Directives on Alternative Investment Fund Managers

Volume II: Evidence

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NOTE:
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Minutes of Evidence

TAKEN BEFORE THE SELECT COMMITTEE ON THE EUROPEAN UNION
(SUB-COMMITTEE A)

TUESDAY 7 JULY 2009

Present: Browne of Madingley, L. Renton of Mount Harry, L.
Cohen of Pimlico, B (Chairman) Steinberg, L.
Hooper, B. Trimble, L.
Jordan, L. Watson of Richmond, L.
Northover, B. Woolmer of Leeds, L.

Examination of Witness

Witness: Mr Andrew Baker, Chief Executive, Alternative Investment Management Association (AIMA), examined.

Q1 Chairman: Mr Baker, may I welcome you to the meeting and just issue one of our customary caveats, that you are being web-cast, I believe. As this is a session being held in public you will get a transcript of what it is that you have said to have a look at. As I explained outside the room, I hope that what you are going to do is talk to us and we will then ask questions. We have not provided you with a list of questions because we did not know what you were not going to tell us.

Mr Baker: That is very kind. My Lord Chairman, and Members of the Committee, I very much appreciate the opportunity to speak to you today. Please feel free to interrupt if anything I say requires clarification; I am very happy to take interruptions. I will try to keep my comments to about 15 minutes or so, if that is acceptable, and then look forward to exploring other matters in whatever detail you require. First of all, who are AIMA? We are a trade association representing the hedge fund industry. The European Directive that sits in front of us affects the alternative investment management industry, which is broader than just hedge funds, but my association represents just the hedge fund industry. We are a global association, we have got about 1,000 members around the world and we are represented in about 40 countries, so we believe that we have got a very good overview of the current opinions on this piece of draft legislation. I am the Chief Executive of that group as well. 60 per cent of our membership comprises managers of funds while 40 per cent comprises those who either are service providers to the industry or who are advisers to the industry, so a very broad cross-section of membership. Fundamentally, we represent the producer side of the debate, not the consumer side of the debate; the investors are a different constituency. In terms of the background to all this, it is essential that I provide a broad statement to say that what we are facing today is, fundamentally, a banking crisis; it is not an investment funds crisis. There are all sorts of things which have gone wrong right the way across the financial services sector, and we are certainly not immune from some of the things which have happened, and there are undoubtedly areas of improvement that can be made. However, fundamentally, this is a banking crisis, not an investment funds crisis, and, therefore, any measures which are taken both to arrest the development of the current crisis and to prevent future ones should be proportionately targeted. One of our principal concerns that I drop at an early stage here is that this is anything but a proportionate measure; if enacted in something like its current form it is quite capable of severely impacting the industry, and some of our estimates are that investors within the EU may face a loss of choice amongst hedge fund managers of up to 95 per cent. We think that is no exaggeration because they are either based in the United States—i.e. outside of the EU—and, therefore, subject to potential lock-out, or they are European managers who happen to use an offshore fund location for funds that they manage. Under the terms of this Directive they would also face punitive conditions that may be difficult to achieve. The potential impact here on investors is really quite significant. When we look at what regulation is going to be required in order to make sure that financial markets can operate fairly and are open and transparent, the two essential provisos which are necessary are, first of all, to protect investors—the crucial acid test for this measure is: are investors protected—and in what way are markets made more stable so that there is assistance to questions about financial stability? That is another crucial metric by which these measures should be measured. There is a third hope, as well, that regulation can be structured in such a way that it creates market opportunities. We believe that the
passouting proposals which are included in this Directive could offer that opportunity if redrafted, but in their current form they are anything but. I liken it, more, to a North Korean passport than something that is going to be actively useful to help to develop a single European market, particularly in these, what are called, non-harmonised funds. Good regulation consists of measures to protect the investor, to foster financial stability and offer the potential for future growth. Those are vital prisms through which to look at this draft Directive. The other point worth making is that we are not trying to put regulation in place where none currently exists; there is already a panoply of existing measures across the investment industry and particularly affecting hedge fund managers. So whether we are talking about the Market in Financial Instruments Directive (MiFID) or UCITS or the Transparency Directive or the Prospectus Directive, there are already a number of measures in place. Indeed, the FSA in this country requires all managers of third-party funds to be authorised with it prior to setting up in business; they insist on having a fit and proper regime to monitor the people who are going into the management of such firms. It is a pretty good process; it has worked for a long period of time. The idea that we need a layer of measures in place for an otherwise unregulated industry is simply not accurate; there are significant measures already there. When we look at the Alternative Investment Fund Managers Directive, this is a measure which is going to be very broad in its sweep. As I mentioned earlier, it will cover a broad section of activities. So it is not just hedge funds; it will include private equity, it will include commodity managers, property managers, managers of funds of funds—anyone managing infrastructure funds. In other words, anyone caught by this general label of being non-UCITS. It is an extremely broad catch-all and is not really a definition which any investor thinks in terms of because you will find that retail investors and institutional investors operate on both sides of this divide. Some retail investors do hold non-UCITS funds and likewise institutional investors hold UCITS funds. So this not just a set of measures intended to provide help for institutional investors; it does propose authorisation requirements for managers, and we think that is a wholly good thing. So it is capable of passing the first test that I mentioned earlier, namely, a mechanism for providing investor protection. We believe that if it is routed around manager authorisation—and to us the limit at which a manager is authorised should be zero, not €100 million as the Directive proposes—and anyone who is managing money should go through a strict authorisation process, it would be helpful if we had a degree of commonality; in other words, convergence of the process across not only the European Union but elsewhere in the world. We are quite a long way from being able to achieve that, but that is a possibility. Greater transparency is the best way, in terms of the second measure—in other words, measures to improve financial market stability. Greater transparency is very hard to beat as an appropriate measure, and we fully embrace as an industry any dialogue whereby information which is regarded as important for systemic risk purposes is divulged by not just our industry but everyone who is taking part, providing that information is not made available in its raw form to the marketplace (because that presents difficulties about commercial confidentiality) but is given up freely to national regulators, and then national regulators themselves can aggregate that information in order that they can get a true systemic picture of where there are pockets of risk building up in the marketplace. The FSA has such a trial taking place at the moment; they started a trial back in May and they have asked the 17 largest hedge fund managers in London to provide information in order that they can “go live” right the way across all the hedge fund managers authorised in the UK later in the year. We completely endorse that approach, and all of the managers have participated extremely willingly because, frankly, they feel that (a) they are a small part of the system—you would not start with this piece of the systemic jigsaw—and, fundamentally, they think that the risk is that too much information could be provided and, therefore, will drown the regulator’s ability to cope with all of the information. So we fully endorse that, but would caution—when we are talking about de minimis limits—against having the de minimis limit for the publication of such systemically relevant information; we would caution against that limit being too low because that is capable of leading to data overload. We think that in the discussion about systemically important institutions it is very important to understand the difference between some of the important institutions—i.e. ones that you would rescue if they got into trouble—and systemically relevant datasets which need to be captured in order to get a picture about the systemic risks within the marketplace. In our view, very, very few hedge fund managers could possibly qualify as being systemically important, namely, that if they got into difficulty it would be unfortunate but it would be hard luck and the losses would go 100 per cent to the equity investors and the system would not seek to rescue those vehicles. So they are not systemically important but they are repositories of systemically relevant information which does need to be captured. That de minimis cut-off should be higher than the current proposal. So we believe that that second test is capable of being passed in this case but the Directive does contain requirements for a high degree of granularity of information from managers right.
the way down to a much smaller number, and we think that is (a) far too much information for regulators to be able to cope with and goes down to too small a level and that there would be thousands of funds reporting information rather than a small number, which we think should be the approach. So why has so much fuss taken place over this? It really is not just the producer lobby that is making a fuss over this, and it really is not just the hedge fund lobby. My email in-tray, if it could groan, would be groaning still with the sheer weight of communications coming into me, not just from within the UK, not just from within the EU; I am getting plaintive requests for extra information for confirmation of what people believe they have read in the draft even from commercial attaches of national governments around the world, because people see the potential threat to their manager community and they see potential threats to their investors. So, on the basis of my inbox, there is a very high level of concern about what this could do to investor choice and what this could do to the manager community. We are treating it with the utmost seriousness. I am devoting, possibly, 80 per cent of my time to the Directive, at the moment, and we are raising awareness amongst investors and managers. We are discovering that, in fact, even within the EU, the level of awareness of the finer points of this Directive is surprisingly low. So raising awareness is an absolute priority for us. Then mobilising potential allies will be a second priority, and then the process of lobbying for changes to what could otherwise be a very sensible Directive but, at the moment, is an extremely rough draft, would be our third and follow-up objective. I am very happy to go through specific items, but they are at a lower level of granularity about areas which represent difficulties for either the investors or for managers, but they are manifold and it is our view that a simple redraft or minor editing will not be sufficient; there are serious complexities and difficulties with this and, even with the best will or the best drafting, we think some clauses cannot be rescued. We think they have to be consigned to the grand filing bin. Nevertheless, we are working as closely as we can with the Treasury, with the FSA and with other EU governments in order to be able to identify those areas which should be redrafted so that the opportunities that will present themselves for us in the weeks ahead, both at the Council level and once the European Parliamentary Committees are reconstituted, we will take every opportunity to come forward with our proposed changes, which we think will mitigate the very worst effects of the Directive. We think there is room for further regulation in this space and we are very happy to contribute constructively towards that, but this is a really bad starting point. I probably ought to leave it there, my Lord Chairman.

Q2 Chairman: Thank you, Mr Baker. I have a question about leverage, because what creates financial instability is not individual equity investors risking their own money, it is very highly leveraged risk. Do you think the proposals are appropriate about leverage? Is this a worry? I tend to think more about financial stability than investor protection because these are, after all, professional investors. 

Mr Baker: Indeed, although some retail investors are captured by this.

Q3 Chairman: As you said. 

Mr Baker: Leverage is an important factor to try to understand in the current crisis, because leverage is not a risk in its own right; leverage is, potentially, an accelerant. It depends how the leverage is applied. We would think nothing of a banking institution which is leveraged, perhaps, 35 times because the assets that it is leveraging are either highly liquid or they are not particularly volatile. Therefore, trying to come up with a definition and a number for the appropriate level of leverage which applies in all circumstances will be extraordinarily difficult. Leverage, also, is not the same measure as P & L (profit and loss) risk that hedge funds manage their portfolios against. That is a crucial issue to seek to understand because leverage as would be used in the financial reporting statements of a going concern—a corporation—is a very valid measure; you have an accounting date, and you want to know how much debt the corporation is carrying—whether it is a going concern. Those considerations do not work in the investment fund world; different measures of risk need to be looked at. So there are numerous complications about (a) a definition, (b) whether it is appropriate to look at leverage in the investment fund community. It is very crude to say that a single number should apply regardless of strategy and regardless of types of assets which are being supported by that leverage. For example, some strategies would not dream of carrying leverage. A distressed securities portfolio, where the securities trade very infrequently, can be incredibly volatile and very illiquid. No distressed manager would carry leverage; it is far too dangerous. So saying that “one size fits all” is inappropriate. The number that is included in this proposal is wholly inappropriate; saying that one times the borrowing limit is highly leveraged, I am afraid, is misguided in the extreme.

Q4 Lord Browne of Madingley: Thank you for your description, Mr Baker. It seems to me that everybody has a different aspect of this proposed legislation that they worry about. If you were picking the top four, what would they be? I would like to follow up.

Mr Baker: I have got eight here, which I gave to the Treasury yesterday, but I will boil those down to four for you. There is a provision about third-country funds, which is the point I referred to earlier about
the lock-out for 95 per cent of hedge funds. Third-country funds provisions are built on the concept that in the future it will be possible to sign up to regulatory and tax equivalence between the country in which the fund is to be sold and the country in which either the manager or its fund is based. Those questions of regulatory equivalence—let alone tax equivalence—have eluded us for the last 20 years, and do not even appear to be on the agenda for future discussion. So, elementary things, such as mutual recognition between the United States and the EU, seem to be a very long way away. That one, I would say is extremely important—number one. Number two: the liability issues for depositaries. There is a requirement here whereby a depositary has strict liability for not only the assets under its immediate control but the network of sub-custodians which are appointed on its behalf. Just to give you a little bit of context here, there are very few financial institutions in the world which operate and own custodial operations in every part of the world. So that if you have got a global strategy—for example, an emerging markets strategy which brings very valuable capital inflows into developing economies—the institution with which you deal, as the custodian for your fund, is most unlikely to have organisations it owns in each of those countries, so it needs to delegate to a sub-custodian. There are restrictions in here which favour an EU credit institution as being the depositary—first and foremost. If you use a depositary from another country, again, you have to go back to this point of regulatory equivalence, and even the worst aspect of it is this concept of strict liability. So if, at a future date, a government introduces, perhaps, either an exchange control or a withholding tax in a way that it is this concept of strict liability. So if, at a future date, a government introduces, perhaps, either an exchange control or a withholding tax in a way that has been visible in the public debate but is unexpected in terms of the way it is implemented, there is the possibility of a custodian being liable to reimburse investors for the tax that is imposed.

Q5 Lord Browne of Madingley: This is what people, I think, in shorthand call the “French model”.
Mr Baker: Absolutely. The drafting that has been put into this document is based principally on the French model, absolutely. So that is two. I think the other item would be what I would broadly call product level restrictions. The stated purpose of this objective is to regulate managers—in AIFM the “M” stands for “managers”. However, there are a number of provisions in the Directive which are nothing other than proposed restrictions at a product level. In the institutional world that is pretty close to anathema, because the idea is that the institutional investor is sophisticated and will want to perform its own due diligence with the manager and will not want its investment choice constrained by the application of investment restrictions at a product level. I would include the leverage point that we discussed earlier as being one such of those measures which would count as a product restriction. We feel that they have no place in something which is targeted at the operators of the funds rather than the funds themselves. I would say that is the third point. The fourth point: we have talked about the impact on institutional investors but that, obviously, is not a concern—it is of great concern to the managers but it is not something that they are ultimately in control of. I think another point which possibly chafes is the fact that banks, or EU credit institutions, will achieve an opt-out under the terms of this Directive; even though they will be performing exactly the same activity as the managers who are to be affected by this Directive. As it is currently drafted, they will be exempt. So you have got the nonsense of an activity of which only half is being controlled. I think those are, possibly, the four items that I would bring to your attention, but I do have some others on here which we would regard as being not just serious but “killer” items and they would impose a cost base—loss of choice and cost base—on the industry which would stop a very large number of strategies being offered to their investors.

Q6 Lord Browne of Madingley: Thank you for that. Some say that the combination of these things—the questions of the discretionary regulation which is bedded in these proposals—might therefore drive people away from, primarily, the UK and they would still discharge or follow these strategies operating from elsewhere, therefore creating whatever situation anyone has in mind, and they will be, as it were, operating outside the tent rather than inside the tent. Is that your view or is that too simplified?
Mr Baker: Very much so. The law of unintended consequences is capable of kicking in here. Again, going back to what are the objectives and will the objectives be achieved, if one of the objectives is to identify which organisations are operating in this space and how do we achieve greater transparency about their activities, if they are not even here you cannot possibly do that. It has been given a variety of different descriptions but, absolutely, if the expertise does go outside of the EU it will lose access to its EU investors and so any such decision would not be taken lightly, but if it is felt that there were sufficient investor opportunities outside the EU then I could not agree more because the access to European capital markets would be unchanged. All of a sudden, the cloak of invisibility would descend and it would be impossible to monitor who was active in the marketplace.

Q7 Chairman: Unless anybody has a burning question, I would like to thank Mr Baker. Thank you very much for coming. We have some written
such inquiry—in October. Not that we do not have inquiry—on the assumption we have time to do any such inquiry—in October. Not that we do not have time but the timetable is moving on fast. There will be a call for evidence, which you will all receive.

Mr Baker: Thank you. I very much appreciate the opportunity to meet with you. Thank you for your time.

Examination of Witness

Witness: Mr Simon Walker, Chief Executive, British Venture Capital Association (BVCA), examined.

Chairman: Welcome, Mr Walker. The same caveats apply, that we are being web-cast and you will receive a transcript of the questions. I do not know if you were here at the very beginning of the session, but what I am saying is please tell us what you want to tell us and leave us a little space to ask questions. We have not set up our normal formal structure of questions we want answering. At the end, I will pick up any we have not been illuminated on. Can I read into record, which I should perhaps have done before, that you should all have pieces of paper that say what our respective financial interests are. I am, for example, a Director of the London Stock Exchange, and Lord Browne, as I am sure you all know, was once at BP. You have got a stack-load of entries, have you not, Lord Browne?

Lord Browne of Madingley: Which I am sure Mr Walker is aware of.

Q8 Chairman: One of his is in venture capital. So you should all—inasmuch as the piece of paper has not enlightened you—be enlightened. Against that background, Mr Walker, what would you like to tell us?

Mr Walker: Thank you very much indeed. May I start by thanking your Lordships for the opportunity to present testimony to you today? The work of the House of Lords EU Committee has long been saluted, both academically and by those at the sharp end of having to work with the European Union and its complicated institutions. I know the work of the Sub-Committee will have influence over the actions of government but it will also make a serious contribution to the debate in Brussels, so it is an important opportunity for us, and I am very grateful. The primary question I have been asked to address is: “What objectives do you believe this Directive is aiming to address? What problems is the Directive aiming to tackle?” From that very basic question flows the logical follow-up as to whether those objectives are sensible and whether the BVCA, as an organisation, and private equity as an industry, are content in principle with the Directive. Those should be straightforward questions to answer but, alas, they are not. I believe I know what objective those tasked with drafting the Directive thought they were addressing; that involves the systemic risk which alternative investment managers and methods might pose to the financial system. That is a very reasonable area to explore and, in fairness, it is not only the European Union but a host of distinguished individuals who are examining that question. Their uniform conclusion, however, is that private equity does not pose a systemic risk of any scale to the wider economic system. The logic of that conclusion, to private equity at least, is that there should be no compelling case for additional regulation, and that, I think, would be particularly true of the United Kingdom where we are already regulated as an industry tightly by European Union standards via the FSA. On top of that, we have the disclosure and transparency regime introduced in the wake of Sir David Walker’s recommendations two years ago, which ensure that the largest portfolio companies owned by private equity do release information about their activities in a manner which is, at least, as forthcoming as those made available by similar sized, publicly quoted companies. In the absence of evidence of systemic risk, there would be a strong case for expanding that system of disclosure through independent regulation over time, but I believe there is no case at all for one-size-fits-all EU regulation, especially one which places private equity together with other models—notably hedge funds—which are radically different in character but which exclude other forms of private ownership besides private equity (I am thinking, particularly, of ownership by individuals, by families or by consortiums that do not amount to funds). I am driven to the conclusion that the underlying objectives to this Directive are political rather than economic, and designed to take the so-called “Anglo-Saxon model” of capitalism down a peg (or seven), rather than address a higher concern. It will not come as a surprise to your Lordships that we do not consider that de facto objective to be sensible. Nor do I believe our worries in this regard are particular and parochial. Around 60 per cent of all private equity activity which occurs in the European Union is based in this country—primarily in London. So a Directive which makes the European Union a significantly less attractive area for the very international industry that is private equity will do much more damage to London and the United Kingdom (to the benefit, I think, of North America, the Middle East and Asia) than anywhere else in the European Union. At a time of recession, with a fragile recovery in front of us, it strikes me as
extremely counterproductive for the European Union to be contemplating hostile action against one of the few sectors which has both the cash in hand to invest and the instinct and appetite to do it. So my core suggestion is that the sensible way forward would be for private equity to be removed from the scope of this Directive (if, indeed, a Directive of any sort is merited) and considered on its own qualities once the recession and the recovery have been dealt with, and when it is possible to make a full assessment of the role which private equity can play in the European economy. I appreciate this is a Committee which deals with technical detail as well as with principle. In seeking to answer any further questions about problems with the Directive and possible changes which can be made, I am going to assume that a Directive of some sort will be pursued and that private equity will, unfortunately, be included in it. If I could focus on five major areas. The first of these involves the capital requirements for private equity set out in Article 14. These require owners of private equity and venture capital businesses, as opposed to investors in their funds, to contribute additional shareholder capital to the management company. The requirement will usually be equal to a whole quarter of a manager’s fixed overheads, including salaries, rent and so forth. That will be a major obstacle to the establishment of new firms, new funds and innovation. In this country, new firms are usually established by small teams of executives spinning off from an established private equity house. If this new barrier to entry is established they would struggle to capitalise the new firm. The increased capital required would be dramatic. One private equity house, a mid-market house, estimates that its owners would need an additional £8 million of capital, which would simply be dead capital in terms of investment. That is from the current requirement for £5,000 as a capital requirement, which I think you could concede would go up. There is no robust case for this provision. There is no market failure that has been identified. The light capital regime operated by the FSA has not given rise to any failures because it was structured to recognise that managers of professional funds are different. A capital requirement linked to overheads may be appropriate to a segregated investment manager with a large number of clients because it would provide a buffer to support an orderly wind-down—the last few clients would otherwise be at risk as the manager’s income declines—but that is not the case in private equity where the fund is the manager’s only client and offers a predictable and stable income throughout the relationship. The position of a fund and manager parting company is really not comparable with a gradual wind-down of any other investment business; the fund is closed, so investors cannot break their commitments. In addition, in most cases, fund terms already provide for a break fee, which is usually 12 or 18 months’ fees, which support an orderly wind-down. The second sphere of our concern is public disclosure, as set out in Article 28. The Directive states that the private equity fund with EU investors must disclose its business plan for each portfolio company to the company, its other shareholders and employee representatives or, where there are no employee representatives, to its employees. That information will become public. That would result in a huge comparative disadvantage for any private equity fund with European investors. Of course, most of those are based in the United Kingdom. So it is a disadvantage for the City with little cost to most other Member States. Any other buyer of a European Union company, no matter how sensitive or important that company may be, would have no such obligation. So unregulated competitors who buy those companies would include oligarchs, continental banks, family officers, conglomerates—even, actually, American private equity firms which have no European investors. It is also, in our view, inconsistent with European company law and corporate governance principles for a 30 per cent shareholder to be setting a business plan for its portfolio company, which we think is the prerequisite of the company board. One alternative would be to apply the requirement consistently to every kind of private investor if disclosure is held to be that important. The proper vehicle for that would be a new company law Directive, but, in the absence of that, we would call for the removal of the requirements on portfolio company disclosure or, at the very least, the deletion of the exemption for EU banks and insurers and for sovereign wealth funds, ensuring that no requirement to disclose trade secrets or confidential information is demanded. Our third concern relates to the structural issues set out in Articles 16, 17 and 18, which require that private equity funds appoint an independent valuer and an independent custodian and may not delegate any function without the permission of the FSA on a case-by-case basis. This would sharply increase costs which would be suffered by fund investors to no benefit. The better response would, in our view, be to remove private equity from these requirements or, in the case of custody, require the manager to segregate the assets from its own assets, which is the MiFID standard. An independent valuer is not needed in private equity funds because investors do not subscribe or redeem at net asset value. The true worth of a portfolio company is only established when it is sold, and it is only at that moment that investors receive value. Interim valuations have no purpose, except to provide information on the development of the portfolio. No current service provider has the skills to value the portfolio company; nor would an auditor, even if it was prepared to assume the liability
to investors. Costs of valuation could be expected to be very sizeable. Similarly, an independent custodian makes no sense when the fund’s assets are share certificates in private companies. Cash is drawn down only when required to fund an investment and it is segregated from the manager’s assets and paid into a bank account. A private equity manager cannot run off with the assets. In any event, requiring an EU bank is excessive; there is no reason why a properly authorised manager or third-party cannot have custody—as, indeed, they can for retail investors under MiFID. The FSA’s approval to each and every delegation on a case-by-case basis would also involve very substantial costs and go well beyond UCITS and MiFID requirements. The fourth sector we are concerned about covers global competitiveness. We are deeply concerned at provisions in the Directive which imply restrictions on the ability of European professional investors to access funds managed outside Europe three years after the Directive comes into force. The provisions are extremely unclear, but the effect seems to be that the only funds which might be marketed to professional investors in Europe are those which are managed by a European firm with an authorisation under the Directive, or which are managed by a third-country firm with a marketing authorisation under the Directive. The marketing authorisation can only be obtained if the third country is judged to be based in an “equivalent” jurisdiction. It is quite possible to read the provisions as saying: “These are the only funds which firms can advise on or put in discretionary portfolios”, and that firms may only provide investment services to such funds. There is no rationale as to why investors should be unable to invest in attractive geographies across the world just because the fund does not have an EU manager. This has the potential to have a huge impact for European investors who will not be able to implement global investment strategies; it will drive business out of Europe because there will be no point in servicing non-European clients from a European office if the firm is limited in the range of funds in which it can invest. It is also discriminatory against funds as there are no similar prohibitions regarding any other kind of investment. We think it would be particularly serious if the United States took the view that the Directive was discriminatory against its fund managers. Any reciprocal action would be a huge blow to EU foreign direct investment. UK firms could easily relocate to the United States, as it is, for many of them, their main investor base anyway—something like 45 per cent of all investment into British private equity comes from the United States. It is vital that we, instead, ensure disclosure to investor funds is managed outside the EU as opposed to banning professional investors from accessing those funds entirely. The final issue I would like to highlight is marketing, as set out in Article 31. The present requirement is for all UK private equity firms to notify the FSA, which in turn must notify its EU counterparts of any proposed fund marketing, including information on the Alternative Investment Fund available to investors. It has to provide final form documents and not change them without resort to the regulator. Subject to those provisions, the manager may market the fund throughout Europe to professional investors as defined in MiFID. Fund marketing is central to the ability of funds to stay in business and the process of fundraising is highly competitive and very time-consuming. The Directive’s requirements are totally at odds with the private placement of units in private funds. Managers go on the road, often for many months, to sell interests to investors who, on the road, will demand additional information from the manager. The investors conduct extensive due diligence and they will often interview key members of the team. Fund documents are simply not in final form before marketing commences because they are, by definition, negotiated in the course of fundraising. The advantage of a marketing passport, we think, is somewhat illusory when it is confined to professional investors, as defined in MiFID. High net worth and sophisticated individual investors are important players in private equity and venture capital funds. At present, in Britain, they can be treated as professional, but under the MiFID test such individuals can only be treated as such if they satisfy specific tests, one of which is the need to have invested in ten funds or private equity transactions a quarter for the previous four quarters. Nobody does that. No one would do that—no individual, sophisticated or professional investor. While the Directive permits Member States to market to retail investors we do not think that is sufficient; the people we have in mind should not be treated as retail, they are professional investors in this field and we fear that other EU countries will simply not permit any marketing beyond the professional class, as an act of protectionism. The solution, we think, is that the notification requirement should simply be to notify the home state of the fact of the proposed marketing of the fund and its manager, and the quantitative test for a professional investor should be dis-applied. In conclusion, I appreciate I have covered an enormous amount of territory in a comparatively short time. If it is any consolation, the list of concerns we have goes well beyond the terrain I have staked out. Had time been longer my testimony would have been. Thank you very much for the opportunity to speak before you and, of course, I am very happy to answer any questions you might have.

Chairman: Thank you, Mr Walker.

Q9 Lord Watson of Richmond: Mr Walker, I want to ask you questions about what you judge to be the motivation for the Directive. You are on the record as
saying, on the grounds that 60 per cent of European private equity is based here, that (and I quote): “Only the touchingly innocent would fail to see that others have an interest in seeing this business relocated elsewhere in Europe.” However, you and the previous witness today have made it clear that the impact of this Directive will be on the EU as a whole. In fact, your phrase was “it will drive business out of Europe”. What is the motivation for this Directive? Is it a conspiracy by some Europeans to get more of the business or is it complete foolishness that they do not mind if we all lose the business?

Mr Walker: I do not think it is a sophisticated conspiracy by other European countries; I think there has been a coming together of people with an antagonism towards what they see as a manifestation of the Anglo-Saxon model which they think, I think with some justification, has been carried to extremes over the past few years. I would not duck from that criticism. What we have seen is an opportunity to hit at a branch of capitalism that has not been responsible for the crisis. The Financial Times characterised it yesterday as a fight in the bar breaks out and you take a swing at the person you have been wanting to hit for some time anyway. So I think there is a sizeable motivation in that. I think there is an indifference to what happens to private equity in some countries in Europe which have no tradition of private equity, and there is certainly a desire in other countries that do have private equity traditions—and I think particularly of France in that context—to see as much of it as possible sort of repatriated to France, which has a good and strong private equity tradition.

Q10 Lord Watson of Richmond: In your judgment, is this Directive likely to repatriate this business to France?
Mr Walker: I do not think so.

Q11 Lord Watson of Richmond: So they are being rather foolish?
Mr Walker: I think they are being unwise. They might well take the view that something like 18 per cent of investment into UK private equity comes from continental investors—pension funds—many of them French, so some of that money might find its way back to France, but I think it is a fairly minor matter.

Q12 Lord Steinberg: Madam Chairman, just a very quick question. If by any chance this Directive is passed—and, unfortunately, the likelihood is that it will be passed in some shape or other—is it your view that most of the business that is currently transacted in Britain would go to the United States?
Mr Walker: It is certainly my view that the large international firms would probably leave the UK and return to the United States. There would still remain a relatively small UK-based private equity sector operating significantly in the UK for some continental investment, but I think it would drive both the big players and international investment away from this country, in particular, and from Europe in general.

Q13 Lord Renton of Mount Harry: I still find it—listening to you with fascination—totally incomprehensible as to why the EU Commission is moving in this direction at all. You mentioned you thought that the Anglo-Saxon model—which had, if anything, really, been too successful in recent years—was perhaps the reason, but just what from Lord Steinberg has asked you, in fact, probably every firm in every EU country will suffer. So what is the motivation?
Mr Walker: It is certainly my belief that every EU country will suffer. I think the motive is to hit at what is seen as—and, indeed, has at times been—a particularly vigorous (its critics would say “ruthless”) manifestation of capitalism. I can see why, in other European states, there is antagonism towards that model. My argument would be that in the medium term, and certainly in the long term, private equity speeds up the transformational process of competition in the marketplace, but there are certainly parts of Europe where that is unpopular. I would not deny that private equity has gone too far, in terms of borrowing, at times, taking advantage of the easy access of cheap debt, and that is something we, as BVCA, have talked about in the past. It has, perhaps, lost focus on its traditional routes in operational improvement of companies while borrowing was cheap, but the market has corrected that.

Q14 Lord Trimble: In reply to Lord Steinberg you said you thought if this Directive went ahead that a lot of major firms would relocate back to the US, leaving a small element operating in London. Could you quantify the loss to London in terms of jobs and capital? Is there any sort of ballpark figure as to how much capital would no longer be available for investment in the EU or UK and how many jobs we would lose?
Mr Walker: I think we would certainly be talking in terms of many billions of pounds every year. Last year, UK private equity raised, I think, £23 billion. My guess is that a very substantial part of that—I would have thought more than half—would disappear. Private equity (the last figures I have on this are for 2006-07) paid something like £5 billion in legal, banking and other advisory fees, quite a lot of which was outside London but most was in London. I would imagine that most of that would go as firms which base themselves in London but invest in Europe and Asia went elsewhere. Our estimate, at the
time, was that something like 12,000 people are directly employed in private equity, many more of those dependent on legal services. I would have thought anything up to half of that number would also go, but I am slightly guessing.

Q15 Lord Browne of Madingley: Can I, Mr Walker, just push you on which of these five is, ultimately, the thing that would drive the industry out of the UK? Which one thing would do it? They are all undesirable—you have made that case. Is there one thing that would do this that we should note?

Mr Walker: I think the third-country restrictions and requirements would be fiendishly difficult to operate within the context of. I think “equivalence” probably applies to the laws of the state of Delaware, for example, and I think it would be hard for equivalence to be achieved with that or many other perfectly sensible judicial regimes. So that would worry me, in particular. I would also, if I may, though, cite the portfolio company disclosure as a particular problem, because it tilts the playing field so much against funds owning anything, and the level is just so great. The Western Cornwall Pasty Company will fall under the Directive; Tele Pizza and Tyrrell’s Crisps will all have to make full disclosure. That has to be a huge disincentive to owning companies like that, via a fund.

Q16 Lord Browne of Madingley: May I ask you one other question? In answer to my colleague’s questions about why this is happening, you gave an answer which said probably not to do with financial stability but with the way in which companies were treated. In your view, if this were all enacted, would that change, or would people simply come from outside to invest in companies that needed repair, restructuring, or whatever they needed?

Mr Walker: I think the fund-based private equity model, ultimately, which benefits pension funds and other institutions, is quite a good way of fixing and repairing broken companies, particularly in recessionary times. The fact that funds last for ten years and that there is an absolute commitment gives a motivation to operate improvement and fixing companies. The returns have historically been very good, and I do not think they are going to be as good for some time, but to me the model is an optimal one.

Q17 Lord Browne of Madingley: If I may, my question is this: if all this became reality, would anything be achieved or would managers managing funds and, therefore, making investments, go elsewhere and simply invest in the same way that they did in jurisdictions in the European Union, buying companies and selling them and doing exactly what they would have done had they done it from the UK, for example?

Mr Walker: Would they do it from other countries?

Q18 Lord Browne of Madingley: From anywhere: from Switzerland, from the United States or from anywhere else.

Mr Walker: I think there would be quite a lot of that, but I think the complexity of it would mean that investing in Europe and picking Europe up out of the recession would be comparatively less attractive to investing in, say, Asia. So I think it would starve the European economy of capital as it was trying to come out of recession.

Lord Browne of Madingley: Thank you. Chairman: Thank you very much, Mr Walker. Thank you for a very succinct presentation, and I think we have got to the bottom of that. It remains for me to thank you for coming.

Memorandum by the British Venture Capital Association (BVCA)
The BVCA is the representative body for private equity and venture capital in the UK. Our members range from very small venture capital houses to the largest global buyout firms. The UK accounts for some 60% of private equity activity in Europe. We focus our comments below on private equity as opposed to any other form of AIF, and use private equity to refer to the provision of equity capital covering all stages of investment.

1. What economic benefits arise from Alternative Investment Funds?

1.1 Private equity brings both capital and management skill to the businesses in which it invests. Funds provide equity capital for companies at all stages of development, from start up to expansion capital through to large buyouts. In addition, private equity firms are active investors. Their hands-on ownership gives investee companies managerial skills to become more successful businesses.

1.2 BVCA members invest significant sums in to companies outside the UK. Over the last three years BVCA members have invested over £70 billion in to companies around the world. Of this, approaching half (£32 billion) was invested in to almost 700 companies in EU member states other than the UK.1

1.3 Private equity also provides a direct economic benefit through returns to its investors. Over half of the £23 billion funds raised last year came from pension, insurance and endowment funds. The rest came from investors in other EU member states (over £3 billion per annum has been raised from this source since 2005). This is money invested on behalf of, for example, pensioners, who are receiving superior returns. Whilst last year was of course a difficult one, UK private equity continues to outperform other asset classes over the long-term: the ten-year return rate for private equity and venture capital funds stands at 15.4% against 1.2% for the FTSE all-share over the same period.

1.4 Other economic benefits from private equity are indirect, from the outperformance of its investee companies: a report conducted for the BVCA showed that, over the five years to 2006–07, on average, private equity-backed companies’ sales rose by 8% per annum, compared with FTSE 100 companies (6% per annum) and FTSE Mid-250 companies (5% per annum); exports grew by 10% per annum, compared with a national growth rate of just 4% and corporate investment rose by 11% per annum, compared with 3% nationally. In addition R&D expenditure increased by 14% per annum, compared with the national growth of 1% per annum.3

1.5 As a recent report by the World Economic Forum concluded, private equity companies will be best positioned to attract fresh capital to invest in illiquid markets because they have established track records of aligning the interests of general and limited partners. Unlike some other forms of investment, the interests of investors and managers are aligned over the long-term: fund managers are typically significant investors in their own funds, and “carried interest”—the profit share earned by fund managers—is only paid when the fund has made healthy realised profits for investors.

What risks to financial markets arise from Alternative Investment Funds?

1.6 Clearly there are risks to investors associated with investment performance, and it is possible that managers could breach their contractual and fiduciary duties to investors. However, investors into private equity funds are able to understand and mitigate those risks: they conduct extensive due diligence and negotiate bespoke contractual agreements with fund managers, usually with the benefit of sophisticated legal advice. In addition, UK managers are extensively regulated by the FSA, so further regulation to tackle these risks is unnecessary and not something investors are seeking. Importantly, these risks are not “systemic” and do not pose a risk to financial markets per se.

1.7 One area which has received attention in respect of the perceived risks associated with private equity is leverage. Private equity—particularly at the larger end of the investment spectrum—has used debt as a central component of its deal structuring, in common with many businesses that are not owned by private equity. Debt: equity ratios were around 2:1 in some larger deals over the last few years, but these ratios are consistent with previous cycles when debt was cheap. In the late 1980s, debt:equity ratios were typically similar to those found in the period leading up to 2007. Whilst investee companies faced difficulties in that period, over their lifetime large private equity funds still managed to produce excellent overall performance (a 19% median annual return).

Market forces have of late brought leverage ratios down significantly to the point where many deals are being financed through all equity structures. We do not expect leverage ratios to return to their pre credit crunch levels for a very long time.

1.8 Moreover, even at times of high leverage, it is not possible to say that private equity poses systemic risk. In private equity, each investment stands alone, so if one individual investee company fails, that company alone falls, and cannot draw on resources from other businesses financed by the same fund. In addition:

— The ECB estimates the aggregate amount lent to private equity-backed companies represents less than 1% of European banks’ assets.

— Total Private Equity/Venture Capital investments in 2007 account for just 0.584% of EU GDP.

— No other proposals on regulatory reform of alternative investments has recommended substantial additional regulation for private equity. This includes reviews conducted by Lord Turner and Jacque de Larosiere, as well as the last communiqué from the G20. Proposals for reform in the US are considerably less onerous than what is contained in the AIFM directive.

— The Commission’s own explanatory memorandum to the directive notes that private equity “did not contribute to increase macro-prudential risks”.

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3 The Economic Impact of Private Equity in the UK 2007 Report.
Even if there were some justification to regulate leverage at the company level, it would be completely inappropriate to do so by regulating funds themselves (see “regulatory aspects”, below). If it is felt that more regulation is needed to prevent companies from taking on excessive debt, then that should be a matter for company law (and therefore apply to all companies and not just those owned by a private equity fund), or the prudential regulation of banks.

*Will the Directive help reduce these risks?*

1.9 The Directive provides no real means to mitigate any identified risks for private equity funds. As a recent set of guidelines drawn up by institutional investors shows, investor protection concerns centre on governance and transparency levels between investors (“LPs”) and funds (“GPs”). The guideline’s recommendations bear no resemblance to the investor protection elements of the AIFM.

2. *To what extent is there a need to create a single regulatory regime for Alternative Investment Fund Managers in the European Union?*

2.1 We support appropriate and proportionate regulation on a national and international level, and we support the proposal in the Directive to create a pan-European passport for investment fund managers (although see comments on the current proposal below). The problem with the draft Directive as it stands is that it creates considerable unjustified burdens for private equity funds which in our opinion would be very damaging for the wider economy. We are not against regulation, and indeed are extensively regulation by the FSA—it is inappropriate and disproportionate regulation which we are against.

