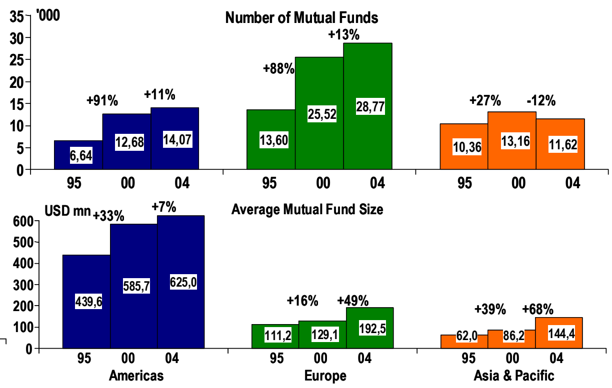
Although growth is observed everywhere, growth rates differ across jurisdictions (see *Appendix B* Table 1), and with respect to the underlying products. Some jurisdictions such as Germany, recorded particularly strong growth in real estate investment funds over the period; formula-based funds grew in a limited number of jurisdictions such as Belgium, France and Spain; money market funds remain largely a specific feature of France and the United States; etc. Considering ICI/IIFA data by asset class, the share of the main regions in total world assets, confirms this perception of a "regional specialization." Whereas the Americas represented about two thirds of 2004 world equity assets, they barely exceeded the weight of Europe (46% against 43%) in world bond fund assets. The weight of Europe in "Other funds" reveals the specific importance taken by more "complex" CIS products, a broad concept extending here from hybrid funds to structured funds, such as guaranteed or formula-based funds (see *infra*, Part 3 for a description).

Chart 2 - Growth and nature of mutual fund assets - 1995-2000-2004

Growth in Assets under Management (AUM)

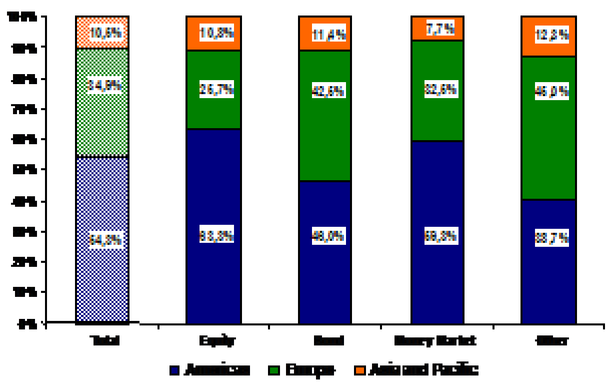


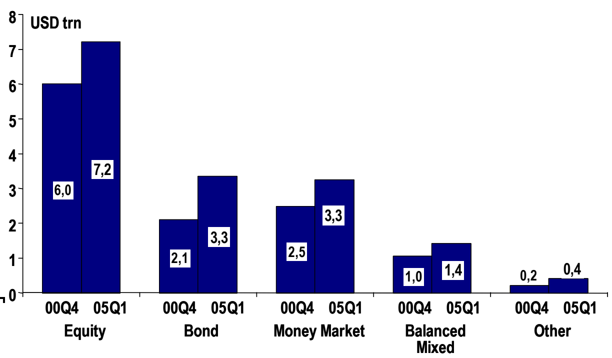
Growth in average Fund Size



Regional Specialization

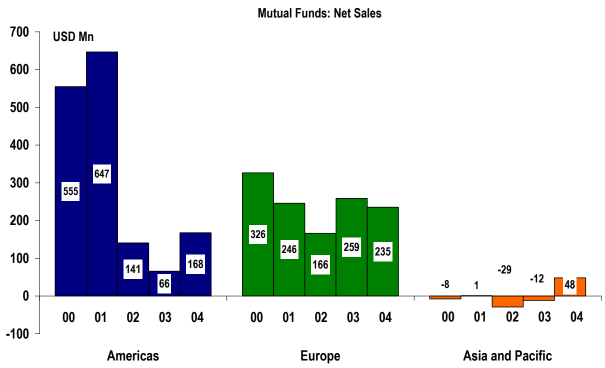
AUM Growth varies depending on Product Categories



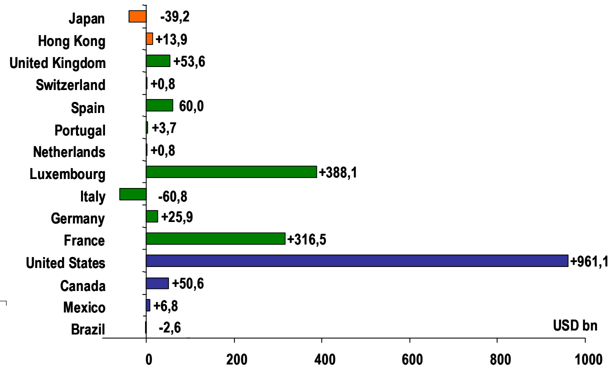


Generally positive, but unequal net investment flows are (both over time and in geographical terms)

Nets Investment Flows by Region



2001 to 2004 cumulated Investment Flows



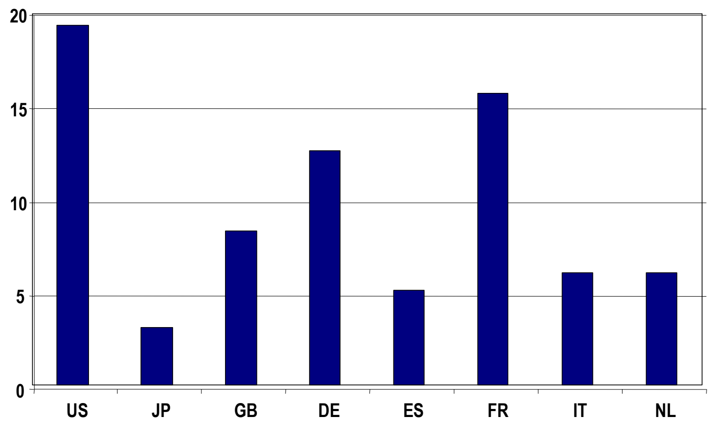
Source: ICI/IIFA

The reasons for such growth are complex. The growth in assets managed by institutional investors has affected different institutional investors and may not be attributable solely to the capitalization of pensions. Indeed accurate explanations seem to require precise analyses of the CIS markets' fragmentation and jurisdiction specific accounting of financial markets regulations and historical developments.

2. Ongoing Market Fragmentation

Fragmentation is apparent both on the supply and on the demand side. On the demand side, jurisdiction differences are observed with regard to CIS assets per head (see Chart 3).

