TUESDAY 14 JULY 2009

Present

Browne of Madingley, L
Haskins, L (Chairman)
Hooper, B
Jordan, L
Moser, L
Renton of Mount Harry, L
Steinberg, L
Trimble, L
Watson of Richmond, L

Witnesses: **Lord Myners**, a Member of the House, Financial Services Secretary, and **Ms Sue Lewis**, Head of Savings and Investment, HM Treasury, gave evidence.

Q30 Chairman: Good morning, Lord Myners and Ms Lewis. This is becoming a sort of regular event. Thank you very much for coming to see us again. I think you will understand the session is on record and will be recorded for a webcast, and consequently we ask all the witnesses to use the microphone. Witnesses will receive a transcript of what is said during the session and will have a chance to make minor corrections where appropriate. I will start by asking if you would like to make an initial statement yourself?

Lord Myners: Thank you very much, my Lord Chairman. I think it might be helpful if I set a little context. I welcome the opportunity to again come before the Committee to answer your questions on the EU's response to the financial crisis. I read your report of 17 June with great interest and agree with much of the analysis and recommendations you make. I would like to reassure you that the Government has been, and remains, very closely engaged in EU negotiations and processes. We published recently our proposals for reforming financial markets and we will use this to inform our continuing work to influence and guide the EU legislative process. I understand that the Committee wishes to focus today on the draft AIFM

Directive and recent developments in the area of EU regulatory and supervisory reform. Before we turn to your detailed questions, I would like, if I may, to start by briefly outlining the Government's position on AIFM and updating you on developments in the area of supervision since I last appeared before you. I hope this will help in setting the framework within which I will then address the Committee's questions. Firstly, on the AIFM, we support the principles of establishing a Single Market in fund management services and we are committed to co-operating within the EU in working to mitigate the potential systemic risks associated with alternative investment fund managers. However, the process by which the Commission developed its proposal was clearly inadequate, particularly in the lack of full consultation. The proposal which has emerged therefore contains many deficiencies. I will talk in more detail about these and our proposed responses when we come to detailed questions. We have established seven working groups of industry experts to help the Treasury fully assess the impact of the proposals and to help us develop constructive proposals which deliver a high level of regulatory protection but which avoid imposing unnecessary burdens. The seven working groups cover custody and third party oversight, delegation and structures, leverage, closed-ended applications, portfolio company disclosure, third country fund issues and marketing. Insights from this process have helped us to develop a number of proposals for significantly improving the Commission's draft. For example, we have developed proposals for a new structure for custody which would offer a better fit with the prevailing prime brokerage model in the hedge fund industry by permitting the use of multiple prime brokers and allowing independent hedge fund administrators to perform the function of verifying that the fund holds all the assets which the manager claims. We have also developed proposals to remove the need for pre-vetting by regulators of fund documents at launch to reduce the time to market for new products. To help persuade others of our case as well as participating in a leading role in Council working groups and in engaging in detail

with the Commission, the UK is reaching out bilaterally to leverage natural alliances and win over others. Treasury officials will lobby in more than a dozen key capitals over the summer. I will be engaging directly with my opposite numbers in key Member States. Turning to the recent developments in the area of EU regulatory and supervisory reform, you will be aware that the Commission's proposals were discussed by finance ministers at ECOFIN on 9 June and by heads of state at the European Council on 18/19 June. The Government welcomes the European Council's conclusions, which give us a clear direction and framework for the upcoming legislative negotiations. I have set out for this Committee before the Government's concerns in this area. I am pleased to be able to tell you that at the June European Council heads of state agreed, firstly, that the chair of the European Systemic Risk Board should be elected by the General Council of the ECB, on which the Bank of England has a vote, and will therefore not automatically always be held by the President of the ECB. A key concern for us was to ensure that this new body represented the whole of the EU and not just the Euro zone. We are pleased with this outcome. Secondly, that while credit rating agencies could be directly supervised at the European level, other Member States heard, and understood and accepted, our arguments that central counterparties for clearing and settlement could not be directly supervised and despite this being in the Commission's original proposals the Council has agreed with our suggestion and central counterparties will not be directly regulated from the European centre. This is because of the huge fiscal consequences which would arise if one of these were to fail. Thirdly, that the proposed binding powers over supervisors given to the new European supervisory authorities will be limited in scope to the implementation of rules and to disagreements between supervisors in home host situations. Crucially, there was consensus between both the finance ministers and the heads of state that any of the proposed powers for the European supervisory authorities would not impinge in any way on the fiscal responsibilities of individual Member States. Our priority now is to make sure that these

important decisions and agreements are reflected in the Commission's legislative proposals in the autumn. I am happy, of course, to go into more detail on these issues in answer to specific questions that the Committee may have and I am very grateful to the Committee in allowing me to make this introductory statement to set the context.

Q31 Chairman: Before we start, Lord Myners, it might be helpful to give us a feeling for the timing of all this, what the Government's view is and how long this is going to take to unravel, as it were.

Lord Myners: On the AIFM Directive, I believe this is something which is likely to be a continuing issue through until the latter part of 2010. On the issues relating to the decisions made after the de Larosière report, I think we will see significant progress before the end of this year.

Q32 Chairman: In the new Parliament?

Lord Myners: Yes.