3. *Is the Directive proportionate given the role of AIF in the financial crisis? Will the Directive introduce over-stringent regulations or does it not go far enough?*

3.1 Our clear view is that the directive does not offer a proportionate response to any identified risks.

4. *Is it appropriate to regulate Investment Fund Managers, rather than the Fund itself? Does the Directive contain appropriate provisions to distinguish between different types of alternative investment?*

4.1 We do not believe it is appropriate to regulate alternative funds as opposed managers, particularly if access to them is restricted to “professional investors”. These types of investors are sophisticated and therefore do not need to be protected by detailed regulation of the fund itself. Indeed the FSA currently regulates the fund manager rather than the fund for this reason. This of course contrasts with the widely accepted position that retail funds (ie UCITS funds) which are capable of being marketed to the general public need themselves to be regulated so that a degree of investor protection is built into the design of such products. Regulating alternative investment funds would stifle product innovation, would be disproportionate and indeed not feasible in practice.

4.2 The Directive does not contain sufficient differentiation between alternative assets. The AIFM covers all alternative investments and, for the most part, applies to them each equally. The BVCA would like to see private equity more clearly distinguished, so as to be able to tailor the provisions in a way which is applicable and proportionate. For example, there are provisions in the directive which relate to investors’ redemption rights, but in private equity funds, no such rights exist.

5. *What is your evaluation of the Commission’s consultation in the preparation of the Directive?*

5.1 The BVCA does not believe any substantive consultation was conducted before the directive was published and that the regulation suffers as a result.

**Regulatory Aspects: Questions 6–8**

6. *Will the passport system help create a single market in investments funds within the EU?*

6.1 The Directive makes it a requirement that UK private equity firms must notify the FSA, which must in turn notify its EU counterparts, of any proposed fund marketing, and provide final form documents and not change them without notifying the regulator. Subject to these procedures, the manager may market the fund throughout the EU to “professional investors” (as per MiFID).

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6.2 The requirement on notifications is totally at odds with the private placement of units in funds. Fund documents are simply not in final form before marketing commences because they are by definition negotiated in the course of the fund raising.

6.3 The advantage of a “marketing passport” is somewhat illusory when confined to “professional investors” (as defined in MiFID). High net worth and sophisticated individual investors are important investors in private equity funds. In the current UK regulatory environment they can be treated as “professional”. Under the MiFID test such individuals can only be treated as such if they satisfy certain specified tests: one of which is the need to have invested in 10 funds (or possibly private equity transactions) a quarter for the previous four quarters. No one does this.

6.4 The Directive makes it very difficult for non-UK (eg US) firms to market their funds to UK (and EU) investors, substantially reducing the investment options for pension funds and insurers who currently invest. Some UK based private equity firms use a UK fund structure and others typically use a Channel Islands fund structure. Investors are perfectly happy with this. Yet the Directive introduces significant regulatory differences between these structures, the effect of which would be to impose significant additional barriers to promoting Channel Islands based funds to investors in the UK/EU. Last year, around 40% of funds raised by BVCA members came from within the EU.

6.5 This is discriminatory against alternative investment funds (no other investment is subject to such restrictions) and limits the investment strategy of investors. Saying that an investor cannot access funds in certain geographies is both protectionist and counter-productive.

6.6 We believe the notification requirement should simply be to notify the home state regulator of the fact of the proposed marketing of the fund and its manager and the quantitative test for a professional investor must be disapplied. The MiFID quantitative tests must also be disapplied.

6.7 A marketing passport must be effective in order to achieve a single market and reduce costs for EU investors. It must also fit the reality of fund marketing—professional funds are often bespoke and negotiated, the marketing processes work to favour investors by giving them influence and input into the fund terms. Depriving funds of this access makes no sense.

7. Is the threshold for defining “systemically relevant” Alternative Investment Funds appropriate?

7.1 The BVCA believes the threshold for inclusion of private equity funds under management of EUR500 million is too low. It would catch a number of venture capital, early stage and small and mid market buyout fund managers who are making quite small individual investments. As noted above, no private equity fund poses systemic risk, even one that makes large investments.

7.2 Capital requirements make sense for deposit taking and other financial institutions where increasing the amount of capital set aside increases investor protection. This is not the case for private equity.

7.3 The Directive requires owners of private equity businesses to contribute additional shareholder capital to the management company, which will usually be equal to a quarter of the manager’s fixed overheads, including salaries, rent etc (as opposed to EUR 125,000 as some mistakenly believe). Capital requirements are not relevant for private equity as they offer no additional investor protection. Unlike other alternative assets, in a private equity fund there are no redemption rights for investors. Equally, there is no identified market failure. The much more proportionate capital regime operated for many years by the FSA has not given rise to any failures because it is structured to recognise that managers of professional investor funds are different.

7.4 Increases in capital required to be set aside will be dramatic: one established mid-market PE house estimates its owners would need an additional £8 million of capital. In addition, this will be a major obstacle to the establishment of new firms, new funds and innovation. In the UK, new firms are usually established by a small team of executives spinning-off from an established house. In many cases, they will struggle to capitalise their new firm. It will also reduce the amount available for investing by the manager on the same terms as the investor, a very helpful way of more closely aligning interests between the two.

7.5 A more sensible way to proceed would be to carve out those closed end funds where there are no redemption rights, and then to focus on professional indemnity insurance as the appropriate mechanism for addressing investor protection.
Does the Directive contain appropriate rules on leverage?

7.6 The Directive contains provisions limiting the amount of leverage at fund level. Private equity borrows at the level of the investee company rather than at fund level, so this proposal should not impact private equity funds. However, more clarity is needed to make this clear.

Is the requirement for independent valuation agents and depositaries for Alternative Investment Funds adequate?

7.7 The Directive requires that a fund must appoint an independent valuer and an independent custodian and may not delegate any function without the FSA permission on a case-by-case basis. The associated increased costs will be suffered by fund investors, to no benefit.

7.8 An independent valuer is not necessary in PE funds as investors do not subscribe or redeem at net asset value. The true value of a portfolio company is established when it is sold and only at that point do investors receive value. Interim valuations have no purpose, save to provide information. Costs of valuation could be expected to be very significant.

7.9 An independent custodian makes no sense when the fund’s assets are share certificates in private companies. Cash is drawn down only when required to fund an investment and it is segregated from the manager’s assets and paid into a bank account. A PE manager cannot run over with the assets. In any event requiring an EU bank is excessive, there is no reason why a properly authorised manager or third party cannot have custody, as they can for retail investors under MiFID. The FSA has for years regulated private equity managers for the provision of custody services to their funds.

7.10 The FSA’s approval to each and every delegation on a case-by-case basis will be a massive cost and will create moral hazard for the regulator. It goes far beyond UCITS/ MiFID requirements. We would suggest removing private equity from these requirements. Or in the case of custody, require the manager to segregate the assets from its own assets (the MiFID standard).

8. Will the provisions strengthening disclosure requirements help to create a more transparent market or do they go too far?

8.1 A private equity fund with EU investors will be required to disclose its business plan for its portfolio companies to the company, its other shareholders and employee representatives or (where none exists) its employees. That information will therefore become public. We estimate that these requirements will cover 500–600 UK based private equity portfolio companies (as well as many more across the EU). This compares with around 6,000 UK based privately owned companies of a similar size who will not be subject to these requirements.

8.2 This would be a huge competitive disadvantage for any private equity funds with EU investors. Any other buyer of an EU company will have no such obligation. Competitors will include oligarchs, Continental banks, conglomerates, even US private equity funds which have no European investors. It is also inconsistent with EU company law and corporate governance principles for a 30% shareholder to be setting a business plan for its portfolio company.

8.3 The proper vehicle for this issue would be a new company law directive which takes in all forms of private investment. In the absence of that, a regime similar in scope to that drawn up by Sir David Walker in 2007 would be a more realistic way forward. The Walker regime currently takes in 16 buyout houses (with another 16 volunteers), most relatively large and organisationally and financially able to cope with the disclosure requirements for the 54 companies covered. The portfolio investment criterion cover 80% of UK buyout activity, roughly equating to the FTSE 350.

IMPACT: Questions 9–11

What effect will the Directive have upon the position of the City of London and the EU as a whole as a leading location for Investment Fund Managers? What effect will the Directive have on flows of capital and financial innovation? How does the Directive compare to existing or proposed regulation of Alternative Investment Funds outside of the European Union, particularly that of the US?

9.1 The Directive has the potential to drive investment away not just the UK, but from the EU a whole. The provisions, particularly the inability of non EU funds to raise money in Europe, could well mean funds look to base themselves in jurisdictions without such restrictions. Around 40% of funds raised by BVCA members annually comes from within the EU. Many of our members are, however, based outside the EU. Any retaliatory measure from the US could also have a dramatic impact on capital flows: around 45% of funds raised annually come from the US (with a further 14% coming from Asia and the Middle East).
9.2 The logical result of this is that the scale of private equity investment in the EU will reduce. This would have a greater impact on the UK given the preponderance of private equity investment from the UK. Some estimates put private equity’s uninvested capital (or “dry powder”) at almost $1 trillion.6 The AIFM as drafted would ultimately mean less of this is invested in to EU businesses, many of whom are struggling in the downturn.

9.3 As drafted, the directive already captures around a dozen pure venture capital funds (and any threshold reduction would clearly bring in more). These funds are making investments in to highly innovative businesses, in areas like cleantech, bio science, digital and advanced manufacturing. Any threat to the funding of these businesses would have negative consequences, not just for these companies, but for the next generation of innovation.

9.4 The US is currently debating proposals on the regulation of alternative investment funds (including private equity). So far these look markedly less onerous than what is proposed under the AIFM, focusing on registration with relevant authorities the creation an oversight council for financial services. This would make the US a comparatively more attractive jurisdiction in which to base a fund, and it is also hard to see how funds based in the US would meet the “equivalence” test set out in the Directive which would allow them to market in the EU.

September 2009

Examination of Witness

Witness: Mr Peter Montagnon, Director of Investment Affairs, Association of British Insurers (ABI), examined.

Q19 Chairman: Mr Montagnon, it is very nice to see you again. You are, we hope, going to tell us about the Directive from the point of view of a professional investor—someone who looks after professional investors. So that instead of the side of the operators, we are now going to hear from the side of people who want things to invest in.

Mr Montagnon: Indeed, Madam Chairman. Thank you very much indeed for the invitation to come and talk to you and the Committee today. Let me just begin by putting us in context. I am Director of Investment Affairs at the Association of British Insurers, representing large professional investors, as indeed you say. We have funds under our control of something around £1.5 trillion and that includes some—not a lot because it is a bit at the margin—investment in hedge funds and private equity. One of the things about our set of investors is that, like pension funds and like the university endowment funds, we consider ourselves as being real owners, so we are, if you like, the end customers. I would want to say just a couple of general things about our approach to the market and the regulation of the markets after the financial crisis, because I think that would put this in context. There is a lot of talk about regulating markets. What we need, as users of the markets, generally, is good quality regulation. If you actually believe that part of the problem with the crisis is we did not have it before, we do not want to try to correct our problems by having bad quality regulation. We think that is of interest to us as users of the markets; we think it is of interest to the European Union generally, because we need goods from financial markets in Europe, and we think it is of use for the City of London. In that context, what we do not want to see is the type of regulation which pushes in the direction of protectionism, which pushes us into fragmentation of markets and regional regulation which tends to keep other participants out and would isolate Europe from the mainstream capital markets and capital flows. So that is an important factor for us. In considering the subject of this Directive, I think it is important to try to remember and remind ourselves that private equity and hedge funds, which have been demonised by politicians in some parts of the European Union, do play a useful role in financial markets, as hedge funds trade and bring liquidity to the markets, and that is actually quite positive. Private equity, as has been mentioned, has the capacity to fund the recovery. So this is a little bit the general context, and, as I said, as large users of the markets we have a general interest in the health of the markets and the way they are going. Why are we interested in this Directive? It is because, as I said, we are the end customers here and we are interested in having choice of what to buy. One important job we do is we allocate assets. We allocate the funds that come in that we are investing on behalf of our customers, and we want to have the choice that enables us to allocate those assets efficiently and generate, in the end, the best rate of return for the customers. So there is a matter of choice here, and the concern that we have about this Directive is that, on the whole, it would tend to limit choice. Choice matters to us, and that is really what we have picked up straight away. The other point about the Directive which concerns us is that it does involve, as drafted, a very large compliance burden in different ways in different parts of the industry, and that is going to generate cost, which actually will ultimately be borne by the beneficiaries for whom we are working—the
savers and pensioners in Europe whose money is being invested. The question is: is that proportionate? We would think, at least as far as the Directive is drafted, certainly not. One of the ways this question has been put is what do we want from this Directive? I have to say I think if we were starting from here we would not have the Directive. However, as others have said, we are going to get something so it is a question of what do we want that is useful. There is an important possible prize here, which is the idea of passporting; the idea that the funds can be marketed across the entire European Union once there is registration and authorisation. This would actually be quite good for Europe because it would help unify the European capital market and it would tend to enhance choice. So we would actually not like to lose sight of the fact that in this Directive there is, potentially, something which is really quite good. In order to have that passporting we also think it is reasonable that we need the right level of professional investor protection in order for people to feel that the funds can be passported. So we actually do recognise there has to be an element of investor protection in that, but it is actually important here to remember that we are looking at professional investors, not retail investors, and there is a distinction. So it can be quite light touch. The question was asked earlier, and I think it is worth coming back to this point, about what the motivation for this Directive is. As I perceive it, one of the motivations is, on the part of those responsible for regulating our markets, a desire to ensure that they have covered all the bases; that nothing slips through the net, and a feeling that some of this stuff—the hedge funds and private equity material—did slip through the net and needs to be covered. We can sympathise with that, I think, as long as it is proportionate. The damage and the difficulty comes when people latch on to that and think, as long as it is proportionate. The damage and the difficulty comes when people latch on to that and have all kinds of different political and other motivations which add up to something which is a little bit toxic. The point I want to make here is that I think, as large investors and users of the market, we are sympathetic to, and understanding of, the need for the authorities to have sufficient information about what is going on in different markets in order to be able to identify and address systemic risk when they see it arising, or potentially arising. So we think that is a legitimate objective here, as part of building a framework of regulation for the future that will help us get over the problems that we have had with this crisis. The points for us, therefore, just to recap, are that we like the idea of passporting, we acknowledge that it is important that there is a level of investor protection which will allow that, and we understand the need of the authorities to be on top of systemic risk. The question is: does this Directive, as drafted, deliver these useful objectives? I am afraid the answer is no, and I am afraid the answer is no for a number of reasons which have already been aired this morning, but I will air them again. Particularly, I hope, it is useful to do so from the perspective of the customer. We do have some quite big problems with this. The third-country arrangements do seem to us very damaging because they are—I think you cannot really disguise the fact—protectionist in their concept. They are certainly going to limit the choice that we, as professional investors, have. That is going to make our job harder in terms of allocating the assets efficiently and generating returns for the pensioners and savers who we are working for. So that is, I think, a really major problem, and we do not much like the idea of equivalence because it is such a subjective concept, and it does enable the authorities, in one part of the world, to devise a regime which is really designed to keep competitors out of the market. One could accuse the European Commission of doing this; one could, at times, in a different context, accuse the American regulatory authorities of doing something similar over there. It is a temptation which arises wherever you are. We think this is, really, quite awkward. So we are concerned about that. We are certainly concerned about the operational arrangements. We have heard this morning about the difficulties with depositaries and the delegation of their activity. I think there is some real difficulty here because, as the Directive is drafted, this could lead us into a situation where it becomes very expensive to invest—or very difficult or even impossible to invest—in certain parts of the world; emerging market funds, for example, might become very, very difficult to deal with because you would have to delegate the depository function and it would be too expensive. That, actually, incidentally, might cut off some flows to emerging markets; it is not good for the world economy or global integration if that happens. I think that really does need looking at very carefully. We have a problem with this Directive, also, because the way it is written is rather in the way of “one size fits all”: it is trying to cover everything which is not UCITS. That embraces a vast range of funds, not just hedge funds, private equity and some of these other funds in which we also invest, and there seems to be very little understanding from the drafters that these are different activities and you have to tailor-make the regulation and transparency requirements and other requirements (for example, on leverage) for each different type of activity. We do not really see that in the Directive; it is a bit of a muddle, I am afraid, from that point of view. We have also, I think, some concern about the way this comes out in a discriminatory fashion. It has been mentioned already that the private equity funds would be put at a disadvantage in terms of the disclosure requirements compared with individual entrepreneurs or some other types of people who actually do the same sort of thing as private equity funds but would not be covered by the Directive. It is true that the banks, if they run hedge-fund-like activities, would be exempt from the

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Mr Peter Montagnon
Directive. That means there is a distortion in the market there, as well, and distortions are not good things for markets, generally. In another area, something that we have picked up in the draft that we do not particularly like is that it suggests that hedge funds should not be permitted to indulge in what was called “naked short selling”. If you are going to legislate short selling, and it is debatable whether you want to do that, you should not just single out one category of investor and say: “You can’t do this and everybody else can”. It is not thought through, from that point of view, and we want the discrimination removed if we think it should be, if we are not going to get distortions in the market from the way people are supposed to behave. Then, finally, I think one of the other things we would like to see—and this would be the hallmark of good quality regulation—is we think it should be compatible with MiFID, with the existing regulation, and it is not. I think that will add quite a lot of compliance burden and compliance costs if that is not corrected. So there we are, I am afraid. It has actually got some potentially quite useful things in this: the passporting, the opening up of the markets, a sensible level of investor protection for wholesale investors which would enable that, and the possibility of enabling the authorities to get a bit of a handle on systemic risk. That is all potentially useful stuff, and we would not deny that. However, the actual detail, as it stands, means, I am afraid, from our point of view, as users of the market, it simply is not fit for purpose. That is, perhaps, the right place to stop. Thank you.

Chairman: Thank you very much, Mr Montagnon.

Q20 Lord Watson of Richmond: Thank you very much. What I think has been most interesting about the evidence you have given is that there is probably a political assumption, or a practical assumption, in this room that something is going to happen; that the politics of the situation require a Directive. What you have indicated is where there are pieces worth rescuing within this potential Directive. My question is this: to what extent are you and your organisation actually proposing quite specifically how you think this thing should be regulated so that it can do what it can do well and not do what it will certainly do badly?

Mr Montagnon: This is quite a long, drawn out process, and I do not think it is our job, also, to draft an entirely different Directive. What we are doing at the moment is sifting through it, trying to identify the things which are worth keeping or useful and making sure they are drafted right. At the moment, we are mostly focused on identifying the things which are not helpful and trying to address those, because in some of those areas there is a major political debate. I would say that the passporting idea to me is pivotal; it is very important because if you have passporting then you do have a sort of EU level market, because people can sell the products across the whole of the European Union. When you have created that EU level market you do have justification for, as it were, EU-level registration/authorisation, and so the European Union has some say in the matter. If you do not have passporting, surely, the logic is that it reverts back to national markets and, as has also been mentioned here today, we do have regulation in force for hedge funds in our own territory and private equity in our own territory. If there is going to be no passporting there is no real need to move away from that; each Member State could be left alone to do its own business. I think there will be a big political debate about passporting, because I think some continental countries do not want it, but if they cut passporting out you have to ask yourself: is there a point to this Directive at all?

Q21 Baroness Hooper: Thank you. I think you have probably answered, more or less, my question with that last point. I was going to ask if, because of our dominant position in this market and the fact that we do have existing regulation, we are at a greater disadvantage than anybody else within the European Union.

Mr Montagnon: I think we are, possibly, under threat from some political interests in the European Union who would like to do down the City of London and, maybe, create centres of their own. I actually think, from our perspective, it is not necessarily a good idea just to bang the drum for London, and I do not think we would get very far with the argument of “It’s the universe versus us”. I think the point is worth making, more generally, in a European context, that Europe needs strong financial markets and, probably, a strong financial centre. It is actually to the benefit of Europe if we get this right and we should stop thinking in terms of: is this the French, or the Germans or others against the City; it is actually what (because this Directive is a European initiative) is good for Europe? Good financial markets and a strong financial centre are good for Europe, and that is the context to look at it in.

Q22 Baroness Hooper: If you make the whole thing too restrictive, is it as bad for Europe as it is for the City?

Mr Montagnon: I think so because the danger, as I mentioned earlier, is that there is a protectionism element of this which would cut Europe off from the mainstream financial markets, mainstream capital flows, and we really need to avoid that.

Q23 Lord Browne of Madingley: Can I ask a bit more about regulation? As I understand it, presently drafted, quite a lot of the regulation of alternative investment funds is removed from national entities, so subsidiarity is distorted some way. Firstly, do you think that is right? Secondly, what is your view of how these things should be regulated? What is the ideal view?
Mr Montagnon: I think that the drafting gives the Commission quite a lot of powers, particularly to impose leverage limits and that sort of thing, which I think is really quite a bad thing because it is arbitrary and it is not properly explained. More generally, I think—and you have seen this in the debate going on in other connections—one of the things that is being learnt as a result of the crisis is that we are going to have to move, because of the cross-border nature of these activities, a bit more in the direction of having regulation done at the European level. We are feeling our way on this, and we will need to feel our way in the context of this Directive as well. I think if there is going to be passporting then there have to be some things done at the European level, but my view is still that you should keep as much as possible at the national level the operation of regulation. There is a question about this Directive with whether it is what is called “minimum” or “maximum” harmonisation. If it was maximum harmonisation you would only be able to be authorised to run these funds if you had EU registration. If it was minimum harmonisation, for your own nationals and your own markets, you would be able to run these funds under national regulation. I think to preserve this idea and preserve subsidiarity might well be worth looking at.

Q24 Lord Browne of Madingley: Would it be right to say that, conceptually, at least, what applies in banking should apply here?  
Mr Montagnon: I think, probably, yes.

Q25 Lord Jordan: Having listened to the previous two institutions extolling so many virtues that Mother Theresa would be in danger, I welcomed your pragmatic approach, which is to look and say: “How can we take on what is in front of us and finish off with a product that is not harmful?” One of the ways, surely, would be to identify the risks that are within this sector and be able to show that what is contained in the proposed Directive does not tackle these and, secondly (do what you have in part), show what positive parts, as with the passporting, should be concentrated on, and I welcome what Lord Watson said. Having done that job and having broadcast it to those people who want the same end as yourself gives people like ourselves ammunition to take the case forward for a good Directive rather than a bad one. 
Mr Montagnon: The answer about what risks are within this sector, I think, is an interesting one, partly because we are talking, from the point of view of the Directive, about a number of different sectors here; hedge funds, private equity funds, property funds and commodity funds are all different. So it is not one sector, which does create some problems because there is a bit of a “one size fits all” in the drafting. Generally speaking, I think one of the problems we have is that it is very difficult to identify, from the sectors affected, that there are real systemic risks. It is not as if the hedge funds were the main cause of the crisis, it is not as if they have turned out, as a result of this crisis, to be systemic risks; in fact, in some ways, it has been quite helpful to have them because they have absorbed losses which otherwise might have gone elsewhere and caused more problems. So they have been, perhaps, a bit of a buffer. It is very difficult, in my view, to argue that private equity involves systemic risk. There are some issues with the hedge funds, I suppose, about the levels of leverage and, also, as we have heard, behaviour in the markets which do probably warrant a bit of attention and transparency and do probably warrant the regulator’s attention. However, generally speaking, I would say these are not the sectors where there is large systemic risk and, therefore, it is appropriate that any regulation should be reasonably light touch and, where possible, also, as local as possible. We are not there, politically, in the European debate, and, as I said, I do think we have to acknowledge it is legitimate that the regulators have the information they need in order to identify systemic risk as it arises because the analysis I gave you could change at some point.

Q26 Chairman: If I could be allowed a final question, the United Kingdom must, on the whole, be in favour of passporting, as you suggest, both on the investor side and on the producer side, because, after all, historically, we have a long record in selling these things. Passporting is a Directive proposal. Is there opposition among other EU states to passporting? 
Mr Montagnon: I think there is going to be a political debate about it, which will partly arise if those people who actually want, instead of building up the markets, as it were, for one reason or another, to choke them off. So if your aim is to choke off hedge funds or private equity for some political reason, then you will, on the whole, not like passporting. I think that debate has yet to play out, although I expect it will happen.

Q27 Chairman: It suddenly struck me there was a bit of, as yet, undisclosed resistance. 
Mr Montagnon: I think when the debate arises, as I said earlier, it is very important to ask yourself: if you do not have passporting, what is the point of the Directive? It will be interesting to see how they answer that.

Q28 Chairman: And what is the point of a European Union? That is the way we are all trying to go. 
Mr Montagnon: Yes.

Q29 Chairman: Thank you very much, Mr Montagnon. That was terrific. Thank you very much for coming.  
Mr Montagnon: Thank you very much for your time.
Memorandum by the Association of British Insurers (ABI)

The Association of British Insurers (ABI) represents nearly 400 member companies and is the voice of the insurance and investment industry. Its members constitute over 90% of the insurance market in the UK and 20% across the EU. They are also large institutional investors controlling funds worth some 1.8 trillion euros, with substantial holdings in European markets.

1. What economic benefits arise from Alternative Investment Funds? What risks to financial markets arise from Alternative Investment Funds? Will the Directive help reduce these risks?

ABI members are large institutional investors controlling funds equivalent to around 1.8 trillion euros. Their job is to invest those funds for the ultimate benefit of individual investors.

In order to be able to do this effectively, they depend on efficient capital markets and on there being a wide choice of vehicles and asset classes in which they can invest.

The scope of the Directive is very wide—it covers not only hedge funds and private equity but also property funds, investment funds and other unregulated collective investment schemes. This means that the specific economic benefits vary according to the fund in question.

However, there is one benefit that is common to all of them: they allow investors to diversify risk and tailor their investment strategies.

For our members, risk diversification means that they can invest a relatively small proportion of the assets they have under management in these Alternative Investment Funds. This allows them to gain exposure to different sectors, investment and trading strategies, and potentially increase their returns. Of course, the vast majority of their overall assets will be invested in traditional asset classes such as equities and sovereign or corporate bonds.

It is very important to note that not all AIFs are risky. On the contrary, some funds caught within the scope of this Directive are arguably a lot less risky than instruments that can be purchased by a retail investor without any intermediation (eg via direct access to equity markets).

In terms of risks posed by AIFs, our starting point is that there seems to be little or no evidence that hedge funds, private equity and other AIFs have contributed in any significant way to the recent financial crisis. Both de Larosière report in Europe and the Turner report in the UK acknowledge this. Many funds are simply too small to be systemically risky, or they conduct the kind of business where failure of an individual fund would have little or no effect on other institutions or market as a whole.

Because of this, and despite not disagreeing with the overall aims of the proposal, we believe that the manner in which they have been realised is flawed. The Directive seems to be an attempt to address both the issues of systemic risk and those of investor protection, which is laudable. But as the Commission did not conduct a full impact assessment or a proper cost benefit analysis before publishing its proposals, the evidence to support either of those objectives is often unconvincing and sometimes inadequate.

It is worth pointing out that many market participants have regarded the activities of various AIFs as being beneficial. Apart from providing an opportunity for investors to diversify risk across their portfolios, as already mentioned, they also bring liquidity to the market, and provide capital to companies and sectors not very well served by traditional investment strategies (for example, private equity investment).

We are also not aware of any evidence that investors have suffered in the hands of these funds. Professional investors such as our members conduct a great deal of due diligence before choosing to put their money in an AIF. As they are often doing so on behalf of clients, they owe those clients a fiduciary duty as well.

Our members believe that the level of protection proposed by the Directive is too high. It is in many cases higher than that for retail investors in the UCITS directive. It is not clear why this should be the case. Importantly, it also creates an unlevel playing field in investor protection across different pieces of European legislation: the same investor could expect a different level of protection depending on what Directive the vehicle it chooses to invest in is caught by.

2. To what extent is there a need to create a single regulatory regime for Alternative Investment Fund Managers in the European Union? Does the Directive achieve its objectives? Should the objectives of the Directive be modified?

The existence of a European single market, and legislation such as MiFID and UCITS which harmonise large swaths of the investment universe across the EU, suggest that a single regulatory regime for AIFMs in Europe would be a positive step forward. Fund managers authorised under this Directive and in possession of a passport would be able to market across Europe. This is an attractive proposition for investors as it opens up choice and competition.
However, we envisage several potential drawbacks.

First, there is a danger that the Directive fails to deliver on its aims. As currently drafted, this will almost certainly happen instead of opening up European markets, the provisions are likely to shut them down. We elaborate on some of the main reasons why this could happen in our answer to Q7.

Second, the scope of the Directive is very wide and catches a lot more than hedge funds and private equity. The idiosyncrasies of various funds—for example, the differences between redemption facilities or legal structures in property funds compared to a straightforward hedge fund—make it very difficult to apply a one-size-fits-all solution.

Finally, although the Directive aims to create a single market in AIFs, we believe there is scope for domestic regimes to continue after the implementation. If a fund wishes to passport across other member states, than it should comply with the Directive requirements. But if, say, a third country fund wishes to market in one member state alone, and this is permitted under the current national regime, we see no reason why this should not be allowed to continue. This respects the principle of subsidiarity while creating a level playing field for funds wishing to compete in Europe.

In terms of the stated objectives of the Directive, please see our response to Q1. To summarise—we welcome the possibility of there being a passport for AIFMs but we are concerned that any benefits will be cancelled out by strict limitations on how funds can operate. We are not convinced that all of the funds in question are systemically risky, or that investors need the level of protection envisaged.


From the investor protection point of view, it is important to remember that there is some degree of risk in all investment and that this is not something that can (or should) be regulated away. This is not simply the market risk but also, for example, liquidity or counterparty risk. The amount of risk will vary across different asset classes and strategies.

For institutional investors, alternative investments represent a relatively small proportion of their portfolios. It remains to be seen whether this is set to increase as investors diversify their portfolios further and seek new avenues to increase returns.

It is important to note that what insurance companies can and cannot invest in is itself heavily regulated. In other words, a decision to invest in a high risk/high return vehicle or asset class (which not all AIFs are) is not taken out of context and without reference to portfolio as a whole, nor is it divorced from the rest of the regulatory framework.

Other directives, such as MiFID and UCITS, provide a benchmark in terms of investor protection given to professional and retail investors respectively. The AIFM Directive, most relevant for professional investors, in some cases prescribes the standard higher than that in UCITS. This does not make sense—for European regulation as a whole, or for the Directive in question.

This is not to say our members would not welcome some additional protections. For example, they are largely supportive of the need for AIFM registration and the proposed disclosure obligations though they do need some fine-tuning and should ideally be subject to a proper cost-benefit analysis. But there needs to be a balance between investor protection and costs created by its demands.

In terms of wider, systemic risks, we do not believe the Directive is proportionate given the role of AIFs in the financial crisis. For example, although a significant number of hedge funds have been liquidated over the last year or so, this does not seem to have spread contagion to other financial institutions. Also, the amount of leverage used by such funds is pretty low and apparently a lot lower than in the heavily regulated banks.

The point at which AIFs such as hedge funds, which can have systemic implications, impact on the rest of the financial system is the point where they interact with it. That is usually the institution such as the bank/prime broker. There is evidence that not only have prime brokers reduced their exposure to alternatives in an effort to repair their balance sheets but that AIFs themselves have tried to avoid concentrating their counterparty risk by using several prime brokers. Arguably, this is the efficient market working in practice.
4. Is it appropriate to regulate Investment Fund Managers, rather than the Fund itself? Does the Directive contain appropriate provisions to distinguish between different types of alternative investment? Does the scope of the Directive create a danger of unintended consequences?

We believe it is appropriate to regulate AIFMs rather than the funds themselves.

The provisions of the Directive are too granular to be applicable to all types of funds that fall under its scope. It is not clear whether the Commission’s intention was to cast a net very widely or whether the problem arose as a result of a difficulty of defining a hedge fund. Either way, a lot more thought needs to be given to how the provisions apply to certain funds. For example, investment trusts are already subject to extensive legislation via the Prospectus and Listing directives. It is not obvious why those are deemed to be insufficient and what additional protections this Directive is trying to provide. The benefits that the AIFMD arguably provides for other funds—the passport and additional transparency—simply do not apply in their case: they already have the equivalent of a passport as they are exchange-traded, and the directives to which it is subject provide a great deal of transparency.

This one-size-fits-all approach has also produced some unfortunate—and possibly not unintended—consequences. For example, the application of liquidity or valuation provisions does not translate to private equity or property funds, investment trusts, etc. The imposition of these requirements on such funds would be unfair and potentially damaging.

A further consequence stems from the directive’s incompatibility with existing regulations, notably MiFID and UCITS, as already noted. Many large asset management firms (and others) will have managers who have to comply with three layers of overlapping but slightly different regulation. This clearly adds unnecessary and burdensome requirements that will raise costs for no added value to the client.

5. What is your evaluation of the Commission’s consultation in the preparation of the Directive?

The publication of the proposal was preceded by only one consultation of seven weeks, which was focused solely on hedge funds. There was also a conference on hedge funds and private equity. As the scope of the Directive is much wider, large parts of it have effectively not been consulted on at all.

This is highly unsatisfactory—it does not respect the Commissions own Better Regulation principles and at least some of the problems inherent in the Directive could have been pre-empted had there been a proper consultation with the industry.

6. Will the passport system help create a single market in investments funds within the EU? How will the passport system established affect the EU and the UK industry and particularly their position in the global market?

From the perspective of institutional investors, we support the creation of a passport for AIFMs. We believe it will give investors greater access to funds and thus greater investment choice. The authorisation requirements mean that an AIFM will only have to register in one member state—this will streamline the process and reduce costs.


Thresholds: We believe the threshold based on FUM is useful in that it will exclude venture capital funds and other small funds which could simply disappear if subject to high regulatory and compliance burdens. However, there are practical difficulties in how and how often the value of funds is calculated and what happens when it is based on market values which will be out of AIFMs control.

Capital requirements: The capital requirements in Article 14 have been set at a level higher than for UCITS funds. We do not believe this is appropriate, and it is hard to see a justification for the increased level of protection. It is also not appropriate that the capital requirements are linked to FUM, considering client assets are already segregated. It is not clear what the additional capital would be used for.

Leverage: We do not believe that regulators should impose artificial limits on leverage as suggested in Article 25.3. Moreover, we do not think there should be a distinction in the Directive between funds that use high levels of leverage and those that do not.

In investor protection terms, leverage on its own may not be an appropriate measure of a fund’s risk profile, nor is low leverage necessarily better. Disclosing information about the use of leverage to investors is in our view sufficient.
From the point of view of managing systemic risk, we agree that competent authorities should have information about leverage in individual funds in order to be able to monitor aggregate numbers across the market (even though we do not believe that many AIFs have the potential to be systemically risky). But this can be achieved via individual firm reporting to its regulator—and, at EU level, regulators sharing the relevant information. Arguably, the existence of regulation (in terms of capital requirements in particular) for those that provide leverage such as prime brokers already addresses part of the problem.

**Independent valuation agents:** The issue of valuation is one which should, in our view, be tackled in more detail at Level 2. This is because the one-size-fits-all approach is not appropriate: for some funds, such as for example property funds, the requirements for frequent valuation will be too expensive or completely unnecessary.

The Commission should consult further on appropriate standards for valuation bearing in mind different types of AIFs. The consultation should also address whether it would be appropriate to appoint an independent valuer or whether an independent audit of valuation methodology should be sufficient in some cases.

For investors, additional reassurance that an AIFM is valuing its assets properly, and that there are no conflicts of interest which would result in a less than fair treatment of investors, is welcome. However, investors also recognise that independent valuation may in some cases be no better informed (and therefore valuable) than the one done by the AIFM. We are not convinced that the level of investor protection would always be higher with independent valuation. Conversely, it is certain that the costs would rise. There needs to be a balance between the two.

**Depositaries:** The rules on depositaries as currently drafted would have severe and negative consequences for the EU financial markets. Although investors are in favour of clear liability provisions more generally, how this is structured and the outcomes it delivers will depend on what the costs are. If the standard imposed ends up being so high as to reduce the number of depositaries in the market place, and/or increase costs to the point where some business or investment strategies are no longer viable, then this would be a clear net loss for investors.

Specifically, the costs of unlimited liability being placed on depositaries are likely to be very high. It is difficult to imagine that many will be able to afford the cost of insurance that would have to be taken out under this scenario. It is possible that some could not continue to provide services at all, or they would have to limit them to “safe” jurisdictions. This would have a major impact on investors wishing to invest in emerging market funds. The same problem arises in the context of a prohibition on sub-delegation of custody.

**Delegation:** The restrictions on delegation to authorised AIFM only would have negative consequences for investors in AIFs. As currently drafted, they would prevent AIFMs from using third country managers with local or specialist knowledge where this is in the best interest of the client. Many firms delegate portfolio management to local managers in, eg Asia, as they have the local expertise. This is standard practice for many asset management firms.

There should also be no prohibition of sub-delegation. Service providers often delegate to others in order to benefit from specialist knowledge and to stop them from doing so would presumably mean they would have to seek a worse—or at least a more expensive—solution.

8. **Will the provisions strengthening disclosure requirements help to create a more transparent market or do they go too far?**

Overall our members are supportive of the transparency requirements to investors. There does, however, need to be some acknowledgement that professional investors should, as under MiFID, request further information where they want it. This puts the onus on their own due diligence.

The disclosure requirements imposed on private equity companies in Recital (17) and Articles 27 and 28 are excessive. Our members do not regard investing in private equity is inherently or quantifiably more risky than investing in any other type of AIF, or believe that private equity companies should be subject to higher level of regulation than other private companies. If the Commission believes there is a lack of transparency in the private sector more generally, that is a legitimate subject for a debate. But these funds should not be singled out. If they were, there would be across the EU an unlevel playing field between private equity funds and other privately owned companies which is clearly discriminatory.

There is a serious danger that such funds may simply chose to no longer invest in European companies, which would not be in the interests of those companies or European citizens. In any case, we have not seen any cost benefit analysis about why the proposed changes may be necessary.

In terms of disclosures to the regulator, some thought needs to be given to whether the amount of information provided is excessive. It is not clear whether the authorities are set up to deal with the volume of information they are likely to receive, or indeed what they intend to do with it.
We would also note that many of the funds caught in the scope of this Directive are not very “risky”, so it is questionable what would be achieved by, for example, an AIFM disclosing on a regular basis that they are still running a real estate fund.

We strongly believe the short selling provisions of Article 21, together with any other reference to short selling, should be deleted. This is not an activity unique to AIFs and should not be tackled in this Directive.

9. **What effect will the Directive have upon the position of the City of London and the EU as a whole as a leading location for Investment Fund Managers? Could it cause many hedge funds to relocate outside of the EU? What impact would the Directive have upon professional investors and institutions?**

As currently drafted, we believe the Directive would have a serious impact on the competitiveness of EU financial markets and London in particular. The implications are such that some funds, particularly those domiciled in third countries, may bypass European markets. This would reduce investor choice and damage EU competitiveness in the long term. For example, some of our members invest in funds of hedge funds. Considering most hedge funds are US-based, the investable universe for those funds of funds—and therefore for investors—is likely to be drastically reduced, even to the point where running a fund of funds, or investing in one, is no longer a viable proposition. This places our members at a competitive disadvantage to their global counterparts, and forces them to invest in suboptimal products. This would be compounded by the rules on marketing—if they do not get changed, EU investors would be limited to investing in EU funds alone.