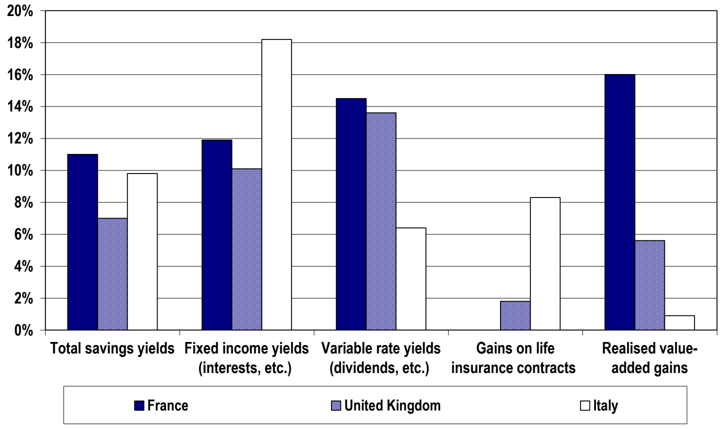
Chart 3 - Average CIS holdings per head (2004, thds USD)



Sources: National Accounts, own calculations.

On the demand side, jurisdiction differences are notably observed with regard to the various types of CIS (as previously noted). Jurisdiction biases in investors' allocation of assets to particular CIS types may result from differences in tax treatments (see Chart 4) and of a general preference for investing in domestic financial assets ("domestic bias").

Chart 4 - Real Tax Rates in 3 European countries (1999)



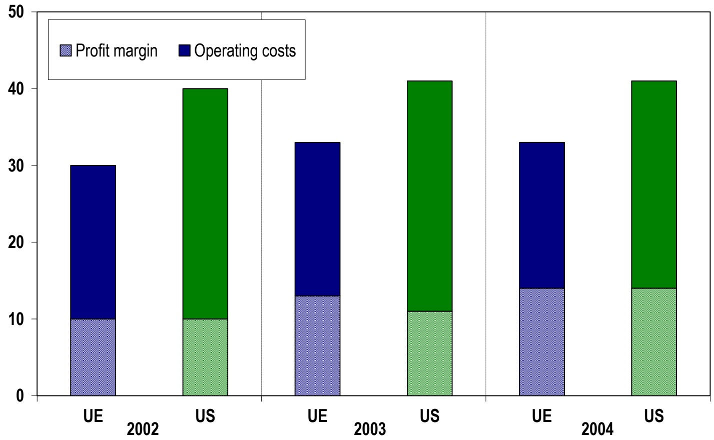
Source: L'Horty (2005), OEE research on tax administration data.

On the supply side, the degree of cross-border integration of subscription-redemption order processing and, more generally, back-office and administration infrastructures remains low, as many different systems and processes still coexist. Despite industry initiatives underway for harmonizing processes, inferred additional processing costs still hinder cross-border transactions. In addition, CIS distribution channels are structured very differently in the various jurisdictions under review. In most continental European jurisdictions, distribution structures entail banking networks, versus an "open architecture," as in the United Kingdom or the United States. In the first case, bank networks integrate asset management subsidiaries and bank branches. In the second case, independent distribution networks channel CIS sales, such as in the United Kingdom where Independent Financial Advisors play a major role in commercializing UCITS. In jurisdictions with prominently bank-based distribution networks, the trend towards an open architecture model may be noted more particularly in some jurisdictions, such as Germany and Belgium.

In addition, on the supply side, the rising use - for tax, regulatory and more general historical reasons - of centers such as Luxembourg and Ireland for domiciling CIS products is more particularly observed in a limited number of jurisdictions (such as Germany, Italy, Austria and Spain).

The market fragmentation translates into strong regional and national discrepancies in cost and profitability structures (see Chart 5).

Chart 5 - Profitability of the fund industry (bp in % of AUM)



Source: McKinsey, Will the goose keep laying golden eggs?
7th Annual Survey on the Profitability of European AM, Oct. 2005.

3. New product launches

In the wake of the stock market downturn, and amid a low fixed income yield environment, the "search for yield" led the investment management industry to promote a number of innovative products, the main characteristics of which are:

a. **A trend towards a bi-polarization of the supply of CIS products, with:**

At one end, a **rise of active strategies and/or risk-return optimization**:

-"Absolute return" and "all-weather funds"

A new generation of CISs has emerged over recent years that invests outside traditional asset classes, such as in inflation-linked bonds (ILBs), securitized products and alternative assets, commodities, real estate or unlisted shares. Given the variety within this category, measuring the growth of these types of products is tricky.

Based on the Absolute/Total Return category in the Lipper database, however, it is estimated that funds of this type launched in 2005 held around 5%[1] of the assets of all funds launched in Europe last year.[2] A few examples illustrate the potential diversity of their investments. Evidence of big sized funds (of some USD 1 bn) investing close to half of their assets into property-related securities and commodity-linked notes is not exceptional anymore. One of this type of fund in Europe, is for example marketed as "a fund that invests in a range of financial asset classes and responds nimbly to take advantage of events impacting prices and yields on capital markets around the world."

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1 5.3% by number of funds and 4.3% by assets according to our estimates.

2 The following fund categories are covered: Equities, Bonds, Mixed and Money Market.

There are some outstanding questions about how these products will evolve. Analysts seem to like the scenario of strong growth in so-called "all-weather" funds,[3] which leave managers broad latitude for opportunistic adjustments to asset allocations. And indeed, absolute return funds are now tending to define themselves in terms of their risk level rather than their allocation. For example, some of the funds, which made Europe's top-ten for net sales in 2005, are labeled and marketed with a direct reference to their risk level (value-at-risk). Such funds can be classified as "Money Market EUR Leveraged" funds, "Mixed Asset EUR Flex-Global" funds or "Enhanced Money Market" by fund data vendors. Such funds may be allocated along both long-term strategic and short-term tactical positions, which allows them to benefit from the opportunities and diversification offered by international bond and currency markets, and thus to use all types of financial instruments. They subsequently use a broad array of investments and techniques, including short-selling of emerging bonds, swap spreads on yield curves and trading in forward contracts.

- **Structured products**

Exemplary in the way their allocations are diversified and geared to take opportunities, the above mentioned VaR funds also offer a good illustration of how funds are defining themselves mainly in terms of their risk level. In the post-bubble world, they exemplify the growing supply of funds that seek to raise returns while accommodating high risk aversion among investors. More generally, in recent years CISs have started offering different ways to "structure" risk, first by building varying levels of guarantees into structured funds, then by introducing increasingly active directional strategies, especially on equity markets. Lately, advanced risk structuring techniques have been extended to include benchmarked investment products and even ETFs. Thus, structured funds are understood here in the sense of CIS products.[4] They relate to the capacity of CIS to specify adjusted risk-return and intertemporal payment profiles, usually by using derivatives and possibly leverage.[5] They have been widely

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3 See, for example, Morgan Stanley, "On and Off-piste: Money Making Trends and Best Ideas in European Asset & Wealth Management," March 2006.