Q33 Chairman: Thank you very much. I think you have the list of questions to be put. I think you have answered in part the first one in that you do agree that there is a role for the EU in terms of regulating alternative investment funds. We have spoken to some industry bodies about this and their argument is that the proposals at the moment are disproportionate, and furthermore that the alternative investment funds pose little or no systemic risk, although you did mention systemic risk as being an element. Would you like to comment on this opinion?

Lord Myners: Thank you, my Lord Chairman. Yes, the UK Government does agree that there is a case for regulation of alternative investment fund managers at the European level. We believe this will bring two significant benefits. First, it will help establish a Single

Market in alternative fund management. We believe this would bring major opportunities for UK firms to open up new markets. Second, it will establish a framework for EU cooperation in mitigating the systemic risks associated with AIFM. Systemic risks can be cross-border in nature, so it is right that the UK agrees to co-operate on this issue. However, the Commission's draft Directive was written in a rush and without consultation and therefore contains a number of major flaws which will need to be rectified. Hedge funds were not a significant cause of recent financial market turbulence, that seems to be widely agreed, including by M Jacques de Larosière, Lord Turner in his review of the operation of the FSA, and indeed by the G20, but we do believe they have the potential to pose systemic risk. That is why we have announced that the FSA will undertake much closer oversight of the market implications of hedge fund investment management strategies and leverage through a regular survey which they are introducing, which will give the FSA the power to intervene whenever necessary to protect the stability of the financial system. The Commission's proposals would establish a similar system of enhanced oversight and exceptional circumstance powers for supervisors across the EU, which we support. However, it would also provide for leverage caps to be applied regardless of market circumstances. We believe this is unnecessary, counterproductive and could in fact lead to false comforts. The Directive, as drafted, certainly goes far beyond what would be required purely to mitigate systemic risk including, as it does, provisions on investor protection, conduct of business and disclosure of the nature of investments. So this is not a Directive which is solely focused on systemic risk, but rather it is designed to attempt to cover a very broad range of issues. There are areas where the proposed rules go well beyond the level of protection that professional investors would demand, for example in the inclusion of a requirement for independent valuation for all types of investment manager or in the requirement that the assets of the fund be held in the custody

of a bank. We are arguing in this case for a much more proportionate approach than the one we currently see in the Directive.

Q34 Chairman: Do you think that investors in these areas need substantial protection from government through regulation?

Lord Myners: I believe that the professional investors whose activities are covered by the proposed draft Directive are, on the whole, capable of forming their own views and there is a danger that regulation, if excessive, would inhibit choice, selection and opportunity for investors to make their own determination. There are, of course, separate Directives and Regulations which apply to retail investment.

Q35 Chairman: Do you see any distinction between the regulation of hedge funds and private equity regulation generally?

Lord Myners: I think the taxonomy of hedge funds in itself is extraordinarily wide, to which the Directive then adds private equity, which in itself is also varied, from green field venture capital through to major material industry leverage buyout, and the draft Directive also refers to commodity investment and real estate investment. So the danger of a single document is attaching too much significance to the common usage of the word "investment" and assuming that one Directive can cover all requirements.

Q36 Chairman: One thing to come out of our discussions with the industry was that there was quite a positive view about passport arrangements making it easier for them. I think you refer to this in your answer. Is this an issue which we can make a positive statement about?

Lord Myners: Yes, it is. I think that although we have been critical of the process by which the Directive has been produced and a number of deficiencies and inconsistencies which evidence a yet to be fully developed understanding of the nature of these industries, there is

much in this Directive, my Lord Chairman, which we welcome, including in particular the facility for passporting which will open up a Single Market, and we encourage that. Like so many things, there is much in this document which we can either endorse or which we can say that actually we are not sure that will achieve a great deal but the consequences do not appear to us to be terribly onerous but there are three or four areas where we think considerably more work is required to get this to an acceptable level.

Q37 Lord Renton of Mount Harry: My Lord Chairman, I wonder if I could just ask Lord Myners to elaborate on what he said. He used that nice word, the "taxonomy" of this draft Directive. If I understand you right, Lord Myners, you are saying that actually this draft Directive could cover deals in commodities, in estate, in land, and so forth, too. Speaking as an ex-member of the London Metal Exchange, I find that very interesting.

Lord Myners: The preamble to the draft Directive does refer to a wish to introduce appropriate regulation and supervision covering a much broader range of investment than currently covered in the draft Directive which we have in front of us. It makes very specific reference to commodity funds and real estate, but when I refer to "taxonomy" I am talking about the hedge fund area incorporating everything from convertible arbitrage, to long and short, to macro funds, to specialist fixed income funds or specialist emerging market funds. So it is a very broad range of styles and products and approaches which fall under the generic name of hedge funds and it is dangerous to generalise to too great an extent about an issue where there is such variety.

Q38 Lord Moser: Does the Government's view and the general view that hedge funds did not have much to do with the crisis apply equally to all the bits in that taxonomy or are some potentially more "guilty" than others?