We would also note that there is a danger of retaliatory action from other jurisdictions. If US or Asian funds are to be prohibited from entering the EU, and if the rules on, eg delegation and depositaries limit the amount of investment EU funds can have in those regions, it would not be surprising to see similar restrictions being placed on EU market participants.

10. **How does the Directive compare to existing or proposed regulation of Alternative Investment Funds outside of the European Union, particularly that of the United States? How will the Directive affect the position of EU Alternative Investment Funds in the global market?**

There are limited similarities between the AIFM Directive and the developments in the US. The US Treasury has proposed legislative amendments to remove the exemption for “private funds” from the Investment Advisers Act of 1940. This would mean all private funds above a threshold of $30m would have to register with the SEC. They would also be required to relay certain information to the supervisors (for the purposes of identifying possible systemic risk). There are also increased disclosure requirements for investors.

However, there are notable contrasts. There seem to be no restrictions on leverage or on service providers used by funds, and there are no capital requirements.

While the objectives of the EU and US are the same (to mitigate systemic risk and to protect investors) the US requirements seem much less onerous and much more practical. Consequently, we believe unless amended to take into account the concerns outlined above, the EU risks being put at a severe competitive disadvantage.

We urge the European Commission and other EU G20 members to fully engage with the US (and other nation states) and to commit to adopting compatible legislation.

11. **What effect will the Directive have on flows of capital and financial innovation?**

We believe the effect will be two-fold. On the one hand, capital flows from other financial market centres into the EU are likely to subside. If, say, US funds and/or fund managers are not permitted to market in the EU (or sell even at investors’ initiative, as the current draft would suggest), or if they are allowed to do so but only with severe limitations (eg having an EU credit institution as a depositary), we suspect many of those funds would simply choose to bypass EU financial markets altogether.

On the other hand, the flow of capital from the EU to other jurisdictions is also likely to be affected. If the rules on delegation remain (ie delegation is not permitted unless the person you are delegating to is also an AIFM), many firms will not be able to have operations in other countries. This will particularly affect emerging markets as that is where many funds are delegated. It is also likely that the rules on depositaries would have an impact on emerging market funds. If the costs of taking on liability for such a fund become very expensive, as seems likely, those funds are unlikely to remain viable for firms running them or for their investors.

The flow of capital is now truly global. Closing off the EU market in a way this Directive is likely to do will damage its competitiveness, and have a negative impact on the investment market.

*9 September 2009*
TUESDAY 14 JULY 2009

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 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
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 do so. 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 depositaries 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 redrafting 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 valuation 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.
Memorandum by Mr John Chapman

1. SUMMARY

1.1 The proposed directive should be welcomed as the first step towards tackling the over-financialisation of our economies. Hedge funds, and, on a lesser scale, private equity, are US-bred entities or practices which, overall, are socially undesirable.

1.2 Hedge funds blossomed through an extraordinary deal—no regulation as they would be for the exclusive use of millionaires. They should be seen as UFORGs—unregulated funds of rich gamblers, with the high net worths still the dominant investors in activities largely closed to ordinary people. They present various risks, not least to the entire financial system. They have spawned complex financial instruments, which make effective regulation and even effective economic management virtually impossible. They have successfully challenged the financial aims of elected governments. They have grossly unfair trading advantages over traditional investors.

1.3 With their high fees, and enormous potential rewards, hedge funds are able to attract much talent to run their sophisticated secret gambling strategies. Like talent has been attracted into the hedge funds counterparties, investment banks, with huge rewards again beckoning. Formerly staid traditional banks have been forced into a “me-too” stance, with bonuses encouraging participation in hazardous financial innovations, and have been caught holding the parcel when the music of the latest bubble stopped. The resulting credit crunch has brought the biggest recession for 75 years.

1.4 Private equity leveraged buyouts have fee structures and potential rewards similar to hedge funds, and also operate hidden from the public gaze. They offer selected management personnel huge incentives to carry out questionable financial and operational restructurings, which may leave the targeted companies with depleted assets and heavy debt burdens. High proportions of companies currently “at risk” have had the private equity treatment.

EU regulation

1.5 With strong pressure from the European Parliament, and a direction from G20, the European Commission has prepared what is largely a basic framework directive for Alternative Investment Fund Managers. Coverage, authorization, disclosures, and marketing proposals are set out, but contentious issues arise over caps on leverage, delays for marketing of third country funds, and on disclosure of the intentions of private equity companies to other shareholders and employees of target companies.

1.6 As regards hedge funds, the proposed directive falls short in covering only the managers of larger funds, and in not tackling short-selling, the use of complex financial products, unfair advantages over traditional investors, high fees, and attacks on the policies of elected governments.

1.7 The provisions on private equity lack possible curbs on high fees, incentives for managers, special dividends, and on the loading of debt.

Taxation

1.8 In December 2005 I argued in the Financial Times for a “levelling the playing field” tax on hedge fund activities to offset their several trading advantages over traditional investors (no regulatory costs, no limits on leverage and use of derivatives, no investment restrictions, tax avoidance with offshore locations, etc).

1.9 Other taxes have been proposed. In 2007 the European Parliament socialists advocated a capital gains tax on hedge funds and private equity. In July this year a Federal Chairman proposed to a Senate Committee that financial firms that pose systemic risks should be subject to regulatory and economic incentives, including capital buffers, restrictions on leverage and risk-based premia (in effect taxes). More recently, the Chairman of
the FSA has suggested a general tax on City transactions, which has been likened to the tax on foreign currency transactions proposed by James Tobin in the 1970s.

1.10 Rather than a general tax, a tax specific to hedge funds would not only be just but highly relevant, as the spectacular increases in stock market activities have been very largely due to hedge funds. Such a tax would operate as a disincentive in the transition period before hedge funds (and private equity) are eliminated.

Elimination

1.11 There is no convincing social case for hedge funds or private equity, except perhaps in the minds of those who believe that free market capitalism should have no fetters.

1.12 Moreover, it appears very doubtful if the world of complex financial instruments, largely spawned by hedge funds, can ever be effectively regulated. The alternative is to starve it to death by eliminating hedge funds.

1.13 If particular hedge fund activities can be shown to be socially desirable, they should be absorbed into mainstream fund management.

The City of London

1.14 The worthy aim of the City as the world’s main financial centre has been soiled by allowing it to become the playground of largely US financiers promoting hedge funds and private equity. In any case, the City is in need of “re-direction” because of its appalling short-termism towards UK companies (dividends over R&D and Capex).

2. Background

2.1 Commentators readily point out that “economics” has taken a hard hit with the credit crunch. Adam Smith, Marx, Keynes and Friedman have limited relevance to “financialised” capitalism. One economist with more credibility is the American Minsky, who not only saw that “periodic instability is a normal result of modern financial capitalism” but also recognised that “financial innovation would stretch liquidity in ways that would make the system more vulnerable to disruption”, (Stabilising An Unstable Economy, 1986). The LibDem sage Vince Cable wrote that “A generation ago Hyman Minsky described the mechanisms by which financial markets regularly overreach themselves through excessive leverage, excessive risk taking, greed and folly, leading to panic and then to ‘reversion’: the stopping of credit” (The Storm, 2009).

2.2 Minsky also suggested that as each crisis was contained and “validated”, the stage would be set for more crises that would probably be more frequent and severe. The surge of unregulated hedge funds from some $250 billion in 1996 to $1,300 billion (or double that?) 10 years later, and the explosion in financial innovations, with leveraged derivatives, securitisations and structured products, has increased the likelihood of more severe crises. Minsky commented that the financial innovations were subverting attempts by the authorities to manage economies.

2.3 Minsky foresaw the relative decline of the importance of banks in favour of “markets”. Financial markets could operate with lower spreads because they were exempt from reserve ratios. Competition from lightly regulated markets forced policy makers to relax regulations on banks. The distinction between “safe” traditional commercial banks and “risk-taking” investment banks largely disappeared. Both types of banks grabbed at the latest financial innovations, with staff incentivised through bonuses to take macho risks like hedge fund managers. When securitised assets were exposed as toxic with mortgage-holders defaulting, banks had little idea of their liabilities, and had to freeze the credit markets. Short-selling by hedge funds then put them at the mercy of the authorities.

2.4 In the 2007 report “Hedge funds and Private Equity—A Critical Analysis” the Socialist Group of the European Parliament suggested that “the real economy is more and more dominated by the operational principles of the financial markets”. But financial markets are increasingly dominated by hedge funds. UK equity market turnover as a % of UK GDP has risen from 10% in 1965 to 88% in 1995, and to an astonishing 296% in 2007 (Financial Times). Such activity reflects frenetic (and socially useless?) gambling by the hedge fund fraternity, rather than traditional investment activity.

2.5 Can we escape domination by hedge funds and the nigh incomprehensible financial instruments that accompany them? The route forward must surely lie in regulation to at least grab hold of the hedge fund beasts, in taxation of hedge funds to disincentivise them, and in elimination of hedge funds, with concurrent starvation of the innovators that live off them. Any elements of hedge funds (and private equity) that are socially useful should be absorbed into traditional investment activities.
3. ACTION AGAINST HEDGE FUNDS

3.1 Hedge funds are difficult to define, but have the following features. They are largely unregulated, a position originating from a US deal that they should escape regulation if they were used only for millionaires (who did not need protection). Currently hedge funds are also open to professional investors. Over time pension funds, endowments, and corporations have become hedge fund investors, but rich individuals still account for over 40% of hedge fund assets. The bulk of hedge funds are managed in the USA, with a fifth of hedge fund assets managed in Europe, and of these 80% are managed in the UK. About 70% of hedge funds are domiciled offshore, mostly in the Cayman Islands.

3.2 Hedge fund managers are incentivised by high fees, typically 2% per annum of funds and 20% of profits made, rewards much greater than the typical 1% per annum of traditional fund managers. Hedge fund managers pursue a variety of some 20–30 strategies, with little disclosed about such strategies except their names, eg global macro, or distressed securities. Such strategies may be highly sophisticated, but they amount to little more than gambling on market outcomes. Such bets are typically “laid off” with bets on contrary outcomes; hence the description “hedge funds”.

3.3 The hedge fund industry has shown little enthusiasm for marketing to “ordinary” investors. Such investors would bring higher admin and marketing costs, but perhaps the strongest reason for not embracing them is that doing so would break the “no regulation/millionaires only” deal, and invite regulation. Ordinary investors may have access to funds of hedge funds, but these involve discouragingly high fees.

3.4 Although hedge funds clearly provide handsome returns to their managers and to many of their investors, what good do they bring to the rest of the world?

(a) they increase the liquidity of markets, perhaps particularly in volatile conditions; but it is unclear how significant such a claimed benefit might be;

(b) they increase the efficiency of markets, but again it is unclear what hedge funds bring that traditional investors do not;

(c) they provide pension funds and others with the opportunity of diversifying their portfolios.

3.5 Against such not weighty benefits, hedge funds can be criticized on several counts.

(a) they bring a variety of risks, most notably systemic risks that may threaten the entire financial system, as in LTCM in 1998;

(b) they can overturn the policies of governments as in the UK in 1992, and in Malaysia in 1997; to some, hedge funds may appear as an unofficial American financial army;

(c) they are prone to market abuse, with their close relationships with counterparty investment banks giving opportunities for insider trading, and other relationships giving scope for price manipulation;

(d) their short-selling may severely damage their target companies (as with banks in the credit crunch), and cause great share price volatility in companies they attack unsuccessfully;

(e) they may misbehave as shareholder activists, typically looking for short term gains at the expense of the long term future of companies;

3.6 One little developed feature of hedge funds is the several “unfair” trading advantages they have over traditional investors. I set these out in an article in the Financial Times of 5 December 2005, “Balancing regulation, risks and rewards” (attached). I quote “Hedge funds avoid regulatory costs and restrictions; they can short sell and use leverage and derivatives freely. Compared to other investors, they can take more concentrated positions and be more illiquid. They can adopt arbitrary valuations and use tax havens. They have mutually beneficial relationships with investment banks and prime brokers, with exchanges covering not only borrowings and commissions, but perhaps also commercial information—what the FSA calls “testing the boundaries on insider trading and market manipulation”. With such advantages hedge funds can entice talented fund managers with lucrative performance fees” One New York prime broker commented that, in comparison, traditional fund managers have their hands tied behind their backs. I proposed a tax to level the playing field.

3.7 Amazingly, neither the traditional fund industry nor the competition regulators have cried foul over such clear unfair trading advantages. I sent my article to Jean-Claude Trichet, President of the ECB, and in a lengthy personal reply of 23 January 2006, Trichet wrote as follows in response to my question “Should the playing field be leveled?”

“The arguments that are commonly invoked to argue for a possible regulation of hedge funds pertain mostly to the areas of financial stability, market integrity and investor protection. In your letter you provide another argument related to the level playing field for all market participants, as, compared to
other market players, hedge funds have few external restrictions on their activities stemming from minimal or light-touch regulatory constraints and flexible mandates. Though competition issues do not fall within the ECB’s competence, I would like to make the following observations.

First, in the European Union several aspects of hedge fund activity are already directly regulated as they fall within the remit of European financial regulation (Mifid, etc). Second, the differences between traditional funds and hedge funds are becoming somewhat blurred, partly due to the expansion of the hedge fund industry and regulatory developments (such as UCITS 3) which allow traditional funds to pursue more hedge fund-like strategies. Third, given the nature of the hedge fund business and the higher concentration of hedge funds in offshore centres, full direct regulation will probably be only effective if it is well coordinated at the international level. Fourth, authorities have up to now addressed the financial stability concerns posed by hedge funds in an indirect way, ie through their interactions with regulated entities such as banks. In that respect I can refer to the sound practices for banks’ interactions with highly-leveraged institutions as developed by the Basel Committee on Banking Supervision. Finally, the absence of direct regulation may not necessarily translate into a trading advantage as counterparties might be reluctant to pursue business with unregulated entities for reasons of sound management practices."

3.8 Trichet’s arguments did not refute my claim of unfair trading practices, unless perhaps there are unpublished examples of counterparties refusing to work with hedge funds because they are unregulated. He did, however, refer to apparent practical difficulties of achieving effective regulation at the wider international level.

3.9 Weighing up the plusses and minuses for hedge funds, it is difficult to conclude other than in general they are socially undesirable.

4. ACTION AGAINST PRIVATE EQUITY (LBOs)

4.1 Action against private equity should be focused on leveraged buyouts (LBOs). Such buyouts became popular in the USA in the 1980s and 1990s, and the US private equity companies have brought their practices to the UK. Typically public companies are bought by a private equity consortium with the purchase financed through one-third equity and two-thirds debt. The private equity company becomes the General Partner, to be rewarded largely through a fee of 2% of funds and 20% of profits, after a hurdle level sufficient to cover returns to the Limited Partners, institutions who are rewarded according to the risk levels of the loans they have provided.

4.2 Making the purchased company private enables financial and operational restructurings to be carried out without outside scrutiny. An important feature of LBOs is the incentivising of company directors and officials to carry out the desired restructuring, with a CEO being offered on average 5% of the equity and his team a combined 16% (LBS study). Such restructuring may often involve the realization of assets, and an increase in the debt burdens of the companies, along with genuine economies in operations.

4.3 The offering of incentives may involve questionable practices with selected directors and managers offered the life-changing chance of becoming multi-millionaires if they will co-operate in the realisation of tens or hundreds of millions for the private equity company. The various steps of the buyout of Debenhams are set out in Annex 2 Here substantial increases in debt, the sale and leaseback of property, and the cutting of capital expenditure enabled the private equity company to make profits of over £1 billion, with the three incentivised managers sharing £100 million. The share price of the refloated Debenhams fell steadily.

4.4 Examples like Debenhams and other LBOs involving substantial job losses encourage a “wider public suspicion of private equity” (Sir David Walker in his 2007 report on private equity transparency), and headings like “Private Equity’s Gain is Our Pain” (Robert Peston in Who Runs Britain? 2009). But by no means all LBOs have negative outcomes. Nevertheless, the 2007 Critical Analysis report concluded from its numerous case studies that LBOs are simply about extracting rather than creating value in the companies. The report pointed to “Reviews of LBO deals five years on, undertaken by the McKinsey consulting firm, have repeatedly pointed out that more than half of those deals have been industrial failures and have massively destroyed value. But they have been generously profitable for private equity funds and their prime brokers”.

4.5 A 2009 Ernst & Young report indicated that more than half of the profits generated by private equity firms in recent years have been made by piling debt on to the books of the companies they invest in. The higher the amount of debt used to buy a company, the better the return in a successful investment. Only a fifth of the profits came from strategic and operational improvements.

4.6 Higher debt burdens on targeted companies reduce their chances of survival. Standard & Poors reports on “weakest link” companies (those with a B minus or lower rating, and nearest to default) feature private equity involvement. A July 2009 report indicated that of the 293 “weakest link” companies more than half
have or have had private equity holdings. Of the further 140 companies that actually defaulted, private equity firms were involved in at least 79 of them.

4.7 It is difficult to reach any conclusion other than in general private equity LBOs are socially undesirable.

5. Regulation

5.1 Pressured by the European Parliament and fired by a G20 direction, the European Commission published a draft directive for Alternative Investment Funds on 29 April 2009. The directive covers all non-UCITS funds, though omitting managers with portfolios under 100 million euros, and those under 500 million euros with no leverage and no redemption rights for five years. It sets out authorization requirements and disclosures to investors and regulators. Authorised managers will be permitted to market to professional investors in other member states.

5.2 The disclosure requirements are broad-brush, though the requirements on private equity companies to disclose investment strategy and objectives to other shareholders and employees will be controversial.

5.3 Particular controversy will arise over the proposal that the Commission should set caps on the leverage allowed, and on the proposed three year delay on the right to market funds with third country domiciles in member states other than that of the manager of the funds.

5.4 An EU-wide single regulatory regime will clear up the confusions arising from the various practices of different member states towards hedge funds. An initial focus on fund managers rather than funds appears sensible, given that it is the fund manager who takes the decisions on the management of the fund.

5.5 No doubt the EU is casting an eye over the development of US regulations. In July the US Treasury announced a bill requiring all managers with “private” funds (including hedge funds, private equity funds and venture capital funds) to register with the SEC. Once registered, the managers will be subject to regulatory reporting requirements on assets, leverage, etc, disclosure requirements to investors, creditors and counterparties, conflict of interest and anti-fraud prohibitions, enforcement and record-keeping requirements, etc.

5.6 Though there are broad similarities in the EU and US proposals, they appear to be particular differences in the “controversial” areas of caps on leverage, delays on full marketing of third country funds, and on disclosures by private equity firms. Given that both hedge funds and private equity are essentially US entities it is unlikely that the US authorities will lead with the more demanding requirements, though, as indicated below, steps like caps on leverage are being considered in the banking sector.

5.7 To some, the proposed directive can only be a starting point towards an effective drive against the socially undesirable hedge funds and private equity. More specific action is required to limit short selling, to remove over-generous fees, to restrain attacks against government policies, and to compensate for unfair trading advantages over other investors. Curbs on the use of complex instruments, like derivatives and structured products should also be considered.

5.8 Similarly, on the private equity side, curbs on high fees, special dividends, incentives to managers, and the loading of debt should also be considered.

5.9 If a tax on hedge fund activities were to be introduced it might be necessary to bring hedge funds within the regulatory ambit, if only so that their buying and selling could be recorded for tax purposes.

6. Taxation

6.1 A major purpose of taxation would be to reverse the growth of the socially undesirable hedge funds. A particular rationale of a tax would be to level the playing field between hedge fund and other investors, as I suggested in 2005.

6.2 The 2007 Critical Analysis report suggested a capital gains tax on hedge fund and private equity profits.

6.3 In July 2009, Sheila C Bair, Chairman of the Federal Deposit Insurance Corporation, suggested to the Senate Committee on Banking, Housing and Urban Affairs steps for a framework for systemic risk regulation “Financial firms that pose systemic risks should be subject to regulatory and economic incentives that require these institutions to hold larger capital and liquidity buffers to mirror the heightened risk they pose to the financial system. In addition, restrictions on leverage and the imposition of risk-based premiums on institutions and their activities would act as disincentives to growth and complexity that raise systemic concerns”.

6.4 Although Chairman Bair’s proposals may have been primarily addressed to banks and like institutions, hedge funds also pose similar and probably greater systemic risks, and measures like restrictions on leverage and risk-based premia (taxes) could also apply.
6.5 In a much publicized discussion with the August issue of the Prospect magazine, Lord Adair Turner made general references to a possible tax on the in part “socially useless” activities of a “bloated” City. Many commentators then dug out the 1970s proposed “Tobin tax” on foreign exchange activities.

6.6 Rather than a tax on general City activities, which would also hit traditional investors, it would be more sensible to tax buying and selling by hedge funds. As indicated above, EU regulations might have to be extended to facilitate EU-wide taxation.

6.7 Consideration should also be given to a tax to disincentivise private equity LBOs in general, or to restrict particular activities, eg the building up of debt, the offering of incentives, and the declaration of special dividends.

7. **Elimination**

7.1 Given that in general both hedge funds and private equity are socially undesirable, the aim should be to eliminate them. But it is possible that certain hedge fund activities are socially useful. If so, they should be absorbed in traditional fund activities, with perhaps some lightening of regulation of those activities. As Pauline Skypala, the editor of FTfm, wrote on 13 July “Rules could send hedge funds into mainstream”.

7.2 Similarly, there may be particular circumstances were LBOs would be socially useful, and not involve the realization of assets, gross incentives to particular managers, the creation of heavy debt burdens, or indecent profits to the private equity companies. A relevant public authority should approve such circumstances.

7.3 With the bulk of hedge fund activities eliminated, much of the rationale for complex financial products may be removed. Without these management of economies should be a more feasible task, until at least the next tsunami of financial innovations arrives.

8. **The City of London**

8.1 There has been concern over the possible impact of EU regulation on the position of the City as a leading international financial centre, and on UK balance of payments, employment, etc. Unfortunately the admirable aim of making the City the leader of world finance has been soiled by the UK’s open door policy to essentially US-bred socially undesirable hedge funds and private equity companies. Maybe the UK authorities should seek EU or IMF assistance to help with the wind-down of HF and PE activities.

8.2 Promoters of the City should take heed not only of Lord Turner’s “bloated” and “socially useless” comments, but also recent comments of others in the Financial Times. For example, LSE professor Willem Buiter considers that “the UK financial sector has become a destabilizing force to the UK”. (The OECD has forecast that the UK may be the last to come out of this deep recession, because of its over-reliance on financial services). Harvard Economics professor Benjamin Friedman notes that “For years, much of the best young talent has gone into private financial firms. We are wasting our most precious resources”.

8.3 The pomp of the City has been a burden rather than a boon for UK companies. As Secretary of the Department of Trade and Industry’s Innovation Advisory Board, I introduced the DTI’s R&D Scoreboard and in 1990 wrote a polemic “Innovation: City Attitudes and Practices”, bringing out the City’s preferences for dividends over R&D. A high level City/industry debate then followed, but few industrialists dared take on the City. Over the subsequent years I have attacked City short-termism in the Financial Times, the Guardian and the Independent.

8.4 Last year I used the 2007 R&D Scoreboard to derive national/regional averages of company performances in 19 internationally traded sectors for particular operating factors- profits, dividends, interest, cost of funds (dividends plus interest), R&D, and capital expenditure, all as a percentage of sales. I then rated such sector/ factor averages using a (standard deviation) rating system (which I originally introduced, and KPMG adopted, for rating pension company charges).

8.5 The results of such ratings are shown in Table 1. The UK comes out second to the USA in terms of profits, top in terms of dividends as a % of profits, top in dividends, ninth out of 10 for interest payments, and top in costs of funds. UK companies are (forced to be) very generous to their shareholders, predominantly City institutions. In contrast, the UK comes out ninth of 10 for R&D, bottom in capital expenditure, and rock-bottom in terms of investment (R&D plus Capex). The City institutions are failing in their corporate governance in not ensuring that UK companies are investing adequately in their future.
8.6 There is a desperate national need to “re-direct” the City away from the short-termism of hedge funds and dividend-seeking institutions towards a regeneration of UK companies with much greater emphasis on R&D and capital expenditure. The aftermath of the credit crunch and the attack on financialisation beginning with the directive on hedge funds and private equity provide a great opportunity.

9 September 2009

Examination of Witness

Witness: Mr John Chapman, ex-Civil Servant, examined.

Q68 Chairman: Good morning, Mr Chapman. Thank you for coming to give oral evidence to us this morning. You should have in front of you a list of interests that have been declared, a note from ourselves. The session is on the record; it is being recorded for a webcast. I am sure that you know that you will receive a transcript of the evidence and, should there be some oddities that you identify, then by all means do make corrections for the final version. We have about 40 to 45 minutes and a lot to talk about, so it would be extremely helpful if we could get through about seven questions. It would be useful if you could keep your initial responses fairly brief and to the point so that if people want to come in with supplementary, which tends to happen as you know, that will be possible. We will start straight in with the questions that you have, but if there is anything that you would like to say first to us by way of introductory remarks, please do.

Mr Chapman: Thank you, My Lord Chairman. I would like to say very briefly that I am an ex-civil servant, a journalist and I look at the big issues. In looking at hedge funds, I think that there are three aspects to look at: the definition, the deal and what I call the devastating effects. Definition? Very difficult. Funds and activities free from regulation with high rewards for operators. All this originated from a bad “American” deal in 1982 which said that hedge funds, or these activities, could be used in public markets if reserved for millionaires only. It virtually amounted to telling millionaires that they could drive any Formula One car or any vehicles down motorways. I think that there are five devastating effects which come from this. First, little talked about, multiple trading advantages over losing traditional investors. In Money Management in 2007, I set out 17 different trading advantages. The second point is that there are some $1.5 trillion in unregulated funds wallowing around the world, posing major systemic risks. $1.5 trillion may be an underestimate; some put it at £2.5 trillion. The third point is questionable behaviour. Hedge funds challenge governments; they create or ride market bubbles; they gamble rather than invest; they short sell and they carry out unwelcome shareholder activism. The fourth point is that a high-risk, high-reward bonus culture from the high rewards for hedge fund operators has spread throughout the financial sector—bringing the bonus culture, with systemic risk higher, with more people taking more risks. The fifth point is that complex financial instruments have grown up with hedge funds, with their complex, 20-odd strategies, that have been backed by complex financial instruments, derivatives, leverages, CDOs, CDSs, SIVs—a whole panoply of almost incomprehensible instruments, which are not only nearly incomprehensible, they are virtually uncontrollable. So what has actually been created by this very bad 1982 deal is a financial monster. I think that people are now realising this and they have to get to grip with it; hence the EU directive and the Obama Bill.

Chairman: Thank you very much. I am sure that we will take up some of those points as we go on.

Q69 Lord Renton of Mount Hary: I have read your evidence with great interest. What I would like to ask you about, accepting the history, accepting how they got started and accepting what a monster they are now—which is your strong view—is a bit more about the specific detail of the directive. That is what our report has to be about. In particular, I know that you welcome it in general terms because it is tackling the over-financialisation of our economies, but is there really a basic need in your judgment to change the regulatory regime, both for hedge funds and private equities? If so, do you think that the proposed directive will be effective in doing that? In a sense I think that is at the heart of what we are asking or looking for. Finally, will the directive introduce over-stringent regulations, which already some people are telling us it would, or does it not go far enough, or is it about right in your judgment?

Mr Chapman: Taking the first point, obviously I do think that there is merit in directives, both in Europe and in the USA. I have gone on record as saying that they should be followed by taxation and elimination of hedge fund activities, except for the ones which are deemed worthwhile and can be brought into traditional fund activities. As for the directive and whether it will be effective in tackling all the hedge fund activities and the allied activities, it is a first step. What with the enormous political pressure from the hedge fund world and the private equity lobby, it will not be a very draconian directive; it will be a first step. I would say that, if one were going to a more extreme position, on the hedge fund side I think that one should add short selling; tackle the fees; reduce unfair trading; and control the complex instruments. Similarly, on the private equity side, the high fees, the
asset stripping, the debt loading, the incentives to managers, special dividends put out—all those ought to be looked at. That is if you were doing a really thorough job; but this will be a compromise directive. It can only be a first step; it can only go so far.

Q70 Lord Renton of Mount Harry: Do you think that it is appropriate for the EU Commission to produce a directive on this subject, given too that, as you are saying, it is only a first step, or would it be better, as some people have said, to leave it to the major countries themselves?

Mr Chapman: The EU is not a major country but it is a major grouping of countries.

Q71 Lord Renton of Mount Harry: Of course it is, but what about leaving it to Germany, France and the UK themselves?

Mr Chapman: They have all made their little nibbles on the subject so far—and a bit of a mess, I think. IOSCO, the G20, all these people, have said more or less that the EU should go ahead and produce a directive, and also people like Trichet at the Central Bank. Yes, I think it is important that the EU does take collective action. People say, “Is it right that the EU should be doing it?” There is a parallel going through in America, which the hedge fund lobby hides their eyes to. It is being tackled by, let us say, two of the major groups in the economic world.

Q72 Lord Jordan: Recognising that people take greater risks depending on the rewards, and that it is people who usually cause the problems when you get down to it, do you consider it appropriate to regulate the investment fund manager rather than the fund itself?

Mr Chapman: There is some debate about this. I think that catching the manager is the first thing to do. If one goes further and looks at taxation of hedge funds, one has to grab hold of the funds as well. When I talk about taxation, I am not the only one. I may have suggested it back in 2005, but many other people are talking about the taxation of financial activities at the moment. I think that bringing hedge funds into the directive would tackle the offshore problem, the evasion of taxes, and also make it easier to tax the hedge funds themselves.

Q73 Lord Jordan: Do you think the directive as it is presently takes enough account of the activities of the manager?

Mr Chapman: There are many activities that the manager does with hedge funds which are not covered by the present directive, notably short selling, and there are others as well. They hope to put caps on leverage but there is no control over the use of derivatives or of other complex financial instruments. I think that in an ideal world they might be tackled as well, but that is a formidable problem.

Q74 Chairman: A number of witnesses have said to us that hedge funds and hedge fund managers are already regulated in the UK and elsewhere. Is that the case or are you saying that they are not regulated at all?

Mr Chapman: In America, for example, there is a suggestion that they should be registered. There was then a court case which rather knocked that down, so they are now having to start again with registration. The vast bulk of hedge funds which are in America are not regulated, therefore. In the UK, yes, there is some nominal regulation, but I think the FSA, when they published their paper on funds of alternative investment funds, described it as light.

Q75 Lord Haskins: In your introductory remarks you made a number of powerful arguments against hedge funds, which will strike a chord with lots of people. Our inquiry, however, is about the role of hedge funds vis-à-vis the economic crisis of 12 months ago. Both Lord Turner and M. de Larosière, in evidence to us, indicated that they did not feel that the hedge funds, though they may have other shortcomings, played a serious role in the cause of the crisis. You presumably would not accept their argument. Because there are two things developing from here: (a) the wider issue about where hedge funds should be in the international markets and (b) the more specific issue that we are having to deal with, which is the response of the EU to the particular crisis and, if they do contribute, if the action that the EU is proposing is appropriate or relevant?

Mr Chapman: Hedge funds and the crisis. I think that in the present, let us say, financially innovative, very complex financial world, there will be regular crises nowadays. In the last big crisis—Long-Term Capital Management, which was narrowly avoided—hedge funds were to the fore. In this particular crisis they were not to the fore; but many factors were involved. They did include two of the factors which I put up as resulting from hedge funds: the high-risk reward factor led the bankers to search for higher returns at greater risk, and the complex products—which I think is my fifth point about hedge funds—were certainly there. Where it went wrong was that collateralised debt obligations turned sour, and these unquantifiable, untried vehicles ended up as a mess. So even though hedge funds themselves were not directly involved in that aspect of the crisis, the activities which came along with hedge funds certainly were. I would also say, turning to Lord Turner, he did actually say, “Hedge fund activity can have important pro-cyclical systemic impact. The simultaneous attempts by many hedge funds to de-leverage and meet investor redemptions may well
have played an important role in the last six months in depressing security prices into a self-fulfilling cycle”. In other words, what he is saying is that hedge funds actually made rather a drama out of a crisis. They aggravated it, as much as anything else. There were reports of UK banks being shorted by hedge funds, and I think that added considerably to the Bill which HMG had to pick up.

Q76 Lord Haskins: The two issues you raise there, which you think the hedge funds had an impact on, are the contagious and effect that their behaviour spread into the banking—
Mr Chapman: Absolutely, yes.

Q77 Lord Haskins: . . . and the complexity factors. These proposals are not intended to deal with that particular problem. I can understand where you are coming from but it is very difficult to regulate to stop the sort of contagion you are talking about. In other words, is it not the banks themselves that have to put themselves right, or the banking system?
Mr Chapman: That may be so, but I think that a knee-jerk reaction to one particular crisis is wrong. One has to look at what happened over, in particular, the last 25 years with this alternative world of finance that has come up. As I say, it will produce a variety of crises and it is wrong to say that crisis A was Long-Term Capital Management and crisis B—“Oh, we’ll attack just the ones with crisis B”. I think that what people like Trichet would say is that one must attack the fundamental cause behind all this, which probably is hedge funds.

Q78 Lord Haskins: So you would really want to regulate hedge funds out of existence?
Mr Chapman: I am on record as saying that, yes. I think it was a terribly bad mistake in 1982 to allow hedge funds and to allow the privileges which they have been given, and what is created is a monster financial army. I remember writing back in 2005 that there had been 22 different attempts by the central banks and other bodies to control hedge funds. It is a major activity.

Q79 Lord Haskins: But is it not scale that you are concerned about? In other words, an individual investor can buy, sell, speculate and bet on shares, and nobody will complain about that—as long as they do not have insider knowledge. It is only when it gets to a certain scale.
Mr Chapman: No. The hedge fund investor has 17 trading advantages over traditional hedge funds, which I think is grossly unfair.

Q80 Lord Haskins: How do you work out the cut-off point? At what point do you become a wicked hedge fund?
Mr Chapman: You become a wicked hedge fund as soon as you are a hedge fund.

Q81 Lord Haskins: We have not been able to define what a hedge fund is.
Mr Chapman: A lot of people have not and a lot of people have tried. I would say that “funds and activities free from regulation with high rewards for operators” covers most of it.

Q82 Baroness Northover: I am very struck by what you say. Lord Haskins has made the point, summarising your position, that it is the contagion from hedge fund practices that has had this effect. That is extremely interesting; that the bankers in your view learned certain practices from the hedge funds, which they wished then to pursue. I suppose one of the differences in terms of looking at what happened here, as Lord Haskins has referred to, is the scale of it. The point about the banks was about their being too big to be allowed to fail; that they would have a systemic effect. One or two hedge funds did go under and they were allowed to go under. If other hedge funds had found themselves in that position, they too would have been allowed to go because they would not have shaken the financial position of particular countries to the core. One would have thought that, if you are right about the effect of hedge funds, it is a failure of regulation of the system overall which enabled the banks to do what they did, given that the banks were going to be in a position of being bailed out. Is not that the difference here?
Mr Chapman: I do not know. On the contagion, I came across a website called CentreRight, which I think is the voice of the Conservative Party, which starts off by saying the growth and rise of power of hedge funds is the most important economic factor over the last 50 years. It then went on to say that the hedge fund activities, in terms of risk and reward, had indeed been copied by the banks. As for hedge funds being allowed to fail and banks not being allowed to fail, I do not think that is strictly true. Long-Term Capital Management was not allowed to fail and that is a hedge fund.

Q83 Baroness Northover: Some hedge funds have failed and nobody has stepped in to assist them.
Mr Chapman: A couple of Bear Stearns hedge funds did fail, yes. They were not, let us say, as important economically as Long-Term Capital Management; but if there had been a big hedge fund involved in the latest crisis of the scale of Long-Term Capital Management, it might have been a different story.

Q84 Chairman: May I follow up a couple of points that you have made? You have talked about there being a parallel Bill in the United States. Do you know enough about that to be able to comment on any
differences in the American approach that is currently being considered and the European approach? In summary, it would be helpful to us to know if there are any differences, because clearly one of the issues is whether, given that some of these funds are global, there should be more co-ordination in approach between Europe and the United States.

Mr Chapman: I am surprised that there has not been an analysis of the difference between the two proposals. I have briefly looked at them. I think that the question of registration and regulation is in the Obama Bill. There are not details like capping leverage and the like, but the American officials involved are quite threatening about really hard treatment of hedge funds that pose systemic risk or act together, and the like. I would have said that, if anything, the American Bill is probably a little bit lighter and less detailed than the European directive. This is not surprising. Basically, hedge funds are an American entity and, in the American world, bizarre things happen, like people being allowed to have guns around their houses, millionaires allowed to run hedge funds—or, at least, to benefit from hedge funds. I cannot imagine that that decision would have been taken by a European country. Though it has been copied, I may say; of course it has been copied, because in the UK we have allowed something similar. However, I cannot imagine it originating here. I would say that the Obama Bill may be a little less draconian—not that this present EU directive is draconian, but it has a little less detail—but there are threats there of real action against hedge funds that cause problems.

Q85 Chairman: The European draft directive of course involves more than hedge funds—private equity, infrastructure funds and so on. Do you have any view about the appropriateness of the draft directive in relation to these other areas or alternative fund managers? Given what you would like to see done to hedge funds, do you have the same enthusiasm and direction of thought about these other alternative funds?

Mr Chapman: I have also written a big article on private equity, featuring the Debenhams case, which was in my written evidence. Private equity—and I am talking about leveraged buyouts now—there is the risk of asset stripping, debt loading, special dividends declared to the owners. It can go wrong. The European Socialists’ report said that private equity is more about extracting value rather than creating value and quoted McKinsey, saying that more than half of the deals are industrial failures but profitable for the private equity people and their prime brokers. Ernst & Young in 2009 said that more than half of the profits from private equity come from debt piling. More worrying is the Standard & Poors’ 2009 analysis of the 293 “weakest link” companies, i.e. companies just about to go bust, where more than half had private equity treatment. I understand that the American consultants who dealt with many private equity cases are inundated with complaints from their clients. It is a model that can easily go wrong. I have already mentioned that perhaps the directive might have tackled high fees, asset stripping, debt loading, incentives to managers, special dividends. I would look a little bit further and say, okay, sometimes these private equity deals may be good, but I would like them approved by a public body rather than go through the risk that they might be bad.

Q86 Lord Trimble: I would like to turn to the provisions in the directive for an EU passport and the restriction on third country funds marketing in the EU. A number of people have said that in this respect the directive is protectionist. I wonder what your response would be to that.

Mr Chapman: Obviously, if I think it sensible to wind up these activities, I am not rushing to allow external countries to add to the hedge fund turmoil in Europe. It may sound a little brutal but if that three-year delay was made indefinite, I would not be unhappy.

Q87 Lord Trimble: You say allow third countries “to add to the hedge fund turmoil in Europe”, but what is proposed here are restrictions on investors within the European Union making investments in funds outside the European Union. How does that reduce the turmoil?

Mr Chapman: Investors in Europe cannot use external hedge funds. Is that right?

Q88 Lord Trimble: In the draft directive there are proposals that would limit the ability of investors in the European Union to invest in funds outside the European Union.

Mr Chapman: Again, I have the same position that, yes, okay, that may be restrictive or protectionist, but if it slows down hedge funds—and indeed it probably will slow down, let us say, the advance of hedge funds—I would be very happy. People are going to be denied access to American hedge funds—is that what you are saying?