4 Structured products are characterized by a promise to make a payout based on a formula derived or based on the performance of an underlying security, basket of securities, index, commodity and/or a foreign currency at a certain time. Against this background, structured products taking the legal form of a fund differ from other structured products in various ways:

- Structured funds are issued by CIS managers not by investment banks;

- Investors own the underlying assets of CISs, whereas structured products usually take the form of fixed income instruments (notes), and thus bear a credit risk;

- In the EU, structured products are regulated by the Prospectus directive and are often admitted to trading on a regulated market whereas structured funds comply either with the UCITS directive or with national fund regulations.

5 As defined here, structured funds include "guaranteed" and "protected" categories. A common form of structured funds aims to achieve a return profile that guarantees a minimum capital protection at maturity (face value of a bond less a Blue Chip index option premium) and to benefit from favourable equity market movements when index performance permits (*i.e.,* when options are in the money at maturity). However, the range of underlying financial instruments and derivative products gives professional

marketed to the general public, and particularly so in some European jurisdictions, since the mid-1990s and especially in the general climate of risk aversion following the market meltdown. These are typically closed-end funds offering specific payout profiles |based on the performance of a basket of reference assets and/or indices (*e.g.*, equities, bonds, currencies or commodities and, more recently, hedge funds)."[6] The investment objectives proposed by these products usually reflect technical considerations, like tax arbitrages to avoid tax on certain types of investment, or a more fundamental desire to offer exposure to risk (*i.e.*,. volatility) limited by principal protection. Although the most common funds of this type combine investments in zero coupon bonds with stock options based on broad market indices, the range of underlying financial instruments and derivative products gives professional promoters considerable creative freedom. For instance, around 35% of the authorizations for structured funds issued by the French regulator in recent months have been for funds with constant proportion portfolio insurance (CPPI). Unlike structured funds, CPPI funds do not set an unchanging asset allocation when they are created. Rather, they pursue a dynamic and active approach, often taking on debt and leveraging the portion of principal that is not constrained by the capital protection mechanisms associated with this type of product.[7]

Structured CISs have experienced mixed fortunes, tasting little real success outside Asia and a number of European jurisdictions, including France, Spain, Belgium and Luxembourg. The rest of the world accounted for less than 10% of the market in 2004. In France, the growth of this type of product has been stunted in recent years by the adverse effects of misselling. While the rules for marketing structured funds have been improved, the initial popularity of these products in France, which lasted up to the end of the 1990s, has apparently faded, with AUM remaining below 7% of the total assets managed by non-money market CISs (Chart 6). Even taking into account the growth, especially in Germany, of investment certificates (or structured notes) which do not count as CISs and are thus less stringently regulated, particularly in Europe where they are usually marketed under the regime of the Prospectus directive[8], total AUM in structured funds and certificates –although showing rapid growth in some jurisdictions–

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promoters considerable creative freedom. Recently, a number of structured ETFs have been marketed in Europe.

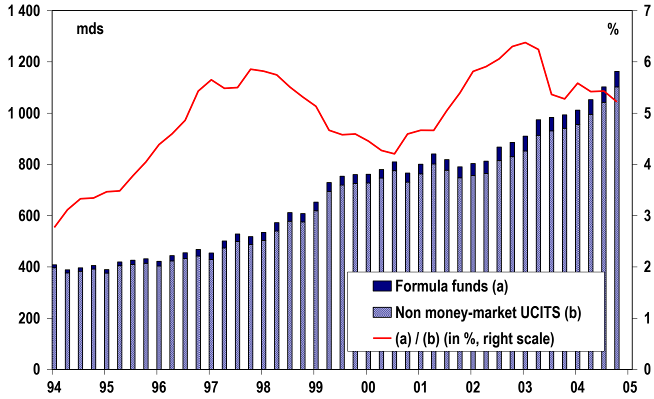
6 IMF GFSR, September 2005.

7 In this instance, capital protection is not necessarily obtained by buying zero coupon bonds. It may also be achieved synthetically via the overall portfolio structure.

8 Structured notes are raising regulatory questions about transparency and suitability at the European level. The European Commission has noted that "even if some certificates are designed exclusively for institutional investors (…), they are mainly marketed to retail clients and are becoming increasingly popular in some Member States. Most certificates are admitted to trading on a regulated market. (…) They can therefore be bought and sold like any other bond admitted to trading. They are not subject to specific disclosure requirements as regards their cost-structure, their strategy or the risk-profile of the product. This issue not only raises concerns with the investment industry for competitive reasons but also regulators increasingly look at this issue as a matter of investor protection." Green Paper on the Enhancement of the EU Framework for Investment Funds-12/07/05.

still seems relatively low as they are thought to make up less than 3% of assets in regulated funds managed in Europe.[9]

Chart 6 - France: total assets and share of structured funds in total non-money market CISs (EUR billion)



Source: Banque de France, French AMF calculations

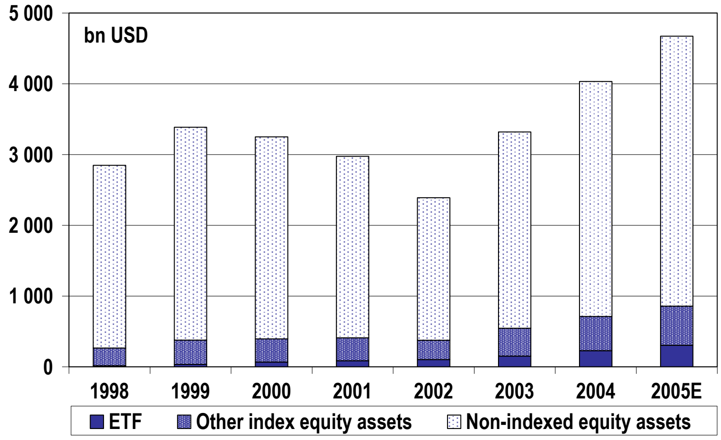
This market segment is nevertheless a fast-growth, profitable sector for promoters. The segment was instrumental in placing some leading European firms among the quickest-growing asset managers in Europe in 2005 by net sales. The Spanish market has also been expanding strongly, with the mega funds launched in 2005 attracting more than EUR 6 billion since their launch.

- At the other end of the product range, a **strong and opportunistic development of passive, cheaper CIS products**

  Index products (Chart 7) practically doubled their share of overall investment in “equity” funds between 1998 and 2005 in the United States, confirming the perception that passive management is an increasingly potent force. Their **growth may be traced back to the rise in ETFs**. From almost negligible levels in 1998, ETFs have grown to account for over 5% of the assets managed by equity funds in the United States.

9 The European Commission estimates that at the end of 2003, German exchanges accounted for 66% of the worldwide volume traded in certificates, compared with 12% for Hong Kong, 7% for Switzerland, 5% for Italy and 3% for Euronext. Turnover in certificates including warrants in that year was EUR 154.8 billion on German exchanges, compared with just EUR 10.8 billion for Italy and EUR 6.3 billion for Euronext.

Chart 7 - Equity funds in the US: Indexed assets



Sources: Morgan Stanley, Bloomberg, Strategic Insight, authors calculations.