Lord Myners: The White Paper that we produced last week talked about the need to operate at, and be aware of what is happening at the perimeter of financial regulation and we certainly saw the emergence, Lord Moser, of a shadow banking system based around CIFs and conduits where hedge funds were quite active, which was not properly appreciated by central bankers and supervisors. So a certain type of hedge fund using a lot of leverage was very active there. I think it is the use of leverage that we need to be alert to and the FSA is taking steps to monitor more closely leverage and it believes the best way of doing that is through the prime broker. There is also an issue of what the hedge fund management industry and those who look at it call "crowded trades". Crowded trades are when a wide range of unrelated managers nevertheless follow very similar strategies and they have a common challenge of unwinding those strategies when they judge it either necessary to do so because the strategy has played out to deliver the outcomes they anticipated or some new external event drives them to do that. Again, the FSA is focused on gathering data which would identify where there was a build up of systemic risk as a consequence of crowded trades or accumulated positions which have a high degree of correlation or commonality.

Q39 Lord Moser: The issue which confuses some people, certainly me, is where one is talking about the Directive targeting managers or funds. The title of the Directive makes it very clear. It is a Directive which specifically talks about fund managers and the European Parliament, we understand, wants to go beyond that and focus on the actual funds. It would be important to have your view on that, Minister.

Lord Myners: Managers have a high degree of control in practice over the action of funds and have responsibility for key areas such as risk management. The FSA's experience of regulating UK managers of offshore hedge funds shows that a high and appropriate degree of control can be exercised through regulation of the manager and the regulation of the fund itself is not needed. Authorisation and regulation of funds themselves is necessary for funds

sold to retail investors to allow regulators to ensure that the investment strategies employed imply only imply risks which retail investors can reasonably assess. Professional investors have a much higher degree of expertise, as I was saying earlier, which should allow them to make an independent decision over a fund's investment strategy.

Q40 Lord Moser: So there are no parts of the Directive which, in your view, should go beyond the managers to the funds as a whole?

Lord Myners: No, because I think in particular in the area of systemic risk it would be the managers who would be best placed to provide the information around the build up of positions or leverage across a number of funds. Our major hedge fund managers will often manage as many as 50 individual funds, so clearly if we examine the data for one fund we will not get the full picture.

Lord Steinberg: Lord Myners, there has been an awful lot of discussion, particularly about hedge funds, and last week we had evidence which suggested that if this Directive went through in its current form, and my colleague Lord Trimble asked the relevant question, "What would this mean to the City of London as the premier financial centre?", and we were told that it could result in the loss of 6,000 jobs and well over £1 billion a year. Am I right in that?

Lord Trimble: I think the financial loss was higher than that. I do not have it at my fingertips.

Q41 Lord Steinberg: So the first part of my question is, does it worry you, as a member of the Treasury team, that London could lose its pre-eminent position as the leading financial centre?

Lord Myners: As my colleague, the noble Lord, Lord Mandelson, said, we have more skin in the game than other EU countries as far as hedge funds are concerned and a lot of skin

relative to others in private equity management. About 20 per cent of the world's hedge funds are managed from Europe and 80 per cent of that is managed from the UK. Clearly, the hedge fund industry is a large employer in the UK if you take into account support services in the area of accountancy, tax, legal advice, et cetera. But our starting point, Lord Steinberg, is that if the EU is to have a Directive which covers alternative investment managers, then it should be a good Directive and a good Directive works for the whole of Europe. We believe the right Directive for Europe will also be the right Directive for the UK and will not be injurious to those engaged in hedge fund management and private equity in the UK. The Directive would allow funds managed inside but domiciled outside the UK, to be marketed to professional investors across the EU provided the country in which the fund was located had reached an agreement on tax sharing with all EU countries into which the fund was to be sold. This is important because many of the hedge funds which are sold in Europe, in the United Kingdom, are managed by managers based in the UK or by management groups based in the UK, but who nevertheless may use an offshore affiliate or delegate some of their responsibilities to others outside the EU. So it is very important that we have a structure which reflects the approach which many fund managers adopt in terms of where they choose, for instance, to domicile funds. Domiciling funds in offshore territories, for instance, is often necessary in order to attract American investors. So in summary, we believe that the proposed draft recognises the complexity of the industry in terms of its structure and we welcome that, but we believe it needs improvement in a number of areas. We do see the draft as currently construed as being a threat not just to the UK but a threat to Europe because, for instance, if this draft as proposed was enacted it would significantly limit investor choice in Europe and it would drive the hedge fund industry out of Europe, it would drive it to Geneva, it would drive it to the Middle East, drive it to Singapore, and that surely cannot be in the

interests of anyone in Europe. We would much rather this industry was based in Europe and supervised in Europe.

Q42 Lord Steinberg: Thank you, but – and it is a big "but" – do you believe that we are going to get the changes in this Directive which will prevent that horrendous thing happening? Do you believe that we have got sufficient muscle to be able to persuade the rest of Europe, who have a much smaller degree of interest? I am talking here purely as a British person. Do you believe that they have got the same degree of interest in ensuring that London stays as the financial centre, or have they got designs on Frankfurt or somewhere else like that in Europe, which would be bad for all of the EU?

Lord Myners: There is nothing in this Directive which would encourage the movement of participants from London to Paris or Frankfurt because it does not lead to Paris or Frankfurt having any further advantage over London, and London has the great advantage of having a community of skills –

Q43 Lord Steinberg: And has got the most to lose!