Q89 Lord Trimble: The effect would be to limit the investment by investors in the EU into these funds outside.

Mr Chapman: The investors in Europe are limited but, at the same time, the American marketing is also limited. That is what it is really all about: the marketing of American hedge funds in Europe. I must admit, the British or French investors are then denied a little bit; but I would not regret the limitation of any marketing of hedge funds, and therefore I do not regret the limiting of the American hedge funds being marketed.
Q90 Lord Trimble: I do not know if you have had the opportunity to look at the Presidency issues paper.  
Mr Chapman: I have not read that, no.

Q91 Lord Trimble: Because on this part the issues paper says, “There seems to be an overwhelming majority of Member States which are against imposing undue restrictions on investment opportunities, especially for institutional investors, as well as creating other barriers to global capital flows”. So there seems to be quite a bit of criticism on that particular point.  
Mr Chapman: Maybe there are, yes.

Q92 Lord Moser: There is a very interesting section in your evidence on taxation aspects. You remind us that the FSA has recently argued, or its chairman has recently argued, for a general tax on City activities. You remind us that — and I certainly did not know — a year or two ago the European Parliament argued for a capital gains tax on hedge funds. Your view is clearly that, because of their trading advantages over traditional investors, something special has to be demanded in the tax sense from hedge funds. It is not absolutely clear to me how that would work and what the real benefits to the world would be that are not achieved by the directive — if you see what I mean.  
Mr Chapman: Yes. There have been a number of tax proposals. Sarkozy, when he was presidential candidate, proposed a tax on hedge funds. Now Strauss-Kahn of the IMF is suggesting a tax on financial activities. Actually it was not the European Parliament: it was the Socialist Group within the European Parliament that proposed the capital gains tax on hedge funds. Your view is clearly that, because of their trading advantages over traditional investors, something special has to be demanded in the tax sense from hedge funds. It is not absolutely clear to me how that would work and what the real benefits to the world would be that are not achieved by the directive — if you see what I mean.  
Mr Chapman: Yes.

Q93 Lord Haskins: The EU has no power to apply EU-wide taxes. It has to be by national government.  
Mr Chapman: Absolutely, yes.

Q94 Lord Haskins: So everybody goes their own way on the taxing of hedge funds.  
Mr Chapman: I think there could be some EU agreement that it should be uniform.

Q95 Lord Moser: In your paragraphs on taxation you say that this would be a good thing to do because it would be a disincentive. Then you say, “ . . . for the transition period before hedge funds disappear”. Let us assume that they do not disappear; let us assume that they are a permanent feature of our world. Would you like to see some kind of a tax permanently?  
Mr Chapman: Yes. I make the argument on unfair trading advantages; others have suggested a tax for the risk factors. One of the federal chairmen by the name of Sheila Bair has suggested a tax on bodies like hedge funds which pose particular risks. There are other arguments rather than the trading argument. There is the risk factor as well.  

Q96 Lord Moser: It may be a simple tax on the excess of money they make. Is that it?  
Mr Chapman: Either the profits or indeed a trading, buying and selling tax on hedge funds.

Q97 Lord Moser: I do not understand the second one.  
Mr Chapman: A trading tax. When hedge funds trade, they would pay a tax—not unlike the Tobin tax on foreign exchange.

Q98 Lord Moser: Currency?  
Mr Chapman: Yes.

Q99 Lord Renton of Mount Harry: And on Stock Exchange deals.  
Mr Chapman: Yes.

Q100 Baroness Northover: I would like to ask you about leverage. I think that you have given some indication within your evidence, but do you think the directive deals satisfactorily with the issue of leverage and, if not, what should be done?  
Mr Chapman: I am not an expert on leverage. As far as I understand it, the directive is thinking in terms of capping leverage according to the different markets and the different risks involved. That does appear quite a complex activity. Whether they succeed in doing that must be a little bit open to question. The caps will be somewhat arbitrary, but that is what has been suggested. Leverage is only one part of it. The use of derivatives, the use of fancy financial instruments — those are things which are almost outside comprehension and control, which just shows how weak the world’s position is vis-à-vis this alternative army. Capping leverage is perhaps the simplest approach but even then it is quite complicated.

Q101 Chairman: There is a theme running through one or two of the questions I asked you. I will try to pull them together. You very much look at the draft directive, and I understand why, from the point of view of its relationship to hedge funds and also, I appreciate, with a particular view about private
Q102 Chairman: You want to catch hedge funds. I understand that. You think this is the opportunity to do so; that it is not being done as vigorously as you would like to see it done; but the directive is drawn up in broader terms than that. Some of the evidence to us has said, “You may or may not have a problem with hedge funds but it is hitting us in a way that you cannot really intend to do”—property funds, infrastructure funds. Do you think that you can tackle the issues that you would like to address in hedge funds with an overarching draft directive that is addressing all other UCITS funds?

Mr Chapman: I have no great answer on this but I would say that this probably results from the way the European Union tackles issues like finance. They have UCITS, they have insurance, and now they have another directive which is catch-all, which happens to be hedge funds, private equity, and all the other ones that are not caught by the other directives. I think it originates from that. Obviously, it does make the directive more complicated and less directed at hedge funds, and people who have escaped regulation up to now are suddenly finding themselves covered simply because they are not covered by the existing directives. There always was a kind of intention to cover hedge funds in some kind of way in Europe, I believe, and these other ones have been swept up with it and are having to suffer a bit of pain as a result.

Chairman: That is probably fair comment. Does anybody else have any more questions?

Q103 Lord Renton of Mount Harry: I am interested in your final comment there that it “always was the intention” to tackle hedge funds. Really? I wonder if that is true.

Mr Chapman: You are probably quite right about “always was”. When they talked about UCITS—and I was at a conference as a Commission expert in 2007 on UCITS—they were talking about alternative investment as being perhaps something to tackle. Let us be a little bit frank about this. I doubt if McCreevy, the European Commissioner, was at all keen on tackling hedge funds. The Swedish and the UK positions, are also very much coloured by the prevalence of hedge funds in those particular countries. You might almost say that the European Commission is being dragged kicking and screaming to produce an alternative investment funds directive, which was always perhaps on the cards, but not too seriously, by the crisis, by G20, by IOSCO, by pressure and all the rest of it.

Q104 Lord Renton of Mount Harry: The problem I have is in actually believing that the EU Commission can do it effectively. I can see why they are being pressed to do it; I can see why they have produced a document; but if they are going to do it effectively, against all those whizz-kids—I doubt it.

Mr Chapman: You probably have a very good point there, but one has to be a little bit of an optimist and hope that they do come up with something, which is a useful first step for somebody like me and can be built on in the future; but there will be a very powerful lobby—as you say, whizz-kids and politicians—to make sure that what they come up with is not too draconian. I may say that, in yesterday’s Financial Times, Pauline Skypala did say that you can almost bring out the champagne; there seemed to be some kind of agreement in Brussels between the two sides to come up with something, but quite what that will be I do not know.

Lord Renton of Mount Harry: One should always be suspicious when the champagne is brought out!

Q105 Lord Jordan: You pointed out that there were certain people, you mentioned McCreevy, whose defence of these things was fairly predictable, seeing where the funds were. There is the other view, however, which says that, given the success of these funds in those countries, there is a certain vindictiveness from those countries that are not involved and want to try to clamp down on that success.

Mr Chapman: Yes. I can see that, and you did put as one of the possible questions to me the 50,000 jobs and the taxes. Unfortunately, I would maintain that hedge funds are probably doing quite a lot of damage to other, traditional, investors. One of the amazing freaks of this world is that some of the pension funds invest in hedge funds, even though they are being clobbered in the market by hedge funds. It is like fighting a war and sending troops to the other side. On the taxes issue, I do not know. Alf Garnett used to smoke for England. It does not mean to say that just because you pay taxes you are a good thing—if you see what I mean. I do not think there is a vindictiveness from other countries. My position is that they are very sensible in trying to stop the advance of hedge funds, which we in the UK have very regrettably allowed on a large scale.
**Q106 Chairman:** Thank you very much. Is there anything further you would like to add before we complete this session?

**Mr Chapman:** One tiny point. I have looked at all the other people who have given evidence. I think it is something like 35 who have given evidence and only about three were vaguely critical of hedge funds. One was myself; second, an American university; third, a European think tank. It is almost a national disgrace that there was no real contributions from British think tanks to this debate.

**Q107 Chairman:** For the record, as you know, our call for evidence is entirely neutral on the issue. We are simply seeking evidence and, in a way, we can only take the evidence we get. However, it is noteworthy, I agree.

**Mr Chapman:** I would have liked not to have been the only person sitting here criticising hedge funds. However, I was told that many other people share my views but very few who dared to express them publicly, against the very powerful hedge fund and private equity lobbies.

**Chairman:** I am pleased to say that today you showed no fear at all! Thank you very much.

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**Supplementary memorandum by Mr John Chapman**

**Hedge Funds—Definition, Deal and Devastating Effects**

**Definition**—Funds and activities free from regulation, with high rewards for operators

**A bad “American” Deal**—Can use public markets if reserved for millionaires only*

**Devastating effects**

1. Multiple trading advantages over “losing” traditional investors—see table below
2. Some $1.5 trillion unregulated funds, posing major systemic risks
3. Questionable behaviour—challenging governments, creating/riding market bubbles, gambling rather than investing, short-selling, unwelcome shareholder activism, etc
4. High risk/ high reward “bonus” culture becomes general, with systemic risks higher
5. Complex financial instruments also become general, with further unquantifiable risks.

* High Net Worths still dominate, but have been joined by some institutions, bizarrely investing in their (superior) market competitors.

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**Table**

**TYPICAL ADVANTAGES OF HEDGE FUNDS OVER TRADITIONAL INVESTORS**

<table>
<thead>
<tr>
<th>Hedge funds</th>
<th>Traditional funds</th>
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<tbody>
<tr>
<td>1 Regulation</td>
<td>Light or none</td>
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<td>2 Investors</td>
<td>HNWs or institutions</td>
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<td>3 Prospectuses</td>
<td>No official requirements</td>
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<td>4 Disclosure</td>
<td>Strategies, holdings obscure</td>
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<td>5 Size</td>
<td>Can be small and nimble</td>
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<td>6 Investments</td>
<td>Levels deter the less sticky</td>
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<td>Lock-up periods, etc</td>
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<td>8 Valuations</td>
<td>Arbitrary; may be guidelines</td>
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<td>9 Relations</td>
<td>Very close with prime brokers</td>
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<td>10 Fees</td>
<td>2 &amp; 20 offers big rewards</td>
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<td>Key element of top l/s strategy</td>
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<tr>
<td>14 Flexibility</td>
<td>Any asset, market, strategy</td>
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<td>15 Positions</td>
<td>Can concentrate in one entity</td>
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**Letter from CMS Cameron McKenna LLP**

We write in response to the proposed Directive published by the European Commission on 29 April 2009 and the House of Lords European Committee’s call for evidence on the proposed Directive (the “Call for Evidence”). We also refer to certain responses contained in the Issues Note by the Presidency subsequently published on 2 September 2009 (the “Issues Note”).

CMS is a leading European provider of legal and tax services with a particular focus on the financial services industry. We represent the interests of clients, both fund managers and institutional investors, whose businesses and operations the Directive is likely to affect.

We set out below our general comments on the key proposals of the Directive together with more specific responses to the questions raised in the Call for Evidence.

**General Comments**

In principle, we are supportive of the Directive and the benefits it will bring to the AIF industry, if its provisions are drafted and implemented appropriately.

From the perspective of both fund managers and institutional investors, a European passport for AIFs is in theory an advantage and will offer increased choice and should hopefully lead to decreased costs involved in promoting AIFs across Europe and therefore enhance Europe’s competitiveness in the global fund management industry. Investor protections can also be clarified and greater transparency introduced to AIF operations with the introduction of, for example, ongoing disclosure requirements to investors, relating to information such as the risk management systems of the manager and the return and liquidity characteristics of the relevant fund.

From a manager’s perspective, the benefits afforded to their investor base must be weighed against any increased burden and additional costs such a regime may place on them which ultimately are likely to be passed on to investors.

In addition we believe the provisions of the Directive, where relevant, should be capable of existing alongside and not be contrary to existing European legislation governing investment funds and managers, such as MIFID, the UCITS regime and the Prospectus and Transparency Directives and should not impose either requirements for “double authorisation” of fund managers and their activities (please see below) or requirements that are more burdensome than those imposed, for example, under the UCITS regime which are designed to protect retail investors.

**Specific Questions**

As legal advisers we have limited our responses to questions raised on the Call for Evidence which are of a legal or regulatory nature and have not responded to some of the wider economic or political questions raised. The numbered responses below relate to the numbers of specific questions contained in the Call for Evidence. However, such responses should not be taken as addressing only those questions and in certain cases the responses provided are also relevant to other questions raised.

2. As stated in our general comments, a singular regulatory regime across Europe would be welcomed if it is capable of existing alongside existing European legislation and the nature and scope of the type of funds and institutions to which it will apply is sufficiently clear. For example, an AIF in the context of the Directive is defined as “any collective investment undertaking”. However, there is no clear definition of a collective investment undertaking, which means that the Directive may catch many vehicles that are generally not thought of, or regulated as, funds, eg, certain joint ventures. It may also have particular implications for closed-ended listed investment companies, since they are currently incapable of being collective investment schemes under the provisions of the Financial Services and Markets Act 2000, but, if included in the remit of the Directive, would also be subject to the EU’s Prospectus and Transparency Directives, thus subjecting them to a “double layer” of regulation.
In the Issues List it is stated that the Presidency believes that the definition of an AIF should be the starting point for clarifying the scope of the Directive and that the “notion” of a collective investment undertaking should be focussed on. We agree with the proposed inclusion of a list of more detailed criteria to define whether an investment is a collective undertaking for the purposes of the Directive.

4. Whist we agree it is preferable to regulate “Investment Fund Managers” rather than individual funds we again believe that clarity is required on the exact nature of the parties intending to be caught by the proposed regime.

We do not understand the distinction, for example, for exempting EU banks, pension fund managers, endowments, sovereign wealth funds or assets held on own account by credit institutions or insurance or reinsurance undertakings from the requirements of the Directive.

The Presidency have commented on this issue in the Issues List and state that for “level-playing field reasons” if such parties manage one or more AIFs they should be considered an AIFM and subject to the Directive. Whilst we do not necessarily agree that the scope of the Directive should automatically be extended to these institutions, we do consider that it is important to look at the underlying activities of such institutions, to ascertain whether they should fall within the remit of the Directive and for clarification to be provided on this. We also agree that the scope of the Directive tries to impose a “one size fits all” solution to the AIF industry when different asset classes (eg real estate and private equity) have very different considerations (please see further comments in subsequent answers).

6. Whilst we together with the wider industry would welcome a singular EU passport regime which would facilitate the promotion of AIFs across the European market and which would be attractive to the global funds market there is a need to ensure that any such regime does not create a “two tier” system so that funds and fund managers, if they meet the relevant Directive criteria, would also have to comply with any country specific private placement regimes and restrictions and, where relevant, other existing overlapping EU legislation eg the Prospectus Directive for listed investment funds. Please also see our comments below on non-EU domiciled AIFs.

7. (a) **Thresholds**

The proposed Directive covers all EU funds that are not regulated under the UCITS Directive, subject to a de minimis threshold for portfolios of less than €100 million or €500 million for managers not using leverage (and having a five years lock-in period for their investors). There appears confusion in relation to the de minimis threshold. For example, there are no provisions:

(i) to deal with the situation where a manager crosses the de minimis threshold;

(ii) to explain how the €500 million euro threshold applies to funds that have leverage at the investee company level; or

(iii) to indicate the basis on which any of the de minimis figures are calculated. It is not even clear if the threshold figures are gross or net.

These provisions will need to be clarified. Indeed, the Issues List proposes a deletion of the minimum thresholds altogether and to possibly introduce a “principled” solution to setting applicable thresholds. This may be preferable, but greater thought will be required to ensure such principles can be implemented with certainty and fairness.

(b) **Capital requirements**

The Directive would give rise to significant costs for fund managers if additional regulatory capital will be required which together with other increased costs may impact on competition and increase barriers to entry for new managers.

(c) **Leverage**

We would comment that the concept of leverage is inadequately defined in the Directive and this has been recognised by the Presidency. For example, the provisions on leverage are presumably intended to affect the use of leverage at fund level, but this is not clear. Furthermore, the proposal allowing the Commission to set a cap on leverage where they identify immediate systemic risks, is the most concerning provision. The systemic risks posed by the leverage of any one fund can only be assessed in the context of wider market conditions so
capping leverage on a fund-by-fund basis might not be an effective protection. Leverage caps could even be counterproductive. Leverage generally increases as investment positions move against the manager. If this caused a fund to break through its cap, it may be forced to sell assets. If this happened across the market, it could cause a massive drop in valuation of assets and other associated issues. The Presidency has proposed as a possible solution to the concerns voiced in this regard that such a cap be deleted. We would agree with this proposal.

(d) Depositories and Valuations

The Directive introduced the requirement for an AIF to have a separate depositary, which must be an EU credit institution. This represents a significant departure from current practice and will require hedge funds and private equity managers to reorganise their brokerage arrangements/custody of fund assets, at significant expense. The Presidency has recognised this as a major problem and has noted that it will require further exploration to find a suitable solution, which we agree with.

In terms for the requirement of independent valuations, this proposal in many cases will be inappropriate. For example, in the case of a private equity fund, the imposition of the independent valuer will result in the replacement of the person who understands the investment with someone who does not. Similarly there should be no requirements for independent valuation where the underlying investments are quoted and where the value is readily ascertainable.

9. We believe that individual national regulatory bodies may be impacted by the Directive in a negative manner as its proposals are likely to lead to a significantly increased administrative burden on EU state regulators. Furthermore, the Directive requires prior marketing notifications to be made and these not only impose a heavy burden on regulators and firms but are likely to prove unworkable in relation to certain structures where agreements are heavily negotiated between professional counterparties. The Commission appears to be assuming that all AIFs operate on a UCITS model where marketing and constitutional documents are undertaken largely on a pro forma basis. This is not the case for the AIF industry, having significant differences across different asset class sectors.

11. In terms of impact on investors the restrictions on promotion of non-EU funds (see below) may lead to significantly less choice of funds particularly within certain sectors where the “norm” is for the fund to be set up in a jurisdiction outside the EU (eg Cayman based hedge funds) and inevitably the increased regulatory burden imposed by the Directive will lead to higher costs of establishing and operating AIFs, which costs are likely to be passed on to investors.

The proposed restrictions on marketing non-EU domiciled AIFs may hamper a manager’s ability to operate funds internationally. Additionally, the Directive may have an unintended consequence for EU fund managers where non-EU countries impose “reciprocal” restrictions on EU fund managers promoting AIFs in their jurisdiction. In the current climate, where fund raising for funds is already challenging, any further barriers imposed in doing so would be an unwelcome addition.

The Presidency has proposed one solution, which would arguably improve the provisions proposed as regards third country jurisdictions. It proposes deletion of both Articles 35 and 39 and to change the definition of “marketing” in Article 3 to allow investors to purchase units of third country AIFs at their own initiative (and possibly subject to the law of the Member State where the investor is domiciled). We believe this would be a less cumbersome and more proportionate way of positioning the AIFM Directive requirements with third country jurisdictions and not unduly restricting investor choice.

*September 2009*

**Examination of Witnesses**

**Witnesses:** Mr GAWAIN HUGHES and Mr ASH SALUJA, CMS Cameron McKenna LLP, examined.

**Q108 Chairman:** Good morning, Mr Hughes and Mr Saluja. Thank you for coming to give us oral evidence today and thank you also for the written evidence that you have kindly supplied in advance. You should have in front of you a note of a declaration of interests of the members of the Committee. Today’s session is on the record, both as a webcast and also as a written record. You will have a copy of that in advance of publication, should there be some wrinkles that you find have crept into the text. We have about 40 to 45 minutes. There is a lot to get through, but if there is anything you would like to say as an opening statement, by all means do.

**Mr Hughes:** The only thing we would like to say as an opening statement is that we, as a firm, represent a number of institutional investors. We are not just active in the UK but across Europe as well. The funds that they set up tend to be both domestic funds, pan-European funds and offshore funds. However, we also represent a number of institutional investors
who invest in those products, and hopefully this provides a more balanced view as to the impact of the directive.

Q109 Chairman: Of course, if you want to bring in Mr Saluja, do so.

Q110 Lord Jordan: As you know, the draft directive has attracted two camps: those who are saying that it does not go far enough and those who say it is already too onerous. From your view, as the directive stands, do you think it will achieve its objectives of supervising the risks that AIFM pose to their investors, counterparties, other financial market participants and, most importantly, to financial stability?

Mr Saluja: In looking at those risks, I think the feeling is that it is a disproportionate response to the risks involved and, in particular, it does not discriminate in respect of the risk posed by funds with different asset classes. It is very much a one-size-fits-all directive and, in doing so, I think it misses the nuances that arise from the different asset classes.

Q111 Chairman: It would be helpful if you could give examples of that. Lord Jordan will no doubt want to follow with supplementaries, but if you could put a little more meat on the bones of that it would be helpful to us all.

Mr Hughes: If you look at some of the key proposals in the directive then, as Ash mentioned, the term “one size fits all” has been bandied around by a number of industry bodies; but I think that there are real, fundamental differences as to whether you are managing and promoting a real estate fund as opposed to a private equity fund. There are a number of markets where to hold those assets are safeguarded—rather than imposing a requirement to use an EU custodian it could be that you would go through a process to take all reasonable steps to make sure the assets, rather than imposing a requirement to use an EU custodian.

Q112 Lord Jordan: There is an argument that runs that it is the hedge fund culture that has got the banks saying, “Why can’t we have some of what they are doing?” and the tricks, the dodges, the devices, were multiplying faster than rabbits—all to make more money, and we saw the effect in the last year or so, a cumulative effect. Where do you think there is a legitimate argument to plug the hedge funds’ weakness in regard to this financial stability?

Mr Saluja: I am not sure whether you are trying to regulate the entities involved or the activities involved. I know this directive excludes funds operated by credit institutions, insurance companies, and other types of entities—sovereign wealth funds, for example. It seems to me that if you think an activity is abusive—say, if you take short selling as an example—you should be applying it to all types of entity that are carrying out that type of activity, not simply the managers of this type of structure. I think that is something the directive misses.

Q113 Baroness Northover: You said that you thought this was disproportionate and then you talked about asset classes being different. Those two things are not linked, are they? It sounds from what you are saying, and what you have said just now, that there needs to be more differentiation within this, but you have not made an argument as to why this is disproportionate.

Mr Saluja: I think there are a number of areas where the response is disproportionate. If we take an example the requirements for depositories, they have to be an EU credit institution under the draft directive. There are a number of entities that are authorised to carry out safeguarding the administration of investments, which are authorised under MiFID, that are not EU credit institutions. There are a number of global institutions, global custodians, that carry out those activities, which would not fall under that definition. In addition, there are a number of markets where to hold those particular types of investments you have to use a local custodian; for example, if you are investing in Thai equities you need to use a local custodian there. In a number of areas, therefore, the directive is disproportionate to the risks involved. If you are trying to protect the risk of misappropriation of assets, rather than imposing a requirement to use an EU custodian it could be that you would go through a process to take all reasonable steps to make sure the assets are safeguarded—rather than imposing a requirement to use an EU custodian.

Q114 Baroness Northover: That is not disproportionate so much as not getting the instruments right, the way of dealing with it—which is what you have also said about the asset classes. It sounds like it needs to be more differentiated and
more complex, but I am not convinced that it is disproportionate, from what you have said.

Mr Saluja: Perhaps “inappropriate” is the right word.

Q115 Baroness Northover: That is different.

Mr Saluja: I agree, in the sense that there needs to be more thought given to the different types of asset classes and the rules that should be applying to funds invested in those types of asset classes, and I think that something the directive does not recognise.

Q116 Lord Renton of Mount Harry: Mr Hughes, you just now used the phrase “We are now seeing development of property derivatives”. Can you describe to us what a property derivative is?

Mr Hughes: It is basically a way of obtaining an interest in property assets without the physical transfer of the asset. Traditionally, they have been based around buying an interest perhaps in one of the many indexes that track the real estate industry, such as the IPD, index and basically trading in relation to that. Effectively, as I mentioned, it is a way of gaining an interest in an asset without physically owning that asset.

Q117 Lord Renton of Mount Harry: You would generally expect, as a result of this, the market to move much more violently than it normally would as a real estate fund.

Mr Hughes: Not necessarily. A lot of real estate funds that have been set up recently still maintain that the bulk of their investment would be within what we would understand as direct real estate assets, and that there are then restrictions imposed within the funds, self-imposed restrictions, on the level of investment that can be utilised for these instruments, because they are perceived to have greater risk than if you are physically owning bricks and mortar. It is one of those issues where the market is regulating itself. Also, sophisticated investors very much have a choice as to whether they want to invest in a fund that has greater exposure to these types of instruments or less exposure; but that is very much the decision that they can make either by themselves or with adequate third-party advice.

Lord Renton of Mount Harry: Let me now ask you the question that I am meant to be asking you, which is about the current lack of a definition for AIFs.

Q118 Chairman: Before you come in, Lord Renton, may I make a point about the last point, about whether or not investing in index is more or less destabilising? I should declare an interest in the past but not now. I have advised and worked with property funds, but not now. If you are in, say, a big shopping centre or a large part of it and hit a recession, first of all it may be unsaleable at all; it certainly will be illiquid; whereas if you are investing in an index property fund, you can buy or sell that and the extent to which it moves will certainly be a lot less than a particular asset or if you own a particular office block. In many respects, being able to invest in a property index increases the liquidity portfolio and, in general terms, it will move less rapidly than the price of any individual property. It is not always the case, but I think that is right, is it not?

Mr Hughes: It may be. I think that most funds would utilise them because they may not be directly correlated with the physical assets which it is investing in in the main fund. It is used as a tool, really, as you said, to increase liquidity for investors in that fund. The returns that may be generated through those instruments may, as I said, be non-correlated with the physical assets which are being held.

Q119 Lord Renton of Mount Harry: That leads on very well to the question I was going to ask you. In your evidence you say there is “no clear definition of a collective investment undertaking” in the directive as drafted. We are here of course primarily to talk about the directive, to see whether it is a good thing or not, how it could be improved or changed. You then go on to suggest that there should be more detailed criteria to define whether an investment is a collective undertaking for the purposes of the directive.

Mr Hughes: Yes.

Q120 Lord Renton of Mount Harry: Could you suggest to us what specific criteria you think it should include?

Mr Hughes: I think that the issues note is quite good at addressing what it believes the criteria for a CIU should be in terms of things like risk spreading, but also the main benefit of it is in highlighting what it believes should not fall within the CIU definition. Most of the arguments within the issues note and also from the industry are that, first of all, there seems to be an anomaly as to what is within the definition of CIU and what is outside. There is also this debate that certain things which currently fall within the CIU definition would lead to a double level of regulation and authorisation. An example of that would be something like a UK-based investment trust which is listed on the Stock Exchange. Not only would it be subject to the Prospectus Directive, as implemented by the Prospectus Rules of the UK, it would also be governed by the FSA in terms of the documentation produced by that fund, and also would be subject to the EU Transparency Directive. There are therefore probably three or four different layers of regulation which exist over that particular type of fund. The argument from the investment trust and the venture capital trust industry is that there should not be an additional layer imposed on top if
something is publicly quoted or listed on a reputable stock exchange and is governed by the appropriate regulatory body within that jurisdiction.

Q121 Lord Renton of Mount Harry: You are saying to me that there are already three or four safeguards, if you like, around a UK investment trust.

Mr Hughes: Correct.

Q122 Lord Renton of Mount Harry: I was for a number of years the chairman of one of them, so I remember it. What we are looking for, however, is the other side of the question. What do you think that the specific criteria should be for those that should be included in the definition?

Mr Hughes: I will ask Ash to respond to that.

Mr Saluja: The difficulty with drawing a definition like that is that, across Europe, you have a number of different types of fund structures. I think estimates range from something like 50 to 100 different fund structures; so drawing a single definition that will be inclusive will be quite difficult. What the directive does at the moment is to draw a very broad definition that includes quite a lot of types of entities, some of which I do not think it intends to capture; say, for example, joint venture companies. If two parties get together to invest in a particular thing, that is collective investment. It does not exclude those types of entities. The approach we have seen from other European directives is having that sort of broad definition and then a number of specific exclusions, and I think that is the approach we would recommend.

Q123 Lord Renton of Mount Harry: Will you be elaborating that more—for example, in a written paper to the EU?

Mr Saluja: Certainly for the UK market we can talk about the different types of structures. If you take, for example, the joint venture companies, if you had some sort of exclusion which excluded undertakings where the investors were all involved in the day-to-day control and management of the entity, I think that would work for joint venture companies. Then you have to take a decision about other types of entities, such as investment trusts that are self-managed. They do not have a separate manager. At the moment, I think a lot of those questions are for the industry itself rather than the lawyers.

Mr Hughes: One of the main difficulties in coming up with an inclusive definition is that the funds industry is constantly evolving and the format of the funds which is used is constantly evolving, both within the UK but even more so in some of the other European jurisdictions and some of the offshore jurisdictions as well. Some use a partnership structure such as a limited partnership; some will use a corporate structure; some will put a partnership structure together with a corporate structure. This means that many of the funds that we are setting up at the moment will utilise many of these different legal structures and across many different jurisdictions. What has gone before does not necessarily mean that those funds will look exactly the same in two to three years. To give you an example of that, historically, UK real estate funds were set up as limited partnerships within the UK. We changed the stamp duty land tax rules several years ago. It meant that, to increase tax transparency and to make them more tax-efficient vehicles, for most of those vehicles there was a Jersey property unit trust structure put on top of that. If you were trying to write the regulations, say, four years ago, you perhaps you might capture some of the elements of the limited partnership but not capture the elements of the Jersey property unit trust, which is a less regulated vehicle. It is almost trying to chase shadows. As Ash has said, the best way is to try to encapsulate what you think should be within there but then to exclude certain types of funds, and then you could continue that process as different types of funds emerge, both within the EU and outside the EU.

Lord Renton of Mount Harry: That is very interesting.

Lord Jordan: I know that the industry, in referring to the directive says that it is trying to get one size to fit all, in a way in a derogatory sense, saying, “You can’t possibly do it”. From your description of the 50 to 100 different funds across Europe and from what you have just said about the creation of new devices, it seems to me that it cannot be anything other than a one size to capture all, to cover the ingenuity of your industry to think up ways of getting out of whatever it covers. Must not that be the case?

Chairman: I think that is intended to be a question!

Q124 Lord Jordan: Is that not a reasonable position for Europe to take?

Mr Saluja: I think that is a reasonable position to take when you are trying to capture what gets caught by regulation; it is a separate question as to what specific rules you then apply to the different types of entity. Are you imposing rules by the types of behaviour, the types of activity that each of the different types of funds carries out, or are you trying to apply them to everything that is within the definition of an alternative investment fund? I think that is the distinction. You do need to recognise that different types of behaviour, different activities, should result in different sets of rules. The example we gave before about the use of an EU bank as a depository, therefore, will not be relevant to all types of funds within that definition.
Q125 Lord Haskins: In my previous role a few years ago as a sort of regulator of regulators, it always seemed to me that the most important principle of regulation was transparency; that if you got everything out, then in a way you half-solved the problem. A lot of criticism is going on about the directive that too much information is being asked and, very conscientiously, you suggest that this is a burden for the regulators, never mind a burden for yourselves. The question I have, therefore, is this. If the complications are so hard, can we not simplify the system? Are we not really dealing with a system that in itself has become too complicated and it confounds the people within the industry, it confounds the regulators and, if it cannot be made transparent, then surely there must be something wrong?

Mr Saluja: I am not sure that it is too complex from our perspective. Our criticism was basically relating to the volume of information that passed to regulators. The criticism coming through from our clients is that they are not quite sure what the purpose of that information is. Some of it seems to be addressing systemic issues: for example, concentration of risk, the investment portfolios of different funds—which, in the context of the current financial crisis, is probably a good thing, reporting to the regulators about those sorts of issues. However, on other information that is disclosable to investors and employees of portfolio companies, I do not think that they are quite clear on what the necessity is for that type of disclosure. One of the other issues we face is that we have recently been through the implementation of MiFID within Europe, the Markets in Financial Instruments Directive, and that in itself imposed a number of transaction reporting requirements—that firms that were carrying out certain transactions would report these transactions to the regulator. What we have seen is that the UK has been very diligent in applying these criteria, in getting UK firms to make these reports to the FSA and, in cases where a firm has been inefficient in those processes, they have imposed large fines. We have not seen that consistency from other regulatory authorities within Europe, who have not imposed the same level of scrutiny around that area; so UK firms to some extent are at a disadvantage in complying with all these quite onerous reporting obligations, where to some extent the issue may be ignored in other jurisdictions.

Q126 Lord Haskins: That is a matter for the EU to make sure that EU regulations are applied effectively. It is a problem, understandably, and we have heard the argument many times that the British enforce regulations more effectively than others—but it is an issue that has to be dealt with. Is not the real problem that the private equity market is private and it wants to be private. Why? Because many companies which were public 20 or 30 years ago went private because they felt that, by going private, they would be less exposed to the attentions of regulators and the attentions of analysts, et cetera. It is the sort of secrecy element about the whole thing that is disturbing people, and the directive is attempting to deal with that in terms of allaying people's fears by transparency.

Mr Saluja: I can understand that, but then surely we should regulate the activity? What is the rationale for excluding sovereign wealth funds from those disclosure requirements if they are carrying on the identical activity?

Lord Haskins: That is a good point.

Q127 Lord Trimble: I want to turn to the restrictions proposed in the directive on the marketing and investment in third country funds. The issues note that the Presidency issued in September sets out a number of options for dealing with the criticisms that there have been of this. I wonder if you are familiar with the options and if you have a view on those options, as to which one might be desirable.

Mr Hughes: Certainly the first four options that are set out in the issues note—if I may turn to those—are basically various permutations—

Q128 Chairman: For the oral record, it would help if you spelled them out.

Mr Hughes: There are two basic articles within the directive, Article 35 and 39, in relation to third country funds. Article 35 is in relation to tax equivalency and sharing of tax information under the OECD. Article 39 is basically an equivalence provision but, rather than in relation to tax reporting, it is prudential regulation and ongoing supervision. There were five options that were specified in the issues note, the first four of which were permutations on Article 35 and 39, and then option 5, which I think has found the most support by the industry, is a separate proposal. Option 1 is basically to retain both Articles 35 and 39, i.e. the tax equivalency and the supervision equivalency, but making it explicit that investment in a third-country AIF; i.e. a non-EU alternative investment fund, should only be allowed where the manager managing the AIF is domiciled in a Member State. Therefore, it would be a UK manager, say with a Cayman-based fund. The second one is a slight variation of that which, rather than talking about investment, is actually the physical act of marketing such third-party domicile funds, but again with a manager as a UK-based manager. Option 3 is to delete Article 39, which is the prudence and supervision, but to retain the provisions in
relation to tax information. Option 4 is to delete Article 39, retain Article 35, but make it explicit in the latter article that investments in third-country AIFs should only be allowed where the AIFM managing the AIF is domiciled in a Member State or where there is a co-operation agreement. I think these are all dancing around the same issues. The one option that has been proposed that I think has found most favour with the industry is Option 5, which is to change the definition of marketing to allow investors, on their own initiative, to acquire interest in third-country alternative investment funds regardless of whether the ultimate manager of that fund is an EU-based institution or a non-EU based institution. Basically, therefore, it is for the sophisticated investor to approach you and to say, “I understand the risk of this fund. I understand that the fund and/or the manager may be based outside the EU, and I still want to invest in this fund”.

Q129 Lord Trimble: Option 5 is basically continuing the status quo, is it not?  
Mr Saluja: Yes. You can have different rules within each different Member State as to how they allow their own investors to invest in that particular fund. For the UK, we have an existing financial promotion regime, which firms comply with even if they are based overseas.

Q130 Lord Trimble: Is Option 5 changing that?  
Mr Saluja: No, it would not be changing that; so it is the continuation of those different national rules, those different private placement rules. For example, the UK financial promotion rules at the moment say that you do not fall foul of the financial promotion restriction if it is a high net worth investor or a corporate worth so much, or if you are a financial institution. It would continue to allow institutional investors, UK pension funds, charities, to invest—if it is at their own initiative.

Mr Hughes: As Ash has said, this mirrors the private placement arrangements we have at the moment throughout the EU. If you were setting up a fund and wanted to promote it within a particular jurisdiction, therefore, regardless of whether that is in the EU or not in the EU, you would have to satisfy the private placement exemptions within that particular jurisdiction. There is probably an additional point on that, which is that some of the lobbying in relation to the EU has been from the offshore regimes and also some of the managers and administrators. The interesting thing is that, when you see a number of offshore administrators and service providers such as lawyers—who have come in to see us to talk about the bases of the directive and the effect that they think it will have—I think there has been a bit of a sea change in their attitude, in that originally they were very apprehensive of it and thought that it would be anticompetitive in its effect. However, probably in the last month or so we have seen some service providers and administrators actually focusing on the positive. If it takes two years to implement the directive and another three-year moratorium to allow these third countries to fall within the remit of the directive, then they see it as a five-year window of opportunity for people to continue to set up these funds offshore. They would still be subject to the private placement regime but they would fall outside the other tenets of the directive; so, effectively, would be less regulated, easier to administer and more cost-effective to set up.

Q131 Lord Moser: I think that you have more or less covered this in answer to Lord Jordan a few moments ago. This is the issue that the directive has been criticised, including by you, for using the same approaches to all firms. The only question I would be left with—and I confess I have not absorbed all of the Swedish Presidency’s notes—is whether you feel that they have dealt with that adequately or whether you still think there is a problem.

Mr Hughes: I think the Swedish Presidency Issues Note has brought a great deal of common sense to the debate. Obviously it is taking into account various submissions from the Member States in any case and also from various trade bodies. However, in some places it states itself within the note that, for certain technical arguments, it has left those to one side. In some places, therefore, it has adopted a broad-brush approach of highlighting certain deficiencies within the directive; in other places it has gone into far more detail. For example, in the definition of a collective investment undertaking, it goes into some details as to what activity should be encapsulated within the definition of CIU. It is also quite explicit in what it believes should fall outside the definition of a CIU. I think it is a bit of a curate’s egg. In some places it does adequately address and provide a workable solution—

Q132 Lord Moser: I am sorry to interrupt you but, on this specific point, the one size fits all—which is a genuine criticism in your evidence, and by others—has the Presidency dealt with that?

Mr Hughes: No, it does not offer specific solutions for different asset classes. It highlights where there may be issues for different asset classes but it does not go the stage further and say, for example, “In the private equity industry we would like to see the following provisions adopted or amended within the directive”.

Q133 Lord Moser: So there is still a problem?

Mr Hughes: Yes, in terms of addressing concrete solutions.
Q134 Baroness Northover: Following on from that, what about leverage? What do you make of what it said on that?