Evidence of **diversification into new fund categories of benchmarked CISs** is revealed in the substantial inflows to schemes with an exposure to investment themes often linked to shifts in business conditions, through the adoption of opportunist strategies.

- **Marketing of CIS translates into an increased customization of products:**

The previously noted differentiation of the CIS supply (globally described as a bi-polarization) leads increasingly to segmenting the customer base and customizing the CIS product offer. Two examples illustrate this trend:

- **Liability-Driven Investments (LDIs) – Target: Institutional investors**

New international financial rules and accounting standards have been introduced in an effort to ensure that institutional investors manage their assets in a way that better reflects their liabilities. These changes were prompted by a series of developments where the bursting of the stock market bubble and a string of accounting scandals eroded the solvency of pension funds. As part of these changes, regulators of insurance companies and pension funds have generally adopted rules requiring asset management to take more explicit account of liability-related constraints.[10] International Accounting Standard 19 (IAS 19), which applies to company-sponsored pension plans[11] requires plan sponsors to discount the value of their liabilities under these plans.[12] In the United Kingdom, meanwhile, "the introduction of the accounting

10 The Netherlands (the Financieel Toetsingskader, or FTK) and the United Kingdom (the FSA's PS04/16) have introduced rules for the insurance industry, for example.

11 International Accounting Standards - Accounting for Retirement Benefits in Financial Statements of Employers.

12 The transposition of IAS 19 to the Netherlands required, in addition, that companies sponsoring defined benefit pension funds record pension commitments on the balance sheet.

standard FRS17 required the assets of defined-benefit pension funds to be measured at market values and their liabilities to be discounted using a market rate of interest."[13]

To meet the needs of institutional investors in this area, management companies and investment banks use core-satellite investment principles to promote active products, which come with higher management fees, based around a core of less costly passive instruments. The growth of packaged offers has spawned special-purpose products like liability-driven investment (LDI) funds. Passive bond funds with constant durations, LDI funds are deployed in full ranges that cover a comprehensive spectrum of durations, sometimes offering different currency denominations. They act as the core of a duration matching portfolio whose duration matches the liabilities of the acquiring institution. Leverage is used to free up additional assets, which are invested in a return portfolio of risky assets and managed dynamically.

A narrow approach best suited to mature, well-funded pension schemes, which is often distinguished from a broad approach, which "is more applicable to younger schemes with complex cash flows that seek a higher long-term return."[14] Looking at Europe in 2005, LDI funds were launched in Luxembourg, but also in the United Kingdom, where one unique asset manager manages an AUM of over GBP 11 billion in LDIs. Two years ago, another investment management firm in the United Kingdom set up a dedicated LDI division, which now manages over GBP 15 billion in pension fund assets. Many other companies, especially in the United Kingdom, put together LDI offers in 2005. Among them, unsurprisingly, most of the ETF promoters were represented.

- **Lifecycle funds – Target: Retail investors**

Packaged products are also being marketed to households. "Life cycle" funds are products that are, in the United States, eligible for certain 401(k) pension plans, *i.e.*, defined contribution pension funds that give investors the freedom to decide how to allocate assets. In the United States, assets held in these funds have soared in recent times, more than doubling since 2000 (Table 3). Several life cycle funds have been launched in Europe recently, the success of which remains to be assessed.

Table 3 - US: AUM and growth of life cycle funds

	1999	**2000**	**2001**	**2002**	**2003**	**2004**
AUM	57.9	63.3	69.2	68.2	101.4	139.7
Net inflows	4.7	5.5	6.7	6.8	21.4	24.2

Source: Lipper[15], Morgan Stanley – cited in IMF GFSR, September 2005

The principle behind these diversified funds, which may also be called "age-based funds" or "target-date funds,"[16] is to adopt an asset allocation strategy that adjusts

13 Bank of England Quarterly Bulletin Winter 2005.

14 "Contemplating Liability-Driven Investing," Financial Times, Joe Moody (State Street Global Advisors).

15 M. Porter, L. Garland; "Life Cycle Funds: Fit for Life;" Lipper Insight Reports; March 2005.

automatically over time. The initial strategies usually have higher equity content, while gains are gradually protected by introducing strategies with a higher emphasis on bonds. As for LDIs, these funds are launched in variable maturity buckets. Among the major US market players some sell actively managed funds, while others promote passive, and hence less expensive, instruments.

4. Investment Behavior

Positive relations have been observed over the last decades between investment flows and past performances of investment funds. Although better documented in the United States, those relations are also observed in other parts of the world (see Charts hereafter).

Chart 8- US equity mutual funds: Net inflows and market performance

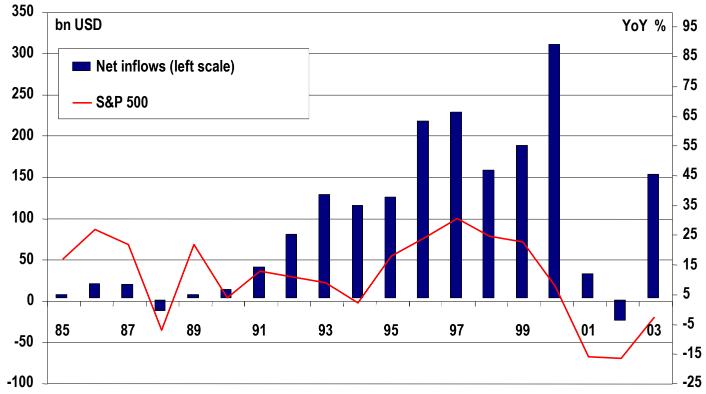
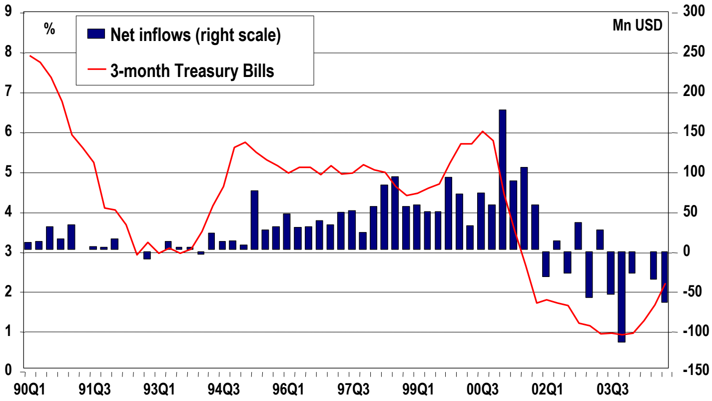


Chart 9 - US money market funds: Net inflows and 3-month interest rates



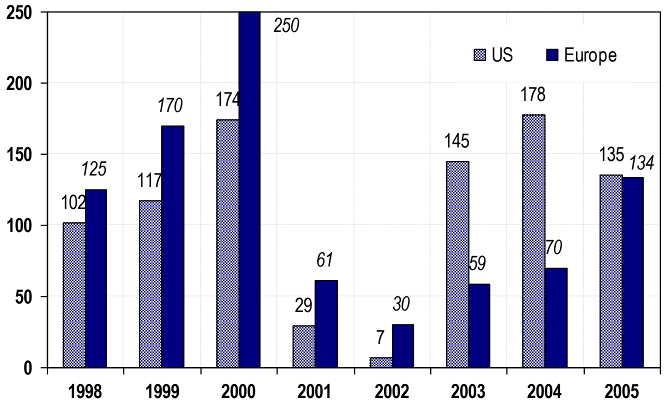
Source: Investment Company Institute, author's calculation.