Lord Myners: Markets cluster around a common forum and common pools of skills, and other centres in Europe have not and are unlikely to be able to replicate in the short term that cluster and community of activity, that network of communication which gives London such a strong position here. Now, will others in Europe take a position that they want to defend London? I think that is not only unlikely but, quite frankly, is not actually their job. Their job is to ensure that we have a Directive which is workable, which is appropriate to the needs of professional investors, is proportionate in terms of its requirements and their burden on the industry and ensures that investors have a wide range of choice. There is nothing in our central intention there which is in conflict with what is in the best interests of Europe, but we will have to work and are working to address prejudice and a lack of understanding because

this is much closer to the heart of the financial system in the UK than it is in other EU Member States. That is why Treasury officials were lobbying our colleagues in Europe.

Q44 Lord Steinberg: Just one final part of my question on hedge funds, and I remember we had a discussion about this when you were last here. Do you not think that hedge funds are getting a very unfair degree of criticism given that in the financial crisis hedge funds were practically immune from this problem, and therefore should not have this degree of criticism or the preparation of different types of control because they are largely a different thing from the banks?

Lord Myners: They are very different from the banks and when we look at the root causes of the financial crisis we find hedge funds and private equity at the tertiary rather than the primary level. There were some contributory factors there, the difficulties at Bear Stearns, and Paribas had a hedge fund involvement. The hedge fund industry is going to have to work harder at promoting its image and reputation. I think one of the things which both the private equity and hedge fund community should be working hard at doing at the moment is getting its own customers to lobby Europe to explain the value which they get out of using alternative investment styles in terms of more precise risk control and a broader range of investment opportunities through private equity because customer voice will be very helpful in supporting the arguments which we are currently making in Europe towards improving this draft Directive.

Q45 Lord Steinberg: Thank you, Lord Myners. I am not convinced completely about everything you have said, but thank you just the same.

Lord Myners: Thank you very much, Lord Steinberg. I suspect the issues of conviction which are required here go far deeper than those which are solely related to this draft Directive on Alternative Investment Fund Managers!

Chairman: I am sure you have read the rather comprehensive piece in the *FT* this morning on this whole subject, which refers to the fact that maybe the partners of these hedge fund managers might not be so enthusiastic about migrating to some remote place in the interests of their partners' wellbeing.

Q46 Lord Browne of Madingley: Perhaps I could quote back to you. You said it was "dangerous to generalise" and indeed one size very rarely fits all, so my question really is, can the Directive contain enough provisions to distinguish between the different types of funds it purports to regulate?

Lord Myners: I think, Lord Browne, the Directive does not yet do enough to distinguish between different types of funds. For example, it would impose new requirements on UK investment trust companies. I know this is a particular area of interest and experience to Lord Renton. UK investment trust companies are listed on regulated markets. Even though they are already very well regulated under the Transparency and Prospective Directives, it is intended that they should come under this Directive. This seems to us to be wholly unnecessary, but if the Directive does continue to wish to cover investment trusts then we must work to ensure that the requirements of this Directive duplicate those of the Transparency and Prospective Directives and that the regimes are all made fully consistent. My own preference would be, if Directives were required here, to have a separate Directive for alternative managers and hedge funds and a separate one for private equity. I can understand the arguments for why one would not wish to see a proliferation of Directives, but it does place a particular burden on the drafters of the Directive to come up with something which is relevant to such a broad range of investment styles and approaches.

Q47 Lord Browne of Madingley: Some have argued that actually what the Directive does is to discriminate therefore against private equity, its foundation being in the examination of hedge funds.

Lord Myners: Yes, I think the term "locusts" has been used in Continental Europe to describe both hedge funds and private equity but, as I have asserted several times already, they are very, very different and in fact areas such as liquidity management, leverage, valuation, are very different for hedge funds from private equity. Private equity is essentially illiquid funds. The leverage lies in the underlying companies rather than in the fund. They do not allow immediate redemption and the fund manager's fees are not paid on the basis of a regular valuation, so all those requirements in the draft Directive which relate to hedge funds are completely irrelevant to private equity. So then the drafters, I think, had to decide, "Well, we'd better put something in for private equity," so they put in a raft of proposals around disclosure, about underlying companies in which private equity finds have invested, which strikes us as being wholly inconsistent with maintaining a level playing field between different types of ownership, tilting the balance against private equity, which we regard as perverse at a time when so many companies are suffering from being undercapitalised, and therefore we should be encouraging private equity, which does have a lot of undrawn capital, to be active in supporting the re-stabilisation of many businesses. So it is a curious logic which has taken the drafter and the Commission in that direction and we think if there had been a more comprehensive consultation some of these inconsistencies would have been teased out.

Q48 Lord Browne of Madingley: Given the fact that there was inappropriate consultation, as you have said, do you think this actually can be fixed in the appropriate way? Is there a sufficient number of things which could be altered to make this fit? Is it not dangerous to generalise?

Lord Myners: I draw encouragement from the regular reports which I receive from officials involved in the working parties in Brussels that the arguments we have put forward are being taken into account and there are many in Europe who neither have a strong national interest in this area, nor a great deal of prejudice against hedge funds and/or private equity and under qualified majority voting they will have a valuable part to play here. So I think we are gaining traction. The quality of our arguments I think is very good, but we must try to advance them in a way which is both effective but does not paint people into corners.

Lord Browne of Madingley: Very good. Thank you.