Mr Hughes: I suppose the difficulty at the moment is that the concept of leverage seems ill-defined. Whilst I think most people would believe that there should be some restrictions on leverage, first of all it does not appreciate the significant differences of the utilisation of leverage within different asset classes. To give you an example, in the real estate industry most real estate funds historically have had a loan to value of approximately 60 to 80 per cent; so, effectively, for every £20 of equity put in by an investor there is £80 of debt. Of course, a lot of those funds need that level of leverage to produce returns for their investors. That leverage is actually at the fund level, whereas in the private equity industry leverage is at the investee company level. In terms of leverage activity, the actual debt is being put in at the investee company level. The definition of leverage does not state whether it should be at fund level, whether it should be an all-encompassing definition of leverage including leverage at the portfolio level. As I said, it does not recognise that there are significant differences in the use of leverage across different asset classes. As the previous person speaking said, it is part of the jigsaw in identifying what the risk is in any particular product, but it is certainly not the be all and end all in defining whether something is a riskier product than any other product.

Q135 Chairman: You have been full and helpful in your responses. I am sure that we could go on a great deal. Is there anything you would like to add that you think you might have missed at this stage and that we should reflect upon in our enquiries?

Mr Hughes: I think the only thing that we would add is that, as we mentioned earlier, we do act for a number of institutional investors as well as for the fund managers. Obviously one of the key parts of the submissions which the institutional investment bodies have made is lack of choice and the restrictions, especially that the third-country funds may have in the asset allocation of those institutional investors. For things like hedge funds, where traditionally the majority of hedge funds have been set up in jurisdictions such as the Cayman Islands, possibly with US managers, I think that it could have a significant impact on the ability of those institutional investors to provide balanced portfolio management going forward—recognising that, for a number of pension funds and charities, the asset allocation to all alternative investment funds is still incredibly small and normally ranges between five and ten per cent of their overall asset allocation. However, as they are seeking to return enhanced returns to their own investors and they become more sophisticated in their own investment outlook, we believe that this will increase over time. Anything that hinders that investment—or, as one of the previous speakers said, the global flow of capital—is probably something which is not desirable in the current environment.

Q136 Chairman: Picking that up, is that a concern which, upon reflection, is one that may be unfounded? In other words, is it a situation that may temporarily be a matter but that, timed over three or four years, even the directive as proposed would deal with? Is it a concern that is perhaps more perceived than real?

Mr Hughes: It may well be, because of course none of us knows what the directive will look like in its final format. For the more developed offshore sectors, of course, many of them do not believe that they will have any issues in achieving either the Article 35 or Article 39 equivalence. Possibly the perception is greater than the risk. The difficulty is that, at the moment, because of the uncertainty as to where those offshore sectors will lie, that is impacting on where certain funds have been set up. A number of managers have commented that previously they may have used an offshore jurisdiction such as the Cayman Islands to set up the fund, but they are considering moving that to an onshore equivalent fund structure—just because this uncertainty may create another barrier to investors investing in those funds.

Chairman: Thank you very much. You have been full and detailed in your responses to us. We are very grateful to you.
Memorandum by Alternative Investment Management Association (AIMA)

The Alternative Investment Management Association Limited (AIMA) welcomes the opportunity to make comments to the Committee regarding the Inquiry into the European Commission’s proposal for a Directive on Alternative Investment Fund Managers.

About AIMA

AIMA is the trade body for the hedge fund industry globally; our membership represents all constituencies which make up the hedge fund sector—including hedge fund managers, fund of hedge funds managers, prime brokers, fund administrators, accountants and lawyers. Our membership comprises 1,100 corporate bodies in over 40 countries, with over half of our members based in Europe.

Since its establishment in 1990, AIMA has worked with the aim of enhancing the regulatory framework in which our members operate. AIMA has a central tenet that good regulation makes for good business and has developed an excellent reputation with regulators worldwide. We have produced, over many years, a number of sound practice guidelines which have been widely used across the industry.

AIMA is not a self-regulatory body. New members are vetted for their bona fides; manager members must be supervised by a recognised regulator in order to qualify for membership. AIMA is currently working with the various international bodies, on behalf of its membership, in order to develop a stronger regulatory landscape which is both effective and capable of allowing the flexibility for innovation which hedge funds need in order to prosper.

Response to EU Sub-Committee A’s Inquiry

We are pleased to submit, on behalf of our organisation, our position paper in response to your Inquiry into the European Commission’s proposal for a Directive on Alternative Investment Fund Managers. This document sets out our views on the AIFMD, specifying the areas which we welcome and those which we feel require revision and we believe that this paper will provide you with the information relevant to your Inquiry, although it does not follow the format of answering each question set out in your Call for Evidence.

Executive Summary

— AIMA supports the authorisation of all AIFMs without any threshold;
— AIMA supports enhancing the safety of European markets by the provision to national regulators of the data necessary to monitor financial stability within their capital markets;
— AIMA calls for an increased limit of €1 billion for disclosure of systemically relevant data;
— AIMA concludes that, without significant revision, the Directive will lead to less choice and greater costs for investors within the EU—without achieving the stated objectives of the Directive.

The European hedge fund industry presently has more than €250 billion of assets under management within the EU, employs about 50,000 people in Europe, and generates tax revenues of an estimated €4 billion a year. The great majority of the money invested with hedge funds comes not from wealthy individuals but from institutional investors, including pension and insurance funds investing on behalf of EU citizens.

AIMA welcomes a Directive which would see appropriate and proportionate regulation of alternative investment fund managers (AIFMs) and which would provide national regulators with the information they need to monitor financial stability effectively within their markets, while allowing Europe to maintain its position as an attractive place in which to do business and increasing investor protection.

AIMA is among those who doubt that the current draft would deliver this—and we welcome moves to improve the present text. We also note that many policy-makers—including among those most active in calling for regulation of the industry—now agree on the need for a proper impact assessment to be undertaken.
AIMA looks forward to engaging constructively with all stakeholders and makes the following observations:

- Proportionate regulation—the purpose of the Directive is to address “systemic risk” yet all significant analysis, including the de Larosière Report to the Commission, has found that the hedge fund industry neither caused the recent financial crisis nor played a significant role in it; good regulation needs to be introduced proportionately, supported by evidence, rather than on the basis of myths and misconceptions.

- Conflict with existing EU financial services legislation—hedge fund managers are already subject to regulation under a number of existing EU financial services legislative measures, including MiFID, the Capital Requirements Directive, the Market Abuse Directive, and the Transparency and Prospectus Directives. The current text of the AIFM Directive overlaps with, or conflicts with, much of this, requiring the deletion and revision of large parts of the present text and/or revision of the above Directives.

- Policy co-ordination—there should be more co-ordination with the G-20 Global Plan for Recovery and Reform, as an EU-only solution risks being detrimental to investors in the EU.

- Registration of AIFMs—all AIFMs operating within the EU should be regulated, regardless of their legal form or the amount of assets under management. Under the current proposed threshold, some AIFMs would not be subject to any regulatory oversight.

- Disclosure of systemically relevant information—the current drafting, and a threshold of €100 million, would swamp regulators with a mass of data of little or no systemic relevance. Whilst we would support regulation of all AIFMs (with no set thresholds), requiring comprehensive data only from AIFMs managing in excess of €1 billion would be a more proportionate and effective means of meeting the Commission’s purpose.

- Third country marketing provisions are protectionist and unworkable—the current draft would prevent non-EU funds from being marketed to EU professional investors for three years and thereafter impose conditions which non-EU managers would find difficult or prohibitive to comply with, making it impossible to obtain authorisation; such a protectionist measure runs obvious risks of retaliatory measures being taken against EU managers wishing to market outside the EU.

- Reduction of choice and diminishing returns for EU investors—the current proposals would mean EU based investors—including institutional investors, pension funds, endowments and insurance companies who invest on behalf of millions of EU savers—would not be able to access funds domiciled in, or managed from, outside the EU. This would deny EU investors access to 90 to 95% of the eligible universe of funds in which they currently invest. This reduction of investor choice would have a detrimental effect on consumers as it would seriously impact portfolio diversification and hence, potentially, the returns on pensions, savings and other financial products. AIMA estimates that the absence of non-UCITS assets as part of a European pension portfolio and the implicit cost related to the draft Directive could cost the industry €25 billion per annum in lost investment performance.

- Leverage—the level of leverage in the hedge fund industry currently averages 1 x assets (source: ECB) as opposed to the levels of 50 x assets reached by the banking sector; the draft fails to appreciate the number of different purposes for which leverage is used by different types of alternative investment funds. To seek to impose a single limit, intended to cover all types of investment strategy and asset classes, is simplistic and would damage the industry and its investors. A more effective way for regulators in Member States to monitor developing leverage trends within their markets would be to require prime brokers to provide relevant lending data in accordance with an agreed and preferably harmonised disclosure template, as indeed is already the norm in the UK (which is home to 87% of EU hedge fund assets under management).

- Depositaries—by insisting on EU credit institutions only, the Directive would severely limit the number of prime brokers and custodians which an AIFM might use, thereby concentrating counterparty risk. It also fails to take into account existing practice in respect of sub-custodians. By imposing strict liability on depositaries, the Directive will raise costs or restrict investment choices—ultimately for investors—as prime brokers will either assume such increased risk of liability by substantially raising their fees or refuse to take on risk in respect of certain markets and/or strategies.

- Master/Feeders—whereas master/feeder structures have been assessed under UCITS IV as being suitable for being marketed to retail investors, it is unclear whether the Directive would permit them to be marketed to professional investors. Such funds are widely used by hedge funds, which would have to choose between costly restructuring or remaining outside scope and thus unavailable to EU investors.
AIMA fully recognises the impetus for greater regulation and supervision for all aspects of the asset management industry, including the hedge fund sector. As mentioned above, we support appropriate and proportionate moves to achieve this. As the voice of the global hedge fund industry, we seek to play a positive and constructive part in the work of reshaping those areas of the Directive where we consider the current provisions require either clarification or revision. AIMA, therefore, looks forward to working constructively with the Commission, the Parliament and the Council to help produce a revised Directive along the lines indicated above, resulting in legislation which:

— introduces appropriate and proportionate levels of protection for professional investors;
— achieves a sensible and efficient means of regulating and supervising AIFMs;
— ensures regulators are provided with the data which they require to monitor financial stability effectively within their markets without overwhelming them with additional but irrelevant, information; and
— safeguards the interests of the EU’s existing investor base while ensuring that the EU remains an attractive market and centre for new investment, thereby ensuring that the alternative investment fund management industry continues to provide enhanced returns for ordinary EU citizens and pensioners.

Note: The AIFM Directive sets out proposals which have relevance to all Alternative Investment Fund Managers. AIMA’s comments, however, are restricted to the Directive’s likely impact on hedge funds and funds of hedge funds, and their respective managers only.

1. INTRODUCTION

1.1 The Alternative Investment Management Association Limited (AIMA) is the not-for-profit trade association which represents the hedge fund industry globally. Its membership comprises 1,100 corporate bodies in over 40 countries and is drawn from all constituencies which make up the hedge fund sector—including hedge fund managers, fund of hedge funds managers, prime brokers, administrators, accountants and lawyers.

1.2 AIMA welcomes the close attention given by the European Commission (Commission) to the issue of how best to regulate and supervise the wider alternative investment fund (AIF) industry in light of the banking crisis which has caused so much turmoil recently to the markets in which such funds operate. The interests of the hedge fund industry are in fact fully aligned with those of policy makers, regulators, and, most importantly, the investors whom they serve—all concerned wish to see the development of an effective regulatory environment based on appropriate and proportionate requirements.

1.3 AIMA endorses the principle of a harmonised EU regime, which will provide appropriate levels of investor protection and will help guard against potential systemic risks which may be associated with AIFs. We are not opposed to regulation. Indeed, in some areas we would go further—we would like to see the development of a harmonised global regime, built on the initiatives set out by the G-20 declaration and the subsequent work undertaken by IOSCO.

1.4 The Commission’s Directive on Alternative Investment Fund Managers (the Directive) contains much that AIMA welcomes and supports.

— Registration of hedge fund managers—AIMA has long led the calls for the registration and authorisation of hedge fund managers globally. Indeed, as explained below, we would prefer the Directive to go further than currently proposed, by removing the de minimis threshold for authorisation of alternative investment fund managers (AIFMs)—(see paragraphs 2.1 to 2.7 below).

— Disclosure of systemically relevant data to regulators—AIMA recognises that regulatory authorities need to be provided with systemically relevant data from all applicable market participants, including hedge fund managers. It is important, however, that regulators seek not only the correct type of data but also the correct volume of data.

— Enhanced transparency—an appropriately drafted Directive will lead to AIFMs disclosing more information to counterparties and to investors, which will, in turn, result in greater investor protection. This is in everyone’s interest and will allow the alternative investment industry to continue to deliver much needed benefits in associated areas, such as employment and pension provisions.

— EU Passport—we welcome the Commission’s concept of a pan-European passport which would allow an AIFM who is authorised in one Member State to market funds to specified EU investors in other Member States without requiring further authorisation. Much has been made of the need for

1 For further information regarding AIMA, see Annex 1
regulation of the EU single market in financial services and the pan-European passport is a necessary measure in this regard.

1.5 However, it is our belief that the Directive in its current form is not capable of delivering, to the proper and fullest extent possible, the regulatory conditions necessary to deliver these benefits. A number of its provisions cause us real concern since we consider that they will diminish the returns of EU investors, damage the EU’s hedge fund industry (currently worth in the region of €250 billion) and deprive the EU of much needed capital inflow and liquidity.

1.6 Amongst our concerns, which we set out more fully below, are that:

— the rationale of the proposed Directive is questionable in that it addresses “systemic risk” and yet the role of hedge funds in the global financial crisis was marginal. All significant analysis, including the de Larosière Report to the Commission and the Turner Review, has concluded that the hedge fund industry neither caused the crisis nor played a significant role in it. This point is, indeed, accepted in the Explanatory Memorandum which accompanies the Directive. Our view, therefore, is that the current draft of the Directive does not represent a proportionate response on the part of the Commission;

— the Directive does not take into account the current, fully operational and complex regulatory framework already in place in many EU Member States, as well as the need to comply with existing EU legislation, such as Markets in Financial Instruments Directive (MiFID), the Market Abuse Directive, the Capital Requirements Directive (CRD), the Prospectus and Transparency Directives and others;

— the Directive ignores the extensive work carried out in the UK and in the US (which is home to the great majority of hedge fund managers), to produce and develop industry standards. Further work was done this year to harmonise the standards along international lines and in compliance with the request of the G-20 in 2009. These proposals have been presented to the Financial Stability Board and are currently being reviewed by IOSCO. As several policy makers and commentators have argued, AIMA believes that this work should be acknowledged and reflected in the Directive;

— there are a number of areas where the outcome of the Directive’s provisions would be detrimental to the EU’s standing as an attractive location for investment. Fundamental harm would be caused to investors in AIFs. Since the majority of assets under management by hedge funds and funds of hedge funds globally is now derived from institutional investors, including pension plans (which, alone, account for a third of such institutional investment), endowments, charitable foundations and others, any harm which is caused to the industry will also have a consequential, adverse impact on the individual end users -that is, ordinary citizens, including pensioners across the EU. We examine below (see Section 3A to 3C) the following areas where we believe the Directive could give rise to such damage:

    — the Directive as a protectionist measure;

    — reduction in investor choice; and

    — third country marketing;

— in addition, the Directive, as drafted, does not properly accommodate or reflect the way in which the hedge fund industry is structured and operates. On this issue, we deal below (see Section 3D to 3F) with our specific concerns in respect of:

    — leverage;

    — depositaries; and

    — master/feeder structures.

1.7 It is our strongly held view, therefore, that the many positive benefits which the Directive could bring about risk being undermined unless there is a measured and thorough revision of the Directive’s scope and of those provisions which have such undesirable and unintended consequences. Without this work, the Directive will not only fail to deliver the enhanced investor protection that is its stated aim but will, instead, significantly limit the choice and opportunity currently available to EU investors. The effect will be to raise the cost of their investment while depressing the returns they receive from them.

1.8 It is inevitable that the Directive will have fundamental implications for the future of Europe’s financial markets. It is extremely regrettable that, as a result of political pressure, it has been produced in haste, with inadequate consultation among stakeholders, including the AIF industry and those who invest in it, and


\[3\] http://www.fsa.gov.uk/pubs/other/turner_review.pdf
without a rigorous impact assessment. Experience shows that the most effective legislation is drawn up following effective and full consultation and drafted by those with technical expertise. In the absence of these, the result is too often, as here, a text which will require substantial clarification and redrafting before it can deliver the benefits which a harmonised regulatory and supervisory framework would bring.

1.9 AIMA fully recognises the impetus for greater regulation and supervision of the hedge fund industry. As the voice of the global hedge fund industry, we seek to play a positive and constructive part in the work of reshaping those areas of the Directive where we consider the current provisions require either clarification or revision. We will be working further to prepare, in the near future, specific proposals, which we believe would offer ways to overcome many of the problems which we identify in this Position Paper.

1.10 AIMA looks forward to working constructively with the Commission, the Parliament and the Council to produce a revised Directive which:

- introduces appropriate and proportionate levels of protection for professional investors;
- achieves a sensible and efficient means of regulating and supervising AIFMs;
- ensures regulators are provided with the data which they require to monitor financial stability effectively within their markets without overwhelming them with additional, but systemically irrelevant, information; and
- safeguards the interests of the EU’s existing investor base while ensuring that the EU remains an attractive market for new investment, thereby providing enhanced returns for EU pensioners along with job opportunities and job security for those many thousands of citizens working in, or servicing, the AIF industry within the EU.

2. Aspects which AIMA welcomes

A. Registration of hedge fund managers

2.1 AIMA has long supported the registration and authorisation of all hedge fund managers globally and believes that the rules of the UK’s Financial Services Authority (FSA), which require this, provide a good model for other jurisdictions to follow.

2.2 At present, the Directive is unclear on the fundamental question of which entity is intended to be the AIFM—this issue needs to be clarified as a matter of urgency.

2.3 Regardless of this, however, given the difficulty of defining exactly what is, and what is not, a hedge fund manager, we feel that all those who manage relevant assets—whether they are traditional managers, alternative managers or others—should fall under essentially the same regulatory regime. There is no rationale for requiring an AIFM to be authorised while, at the same time, excluding an EU credit institution from the scope of the Directive when it is acting as an AIFM.

2.4 AIMA’s view is that any entity which acts as an AIFM, regardless of its legal form or structure should be regulated in the same way as other AIFMs. This would not only create a level playing field between different market participants but also ensure that regulators see the whole picture when assessing the risk posed by AIFMs to the financial system.

2.5 Whether a fund manager requires to be authorised should be determined by the activities which it carries out, not by the amount of funds it has under management. In setting a minimum threshold for registration of €100 million, the Directive confuses two vital but separate issues—authorisation and disclosure.

2.6 In respect of authorisation, there is no logical reason why AIFMs managing under €100 million should not be subject to regulation while those above that level are. Any such threshold would, by its nature, be arbitrary and would allow an AIFM falling below the limit to “stay out of sight” of its local regulator, so avoiding the requirements which the Directive seeks to introduce. This merely increases the possibility of misconduct going undetected. The threshold for authorisation should, therefore, be zero.

2.7 More widely, we believe that both (a) the process used by the FSA to assess whether an entity which has applied for authorisation is “fit and proper” and (b) its supervisory regime for regulated firms could act as good templates on which to build a harmonised pan-European model.
B. Disclosure of systemically relevant data to regulators

2.8 We agree that regulators need to be provided with systemically relevant data from all applicable market participants, including hedge fund managers. It is important, however, that regulators seek not only the correct type of data but also the correct volume of data. They should take great care to avoid being inundated with information which they have requested, but which they may not have adequate resources or expertise to analyse and/or process, and thereby create an increased risk of moral hazard.

2.9 Retaining a disclosure threshold of €100 million would mean that virtually every hedge fund manager would provide its regulator with all information required under the Directive. However, the vast majority of such managers cannot, by any reasonable assessment, be regarded as having any systemic importance. (We would note that, although a number of funds have closed as a result of the current financial crisis, they have done so, almost without exception, in an orderly way and with no impact on the wider market.)

2.10 Regulators would, therefore, risk finding themselves overwhelmed with a great deal of data, but data which had very little prudential worth. A disclosure requirement which is set too low is more likely to conceal the build up of problems than it would be to uncover them—the information which regulators might need in order to identify issues at an early stage would be hidden among a mass of essentially irrelevant data.

2.11 We believe that the threshold, for disclosure purposes, should be raised to €1 billion—this figure would allow regulators to capture the necessary systemically relevant data without also capturing the surrounding “noise”.

2.12 AIMA has been working for some time with the FSA to develop a reporting template as to the data which would most assist regulators; we would also support collection of such aggregated data at an EU level through cooperation between the national regulatory authorities of the Member States or within the new EU regulatory framework proposed under the de Larosière Report.

C. Enhanced transparency

2.13 AIMA supports and encourages moves towards the enhanced provision of information by fund managers to counterparties and investors. AIMA has developed, over a number of years, a series of Guides to Sound Practices and comprehensive Due Diligence Questionnaires, which explain in detail the information which we believe should be made available to each of these parties.

2.14 However, it should not be overlooked that the investor base of an AIFM is, primarily, that of institutional and/or sophisticated investors. These may be expected to have both (a) the knowledge and expertise and (b) the commercial weight to be able to insist upon the provision, by the AIFM, of any information which the investor considers necessary.

2.15 Nevertheless, we reiterate our support for measures to harmonise such requirements, provided that:

- these are set at a sensible level to avoid creating sources of systemic instability or moral hazard, bearing in mind the nature of the customer;
- the cost of compliance (and, therefore, the cost to the end investor) is kept proportionate; and
- reasonable consideration is given to protecting the intellectual property of market participants.

D. EU passport

2.16 The establishment of a passport for AIFMs to market to specified investors within the EU is a welcome and positive step. If implemented in the correct way, this will reduce existing operating and compliance costs and will equalise opportunities for investors in different Member States.

2.17 It is important, however, that the Directive’s provisions should not be narrower than, nor should they undermine, the existing national private placement regimes in Member States. Since not all Member States currently allow this, the Directive should make clear that AIFMs may market to Professional Investors (as defined under MiFID) across the EU as a whole, while permitting—though not obliging—individual Member States to allow the marketing of AIFs to a wider class of investors in their own jurisdiction if they so wish.

E. Short selling

2.18 AIMA supports the development of a global, harmonised short selling regime. We continue to work closely with IOSCO to develop such a framework.
2.19 Short selling is widely recognised as being an entirely legitimate investment strategy which plays a positive role in many respects. Furthermore, it is a strategy which is used by a wide variety of market participants, not only by AIFMs.

2.20 Since the Directive seeks to introduce regulations in respect of one sector of the financial markets only—AIFMs—it cannot be the appropriate vehicle by which to develop coherent rules in relation to short selling in general. Instead, the Commission should continue to work in cooperation with IOSCO, CESR and other international and regional bodies in order to agree, so far as is possible, a single comprehensive and coherent short selling framework for all market participants. CESR’s recent consultation paper on short selling, for example, seeks the introduction of an EU-wide regime which would be applicable to all those who short sell, rather than being restricted to any specific sector.

2.21 We are also aware that the Commission is undertaking a review of the Market Abuse Directive (MAD) and we support this work. The regulatory concerns regarding short selling which have been expressed to date have been based primarily on the fear of potentially abusive behaviour, especially in extreme market conditions. (We would note, however, that no evidence has been put forward to suggest that short selling has, in fact, been used abusively—if such evidence exists, it is in the interests of all that it be made public to deter others who might be tempted to abuse the markets.) The MAD, therefore, provides a far more appropriate framework than the Directive in which to develop rules regarding short selling. AIMA stands ready to provide any appropriate assistance and input to such work.

F. International cooperation

2.22 The Commission’s work in developing the Directive must be seen as only part of a global response to a global crisis. AIMA recognises and applauds the measures taken by the Commission in this spirit.

2.23 The hedge fund industry has a worldwide scope, covering markets from the Americas to Japan and Australasia and with significant manager bases in all of the main regions of the globe. As mentioned above, it is generally accepted that hedge funds were not the cause of the current financial crisis; they are, though, capable of being part of the solution, bringing liquidity and price discovery to the markets and, even in the most recent difficult markets, providing better investment returns than traditional asset classes.

2.24 It is essential that the Commission’s work continues to be in line with the G-20 Declaration of April 2009 and that the European market plays its full part in (and accrues the full benefit of) the financial recovery.

G. Industry-led standards

2.25 In line with the G-20 Declaration of April 2009, and in coordination with the Financial Stability Board (FSB), AIMA, together with a number of other industry bodies (the Hedge Fund Standards Board, the Managed Funds Association and both the Investors’ and Asset Managers’ Committees of the President’s Working Group) have participated in a working group to create harmonised best practice standards for the hedge fund industry, which would be applicable to managers wherever they are based.

2.26 A document setting out Principles of Best Practices for Hedge Fund Managers was delivered to the FSB by the above-mentioned working group on 24 June 2009; this is now being evaluated by an IOSCO taskforce to determine potential next steps. AIMA is committed to continuing to assist with this work, which we see as providing an integral and important part of the regulatory and supervisory infrastructure, and one which should help ensure high standards of conduct, enhanced investor protection, increased transparency and cooperation with regulatory authorities.

2.27 We firmly believe that such industry-led standards should play a material part in any regime under which hedge fund managers are to be supervised, both across the EU and in the other major regions in which such managers operate.

2.28 Specifically, within the EU, detailed standards covering valuation, risk management, disclosure, governance and shareholder conduct have already been developed by the London-based Hedge Fund Standards Board, with the potential for these standards to be adopted at their discretion by national supervisors in those countries with principles-based regulatory regimes. This body of standards, which AIMA publicly supports, is designed to be an adjunct to statutory regulation.

3. AIMA’s Concerns

3.1 Although there are many potentially positive aspects to the Commission’s proposals (as outlined in Section 2 above), a number of the Directive’s provisions cause significant concern. In some instances, this may simply be a result of the haste with which the Directive was produced and the lack of proper consultation through which it went. Clarification, or revision, of the text would suffice to resolve a number of these concerns—AIMA has provided comments on a number of such issues and met representatives of DG Markt in order to help remedy them.

3.2 In other cases, however, we believe the outcome of the Directive’s provisions would be so detrimental to the best interests of EU citizens and to the EU’s standing as an attractive location for investment, that we do not believe that the Commission foresaw fully the consequences of its proposal. We examine these areas first (see Sections 3A, 3B and 3C below).

3.3 Finally, the current text shows a misunderstanding as to how the hedge fund industry operates—without appropriate amendment, it could require a potentially major restructuring of businesses and business models in order to comply with the Directive’s provisions. The cost of such restructuring would inevitably be passed on to the end investor, reducing returns on investment. We mention below three specific examples, which are of particular importance; namely, those requirements in respect of leverage (see section 3D), depositaries (see Section 3E) and master/feeder structures (see Section 3F).

A. The Directive as a protectionist measure

3.4 The Directive conflicts, in effect if not in intent, with G-20’s global plan for recovery and reform—which calls for regulators and supervisors to “reduce the scope for regulatory arbitrage” and to “resist protectionism”.

3.5 The Directive in its current draft is protectionist in a number of areas, most notably in the context of third country marketing (see Section 3C below). To create a “Fortress Europe” would be to isolate Europe from the benefits of globalisation in this most global of industries. The losers at the end of the day would be EU investors, who stand to be denied access to the very large majority—we believe in the order of 90 to 95%—of the funds and fund managers which are available to them today.

3.6 An appropriately drafted Directive would deliver, within Europe, levels of investor protection suitable for the type of investor concerned and a proportionate disclosure regime under which national regulatory authorities could monitor financial stability in their markets effectively. Such provisions would underpin the attractiveness of Europe in the eyes of investors and would lead to the continued growth of the EU’s alternative asset management industry. Such growth would have a positive impact on employment and create further investment opportunities within Member States. This, however, will not come about if protectionist measures are introduced.

B. Reduction in investor choice

3.7 For reasons upon which we expand below, the Directive as currently drafted would cause potentially significant damage to the investor community within the EU. The impact would be both direct—hitting the institutional and pension fund investors which invest directly into AIFs—and indirect, affecting the EU citizens who, through their insurance, savings and pension plans are customers of those institutional and pension fund investors.

3.8 AIMA considers it vital that due regard be given to the views of investor groups as to the impact that the Directive will have on their business.

3.9 In particular, the provisions regarding third country marketing (see Section 3C below) have the potential to lead not only to non-EU funds, and EU funds managed by non-EU AIFMs, becoming unavailable to EU investors but also to the closing of non-EU markets to EU funds and EU AIFMs as a “tit-for-tat” measure.

3.10 In addition, operational costs (including compliance costs) for AIFMs within the scope of the Directive will inevitably rise. Some of this additional cost is likely to be borne by the AIFM. But, in an increasingly competitive market, not all firms will be able to absorb these extra expenses in full and some part of the increase will, almost inevitably, be passed on to the investor, reducing the return received and making investment per se less attractive.

3.11 The result will be an overall reduction in capital inflow into, and investment within, the EU at a time when the EU should be encouraging capital formation, rather than raising unnecessary barriers. We would anticipate that these factors would combine to increase the cost of capital to companies (and also, perhaps, to governments) within the EU.
C. Third country marketing

3.12 Under the Directive’s current provisions, an EU AIFM which is authorised in one Member State but which wishes to market a non-EU fund to an EU investor in another will only be able to do so if the latter Member State has entered into an agreement with the non-EU domicile to share tax information. So, if that latter Member State does not enter into such an agreement, it is able effectively to close its market to these non-EU funds. This is a protectionist measure and one open to abuse by individual Member States.

3.13 During the proposed three year transitional period, a Member State may allow AIFMs to market non-EU funds to professional investors under that Member State’s existing national private placement rules. Non-EU funds, therefore, will be at a competitive disadvantage to EU funds, particularly in countries such as France and Italy, which do not currently allow non-EU funds to be marketed even on a private placement basis.

3.14 Where a non-EU AIFM seeks to market EU or non-EU funds to investors in the EU, this is only to be permitted where, among other conditions:

— the Commission (not the Member State) determines that the non-EU country where the AIFM is established:
  — has “equivalent” legislation in respect of prudential regulation and supervision; and
  — grants EU AIFMs comparable access to market to investors in the non-EU country; and
— the country of domicile of the non-EU AIFM has entered into an agreement on sharing information on tax with the Member State in which the AIFM is seeking authorisation to market.

3.15 As far as agreeing comparable access is concerned, it should be noted that the EU and the USA have been unable to agree reciprocal access for UCITS funds and the US equivalent for over 20 years.

3.16 The conditions imposed in respect of non-EU fund managers mean that it would be highly unlikely that any manager would be able to comply. This would result in the manager being unable to obtain authorisation. One possible response which a non-EU jurisdiction might take, if it considers that its managers are being unfairly excluded from the EU market, would be to retaliate by excluding EU managers from its own markets. This is not in the best interests of anyone—the investors, the funds or the fund managers.

D. Leverage and product level restrictions

3.17 AIMA’s view is that the Commission should not seek to impose leverage limits for hedge funds.

3.18 Attempting to mitigate risk through leverage limits will always be problematic since leverage is not a good proxy for risk. Implementing leverage caps is overly simplistic, since the impact of leverage on the level of risk within a portfolio (and, consequently, the need to liquidate positions in times of stress) will depend on the characteristics of the assets being leveraged. Leveraging government bonds, for example, does not entail as much risk as leveraging small company or emerging market stocks. The crucial point of difference between “leverage” and “risk” is one which the Directive, in its current draft, fails to address satisfactorily.

3.19 Leverage limits for banks have long been part of the structure of systemic risk oversight. Extending the regime of mandatory leverage limits to hedge funds, however, could, in certain circumstances, be pro-cyclical. Such limits would force liquidations of positions during market dislocations as a fund’s capital base erodes due to mark-to-market losses and would thereby exacerbate the pressure on asset prices. All market participants and policy makers are, rightly, highly concerned about reinforcing pro-cyclical behaviour.

3.20 Further, it is also important to remember the benefits brought about by the appropriate use of leverage. Leverage enables investors to earn reasonable returns from otherwise less interesting investment strategies. Markets benefit from being more efficient and are less prone to price distortions and more liquid as a result. In turn, this reduces the costs of placing and funding government and corporate capital. Leverage can also be used to multiply the impact of risk capital, which is currently in very short supply.

3.21 If leverage limits for hedge funds are to be imposed (and we hope that they will not), then these must be implemented intelligently. The Directive’s current approach is too “broad brush” and fails to appreciate the number of different purposes for which leverage is used in the alternative investment funds industry. The Directive also fails to accommodate the fact that a single, all-embracing, definition of “leverage” is not feasible (see further Annex 2 below). The attempt to impose a single limit, intended to cover all types of investment strategy and asset class, is overly simplistic and would cause significant commercial damage to the hedge fund industry and its investors.

3.22 By concentrating on notional leverage (ie, where leverage is calculated using the gross value of all securities and the notional value of all derivatives) as the only measurement, the Directive will inhibit or prevent AIFMs from pursuing a number of strategies which are currently followed. This will result in
diminished returns to investors and removing much needed liquidity from Europe’s markets without
increasing investor protection or safeguarding markets from financial instability to any significant degree.

3.23 In all but the most straightforward circumstances, simple notional measures of leverage are of little or
no assistance in assessing underlying risk. Hedge funds—particularly those specialising in interest rate or
currency investment strategies—routinely construct portfolios with high notional leverage, but modest risk.
Even a well-run bank would be likely to measure its leverage ratio, using notional exposures, in the hundreds
or the thousands.

3.24 Active participants in these markets express their investment strategies by building portfolios which
cover a wide variety of instruments, markets, issuers and countries. There will be many instances of offsetting
exposures, and the underlying instruments will vary greatly in their level of risk—some (such as short-dated
government bonds) may be of very low risk. In these cases, the overall level of risk cannot be properly assessed
by a simple calculation of notional leverage.

3.25 Further, a cap on leverage measured in notional terms (as currently suggested) would encourage riskier
assets to be bought—managers faced with strict restrictions on the amount of leverage which may be employed
would not wish to “waste” limited available leverage by purchasing more mundane assets which have a low
chance of an outsized return—instead, managers would be likely to invest in more risky strategies.

3.26 These issues are already well understood by practitioners and regulators, and practical ways to address
them have already been worked out. The Basle II Accords set out a standard method to calculate a bank’s
capital requirement given its exposure to risks. That regime defines the relationship between bank capital and
riskiness of its assets; it incorporates adjustments for the risk characteristics of an asset and for exposures that
are offsetting, and is altogether a better way of defining leverage.

3.27 Article 25(3) of the Directive states that the Commission “shall” adopt implementing measures to set
limits to the leverage AIFM may employ. This concerns us greatly. We see no justification for the Commission
being required to intervene in the workings of commercial markets within the single EU market by the
introduction of product-level controls and we query the Commission’s ability properly to assess the market
effects of its actions. We would also point to the damage caused to the efficient working of the market when
hedge funds are forced to deleverage quickly and simultaneously, as was seen during recently when
counterparties withdrew lines of credit.

3.28 The primary focus of the Directive is, quite rightly, not on product-level regulation, being directed at the
manager of an AIF, rather than at the AIF itself. An investment contract in this context is one which is made
at arm’s length between consenting commercial counterparties—in the case of the typical hedge fund, the client
is a professional investor (ie, highly knowledgeable and expert in determining those funds in which it decides
it wishes to invest, following due diligence of the fund, its aims and—through the Prospectus—its “terms and
conditions”). As a matter of general market philosophy, a sophisticated professional investor, provided with
sufficient information to enable it to make a fully informed decision, should be entitled to invest in an AIF of
its choice without the Commission determining on its behalf what are, and what are not, acceptable degrees
of risk for it to assume.

3.29 An appropriate, yet effective, way for a regulatory authority to assess the market level of hedge fund
leverage and effectively monitor any developing problems of financial stability, is for it to ascertain how much
is being lent to hedge funds by their prime brokers. The FSA undertakes an ongoing review of counterparties
to this end and we believe it is far preferable to develop a template through which regulators can obtain
necessary information than to impose an artificial borrowing limit on individual AIFMs without reference to
the underlying characteristics of their portfolio.

3.30 In conclusion, seeking to cap hedge fund leverage without reference to the strategy, liquidity and
volatility of the underlying asset class is a clumsy and unhelpful approach. We believe that it is essential that
this issue be examined in far greater detail and a more finessed response reached. AIMA is happy to offer any
assistance necessary to resolve this vital issue.

E. Depositaries

3.31 By requiring the Depositary (in hedge fund terms, “prime broker” or “custodian”) to be an EU credit
institution, the Directive significantly reduces the choice available to AIFMs, since the large majority of prime
brokers and custodians which operate within the EU today, including the top US houses, would not fall within
the Directive’s definition.

3.32 By Article 17(4), the Depositary would have the right to delegate its tasks “to other depositaries”. Given
the definition of “depositary” (see paragraph 3.31 above), it follows that sub-custodians must, therefore, also
be EU credit institutions. This does not accord with the structure of the rest of the investment management
industry (ie, including, but not limited to, AIFs): standard market practice is for custodians to appoint sub-
custodians of securities in the countries in which the issuers of those securities are incorporated, wherever that
may be. Indeed, in certain jurisdictions, such as Japan, it is a legal requirement that title to such securities must
be held by a local sub-custodian.

3.33 In both these provisions, the Directive applies conditions which are stricter than those under the UCITS
Directive. We, therefore, have the anomalous situation whereby higher standards of investor protection would
be imposed in respect of the professional investors in an AIF than for retail investors in a UCITS scheme—
see also paragraphs 3.41 to 3.43 below.

3.34 The Directive also seeks to impose strict liability on the Depositary for its own failures and for those of
any sub-custodians which it appoints (again, a stricter requirement than in respect of UCITS). This provision
would lead custodians to reconsider whether they are prepared to act in respect of some funds, such as
emerging markets, because of the increased risk of being held liable for losses. Where the custodian did decide
to act, fees would inevitably be increased (perhaps substantially) in order to reflect the greater risk being
assumed. Equally inevitably, this additional cost would be passed to the end investor, resulting in higher costs
and lower returns on the investment.

F. Master/feeder structures

3.35 The Directive similarly fails to accommodate the way in which a significant proportion of the hedge fund
industry operates through master/feeder funds.

3.36 The master/feeder structure was developed primarily in order to accommodate the different tax needs of
US taxable and US tax-exempt investors. It serves to minimise costs by removing duplication of investment
and complex administrative adjustments and, as a result, is a structure which is very widely used by the hedge
fund industry.

3.37 Following lengthy deliberation and consultation, the Council of Ministers recently agreed formal
amendments to the UCITS Directive (UCITS IV). As part of this process, the Council was clearly satisfied
that UCITS funds structured as master/feeders can be sold safely as such to retail investors. Paradoxically, it
remains far from clear how such a structure would be treated under the AIFM Directive, in respect of AIFs
which are sold to professional investors. Indeed, at present it is unclear whether master/feeder funds would
be able to continue in their current form for AIFs.

3.38 If it becomes necessary to restructure AIFs established on a master/feeder basis in order to comply with
the Directive, this would have a substantial costs implication which, at the end of the day, would be borne by
investors.

3.39 Alternatively, such funds might simply avoid being within the Directive’s scope and would become, to
all intents, inaccessible by EU investors.