Short-term views on present market investment trends put investors' procyclicity issues again in the spotlight. Those issues indeed gain renewed actuality at times when retail investors raise significantly their equity investments and tend to "chase" returns by investing in less liquid markets such as emerging markets, property, private equity or even CDO funds.[17]

16 Target-date funds are the default option for French popular retirement savings schemes, or PERPs.

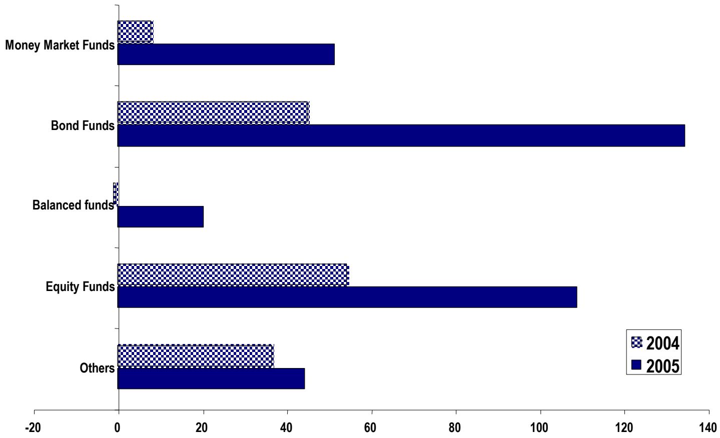
17 See The Economist, 29 April 2006 - Cocktail hour - Flotations of exotic funds may leave investors with a bitter taste.

Chart 10 - Mutual funds equity inflows



Source: FERI FMI, ICI, Morgan Stanley Research estimates.
Note: US fund inflows recorded an upturn in the course of 2005

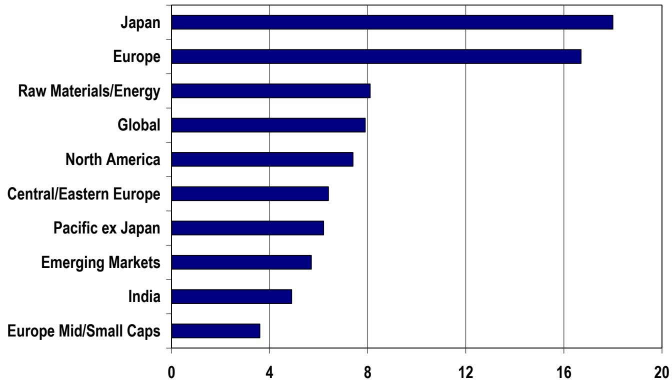
Chart 11 - Estimated net sales by European CIS (2005, EUR bn)



Source: Morgan Stanley, FERI FMI

This trend is further evidenced by the previously noted diversification into new fund categories of benchmarked CIS. In particular, considerable inflows have been channeled towards funds investing in the Asia and Central/Eastern Europe regions, in mid and small caps, and in the energy and financials/real estate sectors. At end-November 2005, for example, the 15 largest equity funds launched in Europe in 2005 included a EUR 1.1 billion, Luxembourg domiciled, India fund by a major US asset management firm launched on 31 January 2005, and two euro area sector funds by a major Swiss asset management firm, the first focused on energy, materials and utilities, the other on the financial sector.

Chart 12- Estimated net sales by European equity CISs (2005, EUR mn)



Source: Morgan Stanley, FERI FMI

Last but not least, the launch of simultaneously listed, actively managed and structured funds appears as a significant event. Such products are characterized as follows by their promoters:

> *"These products do not seek to replicate the returns on an index; they offer investors exposure to a market (...) and, depending on the fund, a cushion (partial protection of principal) or leverage. The leveraged funds are an attractive alternative to derivatives."*[18]

They indeed raise numerous questions to the regulator. We note in particular:

- Retail investors may have limited capacity to understand them;
- The need of an increased focus on information transparency (they do not replicate an index anymore);
- The potentially renewed importance of pricing issues (as they are not passively managed, such products are likely to be comparatively expensive); and
- The fact that they blur existing categories of funds by mixing features of passive and active funds, of structured (formula-based) funds, etc.

Non-quantified CIS evolutions

i) Industry structure

- Most features of the investment fund industry – number of firms and firms' characteristics (employment, fees, costs, profitability, etc.) - appear difficult to assess systematically on a cross-border basis, due to a lack of sources of internationally comparable information (more detail on this issue is provided *supra* and *Appendix A*). In a context where they tend to foster competitiveness amid

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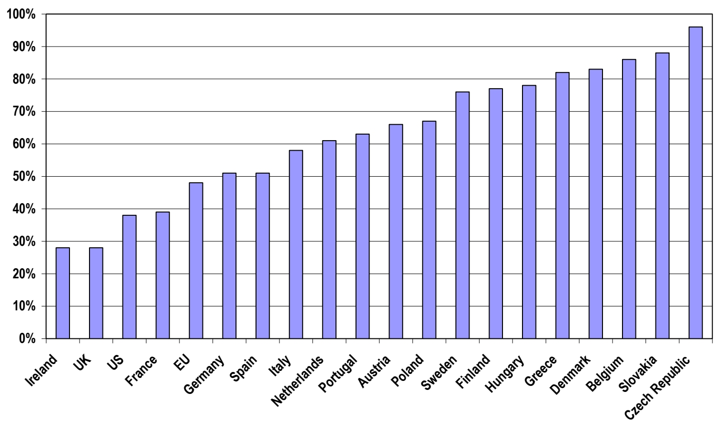
18 "5th Anniversary of Euronext's NextTrack Segment" (2006) – Amadeis. The description relates to series of ETFs based on the CAC 40 and FTSEurofirst 80 indices.

fragmented markets, financial regulators thus increasingly consider this lack of data as an issue.[19]

Nevertheless, basing on empirical evidence and on consulting sources, a high level of concentration and a trend towards specialization of investment firms can be identified, whereby:

- Concentration refers here to the market share of the biggest firms in terms of assets under management (see Chart 11). According to EFAMA 2004 data, the market share of the five largest asset managers was of about 38% in the United States and 49% in the EU. Concentration tends to be lower in the biggest fund markets, such as the United States, the United Kingdom or France, and higher in smaller markets, such as Greece, Belgium or the Czech Republic, where assets managed by top 5 companies account for over 80% of the market, and often consist of subsidiaries of major market players of jurisdictions where the CIS market is particularly developed.