Q49 Lord Renton of Mount Harry: It is very difficult, is it not, Lord Myners, to be both effective and not to push people into corners? It is not the easiest thing in the world.

Lord Myners: That is the story of my life!

Q50 Lord Renton of Mount Harry: I would like to come back to what you said in your opening remarks and the question of the passport system, in a sense coming at it from the other side of the coin to Lord Steinberg. It would seem to me that the draft Directive, in establishing a passport system which permits alternative investment funds to be marketed to professional investors in any Member States on the basis of notification by the AIF manager to the whole supervisor, looks on the surface like a sort of very generous and broad proposition. What is your view about it? Do you think it would work? What help would you give in creating a Single Market in investment funds within the EU, which is obviously something which may potentially worry London?

Lord Myners: We see this as a very significant potential gain for London, which is why I have endeavoured to be measured and balanced in my comments in this Directive. To repeat, we are not saying the Directive is wholly bad, we are saying it needs to be improved in a limited number of areas, but in those areas it needs quite a lot of improvement. I think the

closest parallel we have here is the UCITS Directive, which is Undertakings for Collective Investment in Transferable Securities. You and I, when we were active in investment management, probably knew these as unit trusts. The UCITS Directive establishes a common regime. My officials will immediately say they are not unit trusts, they are slightly different, but in most of their characteristics they are very similar to unit trusts. By saying that I have saved having to write a letter to you! This establishes a common regime for retail investment funds and it has been very successful in establishing a true Single Market in Europe for investment funds and many managers based here in the United Kingdom – not just in London, incidentally, but in Glasgow, Edinburgh, Aberdeen – have benefited from this arrangement. We believe this passport as proposed in the draft Directive on Alternative Investment Managers will deliver the same benefits for non-UCITS funds. So we regard it as wholly good and worthy of our full support. We support the way in which the notification system is specified. It is very close to the significantly improved UCITS passporting system, which was negotiated last year and approved by the Council of Ministers in June. So I think this, Lord Renton, is something we would wish to ensure remains pretty much intact in the final Directive.

Q51 Lord Renton of Mount Harry: I find that very interesting because, of course, it could be argued that in this – and I agree with you, I think it is a very positive matter in this draft Directive, but it could be argued that it is a threat to London because in a sense is it not making it easier for managers of these funds to set up in other EU countries?

Lord Myners: I follow the logic of your argument, but I actually am a firm believer in competitive markets and I believe that we do not need to shelter UK fund managers from competition or fear competition developing elsewhere in Europe. I think the real opportunity here is to market our skills and undoubted leadership in this area to a much larger market in Europe. As I referred to earlier, there are many features of the UK financial services industry

which are quite difficult for other centres to replicate because of the scale, breadth and history of fund management in the United Kingdom.

Q52 Lord Renton of Mount Harry: Thank you very much. Could I finally just ask you about Article 35 in the draft Directive, which is the one which says that a manager may only market a fund domiciled in a third country to professional investors if the third country ensures an exchange of information on tax matters? It is rather strange that, is it not?

Lord Myners: This relates, Lord Renton, to the tax and information exchange agreements which the OECD is responsible for directing and is very much at the heart of the conclusions in this area at the G20 meeting held in London in April. There is clearly a wish here by the drafter to use this Directive as a further lever to encourage laggard nations who have not entered into tax and information exchange agreements to so do. Whether that is a legitimate purpose for this Directive I think is a very debatable matter.

Lord Renton of Mount Harry: Thank you very much.

Q53 Chairman: The Association of British Insurers told us that whilst the passporting system in principle, operated properly, was a good idea, as it is drafted at the moment it could be protectionist and be counterproductive.

Lord Myners: There are elements here which could be construed by some people to be protectionist. For instance, there is a requirement that non-EU managers of alternative investment funds managing alternative investment funds from another centre, even if that other centre offers equivalent investor protection, could not do so for at least three years. That, I think, has a protectionist element to it, as does the test of whether investor protection is equivalent in another centre. To the best of my recollection the Directive does not specify how that equivalent judgment will be made, so I repeat that from a UK perspective we do not

wish to see any form of protectionism here because we happen to believe that UK managers of private equity and alternative investment funds can compete and win against the best.

Q54 Baroness Hooper: Greater openness and transparency seem to be highly desirable in almost any context. The disclosure requirements of these proposals have been welcomed and certainly two out of the three industry witnesses whom we have seen welcomed the greater transparency approach. One did not because it was thought that the competitive edge of the EU market would be lost in the global context. Do you agree?

Lord Myners: Thank you, Baroness Hooper. The Directive contains transparency requirements in terms of disclosure to investors, disclosure to supervisors and for private equity funds disclosure by portfolio companies to their stakeholders. I believe it was in respect of the latter that one of your previous witnesses made his comments. The requirements for disclosure to investors are broadly consistent with current best practice in this industry, and may I remind the Committee again that the UK has been to the fore in promoting hedge fund disclosure and private equity disclosure, the latter as a consequence of the report produced by Sir David Walker. While we question the necessity of detailed disclosure requirements for funds sold to professional clients, there may be some benefit from ensuring higher standards across the board. The requirement for disclosure to supervisors is also broadly consistent with the approach the FSA is developing for enhanced oversight of the hedge fund industry. However, we believe two key improvements are needed. First, regulators must maintain the option of imposing broader or more stringent disclosure requirements where they are justified in their own judgment on systemic grounds. Secondly, to avoid regulators becoming overwhelmed by information not relevant from a systemic point of view they must retain the possibility of not collecting the information where they are confident this is not relevant for systemic purposes. The proposed disclosure requirements on private equity portfolio companies are a critical point for most of the private equity industry.