G. Other concerns

3.40 The definition of “marketing” in the Directive is too broad. One example of the unwelcome consequences
that this brings is in respect of EU funds of hedge funds (FoHFs). These would be significantly impacted since,
in practice, it is difficult to see how such FoHFs could continue to invest in non-EU funds whose AIFM is not
established in the EU, given that the AIFM in question would not be able to market the funds to the FoHFs.
It is also unclear whether “marketing” as defined would entail the client servicing by an AIFM of investments,
and the acceptance of additional investment, from existing EU investors.

3.41 The AIFM Directive seeks to introduce measures which, in a number of instances, would result in higher
levels of investor protection for professional investors than for the retail investors at whom UCITS are
primarily aimed (see, for example, Section 3E above). This situation is, in the Commission’s own words\(^5\)
“evidently not appropriate”. It would, however, be fundamentally wrong to resolve the position simply by
amending the UCITS provisions up to the levels of the AIFM Directive.

3.42 The UCITS brand has been a great EU success since its inception in the mid-1980’s. The original UCITS
Directive has been amended on several occasions, following lengthy and constructive consultation with
industry. The changes which have been made have allowed UCITS vehicles to evolve with the markets and to
remain attractive to investors globally. These amendments have been successful because they have premised
solely on the issue of their relevance to the UCITS model. This process contrasts favourably with the hurried
manner in which the Directive has been introduced.

3.43 The Commission must continue to look at UCITS, and the regulations under which they exist, on their own merits, not in light of what may, or may not, be relevant in other sectors of the capital markets. There is, in reality, no simple, clear cut division between the “UCITS world” and the “non-UCITS world” as the AIFM Directive seeks to impose—the alternative investment sector is too diverse for a “one size fits all” approach to be appropriate. Each model should be analysed in its own right and regulated accordingly. We make these comments in light of the Commission’s recent consultation paper on the UCITS Depositary Function (to which AIMA is responding), in which it is stated that a re-examination of the UCITS regulatory framework is needed as a result of the AIFM Directive’s requirements “with a view to increasing the level of the protection of the UCITS investors, at least to the level of protection offered to professional investors”. (How it is possible to consider how best to amend UCITS requirements in light of the AIFM Directive’s provisions when it is far from clear what the latter will look like in their final form, is another question.)

3.44 The Directive, in its final version, must provide greater clarity as to how it interfaces with the numerous other Directives which are relevant to AIFMs, such as MiFID, the Capital Requirements Directive, the MAD, and the Prospectus and Transparency Directives. Too often in the current draft, the Directive’s provisions are not aligned with, or do not take account of, existing EU legislation with which AIFMs already comply.

3.45 We welcome moves to reassess the Directive’s proposals on independent valuation—these proposals again fail to address the fact that “one size does not fit all” in the alternative investment sector and to impose a single prescriptive method or model of valuation on the industry would be damaging. We would note that IOSCO’s Principles for the Valuation of Hedge Fund Portfolios recommend an approach to valuations that focuses on a more flexible and substantive approach to the independence of the valuation function. This approach, which is also adopted by AIMA in our Guide to Sound Practices for Hedge Fund Valuation and by the Hedge Fund Standards Board, is one which deals with the diversification in AIFM models. Moreover, to place responsibility for the valuation of the AIF’s assets formally with the AIFM introduces a conflict of interest, potentially detrimental to investors, given that an AIFM’s fees are calculated by reference to the value of the assets of the AIF which it manages.

3.46 Since it severely limits the ability of EU investors to invest in non-EU AIFs, the Directive can be seen as an indirect attack on offshore financial centres. Bringing funds onshore in order to fall within scope of the provisions, however, would lead a truly global industry to fragment—local funds would be created, which would be run by local managers for local investors. It is in the EU’s best interests ultimately to engage fully with the international nature of the hedge fund industry.

3.47 This is a most important piece of new legislation which has a profound impact on a successful and, until recently, growing industry. We regret deeply the lack of consultation in respect of its provisions. A number of regulatory authorities introduced emergency restrictions on short selling during the latter half of 2008; these proved again that, more often than not, regulations which are introduced in haste and without proper discussion with the affected stakeholders result in inadequate and ambiguous rules. There are a number of articles in the current Directive where, had more time been spent on the detailed drafting points, or in developing a deeper understanding of the hedge fund industry, a better text would have emerged, which the hedge fund industry could have embraced unequivocally. AIMA is ready to work in cooperation with the Commission, the European Parliament and EU Member States in order to assist in redrafting those articles where greater clarity is required or where a misunderstanding of the way the industry works can be resolved.

4. Conclusion

4.1 A Directive which introduces appropriate and proportionate measures which:
- require the registration of hedge fund managers within the EU;
- provide national regulators with the data necessary to monitor financial stability within the capital markets across Member States;
- provide for a pan-European passport for AIFMs; and
- enhance investor protection by increased transparency

will increase the safety of European markets and is to be wholeheartedly welcomed by those who wish to see the EU alternative investment industry strengthened and the region maintain its position as an attractive place in which to do investment business.

4.2 While we applaud the Commission’s intentions, the proposed Directive which has been produced will not, in our view, deliver these benefits. Instead, in its current form, the Directive risks significantly limiting the choice available to EU investors (by denying them access to funds domiciled, or managed from, outside the EU) and reducing the returns they make on their investments.

4.3 Professional investors (the group to whom AIFs may be marketed under the Directive) include institutional investors, pension funds, endowments, insurance companies and private banks. If such investors are unable to access the large majority—perhaps as much as 90 to 95%—of the funds in which they may currently invest, the ordinary citizens of Europe, who rely on them for their pensions, savings, financing and even jobs will also be affected.

4.4 Assets in the region of €250 billion are currently managed in the EU by hedge fund and fund of hedge fund managers. Taking into account also the related industries which service the fund managers—investment banks, lawyers, accountants, fund administrators, etc—thousands of jobs within the EU (AIMA estimates perhaps as many as 50,000) depend on the hedge fund industry. These jobs, too, would be put at jeopardy if the current proposals within the Directive remain unchanged, and have the adverse effects which we have concluded they would.

4.5 While a number of the more straightforward issues can be resolved by clarification within the Directive of the Commission’s intentions or by minor revisions of the text, there are a number of major areas, outlined above, where we would look to the Commission and the European Parliament to consider very carefully the concerns we raise.

4.6 It is our strongly held view, therefore, that the many positive benefits contained in the Directive risk being undermined unless there is a measured and thorough revision of a number of those provisions which have the unintended consequences outlined above.

4.7 By improving the text of the proposed Directive in these areas, the Commission and European Parliament can deliver a Directive which offers Europe an opportunity to develop a flourishing alternative investment industry for the future. If the appropriate amendments are not made, however, and the above issues not rectified, the existing alternatives industry in the EU will be severely damaged.

4.8 Momentum is growing, backed by the public statements of well respected commentators, across Europe towards a redraft of the text. AIMA will continue to work constructively with the Commission, the Member States and the responsible committees in the European Parliament to this end.

4.9 In conclusion, AIMA:
— supports the compulsory authorisation of all AIFMs (without any threshold);
— supports an increased threshold of €1 billion for disclosure of systemically relevant data;
— is concerned that much of the proposed Directive fails to take into account the existing hedge fund industry model;
— is working, and wishes to continue to work, constructively with the Commission, the Member States and the responsible committees in the European Parliament to produce a proposal which will (i) resolve areas of uncertainty and (ii) accord better with the realities of the way in which the hedge fund industry is structured and operates; and
— believes that, without significant revision, the Directive will lead to much less choice and greater costs for investors in the EU without achieving the stated objectives of the Directive.

Annex 1

THE ALTERNATIVE INVESTMENT MANAGEMENT ASSOCIATION LIMITED (AIMA)

Established in 1990, AIMA is the not-for-profit trade association which represents the hedge fund industry globally. Its membership comprises 1,100 corporate bodies in over 40 countries and is drawn from all constituencies which make up the hedge fund sector—including hedge fund managers, fund of hedge funds managers, prime brokers, administrators, accountants and lawyers.

AIMA’s members manage approximately 75% of global hedge fund assets and over 70% of fund of funds assets.

AIMA is not a self-regulatory body. New members are vetted for their bona fides; manager members must be supervised by a recognised regulator in order to qualify for membership.

AIMA’s member profile is as follows:
— Hedge fund managers—43%
— Fund of hedge funds managers—21%
— Investors—2%
— Advisers/service providers—34%
Members in the Europe/Middle East/Africa region account for 55% of the association’s membership, those in the Americas 22% and those in the Asia-Pacific region 23%. They all benefit from AIMA’s active influence in policy development, its leadership in industry initiatives, including education and sound practice guidelines and its excellent reputation with regulators worldwide.

Since its establishment, AIMA has worked with the aim of enhancing the regulatory framework in which its members operate. AIMA has a central tenet that good regulation makes for good business. Over the years AIMA has developed contacts with 150 separate regulatory or policy-making organisations in 62 countries—these have access to the AIMA website (www.aima.org) and also receive, free of charge, all our educational and regulatory publications, such as Guidance Notes for AIMA Members and our responses to consultations.

AIMA has produced, over many years, a number of specific and detailed Sound Practice Guides which have been widely used across the industry; these include Guides on hedge fund management, administration, valuation, business continuity, governance, anti-money laundering and comprehensive due diligence of managers and service providers.

AIMA has worked closely with its counterpart, the Managed Funds Association (“MFA”) in the United States, as well as with the UK Hedge Fund Standards Board and the US President’s Working Group on Financial Markets’ Asset Managers Committee. AIMA is currently involved with the work on unification of best practice standards as requested by the G20 and is working closely with the Financial Stability Board towards achieving this important objective.

AIMA has a history of working closely with institutional investors and recently published the world’s first collaborative educational guide for institutional hedge fund investors, AIMA’s Roadmap to Hedge Funds. As with our regulatory contacts, we service institutional investors free of charge and provide them with access to our website and to our publications.

AIMA is committed to developing industry skills and education standards and is the co-founder of the Chartered Alternative Investment Analyst designation (CAIA) based in Massachusetts—the industry’s first and only not-for-profit specialised educational standard for alternative investment specialists. Over 10,000 industry professionals have enlisted in this programme since its launch in January 2003.

Annex 2

LEVERAGE


Leverage is the sensitivity of the portfolio to changes in risk factors such as market prices. There are several drawbacks that complicate the use or comparison of leverage “numbers”:

— There is no single agreed definition of leverage. Definitions cover a spectrum ranging from traditional balance sheet type leverage measures to risk based measures (the latter incorporating underlying risk factors such as Value-at-Risk) and dynamic leverage measures (see table below)

— Classic “financial statement based” leverage is not an independent source of risk, so additional information on the underlying risk factors is required

— Leverage “numbers” have to be considered carefully and may not always contain meaningful information. In some instances, a risk reducing transaction can increase some leverage measures while decreasing others

It may therefore be difficult accurately to compare leverage between different funds. However, in managing a fund and communicating with investors, hedge fund managers should come up with a leverage definition which is meaningful in their context and track changes in leverage over time.

Classic financial statement based leverage definitions are not stand alone risk measures and fail to incorporate off-balance sheet positions (for example, derivatives), which could increase or decrease leverage. Risk based leverage measures try to overcome the shortcomings of classic measures by relating a risk measure (for example, market risk) to the fund’s capacity to absorb this risk (for example, the fund’s equity). More sophisticated dynamic measures of leverage incorporate a hedge fund manager’s ability to adjust its risk position during periods of market stress.
EXAMPLES OF LEVERAGE MEASURES

<table>
<thead>
<tr>
<th>Type of measure</th>
<th>Definition</th>
<th>Observations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial statement/asset</td>
<td>Gross assets/equity</td>
<td>Does not incorporate on-balance sheet hedges and off-balance sheet instruments</td>
</tr>
<tr>
<td>based (classic)</td>
<td>Gross debt/equity</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Net assets/equity</td>
<td>Does incorporate on-balance sheet hedges (therefore “net”), but does not include off-balance sheet instruments</td>
</tr>
<tr>
<td></td>
<td>Net debt/equity</td>
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</tr>
<tr>
<td>Risk based</td>
<td>Portfolio</td>
<td>Usually incorporates all (on-and off-balance sheet) hedge positions</td>
</tr>
<tr>
<td></td>
<td>volatility/equity</td>
<td>But does not account for mitigating measures by manager in times of distress</td>
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<td></td>
<td>VAR/equity</td>
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<td></td>
<td>Stress loss/equity</td>
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<td></td>
<td>Other loss measure/equity</td>
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18 September 2009

Examination of Witness

Witnesses: Mr Andrew Baker, Chief Executive, Alternative Investment Management Association (AIMA), examined.

Q137 Chairman: Welcome everybody to this session of the Committee. Mr Baker, you have been here before, so you know the form. We take a transcript and you are allowed a go at correcting the transcript for infelicities. This session is also being broadcast. The interests of the Committee are on the pieces of paper that you are probably sitting on by now. Two Members of the Committee who have interests in PE and hedge funds are not present for this Committee: Lord Browne and Lady Hooper. The rest of us have interests which are fairly tangential. You have a choice, Mr Baker: I can either start straight away with questions, or if you would like to make an opening statement, please feel free to do so.

Mr Baker: Would it be helpful if I give you a quick update on what has happened since I last saw you all back in July?

Q138 Chairman: That would be very helpful.

Mr Baker: Then I would be very happy to go into questions. Back in July we had no European parliamentary involvement, because obviously the parliament had not formed, and we were at an extremely early stage of the Swedish presidency, so very little had happened at European Council level. There have been a number of significant developments since then. We have travelled far and wide across the EU, not only to reach out to investors who are going to be affected by the Directive but managers from other sectors of the investment management industry, because, as we all know, this Directive will affect others than hedge fund managers. We have also spent a lot of time with both the regulators and finance ministers across the Member States. The purpose of doing that is to establish where national interests lie in certain key issues that are of interest to our industry. In summary, as a result of all of this activity and the Committee meetings which have taken place subsequently within the European Parliament, there does appear to be very widespread consensus now about the areas of difficulty with the Directive—which we have seen plastered all over the newspapers almost ad nauseam—but also the potential for areas where improvements could be made, and there does seem to be very, very strong consensus about where the principle areas of difficulty are. I will list them if you like, but they are quite numerous, and they start with “one size fits all” as a single overriding problem. The good news is that there does seem to be a very strong consensus—so it is not just special pleading amongst our managers’ community; these views are shared by investors and managers alike. The difficulty is what happens next, because the nature of some of the difficulties is very severe and coming up with resolutions which are going to satisfy all constituencies is going to present a number of challenges. One idea I would like to leave with the Committee is that either we have a number of years of extremely detailed and technical discussion ahead of us which will involve better definitions, the consideration of how many sectors of the industry and which ones of them are deserving of a carve out, or else we have to retreat to a much higher level and try to get the Directive through much more quickly so that we can all get on with our lives. Our industry has fully recognised that there is going to be a measure on this score. The more it looked like the Obama proposal, the more we
would welcome it. We would like to see it on the statute books in that form so that we can move on. Part of our problem at the moment is that we are stuck in this sea of mud to do with all the technical difficulties.

Q139 Chairman: Does the sea of mud include the Swedish Presidency’s issues note? When I read it, it seemed to me that the areas of mud did look quite extensive.
Mr Baker: Their issues note is extremely good. It is not comprehensive. There are some topics which have not yet been tackled—certainly not in the notes they have published. We are aware that there have been other notes as a result of other meetings, but they have not been put into the public domain, so we are not aware of their official status. Their issues note was extremely comprehensive and extremely thorough—so full marks to them for effort—however, they have identified a series of options to solve some of the problems, they have not come out in favour of one avenue or another. It strikes us that some of these things are not technical in nature; in other words, you cannot just choose left or right in order to resolve a technical issue. Some of them will probably need some kind of political intervention in order to get the process moving forwards. I hate to say it, but I think the toughest nut of all has not yet been cracked, and that is in relation to the definition that should apply to exactly who is the investment manager to whom all of these requirements will apply. Because of the very, very complex and varied nature of non-UCITS investment managers, there is a very large variety of different structures, whether open-ended or closed-ended, whether partnership-related or limited-company related, and some structures are self managed, so there are extreme definitional difficulties which in turn will affect the scope and which in turn will affect the other measures. There are some significant challenges which still lie ahead, although the Swedes have done an outstandingly good job to date.

Q140 Chairman: The major challenge, it seemed to me, still to be looking at us was the size issue. You were suggesting that nobody should be regulated at less than €1 billion, whereas the Commission’s proposal is €100 million. Has there been any movement there?
Mr Baker: No. A point of clarification, My Lord Chairman, is that that billion euros relates to the provision of information, not to the provision of regulation. Our proposal is in fact that the threshold for regulation is zero. Everyone gets regulated, but it is how much information is provided—which is the thorny question about volume of information to supervisors. In terms of the overall threshold, there has been much debate about, for example, smaller funds in the smaller Member States, which are sold only domestically, many of which are way below the threshold, but if they get close to the threshold at what point do they have to apply. There appears to be general recognition, in terms of authorisation, that the current limit could stand.

Chairman: Thank you very much. I have strayed slightly into the question that Lord Trimble wanted to ask.

Q141 Lord Trimble: To pick up on that, you are saying that there is a consensus that one of the problems is the “one size fits all” approach. I presume when you say there is a consensus, that it is a consensus of the people who are in this industry.
Mr Baker: And investors. And increasingly you will hear it from the members of the committees in the European Parliament and from the people on the Council Working Group who are negotiating on behalf of the governments of Member States.

Q142 Lord Trimble: If there is this broad consensus that “one size fits all” is not the right approach, how do you think that is going to be resolved?
Mr Baker: My view is that we are either going to be faced with many years of discussion about definitions and potential exemptions, or we can retreat to a much higher level and principles-led approach and come back and revisit this at a later date.

Q143 Lord Trimble: Could you tell me what you mean when you say “principles-led approach”? Mr Baker: Some of the provisions of the Directive stray into level 2 territory. The landfill issue process allows for this sort of complexity by saying that level 1 issues should be tackled at the principles level and then the level 2 stuff is left to the Member States individually under guidance and advice from their national regulators. We think that is a very sound way of working. It does not appear to be in use on this occasion. The tools already exist.

Q144 Lord Trimble: Turning for a moment to managers, you have a similar situation. You are saying that having the regulation on the managers is a problem because the manager can take so many different forms and the structures can take so many different forms. Would there be a case for switching the tension of regulation to the funds as well as the managers?
Mr Baker: I do not think that solves any of the issues. As the European Commission says in its own paper and as IOSCO has said in its paper on hedge funds, the right way of doing this is to look at the managers because they are the decision makers. The funds are really only empty shells. Given that management activity can take place outside of a fund structure as
well as within a fund structure, you would worsen the level playing field problem by doing that.

**Q145 Lord Renton of Mount Harry:** I would like to ask you a question about leverage. I know that in your evidence you say that you think it is wrong for there to be such strict figures to be imposed by the Directive, but I am not clear in my own mind as to how important this issue is. I get the impression that there is a huge variety between the leverage unit and the hedge fund industry, which tends to be one time assets whereas in the banking industry it is 50 times assets. It is an extraordinary change. Do you think the Swedish note and the ideas they have put forward on this makes sense? What would you like to see happen?

**Mr Baker:** The Swedish note offers a resolution to this. Let us go back to a prior point which needs to be covered; that is to say that if there are build-ups of leverage which become dangerous, of course we need to be able to monitor them and of course we need the tools to be able to intervene in a controlled way to prevent the situation getting worse. From that point of view, we fully accept the principle that leverage should be monitored. Leverage is not the same as risk, by the way, but leverage, nevertheless, is a potential accelerant during market crisis and therefore it is entirely appropriate that there is a mechanism for monitoring leverage. To translate that into, “Therefore there should be caps on leverage”—which is the same cap, regardless of the type of organisation and the type of assets which are being supported within an investment fund—is far too blunt an instrument, because quite clearly you all understand that the liquidity and volatility of the asset which is being supported by the leverage will determine whether it is safe or not to take any leverage to purchase the asset. For very illiquid and very volatile assets, it is extremely dangerous to take any leverage.

**Q146 Lord Renton of Mount Harry:** What you are concerned about is that suddenly, if leverage is fixed in advance, too many people might get into the wrong position at the same time.

**Mr Baker:** That is called the pro-cyclicality argument. That says that at the very time when markets are most stressed, you have to unwind positions and make the situation worse. Reading the evidence from everyone who submitted to this case, they virtually all make that case. The FSA makes it particularly strongly and pungently.

**Q147 Lord Renton of Mount Harry:** Do you get the impression that your point of view is going to win?

**Mr Baker:** We think that having a cap in place at the manager level or at the fund level is the wrong way of looking at it. There needs to be a monitoring mechanism. There needs to be very careful consideration about definitions of leverage. It is nice to think that there is a simple and single definition that equates to borrowing from the bank, but, sadly, that is not the case. Leverage is used in all kinds of ways to assist with hedging. Unless it is tracked and monitored and the definitions are understood and related to individual types of specialist asset class, then you can end up in a frightful muddle. Anything which pushes us away from common definitions or simplistic caps is the right way to go.

**Chairman:** Lady Northover, you wanted to come in on this question.

**Q148 Baroness Northover:** Yes. Obviously if there is a cap, then that is something that can, as it were, be implemented. If it is being monitored, that cannot be implemented. How would you tackle that? Suppose that the hedge fund feels that its levels are okay but those monitoring are worried, what happens then?

**Mr Baker:** The answer is that the regulator will determine the appropriate level of leverage, depending on the cycle and depending on the nature of the asset category. Let me give you an example of what is happening at the moment to illustrate the point. It is very dependent upon where you are on the cycle. For two years everybody was being urged to take out more borrowing because it was a fantastic way to invest. People on the street were being urged to borrow money and to take out mortgages and to buy houses. In the current environment everyone is urging the banks to persuade people to start borrowing, because the borrowing has shrunk. It is critically dependent upon the stage of the cycle, and so coming up with a single number which is evergreen is going to be counterproductive. Our point is that the leverage is used for different things by different funds with different types of strategy, and so you need a body that has the technical competence to understand the assets which are being supported and the nature of the markets, and whether a fund’s footprint in the market is a big footprint or a small footprint, in order to be able to apply its discretionary judgment as to whether there is danger building up.

**Q149 Baroness Northover:** If they do see that danger, how do they then enforce it?

**Mr Baker:** There are two ways of doing it. There is a direct way and an indirect way. Do not forget that leverage has to be provided by counterparties; it is not magicked out of the air. If counterparties can reassure the regulator that they have done their counterparty analysis correctly and that they feel protected by the leverage that has been provided, then, if the regulator disagrees, the regulator can change capital requirements on the lenders or on the providers of the leverage through derivatives.
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Mr Andrew Baker

Q150 Baroness Northover: That would be very indirect, would it not?
Mr Baker: It is very powerful as well. It is an extremely powerful tool to persuade counterparties that there is an issue they are missing and that a particular fund is a strong outlier, and whether they would like to think about that and come up with a good reason why it is appropriate to continue to support that outlier is potentially a very powerful deterrent. One of the issues that is being explored in addition to that is to have direct enforcement measures which are capable of having contained and controlled unwind of leverage. There are various tools that can be applied, but unless you have a reporting mechanism and you can monitor the stuff in real time, you cannot even begin to do it.

Q151 Chairman: Could I just ask you what, from an alternative investment point of view, is an illiquid and volatile asset? Can you give me an example?
Mr Baker: Yes, very easily. Securities which trade on a market and where you can establish the price and where they are traded pretty much any day of the week would be regarded as highly liquid. Shares which are small capitalisation shares which oscillate all over the place and can move by 10/20/30 per cent at a time would be regarded as very volatile. Asset classes which are extremely illiquid would include real estate investment, would include private equity investment, would include some kind of categorisation of securitised vehicles. Some types of over-the-counter derivatives may be illiquid. The closer they are to being traded on the market, the more likely they are to be highly liquid, but it is the two characteristics you have to monitor: the liquidity of the asset and the volatility of the asset. If you cannot establish a price for it, then you have to treat it in a different way and it comes to borrowing in order to buy more of that asset.

Chairman: Thank you. Lady Northover, you wanted to ask about third country marketing.

Q152 Baroness Northover: We have received much evidence on third country marketing provision of the Directive, which you describe in your evidence as a “protectionist measure”. Do you believe that the Swedish Presidency’s solutions of looking at the various options in relation to Articles 35 and 39 and changing the definition of marketing will alleviate this?
Mr Baker: Only if they choose what is called option 5 under their proposal, which means deleting Article 35, deleting Article 39, amending Article 3 so that reverse solicitation is possible, and—another point which is not covered—national private placement regimes should remain in place.

Q153 Baroness Northover: So that is the option.
Mr Baker: Which is the status quo at the moment within the EU.

Q154 Baroness Northover: Following on from that, AFG has argued that any AIF passport should be limited to EU-domiciled funds and managers. Looking at how you set up something which is complementary to the EU passport system, they suggest the possibility for national regulators to provide non-EU funds with a national visa, therefore allowing marketing of non-European funds to local investors but not EU-wide. Can you comment on that proposal as one way of dealing with this complicated area?
Mr Baker: It sounds suspiciously like national private placement regimes again. I cannot see anything in between the full blown passport—which would be EU-wide, it would satisfy the number of criteria and rules—and the existing arrangement with the status quo—which says that it is acts of consenting adults between individual member nations which the FSA has called the patchwork of different measures. Those happen to work at the moment. The passport is going to be fiendishly complex to implement. It is the right thing to do to aspire towards achieving it. The idea of starting it with limited ambition and making it work just for EU funds and EU managers I think is a good one. Let us get it working properly within the EU and let us expand it, but, meanwhile, let us not prevent the access of other investors to non-EU managers and funds by keeping in place the existing patchwork of national private placement regimes. I think it has merit because it allows us to move in small steps.

Q155 Baroness Northover: Is that a shift in your position, to accept the idea of the EU passport in that way?
Mr Baker: No, I think we have always been very supportive and welcoming of the idea of having the passport. It can be a little bit confusing because the idea of a passport is that some people are in and others are excluded. If everyone around the world has the passport, then it would only keep out the managers from Mars presumably. The concept of having to satisfy set criteria before you are let loose on the investors of a country is a good one and that is the one we support; namely, that if the patchwork of arrangements is codified and turned into a single set of achievable rules, we support that completely. It must be part of the development of a good single market.

Q156 Baroness Northover: Yes, and it might give those funds operating within the EU or based within the EU a competitive advantage to start with.
Mr Baker: Indeed. It has worked with UCITS. UCITS has been incredibly powerful as a tool. It is a different product, it is used principally for retail investors, but it has been exported beyond the EU as it stands for something. It is a standardised way of producing a product fit for retail investors. The technical difficulties are immense, but, in principle, there is no
reason why you should no aspire to do the same in the non-UCITS.

Q157 Lord Haskins: Complexity keeps coming. Every time we ask a question the answer is, “It is very complex” and “Information is very complex.” Everybody hides behind complexity. There was an interesting article in the Herald Tribune last week saying that when bankers were not the brightest (the brightest people went into engineering and the less bright people went into banking) they kept it simple and therefore you could understand what was going on. Now, unfortunately, all these engineers have gone into banking and created a complexity which is breaking the system down. Disclosure is a good thing. You would agree that disclosure is a good thing but not too much of it. Why not too much of it? Because it is too complicated; because if we give it all to the regulator, the regulator will not understand it. It begs the question whether the people who are giving the information themselves understand it. At what level do you think the regulator should be exposed to this information? Where do you draw the line between what is necessary and what is not necessary? It makes people a bit suspicious, because of the complexity, when people draw the line and say, “No, we will not have that in because it is not necessary.”

Mr Baker: Wherever I have used the word “complexity” if you replace it with the word “variety” that would serve the purpose. It is back to “one size fits all”. The point I have been trying to make here is not: “Don’t bother, because it’s too difficult.” The point I am trying to make is that to try and come up with the same formula which applies with such variety is going to be incredibly difficult. As regards what information the supervisory authorities should look at and share amongst themselves in order that they can build up the picture, I would urge everyone to view what happens in the banking industry as completely different from what happens in the investment funds industry because they are completely different businesses. In the investment funds industry, the FSA has launched a process, which it has been trialling since April, to seek information from the largest organisations, the largest hedge fund managers which it regulates, in order to start building up this systemic risk picture. As you can appreciate, defining systemic risk, making sure if you were to build a systemic risk jigsaw that you have all the pieces of the puzzle in order to allow you to build a full picture, is not straightforward, but you have to start somewhere. The FSA has started in the case of the hedge fund industry. It has invited the top 50 managers in the UK to complete this return with data as at the end of October, and then it will compile and consolidate that information and see what lessons it has to learn, as to whether it needs to track exposures in addition to tracking leverage—which we have talked about earlier. We would welcome that approach. We think it is entirely the right approach to adopt. They are capturing about 50 different pieces of information—so 50 organisations, 50 pieces of information. We think that is proportionate and manageable.

Q158 Lord Haskins: That all relates to the potential contribution to systemic risk, which assumes, therefore, that the FSA believes that the alternative investment funds have contributed to the systemic risk failure. But you would not agree with that.

Mr Baker: No, I would not say that all. IOSCO and G20 and their various documentation and reports have concluded that all financial market players should be on a radar somewhere and therefore they should be authorised to operate and they should provide information about their activities if what they do is systemically significant and they do it systematically. We would support that entirely.

Q159 Lord Haskins: The Government has tended to say that the hedge funds have not been significant contributors to the systemic risk—which is slightly different from protecting investors. You are suggesting that maybe there is a contribution.

Mr Baker: I am not going to sit here and say there is absolutely no contribution at all, leave the industry alone. I will leave that to other parts of the financial services industry who are arguing their case with respect to the Directive. That hedge funds are users of leverage leverage can cause systemic risk is not to say that hedge funds are therefore systemically significant. Nevertheless, not to monitor it at all and not to pay any attention to it and to turn a blind eye to it does not seem the right response in the current environment.

Q160 Lord Jordan: At the moment Europe and America are looking for some sort of controls that will prevent another financial industry generated crisis that caused an awful lot of pain to the people on both those continents. To what extent is the US proposal on hedge funds similar to that which the Commission is proposing? What do you think are the significant differences between the two? Quite what did you mean when you said, “The more it looks like Obama’s proposal, the more we like it?” Is this being less demanding than Europe is?

Mr Baker: No, because it concentrates on the issues which have been identified at the G20 level as those which should be tracked and monitored. There are two pieces of evidence which I will bring to your attention that were submitted to this hearing: one provided by the law firm Dechert LLP; and one provided by Citadel (who are in attendance as observers today) which lists the similarities between the two approaches and the differences. I would
summarise the two approaches by saying that they are really quite materially different. Where they align and where we support that alignment is in relation to managers being authorised and registered—so if you want to drive on the road, you have to have a driving licence—and in the provision of information via disclosure to the supervisory authorities so they can build up a picture of potential build-up of systemic risk. We support that completely. There I would say the similarities end, because the Directive then goes into what I would call level 2 issues, some of which relate to the fund and not the manager This is supposed to be a Directive about managers, but some of these provisions relate to the fund itself. They are detailed implementing measures, not principles. We would just echo the findings that came out of the G20 meetings, which have been repeated in numerous reports from very distinguished writers, which emphasise these two points: Who is operating the markets?—“Let’s authorise them.” What are they doing?—“Let’s track the information around their portfolio activity and let’s aggregate it and share it at a consolidated and aggregated level in private amongst supervisory authorities.” We wholly support those ideas. Some of these other measures will provide protection to investors, but that is very, very different from providing protection to markets against systemic risk issues.

Q161 Lord Jordan: What would you regard as the single most effective tool that the two continents could have in preventing another disaster of the sort we have seen? I know that you have concentrated on the provision of information, but if the industry is being renowned for anything, it harks back to the brilliant engineers who have come in and enabled you to provide so much information in such a diverse way that people often question whether even they understand it. I know they do: it is just that they know no-one else will. What is the good of providing that information that is deliberately designed to confuse? The complexity has become unbelievable in this last 20 years. What single tool, in spite of these devices that are being used, do you think would be the most important for the governments of the two continents to prevent a reoccurrence of what is happened?

Mr Baker: I would say that this is not just an issue about regulation—because to prevent the future financial crisis, there are obviously political issues and monetary policy issues, tax policy issues, consumer behaviour issues which are far too broad for me to go into at this hearing. Turning just to issues around financial market behaviour and financial regulation, I would say that the single most powerful tool would be avoiding unilateral action and making sure there is a degree of co-ordination to prevent regulatory arbitrage, to prevent people going to a different environment and shopping around for an easier place to do business. If we are told we live in global markets and protectionism is to be eschewed, then surely it would be better to come up with global solutions. If you meet in London on 2 April in the G20 and agree to a certain set of measures, why would you then endorse a Directive three weeks later which goes in the opposite direction. Coming up with co-ordinated measures is incredibly powerful.

Q162 Lord Moser: We had a discussion the other day about taxation on different kinds of investors, *et cetera.* You will not be surprised that not all of our witnesses love hedge funds. Some have been quite critical of them, even their role in the crisis and so on. A particular point that came up at one meeting was that they are unfairly advantaged vis-à-vis other buyers and sellers in the markets and they deserve not exactly punitive tax but an additional tax of some kind. Do you have a view on that? I am sure you do not like the idea.

Mr Baker: No, you are correct with that, Lord Moser. I did read the submission. I have two comments. I think there would be extreme difficulty with it. Even down to the definition of what is a hedge fund. To create good tax policy it has to be clean, efficient, you have to be able to define your target and there has to be merit attaching to it. Even on the grounds of definition and implementation it would be a bit tricky. But let us say that it is a good idea, then it illustrates a very good principle here, in that unless you persuade the authorities everywhere else in the world that this is an equally good idea, the transactions will migrate to those other parts of the world. For funds which have an offshore jurisdiction and which trade in international markets, I do not know how the taxman could lay claim to the transactions which are deemed tax worthy. I would leave you with one final point. In the case of stamp duty tax on UK shares in this country, to alleviate the tax burden of paying the stamp duty gave rise single-handedly to the creation of contracts for differences, which are swaps in relation to UK shares. If a tax is introduced which cannot be implemented or can be circumvented, then unless you persuaded every other country around the world that this is the right thing to do, it will be extremely difficult to enforce it and implement it. At a personal level, it just seems to be the same as taxing tall people in Penge on a Tuesday. It just seems to be very, very, very targeted and inappropriate. I just do not see the merit.

Q163 Lord Moser: That is rather a surprising answer to me. I thought you might say, “This is ridiculous because hedge funds are good boys and they do not deserve this extra taxation.” What you actually said was, “(a) you cannot define hedge funds”—which presumably is a problem that could be overcome—
and “(b) it would be too difficult to arrange this tax.” You did not say it was undesirable.

Mr Baker: I was not seeking to place a moral judgment on it. The tax authorities are the ones who decide who are the worthy parties to incur taxation, so I was not seeking to place any judgment on it.

Q164 Lord Haskins: If you say that internationally you cannot apply taxes with international reasons, does the same not apply for regulation?

Mr Baker: It is the point I was making earlier about everything needing to be joined up. Unless it is joined up, you will get tax arbitrage, you will get regulatory arbitrage, you will get trading arbitrage.

Lord Haskins: Is there any chance of that joining up?

Q165 Lord Renton of Mount Harry: That is a key question.

Mr Baker: It is a very important question. The fact that it is difficult does not mean to say you should not try. If we were all believers in globalisation and the merits of being able to trade with each other and the merits of being able to lend to and borrow from each other, then we have to accept the logical consequence of trying to harmonise our rules.

Q166 Lord Haskins: It means doing the equivalent of what the WTO does for the rest of us in business, creating a WTO for the financial markets.

Mr Baker: Absolutely. It has taken decades for the WTO to function effectively, but nevertheless everybody buys into the importance of it because otherwise everything would break down into bilateral arrangements.

Q167 Lord Moser: The basic point, I suppose, is on whether hedge funds have had a privileged kind of position—“privileged” is the wrong word, but you know what I mean—in the markets and therefore this extra tax was proposed. Maybe the real answer is what you have just been implying, that there be no kind of fund or investment arrangement should have privileged arrangements as regards regulation supervision.

Mr Baker: Sure. I would dispute the fact that there is a privileged trading arrangement that benefits hedge funds uniquely. I would dispute a number of points within Mr Chapman’s evidence statement.

Q168 Baroness Northover: One thing that struck me within your paper was that European hedge fund industry presently has €250 billion of assets under management within the EU, yet the tax take from that is only €4 billion. That seems to me to be an extremely low product of all of those assets. Do you not feel so?

Mr Baker: Yes, but do not forget it is profits and revenues of the management companies.
Chairman: We will be taking evidence on this, Lord Renton, from the pension funds later. I must, riveting though this has been, suggest we call it to a close or we will never get to talk to BlackRock. Thank you very much indeed for coming, Mr Baker. It has been most useful. I would be truly grateful for an answer to Lady Northover’s questions.

Baroness Northover: I have been running through on my calculator to see what I think it ought to be.

Q176 Chairman: If you have €250 billion, what is the revenue and what is taxable?
Mr Baker: Yes, I will respond to that.

Q177 Chairman: I appreciate that the answers to those two questions are not necessarily the same.
Mr Baker: Indeed. Thank you very much indeed.

Supplementary memorandum by AIMA

In response to your request asking for a breakdown of the analysis used to extrapolate the estimate of €4 billion in taxes paid by the hedge fund industry in the EU for 2008 please see the below detail:

— Estimate for total of assets under management for the hedge fund industry in the European Union = € 250 billion (source: 31 December 2008, Hedge Fund Intelligence).
— Estimate for taxable revenue that hedge fund management companies in the EU have generated in 2008 from its management of Alternative Investment Funds = € 13.6 billion.

(By taxable revenue we mean profit that hedge fund management companies generated throughout the course of 2008 and the amount of personal income received by individuals in hedge fund management companies throughout 2008).

— Tax rate applied to estimate of taxable revenues from the EU hedge fund industry: This analysis applied a mean measure of (a) the average EU corporate tax rate (23.6%) and (b) the average EU income tax rate (37.8%).


Therefore estimate of taxes paid by the EU hedge fund industry in 2008 were then estimated at € 4.175 billion or rounded to € 4 billion.

18 November 2009

Memorandum by BlackRock Inc

1. What economic benefits arise from Alternative Investment Funds? What risks to financial markets arise from Alternative Investment Funds? Will the Directive help reduce these risks?

1.1 Benefits of private equity

The common misconceptions about private equity are that it is focused on short term gains and associated with the loss of jobs or breaking up of companies and sale of their various parts. Private equity has actually been shown by many studies to be beneficial for European growth and job creation:

— private equity has a particularly beneficial effect on the economy during downturns when access to capital is scarce;7
— between 2003–07 private equity investments had been associated with the creation of one million jobs in Europe; In 2007, companies backed by private equity capital employed six million people in

7 The Economic and Social Impact of Private Equity in Europe: Summary of Research Findings, June 2009, Per Strömberg, Professor of Finance, Stockholm School of Economics, Director, Institute for Financial Research (SIFR).
Europe, which represented at the time 25% of total employment in the top 600 European public companies;\(^8\)

— a study\(^9\) on French leveraged buyouts concluded that there is “some evidence that leveraged buyouts may alleviate credit constraints and be an engine for growth in small and medium sized enterprises” and that “. . . in France, LBO targets experience a very strong growth in sales, assets and employment after the deal, in particular when they were previously more likely to be credit constrained;”

— the private equity sector can play a “constructive and important role during the current recession and . . . initial recovery”. There is evidence that companies backed by private equity create jobs during the initial stages of economic recoveries, whereas generally employment tends to contract.\(^10\)

1.2 Economic benefits of alternative asset classes

The benefits arise from a number of different sources:

(a) Private equity funds and hedge funds help in the distribution of capital to those that can use it most productively.