Chart 13 - Market share of top 5 asset managers (2004)



Source: EFAMA

- Specialization refers here to two observed market developments:
-
    - The dedication by a significant number of investment management firms of important resources to specific investment strategies (alternative products, passively managed products, structured funds, small caps, etc.).[20]

    - The increasing segmentation of activities along the value chain and growing recourse of investment firms to outsourcing.

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19 In that respect it seems worth noting that the European Commission has mandated several data collection and research projects with a view to gain additional insight on the investment fund management industry since the start of 2006.

20 Lately this phenomenon characterized also the success of a number of small/medium sized firms specialized in successful strategies, such as small cap equity investments.

ii) Environment changes

A number of changes affect the industry's environment, which are worth noting for in a longer-term perspective. We note, for example:

- Private pension funding and risk transfer
  The increasing recourse to capitalized pension funding comes along with a generalization of defined contribution schemes to the detriment of traditional defined benefit schemes and, more generally, with a transfer of pension related market risk to households.

  As, in addition, CIS products tend to be more complex and structured, retail investors' financial education becomes increasingly an issue.

- Technological progress
  - Tends structurally to increase markets' openness and to lower transaction costs thereby raising trading volumes;
  - Tends to make changes in infrastructures less reversible.

- More generally, questions on the exposure of the industry to risks related to its broader environment such as, for example, on the potential impact of an avian flu pandemic on CIS liquidity, remain to be assessed.

Limits to the data underlying the exercise

Conducting the "t*op-down*" exercise stressed the fragmentation and lack of international harmonization of available statistical sources on relevant strategic issues. Underlying differences in conceptual definitions of the CIS industry may thus be understood as strategic issue in itself. Therefore, a detailed review of the data was conducted (see *Appendix A*). Against this background, a number of conclusions can be drawn for the current exercise:

i) A number of sources provide statistical data for analytical purposes that match the needs of the strategic issues identification exercise. International views remain largely dependent however on a precise assessment of underlying data and methodologies. Specific research resources thus need to be dedicated for inferring assessments tailored to the needs of IOSCO.

ii) Several pieces of information remain lacking. In that respect, the absence of official cross-border source of information on investment management firms' characteristics and activity (number, size, concentration, employment, accounting indicators - costs, profitability, etc.) appears particularly striking. An international quantification of the importance of the various economic agents involved along the "value chain"-from investment management to sales (market) and transfer agents (post-market) via depositories also requires a sounder statistical basis.

Due to this general lack of publicly available data, the analysis of the investment management "industry" remains practically unexplored by academics, and essentially limited to investigations of consultants (McKinsey, PricewaterhouseCoopers, etc.) as well as of investment banks (mainly equity analysts).

iii) Similarly, aggregate views on non-regulated investment products such as hedge funds remain largely restricted to a few market players whose claim to have a global view on the market appear credible to some extent, due to their specialization and/or market share.

Inferred strategic priorities

Although of a limited scope, the "t*op-down*" review conducted enables SC5 to draw a few conclusions:

- Global CIS market growth

  The CIS industry, in a context of significant wealth accumulation and AUM growth, is rationalizing its processes and consolidating. As it takes a central place in institutional asset management, the importance of related developments thus appears increasingly crucial. A global perspective on financial risk transfers between the various types of economic agents hence appears relevant for the purpose of financial regulation.

  Against this background, various issues of regulatory concern resulting from the variability of financial asset prices may be pointed out:

  - CIS markets' financial stability issues, and particularly with respect to the increasing use of passively managed CIS;

  - The rationality of investors[21] and procyclicity of both retail and institutional investors may be questioned;

  - The scope of financial market regulation, and more particularly the limits separating regulated from non-regulated investment products (OTC derivatives, alternative investments, etc.) need to be better identified.

- Analysis of the asset management industry's reaction amid a low yield environment and an international opening of the markets

[21] This point is widely documented by academic and empirical literature, and relates to several types of biases in investors' behavior ("non-participation puzzle", "domestic bias", etc.). Polkovnichenko V. (2005); 'Household Portfolio Diversification: A Case for Rank Dependent Preferences"; The Review of Financial Studies, Winter, no 18. mentions, for example, that, in 2001, the median number of stocks held by shareholders in the United States was three, and that four out of five shareholders held fewer than five stocks.

Investment diversification and management technique sophistication are intrinsically beneficial to investors, as they improve risk-return options provided to investors. They however have also implications for financial regulators at a more fundamental level, as they do not come without risk. We point out:

- Both investors and distributors find it hard to get to grips with the complexity of these innovative products. Additional efforts may be needed to ensure product suitability (for investors) and transparency, through disclosures on operation and performance;

- Because of those informational asymmetries between the asset management industry and its customers, there may be an increased risk that uncompetitive processes may arise. Such risks, which are evidenced by low fee transparency levels, may be further exacerbated by market segmentation;

- There is less clarity – notably in Europe – on the abundant and sometimes redundant supply of products, in which the lines between the different categories are blurring. This risk also makes it harder for statisticians and analysts to mark out conceptual boundaries and produce meaningful aggregate indicators.

• Ongoing market fragmentation and impact of the opening of markets on financial activity's localization

The transition between fragmented and integrated CIS markets, in a context where regulators promote actively market competition, stress the importance of questions on the industry's structure, and notably on:

- Market and post-market infrastructures;

- The industry's demography (new entrants, mergers and acquisitions, etc.);

- Potential changes in the segmentation of the value chain and outsourcing issues;

- The geographical location of related activities

Appendix C: Findings of the Combined Top-Down and Bottom-up Exercises

The SC5 issues are prioritized relatively to one another in a chart that incorporates the results of both the top-down exercise and the bottom-up exercise.

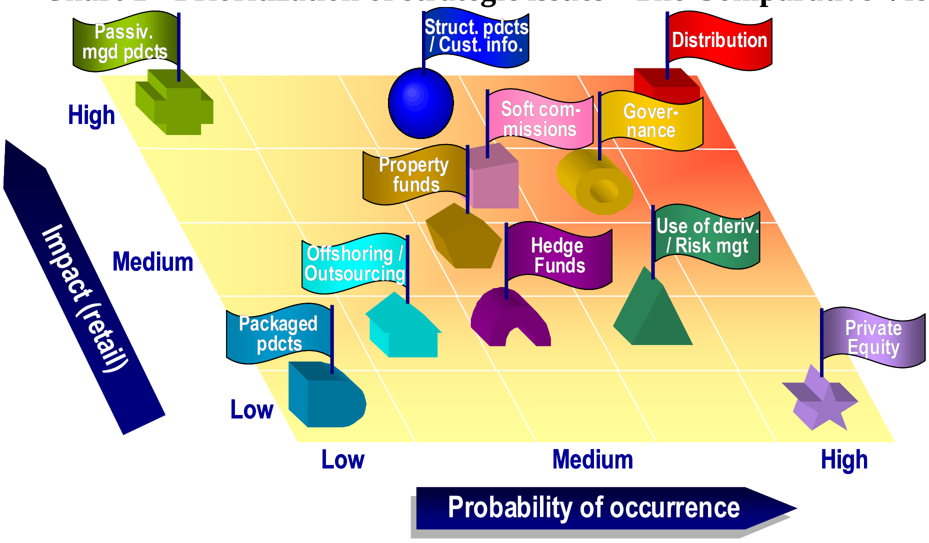
Two axes are considered simultaneously to that end.