Private equity ownership is not fundamentally different from any other private ownership model and UK regulation recognises this. In the current economic model many overstretched businesses are in real need of additional equity capitalisation at a time when many private equity firms and funds have funds available undrawn. We should actively encourage private equity to provide more funding, not burden it with unnecessary rules or regard it prejudicially as an unwelcome form of capital or skill. I therefore very strongly oppose the Commission's proposals to impose stringent and costly disclosure requirements on portfolio companies of EU private equity funds. With the low thresholds in the Directive, these requirements would apply to relatively small companies. They would impose administrative costs and put these companies at a competitive disadvantage by effectively forcing them to disclose details of their business plans to competitors, rendering private equity disadvantaged in status to other provisions of capital. These requirements would not apply to companies owned by family offices, sovereign wealth funds or even non-EU private equity funds, but would apply to investment in non-EU companies by EU firms. To put it simply, an American private equity fund investing in a EU company would not be obliged to make these disclosures but an EU private equity fund investing in a Chinese company would. That strikes me as being a nonsense and something which would have been exposed if there had been a thorough consultation and good and open discussion earlier on, and I am much encouraged by the fact that as we talk about this in Europe these sorts of arguments are gaining traction. I think, Baroness Hooper, in this particular area the private equity industry has every right to express its anxiety. That said, disclosure about private equity investment of the sort proposed by Sir David Walker and accepted by the UK private equity industry has undoubtedly been good for private equity because it has addressed some of the misunderstandings and fears about private equity and, I think, made it a more transparent industry and had the effect of strengthening its licence to operate.

Q55 Baroness Hooper: So from what you have said this is clearly one of the areas where you will seek to make changes to the proposals. Do you feel you will be successful?

Lord Myners: I think there is a great deal of work to be done, Baroness Hooper, but I hope I have conveyed to the Committee by the confidence with which I expressed my views on these points that they are ones where we feel our arguments are rooted in a deep and good understanding of the issues and that we can persuade our European colleagues that we do have valuable insight. I would certainly say the disclosure by private equity finds is one of the key issues on which we are really working in Europe. The others will be the leverage limits and to make sure we come up with a sensible marketing regime, and then there are some second tier issues around valuation and depositories and custodians where we are working, but private equity is one of the three major issues on which we are currently focusing.

Q56 Lord Jordan: Lord Myners, on this issue and many of the others, if at some point in the development of this Directive, despite your determination and best efforts, it is clear that the effect of the Directive will damage or undermine elements of the City of London's success, what will the British Government do? What can the British Government do?

Lord Myners: Lord Jordan, I would rather not answer a question which contemplates failure. I am confident that the Directive will be significantly improved. We are already seeing that. As I said in my introductory statement, some of the work which we are doing at the moment is in some of the more technical areas of the Directive and we are getting movement. I do not think any other European country would have established seven domestic working groups to look at different aspects of this Directive. They are working with the various participants in the industry to identify a route through to improving the Directive. So I would say that as I see things at the moment I have a considerable degree of confidence that this Directive can be

significantly improved and I would rather continue to work to that objective than contemplate failure.

Q57 Lord Jordan: An adequate risk assessment includes looking at the risk of failure, whatever your private views and confidence. What can the British Government do if it arrives at a point where it does not believe that in totality this Directive is going to not only not serve London but perhaps do damage to its present reputation?

Lord Myners: I would hope we would reach that position with the support of a number of other European countries so that we would not be isolated and alone and that we would be able, through the approval processes in Europe, Lord Jordan, to ensure that a bad Directive was not adopted. I take considerable encouragement from the fact that there are a number of European countries which are already publicly saying they find this Directive inadequate and are making comments in public – I am thinking particular of Sweden – which are very, very close to the views which we are expressing. I have recently visited Sweden to meet with their finance minister responsible for financial services and was much encouraged by the discussion which we had.

Q58 Lord Watson of Richmond: Lord Myners, I am delighted to hear your qualified optimism about the outcome of this but you are, of course, up against the wordsmiths who produced locusts and it was interesting that right at the beginning of your evidence you referred to the Directive succinctly as having been "rushed", in other words it was responding to political pressure, popular pressure, so that is the barrier to jump. In that context, to what extent are you helped in your argument if you can really make it clear that the issue here is not competition within the EU between different financial centres, the real, important element of competition is with the US-based? Can you get that message across?

Lord Myners: Yes, and we are doing that. I think it is a message which is absolutely critical. I noticed when I made an earlier reference to it you nodded your agreement, so I will apply myself with even more energy in the knowledge that it has your support and endorsement!