(b) Hedge funds contribute to the liquidity of financial markets.

(c) Hedge funds contribute to the efficiency of financial markets.

(d) Alternative assets have contributed to employment and tax revenues in the UK (and more widely in the EU).

(e) Hedge funds have their place in creating diversity in the markets: they are mostly small and medium-sized businesses; dominant players are rare; diverse in their investments (eg hedge funds were both long and short of Northern Rock into its demise).

(f) AIFs can improve risk-adjusted returns and increase diversification for investors. By restricting access to AIFs, investors lose the ability to invest in funds that historically have less beta and more idiosyncratic returns than many other asset classes.

1.3 Risks to financial markets arising from AIFs

The de Larosiere and Turner reports state that alternative investments did not contribute materially to the liquidity crisis and are not a systemic risk. BlackRock believes that market practice has changed significantly since the demise of Long Term Capital Management and the systemic risk which it brought to the market place in 1998. Space prohibits full details of that situation but many lessons have been drawn from LTCM’s demise and this has helped the industry since prosper:

— Improved understanding of leverage.

— Improved measurement of liquidity: in some sense LTCM was the market in some assets and derivatives; hedge funds in total may have been the dominant participants in some market sectors but no single hedge fund enjoyed dominance on its own.

— Improved understanding of credit risks (in both directions). The prestige of LTCM was such that banking counterparties were keen to lend to LTCM without full due diligence on the contents and riskiness of the fund. By the end, LTCM was approximately 100% manager owned showing that even this risk of personal loss did not act as a brake. Nowadays, banking counterparties to hedge funds ask for and receive information about the contents and riskiness of the fund as a prerequisite to credit being extended.

— Increased collateralisation of positions. The security of credit has been improved over recent years through the use of collateralisation of debits. Hedge funds borrowing money give the lender first call on assets of the fund. So, were such a fund to default, the lender would be protected from loss by being able to have the first claim on the proceeds from the sale of the collateral. In this way, lenders to hedge funds are protected from significant losses in instances where hedge funds lose money precipitously. Similarly, collateralisation is a tool increasingly used by hedge funds when they lend cash to banks.

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\(^8\) A study by AT Kearney in 2007.


\(^10\) The role of the private equity sector in promoting economic recovery, Robert Shapiro, March 2009.
2. To what extent is there a need to create a single regulatory regime for Alternative Investment Fund Managers in the European Union? Does the Directive achieve its objectives? Should the objectives of the Directive be modified?

2.1 Extent to which a single regulatory regime for AIFMs is needed in the EU
BlackRock is in favour of well-regulated securities markets and believes that they are good for investors and markets. Although it should be noted that professional investors did not request legislation and have increased their allocations to AIFs over recent years, we are in favour of the goals listed below.

2.2 Does the Directive achieve its objectives?
We are broadly supportive of the goals of the Directive and believe that the EU can have a positive impact on the alternative investment management industry both in the EU and globally by achieving its stated goals, which we understand to be:

— the monitoring and limitation of systemic risk;
— ensuring the appropriate protection of professional investors;
— providing appropriate transparency;
— facilitating the marketing of AIF to professional investors throughout the EU; and
— ensuring that regulatory actions are proportionate to risk and reflect different alternative asset business models.

Our major concern is that the Directive goes beyond the requirements necessary to meet the goals to the detriment of investor choice and returns. In our view, the objectives of the Directive are appropriate, but it is the means by which the Directive goes about achieving these that we would wish to see moderated/modified.


3.1 Role of AIFs in the financial crisis
Please see response to Question 1.

3.2 Will the Directive introduce over-stringent regulations or does it not go far enough?
BlackRock’s concern is that the Directive:

— is not proportionate to the risks presented by AIFs;
— is in many instances too prescriptive in its approach;
— may have unintended consequences which may be detrimental to EU investors and markets. (See also the response to Question 4);
— as drafted, allows EU professional investors to hire only EU managers of EU domiciled funds that employ EU custodians and EU auditors. Investors currently are able to exercise their own judgement to select the best managers the world has to offer in pursuit of their investment objectives;
— as drafted, does not reflect the market practice and business models of many of the fund types and asset classes in scope;
— is inconsistent with, and in some respects duplicates, requirements in other legislation—for example, the MiFID, Transparency and Prospectus Directives; and
— may create an unlevel playing field between different types of providers and between funds and securities.
4. Is it appropriate to regulate Investment Fund Managers, rather than the Fund itself? Does the Directive contain appropriate provisions to distinguish between different types of alternative investment? Does the scope of the Directive create a danger of unintended consequences?

4.1 Regulation of Managers rather than Funds

BlackRock believes that it is appropriate to regulate Investment Fund Managers, rather than the funds themselves.

The problem is that, in applying an all-encompassing approach (what some have termed “one size fits all”), the Directive is not always proportionate to the risks presented by different types of fund structure or asset class. Proportionality is key to ensure that risks are adequately addressed, but that AIFs that do not present specific risks are not disadvantaged. The difficulty will be in ensuring that there is proportionality, whilst at the same time not straying into product regulation (which the Directive already does in some areas, for example leverage).

4.2 The risk of unintended consequences

The Directive risks creating unintended consequences by applying one approach to a vast array of different asset classes and fund structures.

The Directive does not cater for the multiplicity of fund governance structures that exist across all in-scope asset classes. It states that the AIFM’s role is that of management and administration, in contrast to existing governance structures which frequently separate out oversight, investment management and administration.

We believe that the regulatory aims of the Directive can be achieved by working within existing fund governance and structures without imposing the reorganisation of fund structures. Any reorganisation would not provide any additional protection for investors, and would only potentially add cost and lead to a reduction in returns for EU investors. The Directive needs to appropriately identify the AIFM for different fund structures by defining the AIFM as the entity that controls the day to day management of the fund assets (ie portfolio management).

The Directive does not reflect current market practice for the many different types of fund and asset classes in scope in relation to delegation, depositaries, valuations and transparency requirements.

The Directive does not always reflect the reality of integrated capital markets and risks being considered protectionist, creating an unlevel playing field between EU and third country AIFMs and AIFs:

— The equivalence provisions for third country AIFMs are such that it is unlikely that many third countries would be considered equivalent.

— There are important divergences between the approach taken by the Directive and that taken by the US Treasury which casts doubt as to whether the US regulatory regime would be considered “equivalent”.

— We are concerned that the Directive may provoke regulatory retaliation from other jurisdictions.

— The requirement that delegation of portfolio and risk management functions must only be to other AIFMs effectively prohibits the delegation of these functions to non-EU entities.

The Directive may also create an unlevel playing field between different types of providers and between funds and securities.

Instead of offering further protection to EU investors, the Directive, as currently drafted, may in fact have damaging consequences for them, reducing the scope of opportunities open to them and potentially reducing their returns. (See answer to Question 9).
5. What is your evaluation of the Commission’s consultation in the preparation of the Directive?

BlackRock believes the objectives of the AIFMD to be laudable and understands the political imperatives which led to a compressed process in terms of the preparation of the Directive. As a result, however, significant amendments are required to ensure a workable solution and to avoid unintended consequences.

REGULATORY ASPECTS

6. Will the passport system help create a single market in investments funds within the EU? How will the passport system established affect the EU and the UK industry and particularly their position in the global market?

We are supportive of the objective of the EU Commission to develop the single market in AIFs. A passport would theoretically allow AIFMs to distribute their AIFs more widely and more easily cross-border within the EU and will provide EU investors to access to a broader scope of opportunities.

However, the passport is unlikely to be a realistic possibility for non-EU AIFMs managing either EU or non-EU AIFs, or for EU AIFMs managing non-EU AIFs for the reasons set out in the response to Question 4.

The passport is likely to create a single market for those AIFs that are managed and domiciled in the EU and are not adversely impacted by other requirements of the Directive.

However, many of the AIFs in scope are nationally regulated, nationally distributed, and there is no intention or desire to market them more widely within the EU, nor indeed is wider distribution in the EU appropriate for many such funds. This applies to, for example, charity funds in the UK (themselves registered charities in England and Wales, they are also only sold to registered charities in England and Wales) and other nationally regulated and distributed non-UCITS retail-type funds in other EU countries.


7.1 Threshold

BlackRock believes that the threshold set out in the Directive is potentially problematic:

— It seems inappropriate for all AIFs above a certain arbitrary threshold to have to submit a standard set of information to Home State regulators.

— We believe that it would be more appropriate to require that all AIFs, regardless of size, register with their Home State regulator. The AIFMD should then introduce a threshold for the disclosure of systemically relevant data to Home State regulators. This threshold should be based on AUM, should reflect the type of liquidity offered to investors and the size of the AIFM’s programme.

7.2 Capital Requirements

In terms of capital requirements, the Directive does not include a cap on the capital requirements of AIFMs. We would propose the introduction of a cap on the capital requirements of EUR 10 million, as per the UCITS Directive.

7.3 Leverage

BlackRock believes that the AIFM Directive is not the appropriate place to seek to regulate leverage. Particularly problematic are the standard approach to leverage that the Directive sets out and the ability that it gives to the Commission to intervene in capital markets by imposing limits on leverage. We believe that it would be more appropriately addressed on the supply side, through the forthcoming CRD revisions. If rules around leverage were to be left in the Directive, we would certainly suggest that, at a minimum, the arbitrary caps on leverage should be removed (which we fear may in fact exacerbate procyclicality), and that leverage should be measured on a net basis and at fund level, rather than asset level.

7.4 Depositaries and Valuation Agents

For both depositaries and valuation agents, the Directive ignores current market practice. BlackRock has some concerns and recommendations in relation to the provisions on depositaries and valuation agents.
8. Will the provisions strengthening disclosure requirements help to create a more transparent market or do they go too far?

BlackRock is supportive of transparency and appropriate disclosure in the context of AIFs, to facilitate the monitoring of risks to the financial system and so as to afford greater protection to investors.

We do, however, have concerns in a number of areas, including:

— we have concerns about the provisions set out in articles 26–29. They are in many cases not proportionate to the risks presented and also potentially put AIFs at a disadvantage compared to other market participants; and
— whilst we believe that disclosing the existence of preferential terms enhances transparency, requiring that the names of investors receiving preferential terms be disclosed is highly problematic and does not afford any additional protection to investors.

**IMPACT**

9. What effect will the Directive have upon the position of the City of London and the EU as a whole as a leading location for Investment Fund Managers? Could it cause many hedge funds to relocate outside of the EU? What impact would the Directive have upon professional investors and institutions?

9.1 Impact on professional investors and institutions

We are concerned that the AIFMD, as currently drafted, will have a detrimental impact on:

— opportunities available to professional investors in Europe;
— returns that professional investors will be able to achieve; and
— european markets and economies.

The AIFMD may have the effect of limiting the choice available to investors making it harder to meet their investment objectives—we are concerned that EU investors will be restricted to only EU managers of EU funds investing in EU assets due to the following:

— Choice of assets AIFs can invest in may be limited, likely to EU assets, by requirements that depositaries be EU credit institutions and depositary liability provisions. These provisions may give rise to prohibitive costs.
— Restrictions on portfolio management delegation will make it problematic to offer funds with global investment themes (eg global hedge funds, private equity funds, real estate funds) and global multi-manager funds.
— Significantly reduced investment choice for EU fund of funds as investments are limited to EU domiciled funds. This concentrates investor risks in their home markets.
— AIFM will cease to offer AIFs with certain leverage profiles given the restrictive provisions in the AIFMD, despite demand from professional investors.
— Investments “at the initiative of the investor” are considered to be marketing and are thus caught by the AIFMD, limiting the ability of investors to approach managers about fund opportunities.
— EU investors may be locked out of attractive opportunities due to the proposed more time-consuming regulatory review and clearance process. Examples of opportunities that may not have been possible had the AIFMD been in force include:
— TALF Funds/PPIP Funds: US government program to recycle toxic assets from US banks balance sheets; US Manager, Cayman domicile; Levered with cheap financing from US Government; Asset managers look to raise capital from global institutional investors,
— Private banking channels will no longer be able distribute close ended funds under the Qualified Investor exemption (Prospectus Directive).
— The equivalence criteria for non-EU funds and managers are so comprehensive that it is unlikely that other jurisdictions, such as the USA, HK or Singapore, will be considered equivalent. In including provisions such as these, the AIFMD does not reflect the reality of global capital markets. It creates an unlevel playing field between EU funds and third country funds and between funds and securities.
In addition to the impact on returns resulting from the above, they may be further reduced by:

— The need to make significant changes to the structure and operation of existing AIFs and AIFMs to meet the one size fits all AIF governance, depositary and valuation provisions.
— Consequently, pensioners and retail clients as well as institutional investors may suffer lower investment returns and/or the tax payer may pick up the risk of higher pension fund deficits.

Investor benefits in terms of increased transparency and protection may thus be outweighed by reduced choice and lower investment returns.

It would have a negative impact on the European economy were the AIFMD to be approved as it currently stands:

— It would reduce the amount of risk capital currently invested in European companies, making them more dependent on (national) bank capital.
— In addition, it would reduce trading activity and liquidity levels leading to less efficient markets and inhibited price discovery.
— Competition will also be reduced leading to fewer viable investment managers as small AIFMs may not be able to withstand the greater regulatory/compliance burden.
— The EU credit institution requirement (for depositaries) consolidates rather than disperses risk and may exacerbate “too large to fail” risk with respect to depositaries.

10. How does the Directive compare to existing or proposed regulation of Alternative Investment Funds outside of the European Union, particularly that of the United States? How will the Directive affect the position of EU Alternative Investment Funds in the global market?

Please see Appendix for a comparison of the EU and US regulatory proposals.

11. What effect will the Directive have on flows of capital and financial innovation?

No comment at this stage.

20 October 2009

Examination of Witnesses

Witnesses: MR PETER ROSENBAUER, Managing Director, and MS JOANNA COUND, Managing Director, BlackRock, examined.

Q178 Chairman: Welcome to you both. Thank you very much for coming to attend. We are on air and you will receive a transcript of this session which you can correct for infelicities. You will have seen the declaration of interests on behalf of those Committee Members who are taking part in this inquiry, which does not include, for example, Lord Browne, who is a director of one of the big American hedge funds. If I may, I am going to recast very slightly the first question and you can either answer it or take it as opening statement. The general assumption attached to this Directive, which started with the de Larosière report, is that hedge funds and alternative investment were not the major contributors to financial instability. There remains a prevailing belief, among the Members of this Committee and among all sorts of other people, that they did indeed contribute something to instability. When you are thinking about whether the Directive is proportionate, can I ask you to make the case, as it were, for what contribution hedge funds made—and not necessarily BlackRock, but any hedge fund, any alternative investment. Where is the intrinsic instability? If we may refer this question to the past: What contribution do you both feel hedge funds in general made to instability. Then we can think more accurately about what ought to be done differently.

Ms Cound: I would like to step back and address that question more broadly. In looking at whether the Directive is proportionate or not, more general considerations exist that affect all asset classes. The first one is reiterating something that Andrew Baker said, which is that, as currently drafted, the Directive would allow EU investors to invest only in EU funds managed by EU managers with EU depositories, investing largely in EU assets. We do not believe that is proportionate. It would have a fundamental impact on investor choice, returns and diversity. That is one factor. The other factor that we do not think is proportionate—and I am speaking as BlackRock, a global company offering a wide range of asset classes—is that the Directive covers all non-UCITS funds—so it impacts not just BlackRock’s clients investing in hedge funds but also clients investing in private equity funds, real estate funds, institutional funds in a range of countries, UK investment trusts, UK charity funds, and non-UCITS retail funds. We have over 200 funds that are captured by this
Directive, of which fewer than ten per cent are BlackRock proprietary hedge funds and around 50 per cent meet the classic definition of alternative investments—so hedge funds, private equity funds and real estate funds. The others funds are mostly long-only, traditional investment products. That is a second reason why we say the Directive is very broad in its approach. There is a third, for us, fundamental unintended consequence which we also believe is not proportionate, and that is that the Directive assumes a certain form of AIM—what Andrew Baker is referring to as ‘Who is the AIM?—a UCITS style management company, whereas the vast majority of BlackRock fund structures have corporate or partnership structures without a UCITS style management company. The cost of restructuring would be significant, with no benefit to the client in terms of increased investor-protection or transparency or a contribution to monitoring systemic risk. Those are the main reasons that we would say the Directive is not proportionate. We can then address the particular question you raised in terms of hedge funds. I should introduce myself: I am Joanna Cound. I am the International CoO of our cash business but I am also co-ordinating BlackRock’s response to this Directive. We are engaging very actively, primarily with our clients but also with a wide range of regulators, Member States, EU institutions. Perhaps I could turn to my colleague.

Mr Rosenbauer: Good morning, My Lord Chairman. My name is Peter Rosenbauer. I oversee the client activities for BlackRock Alternative Advisors, which is our fund of funds business: our hedge fund of funds, private equity fund of funds, as well as real estate fund of funds, at our business headquarters here in London. With regard to your question, perhaps I might seek to clarify it a little bit. There is quite a bit of debate around the role that hedge funds and private equity funds and other types of funds that are caught up in this Directive played in the crisis. Your question is: Did they exacerbate the crisis? Were they catalyst for the crisis? Am I correct in understanding that?

Chairman: It is the more general question about what part hedge funds played in the crisis. I think we all understand about PE funds. For instance, if I attacked the ten per cent of BlackRock proprietary funds, is that ten per cent by number or by value?

Ms Cound: That is ten per cent of the funds captured by this Directive.

Chairman: By value?

Ms Cound: By number of funds. If you think of BlackRock’s total assets, those propriety funds would be less than half a per cent. If you add in other hedge funds of the fund of funds business, it would be about two per cent.

Chairman: We are trying to have a go at the general public perception that hedge funds caused the trouble. It would help us to know to what extent any of that was true.

Mr Rosenbauer: I would start by saying that it is our supposition that hedge funds did not start the crisis. As market participants, they were certainly affected by the crisis. It is also interesting to note that whether you are referring to hedge funds or private equity funds, it is a very broad generalisation and there are lots of different strategies and there are lots of different investment managers operating around the world who are investing in playing a part in different ways. Some of that can be viewed as less constructive and in some ways it is quite constructive. I bring that up because hedge funds often invest differently than many long-only funds. They have more strategies available to them and they are able to offer or construct an investment position which is different from long-only measures, whether that is in the equity world or in the fixed income model. We believe that hedge funds provide a fair amount of price discovery; that is, through very focused analysis they are able to discover the fundamental value of certain securities that may not be recognised in the broader market. They also have the ability to go long or short as security. We believe that that is a very important part, that liquidity that is provided, that counter-opinion about the value of a security provides quite a bit of value, in the sense that it provides equilibrium. When others are selling they are able to buy and so forth. A good example might be when the various regulatory bodies around the world sought to limit the damage that was being effected by financial institutions and so put a ban on short selling. I think all academic evidence at this point suggests that that was a poor idea. It was poorly constructed. Whether in the equity markets or in the fixed income markets, the velocity of the decline of those securities increased. Because they were not able to short a security, a hedge fund almost by definition was not able to participate in that trade and offer a different opinion. When you look at hedge funds with regard to what happened in different financial institutions, there were some that were short. Certainly there were some hedge funds that were quite vocal about certain financial institutions being overvalued and their business model was not strong; there were others that had a countervailing opinion and lost a great deal of money because their opinion turned out to be wrong.

Ms Cound: Reinforcing the point, the LSE looked at the period when the FSA banned short selling. That was about September to January. Liquidity reduced dramatically; the cost of transactions increased by about 115 per cent; and there was less efficient pricing as well and greater volatility. We definitely would support all the august bodies that say hedge funds did not cause the crisis. It is difficult to say what exactly
they contributed, but that evidence would say it was a minor part. There are a lot of statistics—Andrew Baker referred to them a little while ago—in terms of the average leverage that hedge funds had compared to the proprietary desks of banks or the balance sheet of banks. There is a whole raft of statistics on this. For example, the FSA statistics show that leverage on average was approximately two times in 2008. Compared to this, proprietary desks of banks was about eight times. The banks were deleveraging—they went down to about four times, but still above where the hedge funds had started.

LORD MOser: Without wanting to repeat the Chairman’s question I am still a bit puzzled. I think nobody would argue that hedge funds started the crisis. I do not think anybody would argue that they were the main part of the crisis. It would be terribly helpful certainly to me in my understanding what happened. You just referred to various little bits where they contributed to the crisis or are perceived to have contributed to the crisis. Are you really saying that it is impossible for us to get a clear picture? I am not saying that we want a picture that says they contributed 13.5 per cent to the crisis—it is not that sort of an issue—but how can we get a better understanding of the degree of involvement? Can we get that on paper from you or perhaps from our previous witness? I do not know.

Q182 Chairman: This is an extremely important question because if you are considering regulation of alternative investment funds, one of the things you have to know is who did what.

Ms Cound: I do agree with that and we do have some papers that we would gladly give the Committee.

Q183 Chairman: Thank you.

Ms Cound: One I think is called Hedge Funds in the Crisis and one is focusing on short selling of hedge funds. One point I would like to make specifically with regard to that is that I do not think this Directive has come about in response to the crisis and the perceived systemic risk. That is a part of it, but the origins of it were long before. Hedge funds and private equity funds were discussed as far back as 2005 and 2006 in the European Parliament in. The Directive is seeking to prevent systemic risk in the future but it is also about increasing investor protection, transparency and then providing a passport. In commentating and critiquing the Directive, focus is required on all those areas. I do not see this as purely the European Commission and the European entities responding to the crisis.

Q184 Chairman: Hooked on to the financial crisis.

Ms Cound: That exaggerated it.

Q185 Chairman: But it was driven for some years before.

Ms Cound: Yes, that is right.

Q186 Lord Haskins: I hear what you say, that it was jumping on to a passing bandwagon, but the failures of the banks raised issues which are about protecting investors in hedge funds, protecting other investors, competing investors in markets, and the impact that hedge fund activity had, but you got confused with the systemic risk issue.

Ms Cound: I think that systemic risk did accelerate considerations, but a number of different parties were concerned in the various institutions beforehand.

Chairman: That makes our question “Can we pick out what the contribution was to systemic risk?” the more important, because systemic risk is what we are all really about.

Q187 Lord Jordan: You are right, it does go back a long way in Europe. Their worries about it were over the perceived reward structure for the whole of the hedge fund industry. Would you say that that reward structure encouraged the otherwise sedate more general financial industry to get in on the act? That is what a lot of people have thought. In the same way that in Britain we have seen the banks’ reward systems start to escalate, for the first time ever we have seen civil servants believing they too should have bonuses. In other words, everybody wants to get in on what was seen by Europe as a greed culture that the hedge fund industry seemed to generate.

Ms Cound: In the hedge fund industry, the managers are paid and participate in performance: you gain with good performance; you lose with bad performance. It is very transparent. The clients of the hedge fund industry are mostly, in the majority, professional investors. That percentage is increasing. This is a very professional, well-regulated industry. The majority of funds are regulated with the FSA. They are covered by MIFID, the Transparency Directive and the Market Abuse Directive. I cannot think of who is trying to get in on the act? That is the perception out there, yes, that is right.

Q188 Lord Jordan: Are you denying that the hedge fund industry was perceived to be an industry of very big rewards both to investors and—

Ms Cound: No, I do not. There is a perception out there, yes, that is right.

Q189 Baroness Northover: Just picking up on some of the points that you have made. I was interested in what you said about hedge funds being able to discover the fundamental value of assets. Surely in some sense this
Mr Peter Rosenbauer and Ms Joanna Cound

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Mr Rosenbauer: Thank you for the question. Maybe I will start the second part first before answering the first. Academic research would suggest—what has been demonstrated in the price of the securities when that ban has been put in place—that the result was different. What the regulators and other bodies that put the ban in place hoped for did not come to fruition. Even though they banned the short selling of certain types of securities for a very large group of companies that were deemed to be financial companies—and I think that was everything from your banks and insurers to broker-dealers, and in some cases even the financial arms of various industrial firms—that did not arrest the decline in the value of those securities. The catalyst for stopping that decline was rather confidence that the entities themselves presented fair value, that the downturn was exacerbating and it overshot what the real concerns were of the investment community about those.

Q190 Baroness Northover: And presumably a realisation that governments were not going to let some of these banks fail and therefore these things were not going to crash.

Mr Rosenbauer: There were certainly investment strategies that did capitalise on that, that said that certain institutions are too big to fail or will be backed up by institutions and they would hedge that exposure with institutions that they thought would not be deemed to be systemically important—so, yes, to some extent. Certainly the academic research suggests, and I think we also believe, that the ban on short selling exacerbated the crisis because you took market participants out of that space. Let us say that a manager who by their investment charter is supposed to be hedged and they believe that they saw a value in a certain security in a financial company, they are unable to purchase that security because they were not able to offset that risk by shorting another company. There is also an example in the convertible bond market-place. The convertible bond market is one that is a great deal of source of financing for financial companies. Almost by definition, investment firms that invest in that strategy go short the equity security/go long the fixed income security, and they will go short the equity security to offset risks in a hedged risk. Because they were unable to do that, those types of firms were not able to purchase convertible bonds which were a big part of refinancing the financial sector. That was fairly quickly realised by regulators and a carve-out was put in place for that. It is a good example of unintended consequence, if you will. To your earlier question whether hedge funds did a poor job of discovering fundamental value, many types of institutions did not appreciate the volatility or the value of certain types of securitised credit—the asset-backed securities and CDOs that you are referring to. I think that some of the market participants that first realised that—and there are a number of them—were in fact hedge funds, so it was not that hedge funds did a poor job of understanding the complexity of certain instruments, but rather that the market-place did a poor job. One of the concerns we have when an asset or something has a stamp of regulatory approval—or in this case of a rating agency—is that investors will not dig as deep into those securities in trying to understand the fundamental value because they think that something is AAA—so they did not do the same amount of work on it that they might have with a different type of security.

Q191 Chairman: What an interesting idea: hedge funds in the role of removing the Emperor’s clothes. Mr Rosenbauer: We did certainly see examples of that. There are a number of managers who profited quite handsomely throughout the crisis as a result of taking a very contrary view on whether it was specific to a specific company or to a type of asset class, such as securitised credit.

Chairman: It is arguable that the first person to spot an asset is poorly valued contributes to instability. A most interesting discussion, for which thank you very much. I have tried to eliminate some of these questions but they are all important, so could I ask colleagues to get done fairly fast and BlackRock to answer ditto. Lord Moser.

Q192 Lord Moser: I think this is straightforward to help us to understand the relation between EU-based funds and non-EU based funds. There are various rules in the Directive. First of all, there is a three-year transitional period that applies. I am certainly not very clear what an EU fund can do towards another EU country as opposed to a totally non-EU country. If you could explain that, I would be happy.

Ms Cound: If you have an EU fund and an EU fund manager, then you can get the passport. That is nice and easy. If you have a non-EU fund and a non-EU
fund manager, then a passport depends on satisfying certain equivalency tests. Equivlancy tests have been implemented before, but before, in prior legislation, they have normally been seeking equivalency of outcome, whereas this Directive seeks equivalency of rules, equivalency of supervision, equivalency of reciprocity as well as a tax hurdle. If a jurisdiction is deemed to have met all of those equivalency tests, then the third party fund will benefit from a passport into the EU. That is the theory. Our feeling is that it would be very problematic for a lot of countries to meet those equivalency tests. For example, in the US—we heard from AIMA the difference between the different regimes—the US may find it hard to meet the equivalency of rules or equivalency of reciprocity. In some offshore centres such as the Caymans, for example, France might not judge the Caymans as providing equivalency of supervision in terms of its capacity and capabilities. It is problematic to assume that all these jurisdictions after three years will meet the equivalency hurdles. The Directive allows private placement schemes to operate for three years but thereafter they will not be allowed to continue. We have feedback from our clients who are very concerned, because they say, “We can continue investing for three years, but then what happens?” There is no certainty over which jurisdictions may achieve equivalency. The detailed analysis will be performed by Comitology and CESR. Many commentators believe that they are unlikely to complete this within three years, which increases the level of uncertainty.

Q194 Lord Moser: You are in favour of equivalency. Ms Cound: Not as the equivalency provisions are currently drafted. Given the current drafting, BlackRock believes you have to have the continuation of national private placement schemes to make the Directive more proportionate. We think it would be very difficult for the various jurisdictions to achieve equivalency. We have big doubts that many jurisdictions will achieve equivalency within three years. There is a certain category that could achieve equivalency. It is very complicated. If you are an EU fund manager with a fund domiciled outside the EU, to get equivalency that jurisdiction has only to be on the OECD “white list”. In contrast where a fund manager is located outside the EU, a number of additional equivalency hurdles have to be met. In BlackRock, for example, we have 16 proprietary hedge funds, all based in the Caymans, seven of which are managed by BlackRock in the UK, nine by BlackRock in the States. The seven that are managed by BlackRock in the UK could achieve equivalency as the Caymans has said it is going to meet the tax requirements and the fund manager is located in the EU. They will be able to be passported. But jurisdictions outside the EU are unlikely to meet the additional equivalency jurisdictions and so we do not believe that funds managed by BlackRock in the USA will achieve the passport. This means, we believe, that European investors can only continue to invest in such funds if national private placement schemes continue to operate. In terms of making the directive more proportionate, we think you need that. You need also for the European investor to be able to approach a fund and ask for information about that fund and do its due diligence. At the moment, the marketing provisions ban that. They do not allow the investor to approach the fund. We think that is important. We also think that managers should be able to delegate outside the EU into other authorised entities as long as there is all the appropriate supervisory co-operation available.

Q195 Lord Moser: Thank you very much. I am glad I am not involved! Ms Cound: It is horribly complex subject. Chairman: Lord Renton, has that mucked up your question?

Q196 Lord Renton of Mount Harry: It pretty well has mucked up my question! I was going to ask you how you view the proposal about an EU passport, and whether, as currently drafted, the passport will operate as intended. You have pretty well said already that you understand what the EU Commission perhaps are after, but you do not think the EU passport is the answer and you do not think
it will work as intended. Perhaps I could ask what you would put instead. I do not wish to be rude in saying this, but it is very easy for you as BlackRock because you are already a global, very big company and you are obviously hugely successful—good on you—but what about the alternative investment fund manager in one of the EU countries who wants to grow, wants to become more established in other countries, etc. et cetera, surely for them there has to be some other international means, not just standing on national status and national passports.

**Ms Cound:** I agree 100 per cent. As BlackRock, because we have certain resources the additional compliance burden is not as daunting for us as it may be for a lot of other companies; but just 20 years ago, BlackRock was only nine people and in December we are going to be 9,000 people, 2,500 of them here in Europe. We fundamentally believe that competition is good. The comments I made before were only about: Do I believe there will be a passport for funds based outside the EU to come into the EU? We do support a passport for funds that are already in the EU with a manager in the EU. We do support that passport. We think that is a good idea—just as AIMA did beforehand. The smaller managers and also the managers with funds based in the EU can use that passport. In summary, a passport for EU funds with EU fund managers is good. We just do not believe that you will be able to get a passport for funds where fund managers are based outside the EU. Private placement schemes are required for European clients to be able to continue to invest in them. So the passport and the private placement schemes go hand-in-hand.

**Q197 Lord Renton of Mount Harry:** I find it difficult to see how a company in the EU at the moment is going to do what you have done over the last 20 years: grow from nine people to nine thousand.

**Ms Cound:** That is our concern. We are concerned about that. We think competition is good for the market and competition is good for clients. I agree with you. We want competition in the market-place.

**Mr Rosenbauer:** My Lord Chairman, could I add one point, which is that not only do we believe it is good for managers to have competition and be able to grow, but we fear one of the unintended consequences of reduced opportunities for investors if the EU were to install these rules is that we would see some type of other, whether in the US or Asia, disallowing EU firms to come into their market-place and offering their products to investors there, which we think is a fundamentally bad outcome. It would limit their ability to grow and offer their services.

**Chairman:** I am going to drag us from the passport rules, important as they are, and go back to the systemic problems.

**Q198 Lord Haskins:** Can you tell us a bit about the Directive’s proposals on leverage and whether problems might arise or whether they are heading in the right direction.

**Mr Rosenbauer:** BlackRock would suggest that the provisions regarding leverage should be removed from the Directive for a handful of reasons. First, we believe that the issue of leverage is better dealt with at the supplier level or at the bank level and better addressed through the Capital Requirements Directive rather than at market Directive level. We also think that leverage is a very complex and nuanced topic and that all leverage is not created equal. In fact a very simply leverage calculation is not a good indicator of risk because leverage on different types of assets is where you find different types of risk. It is the underlying asset sense, the underlying investment strategies that present risk, and you need to look through and understand that. Finally, it is important to note that leverage is one part of a manager’s strategies and risk profile. Professional investors for many, many years have in the past and will continue to look at the quality of the team, to look at the quality of the investment operations, to look at portfolio construction and other risk management guidelines to get a better sense of how risky a certain investment strategy is. It does not really come down to leverage.

**Q199 Lord Haskins:** You are more or less saying that the people who lend to the hedge funds will be able to look after themselves.

**Mr Rosenbauer:** We would suggest that as market participants they have a better day-to-day sense of where risk is and understand the trading strategies as counterparties, and that regulation through the Capital Markets Directive is able to indirectly influence what happens in the alternative investment funds.

**Ms Cound:** We understand that the Commission is planning to introduce some leverage on the supply side considerations into the CRD early in 2010.

**Q200 Lord Trimble:** It has been suggested that if this proposal goes ahead as originally drafted that some would move their business out of the EU elsewhere. Would BlackRock be tempted in that direction?

**Ms Cound:** We think it is far too early to start looking at issues such as relocation at the moment. We have been focusing in everything we have been doing on trying to analyse the Directive from the point of view of the investor. When it gets a little clearer how the Directive will end up, that is when we will take a look at what are the implications for the asset manager. I should say that Europe is fundamentally important to us. It is a key and growing strategic region for us. We will have, at the end of this year, 2,500 people employed in Europe in 19 offices.
Lord Trimble: So you cannot afford to move!

Chairman: Roughly speaking.

Q201 Lord Jordan: As you know, the whole idea of this Directive and what America is doing is crisis prevention. Which of the American proposals coincides with the European proposal that you think is strongest on this crisis prevention? Which of the proposals of the two continents, where one has them and the other one does not have them, are proposals that would equally contribute towards crisis prevention?

Mr Rosenbauer: BlackRock is a global organisation that operates in many different jurisdictions around the world and I think it is interesting to note that there is a parallel process going on in the United States that is seeking to address many of the issues that you outlined. From a macro perspective, it is important to note that what the Directive is trying to do is different in one different way, which is harmonising the number of different regulatory regimes and creating a passport or what have you, so there are different thrusts to it. To echo our colleague Andrew Baker’s suggestion that harmonising the two approaches would be extremely helpful not only to BlackRock and to our clients but to all organisations, I do think it is worth pointing out that there are differences in the approach, certainly in the scope. In some senses, the US approach takes a much more narrow focus as to who gets incorporated into this new legislation. They are defined as private pools (which are hedge funds, private equity funds, venture capital) whereas the EU suggestion for a non-UCITS certainly incorporates a much wider range of actors and it is not only hedge funds and private equity funds but certain types of charity funds, real estate funds, investment trusts and other things. In some senses, they are taking a more narrow approach. Certainly they have lowered the threshold, whereas all firms are to be registered regardless of size. But it is important to note that the compliance with that registration would probably be materially less because the focus is more on identifying systemically important firms which they have termed tier 1 financial holding companies, and those firms which would be almost by definition more systemically important would be held to a greater regulator compliance. We would suggest that those types of firms are better prepared for that outcome. We would also suggest that we live in a resource-constrained environment. Whether it is the regulators or whether it is the managers, focusing on those that are systemically important will help the regulators identify issues more readily. They will be able to focus their resources on those that can have the greatest effect on the system. We would not like to see regulators miss the forest for the trees, if you will, so we think there is a possibility that if you put forth so much information the regulators will have trouble discerning which is most important and what to focus on.

Q202 Baroness Northover: In his evidence John Chapman has suggested imposing a tax on buying and selling by hedge funds to level the playing field between hedge funds and other investors. We spoke of this earlier. I am assuming you are going to think that is not a good idea. I would be astonished if you thought otherwise. Perhaps you could comment on the suggestion.

Mr Rosenbauer: Your supposition is correct.

Q203 Baroness Northover: Well I never!

Mr Rosenbauer: It is a shocking idea, I realise, but we have read Mr Chapman’s evidence with great interest and we would suggest that many of his suggestions are contrary to the facts that we have found in the market-place. Dealing with some specifics, he implied or asserted that private equity destroys jobs and value, whereas we have seen that private-equity-backed companies have created over one million jobs in Europe from 2003 through 2007—which is the latest information we have. As of 2007, over six million people worked for private-equity-backed firms here in Europe and certainly private equity provides a stable source and a durable source of capital when other types of credit is not available to institutions. We are certainly seeing that now. As we move through this process, we will see more private equity dollars being deployed in that sense. Strictly on the hedge fund side, he dismisses the important role we would suggest that hedge funds play in price discovery, including enhanced liquidity, and certainly the ECB has recently come out with some comments that rebuke his assertions. We think that is important. We also would take issue with his assertions that hedge funds are not regulated or unfairly have a less regulatory burden, when in fact many institutional quality firms, firms that are systemically important, are certainly registered with the FSA. They are certainly looked after by the Transparency Directive, the Market Abuse Directive and the registered with the SEC in the United States under the Investment Advisory Act. We would also take issue with his invocation that all hedge funds are short term in nature whereas many hedge funds and different types of strategies require long-term investing and look to create value over a very long period of time. Finally, on his assertion that this is a millionaires’ club, that only the wealthy benefit from this and there is something wrong with that, when you look at the facts, the majority of investors now are institutions in these types of strategies. They are unions, they are corporate and state pensions, they are foundations,
endowments and sovereign investment vehicles, which benefit a great number of people—which has historically not been the case. We would expect to see institutional investors growing as a proportion of the assets in our management in all of these strategies.

**Q204 Baroness Northover:** I do not think, unless I missed it, you said anything about the tax benefits to us. Are you as surprised as I am at the product from the quantity of assets under hedge fund management?

*Mr Rosenbauer:* I was not familiar with the numbers you were referring to. I would like to look at them.

**Q205 Baroness Northover:** Have you run it through your calculator?

*Mr Rosenbauer:* I have run it through my mental calculator.

**Q206 Baroness Northover:** Are you surprised?

*Mr Rosenbauer:* In your initial comment, I did not hear the period of time that was involved. I think there are many influencing factors. Maybe we should take that away and come back to you.

**Chairman:** We would be very grateful for a paper which specifically addresses the issue of tax. That is the other thing that everybody thinks about hedge funds, that they do not pay any tax.

**Lord Haskins:** Although it is nothing to do with the systemic risk.

**Chairman:** It has nothing to do with systemic risk; it does have to do with the Directive.

**Q207 Baroness Northover:** It becomes sort of relevant when you are arguing the central case, as you just have, of hedge funds and the positive part that they play.