The first axis – Impact (retail) - measures the relative importance of the considered issue, based upon its effect on the investing retail public. This axis reflects the spread of products among retail investors, and evaluates the extent of retail exposure to certain practices. This axis relies more on global market views such as provided in the top-down exercise.

The second axis reflects the timeliness of the issue – the probability of occurrence. It relies more particularly on practical assessments by operational regulators.

Strategic issues are subsequently represented on a grid as follows (Chart 1), where the upper right corner shows both the biggest potential impact on and the highest probability of occurrence, the lower left corner, the least potential impact and the lowest probability of materialization.

Chart 1 - Prioritization of strategic issues - The Comparative View



Finally, it appears that Table 1 of the main paper revisited in the light of the "*top-down*" approach does not fundamentally change the ranking of priorities. However, it changes the focus of the priorities. Accordingly, for example, distribution related issues could be considered with a specific focus on complex - and more particularly structured – products.

The Dynamic Analysis

Lastly, in addition to situating the various issues relatively to one another, an individual assessment of each issue over time was attempted. Each issue was considered dynamically using the same type of grid as in the previous flowchart. This assessment determined the past and present status of the identified issue, and attempted to identify the issue's future importance and timeliness. For example:

Chart 2 illustrates the dynamics of the issue of structured funds and customer information. Starting from a situation in the 1990s, when (in certain SC5 member jurisdictions) no standard prospectus was provided to CIS investors, improved regulatory requirements led to providing shareholders with more information. A parallel trend towards an increased complexity of CIS products was observed. The present situation can still be characterized by a significant potential retail impact, but the probability of occurrence of related risks has been mitigated by the development of more appropriate risk management tools, the improvement of asset managers professional standards and the development and rising liquidity of the markets for underlying derivative products. Several ways can therefore be contemplated by financial regulators, ranging from an improvement of investors' information requirements and a better suitability of investments to CIS shareholders' risk profile, to a more systematic restriction of sales of complex, structured CIS products to the general public.

Chart 2 - Example 1: Structured funds and customer information

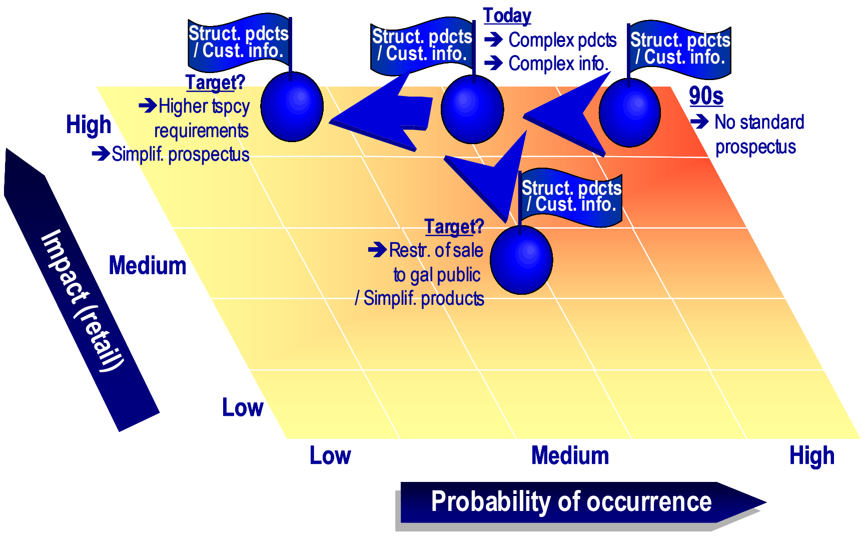


Chart 3 illustrates the dynamics of the issues related to the distribution of CIS products. Distribution issues came in the spotlight during the 90s due to some major misselling cases in certain SC5 jurisdictions. The above-mentioned increasing complexity of CIS products, as well as evidence for significant conflicts of interest concerning CIS distributors, have increased probability of occurrence related to distribution issues in SC5 jurisdictions. The development of cross-border sales of CIS products adds significant competitive issues to the question of distribution. In a first stage, financial regulators may be tempted to mitigate the potential impact and probability of occurrence by influencing both the demand and the supply sides of the CIS market. Investors may be prompted to become more capable of appraising CIS management services and related costs, through increased information flows, while the management side may be required to enhance the suitability of its sales to investors needs.

Chart 3 - Example 2: Distribution

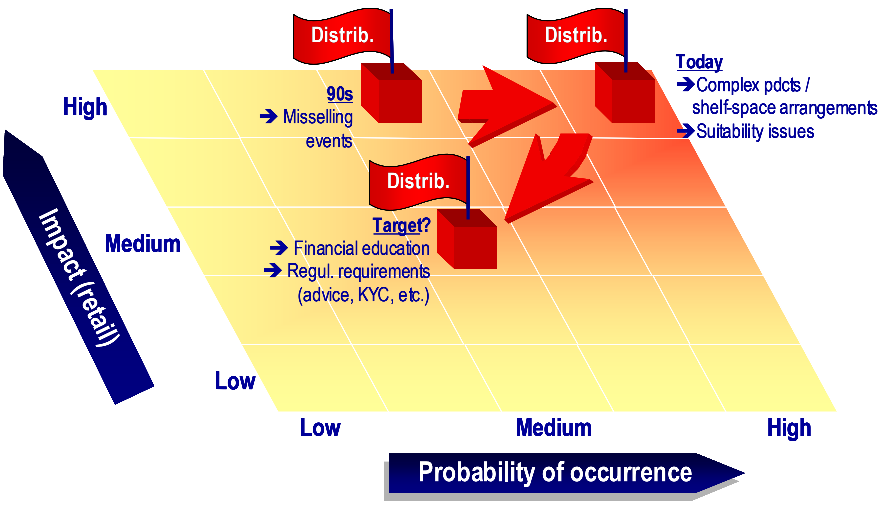
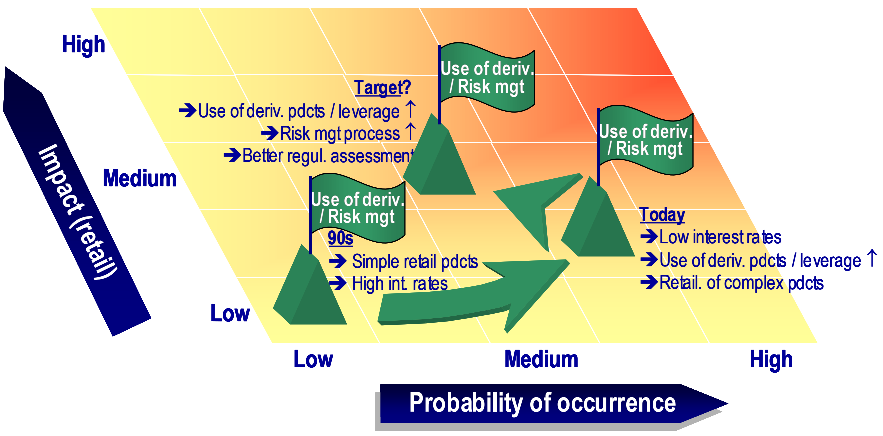