Q59 Lord Watson of Richmond: I am delighted! We have had, as you know, from the industry witnesses a whole series of particular complaints and concerns, about this, although these were balanced by a broad welcome for the passporting. Let me just quickly put to you four points which they were arguing imposed disproportionate burdens on investment funds. Some of them we have already touched on. First of all, the provision on leverage gaps. If you could just comment on that. Secondly, that the Directive applies to managers of smaller funds and two thresholds were mentioned, €100 million and €500 million. What is your comment on these levels? Third, the requirement for independent valuation agents and depositories. Fourth, the provisions on capital requirements. You have touched on some of these already, but these really emerged as perhaps the most pressing individual complaints which the industry seems to have.

Lord Myners: Yes, the Directive, Lord Watson, as currently drafted would impose unnecessary burdens. A particular example is the proposal for disclosure requirements on private equity portfolio companies, which would extend to relatively small companies with the proposed €50 million minimum turnover threshold. Another broader example is the proposed restriction on delegation, which would prevent managers from delegating management outside the EU. This could impose substantial burdens by requiring firms to repatriate activities which are currently carried on elsewhere. To ensure that we minimise unnecessary burdens we are consulting closely with the industry through a system of expert working groups, as I described earlier. This will help us to gain a very full understanding of all the potential burdens and develop proposals for re-drafting the Directive to deliver a high

level of regulatory protection. On the subject of leverage caps, I agree that leverage in the hedge fund area can pose a potential systemic risk. Therefore, I find myself at one with –

Q60 Lord Watson of Richmond: This is probably the main area, is it not, where there is systemic risk?

Lord Myners: This is the main area covered by this Directive where there is systemic risk potentially. Therefore, we should ask ourselves, is this the right way to handle that or is the right way to handle it the one which we are recommending and indeed currently pursuing through the FSA, which is to have high standards of supervision and approval around the managers and close and constant supervision of the prime brokers, enhanced by the data-gathering processes which Lord Turner and the FSA are now proposing? We believe that in combination that is a far more effective response than a rather brutal and blunt leverage cap, which actually might give rise to some false comfort and also could itself have an unintended consequence because if markets fall and the equity in a fund reduces, that may in itself trip forced realisations. I also think the Directive shows a lack of depth of understanding about leverage because it focuses on a traditional form of leverage, which is debt. There can be a considerable amount of embedded leverage within a fund which appears on the face of it to have no debt and yet has many debt-like characteristics in portfolio construction. (The Directive does not capture that; FSA regulation does). The Directive will not apply to managers of smaller funds. In the UK managers must be authorised and regulated by the FSA regardless of the quantity of assets they manage. This is because we adopt a risk-based approach where we can flex the degree of supervisory intensity depending on the size and potential risk of the firm and we in the UK will continue to require all managers to be regulated. As far as independent valuation agents and depositories are concerned, independent valuation is very widely adopted as best practice for UK hedge fund managers. The best practice standards established by the Hedge Funds Standards Board recommend

independent evaluation except where this is impossible because the expertise needed to value the fund's assets is not available externally. For managers valuing internally, the standards recommend the establishment of an independent internal valuation function with disclosure of the arrangement to investors. We have, therefore, proposed an approach where managers would retain the option of valuing internally provided they appointed an independent firm to verify the valuation methodology. That is a more subtle, but I think appropriate, approach than the rather simplistic one which is currently suggested in the draft Directive. We also endorse the principle of independent depositories. Independent custody of the fund's assets offers an important protection for investors. However, we believe improvements are needed to the Commission's proposed rules. In particular, we believe that the proposal to require that the depository be an EU credit institution is too restrictive and could indeed be construed as protectionist. EU funds should also be allowed to use firms authorised to safeguard clients' assets under the Markets in Financial Instruments Directive, the MiFID Directive. Funds domiciled outside the EU should be allowed to appoint local depositories, subject to appropriate regulation. Finally, I believe you raised questions about capital requirements, to which I think the answer is, yes, to your question. A similar system of capital requirements already operates for hedge fund managers and some private equity managers under the provisions of MiFID and the Capital Requirements Directive. It is appropriate that fund managers should hold capital to ensure they are creditworthy and that supervisors have a warning signal if the manager runs into solvency problems. However, the requirements should be more differentiated to reflect the different business models covered by the Directive, as Lord Browne's question suggested. In particular, the requirements would imply a significant increase in capital requirements for private equity managers which currently fall outside MiFID and which we do not consider to be justified.

Q61 Lord Watson of Richmond: Thank you. I think you have answered all four. It demonstrates a very balanced approach to the dialogue with the Commission. Could I just finally ask you on that, you made a reference to your pleasure at support from the Swedish authorities. My own experience, I have to say, with the Commission is that the real allies you need are basically in Frankfurt and Paris so in your campaign to get this thing changed do you think you could get some support from Frankfurt and Paris?

Lord Myners: I am sure that Frankfurt and Paris will always find themselves able to support something which is in the best interests of the European Community.

Lord Watson of Richmond: All power to your elbow!

Q62 Chairman: Just before leaving this subject, I know Lord Trimble has got a question on the broader issue of where we are on banking supervision, but is it not fair to say that if we get banking regulation right that sort of deals with the problem of alternative investment because most of the funds which are going into it are coming from the banks, therefore it is regulated properly? By implication, these alternative investment funds are being regulated properly as well.

Lord Myners: I think you are absolutely right, my Lord Chairman, and I referred earlier to primary, secondary and tertiary risk issues here. The primary risk issue in terms of systemic risk is leverage in a certain type of hedge fund and that is best addressed by regulation and supervision of the prime brokers and banks who supply the leverage, regulation and supervision of the managers, which we do through the FSA, and enhanced data collection. That will all be achieved outwith the Directive.

Q63 Lord Trimble: I am going back to the June Council, and if you will forgive me pursuing my own personal education in this matter, when on the statement I used the phrase

"binding arbitration" you corrected it to binding mediation? If you do not mind, I would like that to be elucidated. What is the difference?

Lord Myners: I think binding arbitration compels the two parties to accept the outcome of the binding arbitration process. A binding mediation process is one in which we are bound to participate in mediation but with limitations on the outcome of the mediation, and those limitations are particularly that it should have no fiscal consequences. I believe in my response to your question in our House I was on the whole seeking to ensure that we use the term as used in the statement rather than making a significant difference of definition between arbitration and mediation.

Q64 Lord Trimble: On that point about the scope for protection of the fiscal position, which I noticed you mentioned at the outset, attention has been drawn to the view expressed by Bini Smaghi where he says, "The recent crisis has shown that it is an illusion to think that national taxpayers can be protected simply by maintaining supervision at the national level ... ultimately taxpayers might also have to support the domestic parts of insolvent institutions which are supervised by foreign authorities." Is that undermining the protection you think you might have on fiscal matters?

Lord Myners: I would start, Lord Trimble, by saying there needs to be a clear link between day-to-day supervision and crisis management arrangements, including possible fiscal support. Given that only national governments can, if they believe it necessary, support the financial institutions in extreme difficulty it is right that day-to-day supervision remains national. That is why I am reassured that EU leaders agreed that day-to-day supervision remains national and that no EU decision could have a fiscal consequence for national governments. I agree with Mr Smaghi that maintaining national supervision alone is insufficient to protecting national taxpayers given the EU's internal market arrangements. This is an area which the UK has particularly relevant knowledge of given our experience of

branches operating in the UK but supervised abroad. I refer in particular to Icelandic banks, where we have seen there were insufficient safeguards for cross-border branches and indeed my Rt Hon friend, the Chancellor of the Exchequer, drew this specifically to the attention of the Presidency in early March of this year. It is clear that we need to improve the quality of supervision across the EU as well as the quality of crisis management arrangements. This means improving the quality of the rules that supervisors apply. It means ensuring that deposit guarantee schemes are of the highest standard. I welcome the recent revisions of the EU Deposit Guarantee Schemes Directive in this regard. However, alongside this we need supervisory colleges combined with supervisory audit, peer review and home host mediation. I think the combination of that – the colleges, which the UK has been very much to the fore in promoting, which now cover the world's 30 or so largest global banking institutions, a supervisory audit to ensure that supervisory functions are performing as expected, peer review to ensure that independent national supervisors benefit from best in class practice, and home host mediation to address the issue we confronted with the Icelandic branches – represents a co-operative approach, which I think Mr Smaghi was saying, that we cannot do this nationally alone, we have to do it as part of a community of nations.

Q65 Lord Trimble: I am sure you are quite right in your earlier answer to say that it is best to stick to the particular terms which are used in the Council's conclusions. I am at a slight disadvantage here because I do not have the precise terms in front of me, but I am thinking of the legislation which the Commission was directed by the Council to prepare and I think in the actual conclusion there is an interesting use of terminology. I do not have the precise words to hand, you probably do, but it is along the lines of saying that the Commission is being directed to draw up legislation advancing along the lines indicated by the Council, which carries with it, to my mind, a danger of mission creep or that the Commission may in fact develop the ideas further in drafting the legislation.

Lord Myners: I do not have the precise words in front of me, but in my introductory statement I sought to emphasise that the next step of the challenge was to ensure that the agreement which had been reached at the European Council was reflected in its entirety, but not beyond its entirety, in the preparation of legislation. We will be vigilant.

Lord Trimble: But it is legislation by a qualified majority, is it not? I wish you well!

Q66 Chairman: It remains, nevertheless, on this issue that the home host regulation appears to be the really difficult problem. It is not just a European problem, of course, it is a global problem. What happened, for example, with the rapid withdrawal of credit in Eastern Europe was that Western European banks pulled credit very quickly and created a serious crisis there. What is to stop that from happening again?

Lord Myners: I think it is a normal response, I am afraid, to economic crisis. I observed it in my career of 30 years or so working in financial institutions that portfolio managers tend to rebalance their portfolios towards domestic securities and banks tend to withdraw back to their domestic territory as well. We have seen that happen in this country. The Bank of England's monthly lending report shows the decline in lending by foreign banks in the UK and that is similarly happening in Eastern Europe, but I think improved confidence in regulation and supervision, improved flow of information about the world's major banks, more co-operation in forums such as the IMF's Financial Stability Board will all improve knowledge and thereby confidence, because at the heart of so many of these things is an erosion of confidence and where fear begins to prevail then people come back to territories which they regard themselves as being more knowledgeable about and more secure within. So I think that is the answer. On Eastern Europe, we do, through the FSA, monitor the exposure of British banks to Eastern Europe and I think that is widely known. It is not particularly high.

Q67 Chairman: Good. Unless there are any questions, thank you, Lord Myners.

Lord Myners: Thank you. It is very good to see you all again and I will look forward to receiving the transcript. Thank you very much indeed.