Chart 4 illustrates that the use of derivatives (in certain SC5 jurisdictions) and related risk management tools by CIS has created significant issues over the last decade, increasing both the potential impact on retail investors and the probability of occurrence. The trends identified here above point out that the retail reach of CIS products using derivatives and/or leverage should rise, still, even when the global low yield environment fades out. However, the extent to which the ongoing improvement of risk management processes will mitigate potential occurrence remains to be more precisely assessed, before it can be decided whether financial regulation has to provide increased protection to final investors.

Chart 4 - Example 3: Use of derivatives and risk management



Appendix D: Feedback Statement

Background

This document provides a summary and a feedback statement of the main comments received by IOSCO to its consultations between April and July 2007 on *An Experiment Within The Technical Committee Standing Committee On Investment Management (SC5) To Establish A Framework For Identifying Strategic Priorities* (April 2007 Consultation Paper).[22]

Three types of contributions were solicited with regard to the April 2007 Consultation Paper:

(a) reactions to the list of strategic priorities set forth in section 5 of the paper;

(b) comments on the process whereby the list was generated (relation of a top-down and a bottom-up process);

(c) critical and constructive views on the statistics that were collected and processed and on the trends that were identified.

Summary of responses

1. Replies to the April 2007 Consultation Paper adopt different standpoints on (a) above, as some do not endorse the proposed list of strategic priorities:

- Some commented that IOSCO, in developing its list of priorities, should take into account actions being taken at a regional (*e.g.*, MiFID/simplified prospectus revision in Europe) or national (*e.g.*, Rule 12b-1 in the United States) level.

- Industry representatives contend that the cost of regulation might be considered as a strategic issue itself.

- Some commenters noted that the priorities selected depend on the scope of possible priorities considered. For example, certain of the commenters call for a consideration of how issues raised by non-CIS products that compete with CIS (*e.g.*, structured notes or certificates) impact SC5's list of strategic priorities.

2. Responses to (b) above range from the unquestioned support of the adoption of a risk-based methodology to more interrogative comments on the combination of the top-down and the bottom-up approaches.

3. Concerning (c) above, the April 2007 Consultation Paper appears to provide good coverage of major statistical sources, as no major alternative data source is proposed. Interestingly, however, on more specific points, such as the measurement of the structured product market size, sources of additional data are provided.

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22 *An Experiment Within The Technical Committee Standing Committee On Investment Management (SC5) To Establish A Framework For Identifying Strategic Priorities*, Report of the Technical Committee of IOSCO, April 2007, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD245.pdf.

With regard to trends identified, the views expressed in the April 2007 Consultation Paper are generally endorsed. The identification of limits to CIS investors' rationality (and potential needs to be subsequently addressed), as well as the importance of financial stability issues related to the CIS market, are, however, not agreed upon by all respondents.

4. Some respondents called for a more precise description of the structured product market.

<u>Feedback Statement</u>

5. Against the background of responses to the April 2007 Consultation Paper, the following changes are incorporated in the Report.

- In response to the calls to widen the scope of analysis to non-CIS products competing directly with CIS, SC5 made no changes to the paper because its mandate is limited to CIS.

- The need to take into account costs of regulation has to be balanced with an assessment of related benefits. Such types of analyses are conducted in many jurisdictions (see OECD reviews), both at national and regional levels, and tend to show that such assessments preferably apply to specific rules, principles or recommendations. As the latter fall out of the field of the current consultation exercise, and given the amount of resources required for conducting such an analysis at an aggregate level, this issue will be submitted for consideration of the TC at a later stage.

6. With a view to improving the understanding of the relation between the top-down and the bottom-up exercises, a sentence is added on page 4 of the Report, at the beginning of the section describing the top-down exercise, as follows:

*"**The Top-Down Exercise.** The Top-Down Exercise is primarily designed to avoid the risk that the bottom-up approach could, for example, overweight specific enforcement cases or, on the contrary, miss important topics not yet addressed by enforcement cases. The framework entailed…"*

7. In order to provide support for the identification of limits to CIS investors' rationality, footnote 21 has been added on page 31 after "rationality of investors" (first bullet point):
"*This point is widely documented by academic and empirical literature, and relates to several types of biases in investors' behavior ("non-participation puzzle", "domestic bias", etc.). Polkovnichenko V. (2005); 'Household Portfolio Diversification: A Case for Rank Dependent Preferences"; The Review of Financial Studies, Winter, no 18. mentions, for example, that, in 2001, the median number of stocks held by shareholders in the United States was three, and that four out of five shareholders held fewer than five stocks.*"

8. In order to make mentions of the structured products market more precise, "*structured products*" is changed into "*structured funds*" whenever it relates to CIS products;

More specifically, regarding the description of the market for structured products in Appendix B:

- footnote 4 has been added on page 21 at the end of the sentence, "Thus, structured funds are understood here in the sense of CIS products:

Structured products are characterized by a promise to make a payout based on a formula derived or based on the performance of an underlying security, basket of securities, index, commodity and/or a foreign currency at a certain time. Against this background, structured products taking the legal form of a fund differ from other structured products in various ways:

- Structured funds are issued by CIS managers not by investment banks;

- Investors own the underlying assets of CISs, whereas structured products usually take the form of fixed income instruments (notes), and thus bear a credit risk;

- In the EU, structured products are regulated by the Prospectus directive and are often admitted to trading on a regulated market whereas structured funds comply either with the UCITS directive or with national fund regulations.

- the mention "*(usually investment banks)*" on page 23 of the April 2007 Consultation Paper, which relates to the promoters of underlying financial instruments, not to structured fund promoters, has been deleted;

- Chart 6 of the April 2007 Consultation Paper on the estimated breakdown of worldwide issuance of structured funds (2004) is deleted as underlying estimates for the United States are not documented enough;

- the last sentence before current Chart 6 is changed into:
"investment certificates (or structured notes) which do not count as CISs and are thus less stringently regulated, particularly in Europe where they are usually marketed under the regime of the Prospectus directive[8], total AUM in structured funds and certificates –although showing rapid growth in some jurisdictions– still seems relatively low as they are thought to make up less than 3% of assets in regulated funds managed in Europe.[9]"