**Ms Cound:** Tax generation.

**Baroness Northover:** Yes. Given the amount of support that has been given to the financial sector by EU governments and especially the UK Government, therefore it is kind of relevant.

**Chairman:** I should observe in conclusion that we shall be taking evidence from some of the institutional investors like pension funds and anything else, indeed, that we can find inside the time. It remains for me to say thank you both very much for coming. It has been a very useful and interesting session. We look forward to your written paper on tax.
TUESDAY 3 NOVEMBER 2009

Present
Cohen of Pimlico, B (Chairman) Northover, B
Haskins, L Renton of Mount Harry, L
Moser, L Trimble, L

Memorandum by the Financial Services Authority (FSA)

1. We are submitting this memorandum to the Committee as part of its inquiry into the Directive on Alternative Investment Fund Managers (“the AIFM Directive”). If the Committee would like us to provide more detailed information, we would be happy to provide it, including in oral evidence.

2. Since our inception we have supervised all investment managers undertaking regulated activities in the UK, including those undertaking these activities in connection with the management or administration of alternative investment funds (AIF).

3. Four years ago we set up a specialist supervision team to focus explicitly on managers of the larger hedge funds (a sub-set of the AIF industry). Since then we have continued to enhance our supervisory practices, including our focus on the data we collect regularly about the activities of investment managers and the exposure of the investment funds they manage. So we are entirely supportive of the robust regulation of the management and administration of AIF and would welcome the application of this type of regulation at an EU level.

4. The draft AIFM Directive puts forward a number of proposals for the harmonisation of AIF regulation across the EU. We support many of these proposals, including the creation of a pan-European regime for the private placement of funds, which we see as desirable to improve efficiency and reduce complexity.

5. As our Chairman Lord Turner set out in the Turner Review in March this year, we also fully support the G20 commitment that financial sector authorities should have the power to gather information on all significant unregulated financial institutions to allow assessment of overall system-wide risks. We therefore see benefits from a more harmonised framework for the collection and sharing of systemically important information for the purposes of assessing and mitigating risks to financial stability.

6. We therefore believe there is a case for a strengthening of the regulation of the management and administration of AIF at European level. However, as Jacques de Larosière, chair of the High Level Group on Financial Supervision, acknowledged in his report in February this year, it is important that any changes accurately identify and address proportionately the major sources of weakness in the present arrangements. Ill-considered and disproportionate regulatory intervention may in the long run damage European markets and European investors.

7. We are concerned that the process for producing the draft AIFM Directive has contributed to a range of specific problems in its provisions that undermine the objectives we can support and, in particular, would impose disproportionate costs on, and unduly restrict the choice of, the EU investors in AIF. The Financial Services Secretary to the Treasury and City Minister, Lord Myners, has expressed similar concerns publicly.

8. The UK stands to be more directly affected by the Directive than any other EU Member State. Recent estimates suggest that around 30% of global hedge fund assets are managed from Europe, but the bulk of that (around 20% of the global total and 80% of the EU total) is managed from the UK. In the private equity sector, around 60% of the largest EU private equity firms are based in London.

9. We are working closely with the Treasury during the negotiations on the Directive in our role as technical adviser. We will also seek to work with the Commission, the European Council and European Parliament during Level 1 negotiations and the Level 3 Committee(s) appointed to provide guidance to the Commission on Level 2 implementing measures. This is to ensure that the proposals adopted are effective in providing investor protection and maintaining financial stability.
RESPONSE TO SPECIFIC QUESTIONS ASKED BY THE COMMITTEE

Question 1: What economic benefits arise from Alternative Investment Funds? What risks to financial markets arise from Alternative Investment Funds? Will the Directive help reduce these risks?


10. The scope of the AIFs covered by the proposed Directive is very broad.1 It presents considerable challenges in undertaking an accurate assessment of the economic benefits that the AIF sector brings and the risks that AIFs present.

11. AIFs provide economic benefits to investors. These can include the potential for higher but, lower or uncorrelated, investment returns, thereby allowing investors to construct more efficient and more diversified investment portfolios to reduce their level of investment risk.

12. Hedge funds and other AIFs which participate in financial markets can also provide a number of important benefits to these markets in generating market liquidity and enhancing price discovery.

13. Those AIFs which do not as a matter of course participate directly in financial markets, such as private equity and venture capital funds, instead provide an important source of capital finance to small and medium-sized enterprises alongside traditional sources of capital. Curtailing the provision of these important sources of capital financing through either restrictive or anti-competitive regulation could have unintended detrimental consequences for these enterprises. These consequences would appear contrary to the Commission’s objective of “driving economic recovery”. The same can be said for funds investing in property and infrastructure which have “real economy” benefits through the funding and management of those buildings/assets.

14. Concerns have been expressed over the potential for certain AIFs, either collectively or individually, to pose risks to investors and financial markets. Such concerns expressed in relation to hedge funds have included their use of leverage and the opacity of their trading strategies. Questions have also been raised about the ability of funds to move markets due to concentrated trading and the effects of market practices such as short selling (though not solely in relation to hedge fund strategies).

15. Through the nature of their activities, the prime brokerage arms of banks who provide the vast majority of finance to hedge funds, are exposed to certain inherent risks. These risks are however managed through appropriate counterparty risk management including the provision of capital.

16. The primary risks posed by other types of AIFs, such as the private equity or real-estate funds, relate more to their choice of investments, how they manage these portfolios, and the means by which they raise capital to invest (and, where they are available to retail investors, issues such as appropriate disclosure). In our view, the scale of risks posed by other types of AIF is quite different from that posed by hedge funds. Furthermore, AIFs such as private equity, venture capital or real estate, which have no involvement with those public markets which are deemed to be vulnerable, pose no real systemic risk. This is also true of the majority of closed ended funds.2

17. The AIFM Directive could play a valuable role at the European level in addressing those risks arising from AIFs. However, to achieve this we believe the Directive must take a focused, proportionate and appropriately differentiated approach to the real risks in the sector, and must recognise how different types of AIFs are structured and operated (including their interactions with non-European Economic Area (EEA) jurisdictions). We also believe that some elements of the Directive (notably the requirements for employee consultation by private equity funds when proposing investments in certain companies) stray from what should be its main focus on risks to investor protection, market efficiency and financial stability and appear to create an unlevel playing field vis-à-vis funds (eg family offices) not within the Directive’s scope.

18. Although the Directive is one of a package of measures put forward by the European Commission in response to the financial crisis, the AIF sector is diverse and it is reasonable to distinguish the role which different parts of that sector may have played in the global financial crisis. We believe that the hedge fund industry did not play a major role in the emergence of the crisis. Furthermore, other types of AIF such as private equity vehicles in our view played no role in precipitating the financial crisis.

1 With a few exceptions, the Directive covers the management and administration of all “collective investment undertakings” which are not subject to the European UCITS regime (the regime for collective investment undertakings that invest primarily in transferable securities). It therefore covers, amongst others managers of hedge funds (with themselves a wide range of investment strategies), private equity funds, venture capital funds, property/real estate funds, infrastructure funds, investment companies, investment trusts, commodities funds, non-UCITS retail funds, and funds of such funds.

2 Closed-ended funds (as opposed to “open-ended funds”) do not continuously offer their units/shares in the market. They issue a fixed number of units/shares at one time. If the vehicle is listed, the shares may trade on an exchange. Many are thus already regulated under the EU Prospectus Directive.
19. We agree that regulators must have necessary information about the trading of relevant AIFs to allow them to take a view of the potential systemic impact of any fund(s) on the financial markets. However, given our analysis, we believe that the thresholds proposed in the Directive are too low to capture only those AIFs which are systemic. We also believe that other provisions in the Directive are disproportionate as they do not take specific account of the differing types of AIF or provide regulators with the ability to act to address the dynamic nature of the potential systemic impacts arising from AIFs. In addition, despite the heightened attention given to short-selling practices during the crisis, we are not convinced that it is appropriate to tackle this issue, which has general market applicability, through a directive targeted at the AIF industry alone. We have already extended, without a time limit, the current short-selling disclosure regime for significant net short positions in the stocks of UK financial sector companies.

Question 2: To what extent is there a need to create a single regulatory regime for Alternative Investment Fund Managers in the European Union? Does the Directive achieve its objectives? Should the objectives of the Directive be modified?

20. The European Commission’s stated objective is to create a harmonised, comprehensive and effective regulatory and supervisory framework for the management and administration of AIFs across Europe. We support the robust regulation of this area and see considerable benefits in creating common standards which appropriately address regulatory concerns over investor protection and financial stability.

21. We do not therefore believe that the Commission’s stated high-level objective needs to be modified and there is much in the proposed Directive that would appear to go some way to delivering this objective and which we can therefore support. In particular, we support the following proposals:

   — in principle, a pan-European regime for private placement, which would replace the current patchwork of regulation across the EEA, which is complex and inefficient;
   — a more harmonised framework for the collection and sharing of systemically important information for the purposes of assessing and mitigating risks to financial stability;
   — regulation across Europe of managers of hedge funds (as indicated earlier, at least 80% of Europe’s hedge fund industry is in the UK and alternative investment fund managers (AIFM) are already subject to FSA supervision); and
   — sensible and proportionate harmonisation of standards in the regulation of alternative investment fund management and administration.

22. It has been suggested that large sections of the European asset management industry, particularly hedge funds, are unregulated or lightly regulated. In reality, the industry is subject to a very large existing body of European Directives.3 The Directive must seek to build on the existing EU framework for investment managers and other relevant vehicles (such as investment companies). As first proposed, there are various inconsistencies with other pieces of EU law.

23. There are a large number of specific problems with provisions in the Directive which to some extent undermine the Commission’s overarching objective and therefore in our view require improvement. These include:

   — the Directive’s scope (including thresholds)—which does not only capture those funds which give rise to regulatory concerns;
   — the standardised “one-size-fits-all” approach which fails to recognise the relative risks posed by the different activities undertaken by AIFM and the different types of AIF. In particular, it fails to acknowledge differences in how AIFs are structured and operated and as a result may in fact weaken investor protection;4
   — restrictions on the delegation of management services, custody and depositary activity to non-EU providers. This fails to reflect the practical operation of many AIFs across global markets and would in many cases significantly restrict investor choice; and
   — the potential for disproportionate regulation which fails to achieve regulatory objectives.

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4 In addition, despite the Directive’s wide scope, some key competitors of AIFs are not caught—eg family offices and sovereign wealth funds. This risks creating an unlevel playing field.
24. In relation to the intended creation of a pan-EEA “private placement” regime for marketing alternative investment funds to professional investors, the proposal’s restrictions on funds not domiciled in the EEA mean that (based on current business models) the actual benefits and efficiencies in this regime for AIFs and their investors is likely to be limited, particularly to the hedge fund industry.

Question 4: Is it appropriate to regulate Investment Fund Managers, rather than the Fund itself? Does the Directive contain appropriate provisions to distinguish between different types of alternative investment? Does the scope of the Directive create a danger of unintended consequences?

25. In general, where the fund is not aimed for sale to retail investors, we think it is more appropriate to regulate those firms undertaking activities in connection with the management and administration of the fund rather than the fund itself. This ensures that those firms undertaking activities which have the potential to give rise to regulatory concerns are subject to adequate oversight.

26. Retail authorised funds are subject to product regulation (eg the investment concentration limits in the UCITS Directive). The AIFM Directive will also apply to some non-UCITS retail funds which are also subject to detailed fund regulation (so risking duplicatory or inconsistent requirements).

27. While it is appropriate to regulate the investment manager rather than the fund itself, one of the most fundamental issues in determining the scope of the Directive which remains outstanding is to identify who is the correct party to be considered the “AIF manager” (AIFM) and therefore to ensure that the Directive’s provisions operate effectively.

28. The issue of determining who should be considered the AIFM is exacerbated by the diverse range of investment funds falling under the AIF definition. In different fund structures, for instance, different entities perform different functions and activities (and some perform more than one). Aspects of the Directive are also incompatible with the roles that prime brokers play for hedge funds. Reflecting these differences, existing EU law already applies to some of these structures and arrangements (notably listed investment companies) in different ways; to operate effectively and ensure legal coherence, the AIFM Directive must do the same.

29. In addition, some fundamental concepts and issues that are relevant to one type of AIF may not be equally applicable to others. Leverage and liquidity issues, and capital risks, are for example different for closed-ended funds and the additional investor protection afforded by requiring independent custody is quite different for private equity investments (eg private company share certificates) or real estate fund assets (eg a building) than for funds which invest in financial securities or derivative contracts.

30. We believe that the lack of differentiation in the original proposal would create unintended consequences, in addition to the foreseeable consequences which we explain in this note. We are also aware that individual sectors of the European AIF market have identified their own specific technical problems and examples of how the draft Directive either creates legal incoherence or inconsistency with the operation of investment funds under existing EU law.

Question 5: What is your evaluation of the Commission’s consultation in the preparation of the Directive?

31. Our impression is that the process for producing the Directive has not followed the good consultative approach usually taken by the Commission. In the past, pre-consultation has generally resulted in better proposals with a more considered impact analysis, and greater buy-in from, and fewer surprises for, those affected.

32. The process adopted by the Commission to produce this Directive can be contrasted with that it followed when revising the UCITS Directive. The proposals and changes made to the UCITS Directive were widely debated, the impacts on markets and participants clearly understood and a broad consensus achieved on nearly all the key elements. This has not happened with the AIFM Directive. We believe this is one reason why the original AIFM Directive proposal was unclear in many respects.

Question 6: Will the passport system help create a single market in investments funds within the EU? How will the passport system established affect the EU and the UK industry and particularly their position in the global market?

33. In principle, we welcome the proposed “passport” to facilitate cross-border marketing of AIFs. However, the proposal’s restrictions on funds not domiciled in the EEA mean that the actual benefit of the passporting proposals for many AIFs, particularly hedge funds, is likely to be limited.

34. One of the most significant aspects of the changes proposed by the original Directive is the requirement for jurisdictions of AIFM based outside the EEA to meet certain equivalence tests (including in relation to prudential regulation and supervision) before these AIFM are allowed to market AIFs to EU investors.
Equivalence tests for tax accords are also imposed by the Directive on non-EU AIF domiciles such as the Cayman Islands, Bermuda and the US.

35. Though investors must be provided with an appropriate level of protection, a strong and integrated EEA system of regulation/supervision must also promote an open world economy rather than fall into protectionism.

36. In the UK, we have successfully permitted non-EU funds of various types to be marketed locally for a number of years. At the same time, we have banned the marketing of hedge funds to the retail market, while permitting them to be marketed to institutional and sophisticated investors and sold on an advisory basis. We believe this provides an appropriate level of investor protection without unduly restricting investor choice and access to specific investment management expertise.

37. An outright ban on non-EEA funds and managers would restrict the access of European investors to valuable, open and successful markets, in our view without justification. Such a step change from current arrangements would also create real practical problems for investors and limit their ability to benefit from the diversification offered by the AIF sector. The problems and complexity with these proposals would be exacerbated by the proposed restriction on the marketing of non-EU funds three years after the date for Directive transposition. In addition, it is proposed that the scope of AIF “marketing” under the Directive includes the situation where the investment is made at the own initiative of the investor. The result of this would appear to place a non-EU investment manager in breach of the Directive as a result of accepting an investment from an EU investor. The Directive would be seen as protectionist, offend the principle of subsidiarity, and invite retaliation from other global markets.

**Question 7:** Is the threshold for defining “systemically relevant” Alternative Investment Funds appropriate? Should the Directive include provisions on capital requirement? Does the Directive contain appropriate rules on leverage? Is the requirement for independent valuation agents and depositaries for Alternative Investment Funds adequate?

38. Thresholds—We believe that the Directive’s scope and thresholds are too broad and too low to adequately focus on those AIF which pose significant risks to financial stability and market efficiency. We do not consider that they strike the correct balance between imposing additional costs and enabling regulators to identify and therefore mitigate systemic risks.

39. Capital—We do not object, in principle, to the Directive setting minimum capital requirements, as long as they are appropriate, differentiate appropriately between different types of AIF manager, and are consistent with other relevant EU capital adequacy regimes (including, for example, the same €10 million cap on capital as exists for UCITS managers).

40. Leverage—We are concerned that the proposal to allow the European Commission to set hard limits on the level of leverage AIF managers can employ could result in significant pro-cyclical effects and exacerbate financial instability. These could occur, for instance, if a cluster of funds with concentrated exposures were forced to simultaneously unwind their positions to avoid breaching these limits. There are also problems at the outset with any single approach to the idea of “leverage” because of the many ways in which leverage can be measured depending on the particular strategy. It is a common misunderstanding that higher leverage necessarily means higher risk.

41. As we proposed in the Turner Review, regulators should, however, have the ability to take measures to address risks that threaten the stability of the financial system. The availability of leverage limits is an important lever in a regulator’s toolkit to maintain financial stability, alongside capital, liquidity and risk management requirements.

42. As the Turner Review set out, in order to create a sound banking system there are good arguments as to why the use of leverage ratios or limits as back-stop control measures (in conjunction with other measures) are appropriate. However, AIFs, including hedge funds, are fundamentally different to the banking system in the nature of the potential systemic effects which can, in certain cases, arise from their activities.

43. In general, hedge funds do not perform “bank-like” activities and in particular:

(i) have far lower leverage levels, in general (though with some exceptions), than those of banks;

(ii) do not deal directly with the retail mass market but instead with professional sophisticated investors;

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5 The present formulation of subsidiarity is contained in Article 5(2) of the Treaty Establishing the European Community which states that “In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community.”
44. Hard limits on leverage are therefore inappropriate, unworkable and could result in considerable unintended consequences for the majority of AIF. A more appropriate solution would be (i) to require better disclosure to regulators of the appropriate metrics to allow them to assess risk, and (ii) in extremis to give powers to local regulators to require an AIF to reduce risk. This would ensure that the use of leverage limits would be prudent, proportionate and sufficiently dynamic to address the risk they are seeking to mitigate.

45. It is also notable that during the financial crisis, the leverage in most hedge fund strategies was substantially less than the leverage in many banks during the same period. Clarity about the purposes of leverage limits will be paramount in developing the Directive proposal if we are to avoid unjustified intervention.

46. Independent valuation agents—We believe that it is appropriate to require some form of independence in the valuation process but that regulatory concerns are not always most efficiently addressed by requiring the appointment of an independent valuer. In particular, the additional cost of appointing an independent valuer appears disproportionate for those AIFs which are either not actively traded or where conflicts of interest typically inherent in the valuation process are mitigated through other methods (eg by not linking AIFM remuneration to the net asset value of the AIF). In these cases investor protection can be provided in other ways, for instance through independent oversight of the methodology used for in-house valuation (eg as part of auditing procedures) and appropriate segregation of duties.

47. Requiring independent valuation in certain instances may in fact weaken investor protection rather than strengthen it as valuations may be undertaken by persons less familiar with the AIF’s investments and who may not be subject to the same level of supervision to the AIFM. Retail UCITS funds have operated successfully without the requirement for an independent valuer for many years.

48. Depositaries—The Directive seeks to impose organisational requirements on depositaries and a higher standard of liability than that imposed by the EU UCITS Directive. Depositaries would be required to be EEA-authorised credit institutions and will only be permitted to delegate to other such institutions. Their liability would be increased to require them to make good losses resulting from their failure to perform their duties (whether justifiable or not), including where these losses have occurred through delegation. These are major changes with a number of potentially damaging and unjustified consequences.

49. We do not believe that the safekeeping/depository function needs to be restricted to EEA credit institutions. Others (such as prime brokers, investment banks, other Markets in Financial Instruments Directive (MiFID) firms and insurance undertakings) should continue to be able to provide this service as long as they are suitably regulated and supervised. Requiring the depositary to be an EEA credit institution and restricting delegation only to other EEA credit institutions would effectively prevent AIFs of all types from investing in non-EEA markets with local custody requirements (eg Brazil, Russia). Such restraints on investor choice and competition are an undesirable consequence of this particular provision.

50. The imposition of a higher standard of liability will sharply increase costs (eg capital and insurance), which will be passed on directly to investors in the funds, and/or alternatively reduce the number of firms willing to provide depositary services. In a low interest-rate investment environment, the former will have a materially damaging affect on long-term investment and savings for consumers, both retail and institutional.

Question 8: Will the provisions strengthening disclosure requirements help to create a more transparent market or do they go too far?

51. In terms of the information which AIF managers must provide to investors, we believe these are broadly aligned with the good practice standards already adopted by many hedge fund managers. Such standards do not exist for other sectors of the AIF market such as private equity. These requirements will have significant cost implications for smaller AIF which are less likely to be of systemic relevance/importance.

52. The Directive requires portfolio companies acquiring controlling interests in companies to make certain disclosures to the employees of those companies. We believe that these disclosures, including aspects in relation to employee protection, do not take sufficient account of other existing relevant EU legislation, apply to investments in too wide a range of companies, and would disadvantage private equity funds in comparison to their competitors who are not subject to these requirements.

6 The most notable addition being that the identity of investors receiving preferential treatment would need to be disclosed.
53. The Directive requires the reports to be provided on a periodic basis from managers to their home regulators. The financial crisis has demonstrated the need for regulators to understand better the effects of all potentially systemic entities on the financial system. The Turner Review highlighted the legal, structural and political barriers which regulators currently face in undertaking an accurate assessment of the risks.

54. The Directive seeks to address these barriers by requiring regulators to collect significant volumes of information from all affected AIFM. Although it is important that regulators collect a consistent set of information from systemically significant AIFM, providing regulators with huge volumes of information about insignificant AIF would be counterproductive, costly and contribute nothing to improving our understanding and ability to tackle effectively emerging systemic issues. We believe that this standardised approach to disclosure needs significant readjustment to capture information that is useful for regulators but also to provide regulators with the flexibility to collect additional information where this is deemed necessary. Our work on the data we collect from investment managers should help inform what information may be most useful in this area.

Question 9: What effect will the Directive have upon the position of the City of London and the EU as a whole as a leading location for Investment Fund Managers? Could it cause many hedge funds to relocate outside of the EU? What impact would the Directive have upon professional investors and institutions?

Question 11: What effect will the Directive have on flows of capital and financial innovation?

55. We recently commissioned an independent study of the potential impact of the Directive, to help us assess the possible implications for European markets and investors, with impacts quantified as far as this is possible. We have asked for this report to be completed by the end of September. This will supplement information we already have. We will provide this to the Committee when it is available.

56. If it becomes legally impossible or economically difficult for AIFs to continue to operate as they currently do (including in the way they interact with non-EEA locations), we can expect such AIFs, AIFM and supporting service providers seriously to consider relocating outside the EEA.

57. If the Directive were to have the effect of increasing costs to investors in AIFs and reducing the choice of AIFs available for them to invest in, the impacts would also be felt outside the fund management sector itself. Restricting investor choice means less efficient investments and is likely to lead to worse investment outcomes for investors. Significant investors in the AIF sector include EEA pension funds, insurance companies, local authorities, charities, educational foundations (eg universities), and other institutions and corporates. Beneficiaries of private equity, venture capital and real estate fund investment across Europe would also be affected if funds relocated or had less capital to invest as a result of the Directive’s burdens.

Question 10: How does the Directive compare to existing or proposed regulation of Alternative Investment Funds outside of the European Union, particularly that of the United States? How will the Directive affect the position of EU Alternative Investment Funds in the global market?

58. The US has yet to finalise its proposed future regulation of hedge fund managers but seems likely to incorporate manager authorisation and disclosure requirements to the regulator. Both these are already in place in the UK. There is no reported intention of the US authorities to follow the more onerous elements of the Directive (eg depositary requirements, leverage caps, delegation restrictions, capital requirements).

59. The Directive as originally proposed would severely affect the position of European AIF managers in the global market place. We think it likely that some hedge fund strategies would consider relocating outside the EU to avoid the leverage restrictions. Some private equity firms may be forced to relocate operations if capital requirements make their business uneconomic and the disclosure requirements make them uncompetitive. These firms would still be able to invest in EU capital markets as they did before, but they would do so without the desirable EU regulatory oversight.
Examination of Witness

Witness: Mr Dan Waters, Director of Conduct Risk, and Asset Management Sector Leader, Financial Services Authority, examined.

Q208 Chairman: May I formally welcome you, Mr Waters, and thank you very much for coming to give evidence and for bringing such a substantial audience with you! You will find in the declaration of interests of various members of this Committee that the two members of the Committee who were in fact part of the management of a hedge fund have excused themselves from this inquiry, so we do not have Lord Browne and Lady Hooper. For the rest of us, our interests are fairly tangential, and I am myself a Director of the London Stock Exchange. You have probably done this before and you know that the session is broadcast and that you get a transcript so that infelicities can be removed. Now, we can do this in two ways: we can either launch straight into questions; or, if there is an opening statement you would like to make, please make it, if you would prefer to start that way.

Mr Waters: Thank you, my Lord Chairman. I am very happy just to launch straight into questions, if that is what you would like. We have already submitted our evidence and I think you know where we are, so I am very happy to revert to you for questions.

Q209 Chairman: What would I like to ask is the broad, general question: do we think that this Directive will improve macro-prudential oversight of alternative investment funds and the detection of systemic risk or not?

Mr Waters: I think we believe it has the potential to do so, if it is correctly drafted. I am not trying to give you an evasive answer, I think that is the reality of the situation. And one of the things that the FSA, in supporting the Treasury who are in the lead on this, has been very keen to do is to improve the ability of the Directive to deliver precisely the outcome of improving the monitoring and addressing of potential systemic risk. I think it is possible that, with the right information being gathered in the right way and the right powers given to the national supervisory authorities through the mechanism of this Directive, and the ability to share that information and pool that information not only with Europe, but ultimately internationally, then the answer to your question would be yes, it will make an improvement.

Q210 Baroness Northover: I want to ask about, to carry on from what you have just said, whether this proposal might help prevent a future financial crisis. Now, one of the things that is obviously apparent from what has happened over the last couple of years or so is that it is very difficult to predict what financial crisis is going to come down the track and, therefore, regulation is often addressing what has happened as opposed to what might happen. One of the interesting things about this is that it is looking at hedge funds and other such funds and seeking to regulate something which was not regarded as significant in playing a part in the systemic problems, but has been identified as something which might play a part in the future, so I want to ask you a bit about predicting the future: will this proposal, do you think, help in that regard?

Mr Waters: Again, I think it depends on where we land in terms of the information that we receive, and I think that is something that is really important to get right. The FSA, as you may know, has been regulating all of these kinds of fund managers from the beginning of its existence and there are many different kinds of entities captured by this Directive. One of the biggest challenges in the Directive is that it has a ‘one-size-fits-all’ approach to these business models which are very, very different, so, in respect of hedge funds themselves, we have been gathering information about their potential impacts on the market via the prime brokerage survey for the last four years. What we have been doing over the course of the past year is developing, what we have called, a ‘hedge fund manager survey’ which is focused on the hedge fund managers themselves and is seeking information about their impacts both in sub-sectors of the market where they maybe have a significant footprint, but also more broadly in respect of their leverage, both lending leverage and embedded leverage. If the right information can be gathered in that way and if the Directive provides the foundation for doing that across Europe, that would be a very good thing and that would provide then a network or a framework for sharing in that information. It should be possible, to answer your question, looking forward into the future, to see congestions in particularly vulnerable sub-sectors of the market developing over time, to see the building up of leverage and to see even the growth of an individual fund to a level which itself could become systemic. That may seem like a far-fetched idea, but, if you look to LTCM, which was not that long ago, that was a fund which got to the size, and through a very substantial amount of leverage, much more than we have seen in any funds currently, where it did have a potential systemic impact. That is the sort of thing you would like to be in a position to see happening before it happens and you would like to have power to address the concerns that you have at the time that it is arising so that you are not just in reactive mode; I think that is the main thing. It is very hard to say what the next crisis is going to be, but having a better set of tools and a flexible set of tools to address it, we think, would put us on a sounder footing.
Q211 Chairman: If I can just pick up a supplementary on that, I have often wondered what would you have done about LTCM if, as it were, you had seen it coming. I have two questions. You did not see it coming?

Mr Waters: Yes, that was a long time ago, my Lord Chairman.

Q212 Chairman: Yes, it was, was it not?

Mr Waters: I would not want to testify exactly about who knew what when back when that occurred.

Q213 Chairman: But people were caught out?

Mr Waters: I think it is fair to say that the regulators were surprised and not just in the UK, but generally around the world. I think that the level of leverage which was revealed in what was thought to be a very unrisksy trading strategy was really quite remarkable. In a different kind of world where you have information about the positions of a fund of that size, and indeed the hedge fund manager survey that we are producing would give us an indication about a fund of that size and would give us information about the individual fund itself, then I think you would be in a position to go to the manager of the fund and say, “What is your strategy? Where are you heading with this? What scenario analysis have you done in order to protect yourself against possible market developments that might undermine the strategy that you have adopted?” I do not think those questions were asked then. I think they were asked after the fact and it is better to be in a position to ask them before, frankly.

Q214 Lord Haskins: Can you remind us how the LTCM issue resolved itself because one of the things that I think Lord Turner said to us was that he did not believe that the alternative investment funds had contributed to the systemic failures of recent months. That begs the question in that a lot of people are talking to us about regulating the alternative investment fund manager directive and the evidence we commissioned in respect of this proposed Directive, suggested that hedge funds in their own detriment might have been spotted further and quicker if the FSA had not existed and if the real responsibility had still been with the Bank of England and the Treasury?

Mr Waters: We are talking about the recent crisis more generally, we are not talking about LTCM anymore?

Q215 Lord Haskins: Is that not the right way to do it?

Mr Waters: Well, I would not want to make a judgment on what the Fed did at that time; they did what they needed to do with the tools that they have available to them. I guess the question then becomes: do you not, and I think we would say we would, prefer to be in a situation where we have a much better idea of who the players and the major players in the market are and what the level of their leverage is? We are in a position now in respect of the UK hedge fund management industry where we do know that—and there is nobody out there that looks anything at all like LTCM.

Q216 Lord Haskins: But, if the information on the LTCM had been available, what would have been done and what could have been done—forced them to reduce their leverage?

Mr Waters: I think a number of things might have been done, depending on the powers of the authorities involved. As I was answering my Lord Chairman a minute ago, I think that, if you are armed with the information and you can see things developing, it is possible then to intervene before you get into a crisis scenario or at least you would understand, at the very least you would understand, what sort of scenarios or circumstances would be likely to trigger a crisis in a particular fund, and you might be in a better position then to respond more quickly to it if a crisis began to develop.

Q217 Lord Renton of Mount Harry: Might I ask, just as a follow-up to that: do you think that the crisis might have been spotted further and quicker if the FSA had not existed and if the real responsibility had still been with the Bank of England and the Treasury?

Mr Waters: We are talking about the recent crisis more generally, we are not talking about LTCM anymore?

Q218 Lord Renton of Mount Harry: No.

Mr Waters: Well, you have asked me a question that probably my Chairman would be better-placed to answer.

Q219 Lord Renton of Mount Harry: But you must have a view.

Mr Waters: The FSA, in terms of speaking from my own area of knowledge in terms of what we knew about hedge funds and their role, I think we were aware of the level of leverage and the broad positioning in the market of hedge funds managed from the UK, and I think what we have said is that the levels of leverage in hedge funds were far, far lower than those in the heavily regulated investment banking industry actually and the de-leveraging that occurred as the crisis materialised was very substantial. It is probably fair to say, as you may know, that the report from Charles Rivers Associates, which we commissioned in respect of this proposed Directive, suggested that hedge funds in their own de-leveraging may have contributed to the general de-leveraging in the market at the time, so I do not think we would say that there was no connection at all of
hedge funds to aspects of the crisis, but that is a very different thing from saying that hedge funds were the cause or the drivers of the crisis; we do not think there is any evidence about that and we are not alone in thinking that.

**Q220 Lord Moser:** Just on that last point, I still find myself very puzzled. At one extreme, there are people who say that hedge funds were a major starter to the whole crisis, and we have certainly had evidence at that extreme. At the other extreme, they had really nothing much to do with the crisis, they are total ‘goodies’. My question to you is: is there any way that the FSA or anybody could help us to get that in proportion because it is somewhere in the middle probably?

**Mr Waters:** Yes, I think that is fair.

**Q221 Lord Moser:** Is there any statistical way of finding evidence of their impact?

**Mr Waters:** We have collected some information from our survey of prime brokers—who are the ones who were financing the hedge fund managers in London—which indicated that leverage, on average, across hedge funds managed from London was 2.5 to 3 times portfolio assets, which is a far cry from where the investment banks landed, as I am sure you know, during that period of time. The Charles Rivers Report also suggests that the de-leveraging that occurred at the height of the crisis accounted for, and I do not have the figure but a significant de-leveraging of hedge fund assets. I will not quote the number to you, but it is in the report that Charles Rivers has reported, so there is some evidence of hedge fund influences in terms of their trading as the crisis developed and their need, as everybody else was doing, to de-leverage. However, frankly, in terms of the overall contribution to the crisis and in terms of the driving of the contribution, our own analysis, the analysis that de Larosière has done in respect of Europe, the analysis that Lord Turner has done in his report and the analysis that has been done in the US suggests very strongly that those who say that hedge funds caused this crisis, they are not speaking to the evidence.

**Q222 Chairman:** Can I take you back to the future again for a minute. If there were an LTCM roaming around in the field now run from the UK, you would know about them?

**Mr Waters:** Yes.

**Q223 Chairman:** That much, I think, is clear. What would you be able to do about them, aside from asking for their plans? I can imagine people sitting their snapping their braces and saying, “It’ll be fine”. If they did that, what could you do about them?

**Mr Waters:** That is a very good and a very challenging question. I think we have a range of powers now that we might be able to invoke in respect of a potential threat to market stability or to the financial soundness of the system or indeed to a systemic disruption of a vulnerable sector of the market, but I think one of the benefits of this new Directive would be the power that was clearer than the powers that we have now. I am not saying that we could not make an argument, that we could not try to take action, but to have the more specific kind of power that the Directive envisages or which we would like the Directive to envisage is not quite the place we want it to be in in respect of leverage, but to have a power that is more tailored and given to the supervisory authority, we think, would be a good thing.

**Q224 Chairman:** Because, after all, we do know that LTCM caused a great deal of disruption in its time and, whilst it was not around and that had been settled long before the recent crisis, were it to happen again, one might easily be blaming hedge funds.

**Mr Waters:** One would certainly want to be in a different position from what we were before LTCM happened; I think that is right.

**Q225 Chairman:** If I could move you on to your written evidence where you argue that it is more appropriate to regulate investment fund managers, we had a bit of a struggle with this because some, including some of the people who manage hedge funds, say that you should be regulating the funds and others say that you should be regulating the managers. Could you give me the case for regulating the managers?

**Mr Waters:** I think the strongest case for regulating the manager is that the manager is the entity that runs the strategy of the investment of the fund and makes the decisions about leverage both in terms of borrowing from its prime brokers and in terms of the embedded leverage of the derivatives positions in its various portfolios. That information is available to us here. We live in a world where, for tax reasons, the funds themselves are not in the United Kingdom, but we have found that that does not matter. We can get the information that we need, the information that is potentially systemic, the information that will contribute to our analysis of a potential developing congestion in an area of the market from the managers of the funds; they are the ones who have got the data and they are required to give it to us and they do. Just as a pragmatic thing, you may imagine that trying to gather information from funds that are sitting in the Cayman Islands is a rather more difficult task. We do not need to go there, we do not need to do it, and I would also say that the case for regulating the entity itself is an interesting one. Those jurisdictions which have tried to regulate the fund itself along the lines of,
for example, cross-border mutual funds in Europe, the UCITS funds, which are heavily regulated fund vehicles because they are for retail investors, there are a lot of fund rules about borrowing, about leverage limits, about investment diversification and concentration rules and a load of rules to which that fund must be managed quite strictly because they are targeted to the retail market. Hedge funds are not and they have very flexible strategies. They are not marketed in the UK and we do not permit them to be marketed to retail investors, so the case for that kind of control, if you like, over the fund itself we do not think exists and, frankly, those countries that have tried, the hedge funds do not go there, they do not set themselves up there because actually it does not work and it is very difficult to deliver the kinds of portfolio returns that sophisticated investors are looking for if a regulator has told you how to run your fund; it does not happen.

Q226 Baroness Northover: So might the individuals not move? If you are regulating the individual, might you not then see them moving away?

Mr Waters: We regulate the hedge fund manager. They have not, they are here. I think the truth is that the hedge fund manager industry in London recognises the importance of sensible regulation. Investors want to feel, particularly institutional investors like pension funds, endowment funds and others, and maybe they will testify today, want to feel reassured that the fund manager is subject to sensible and sound regulation in terms of its capital, in terms of its disclosure requirements, in terms of the fitness and properness of its principles and all the things that regulation of the fund manager delivers.

Q227 Lord Haskins: You referred then, and this keeps coming up, to the distinction between protecting retail investors and other types of investors, whoever they are. I have two questions. First of all, can you give us a clear description of what is a retail investor and what is a non-retail investor? Secondly, is it the FSA's view that retail investors are the key ones who need protection and that the wholesale investors, as it were, are less in need of the protection of the FSA office?

Mr Waters: Very, very good questions. For the purposes of the FSA's regulations, there are three categories of people and these categories come from European legislation. There are natural persons (known as "retail investors"), like all of us in this room, then there are the sophisticated investors (known as "professional investors"), which could be some of us in this room, and then there are the institutional market participants (known as "eligible counterparties"), and that broad categorisation, we think, makes sense. The retail fund protections apply in that first case and in the second case we have allowed, for example in respect of hedge funds, that those persons can be, on advice, sold hedge fund investments in a permissive regime in the UK. You cannot put up advertisements in the Tube, saying, "Buy my hedge fund" because that is marketing to the general public. We have tried to draw a sensible line there between what is, broadly speaking, the institutional market which is composed of these market participants and these more sophisticated investors, and they may be family offices, they may be individuals with very substantial assets who can meet minimum investment requirements. This is an approach that applies throughout Europe and it is an approach that is similar to the US, for example, so, broadly speaking, that is who the different categories are. In terms of the protections applied, I think we do take the view that retail investors are not in a position to protect their own interests as effectively as a market participant or a sophisticated investor would be. They do not have the experience, they may or may not have access to advice, and we know from all of our work on financial capability that financial services markets are a big challenge for the average person in the street, not just in this country, but really more generally speaking, so we do think it is appropriate that there are more protections in place, we do think that fund regulation is more sensible so that we have nationally authorised retail funds and we have European-wide UCITS funds that are authorised fund structures. However, when you move into the more institutional sphere, we think it is sensible that, in respect of some of those protections, those investors are not asking for them and they do not require them, and some of the evidence which has been coming forward is quite interesting now to the Commission in this debate from institutional investors, saying, "We don’t want these protections. We don’t need them. These are just extra costs for us which are removing returns for benefits that we don’t see", so we think it is right to make a differentiation there. There is obviously some protection that institutional investors need in terms of things like market abuse and things like that and they work very clearly on that pitch.

Q228 Chairman: Just to tie this subject off, we have had other evidence that argues that the Directive is moving towards regulating funds as well as managers.

Mr Waters: Yes.

Q229 Chairman: Would you agree?

Mr Waters: Yes, there are some provisions in the draft Directive that kind of step into the space of going straight to the fund, for example, the idea of a leverage cap and that is a direct interference in the management of the fund ex ante. That kind of intervention we do not think is a sensible thing at all, and in fact our concern about something like that is that in a market crisis, which you may not have foreseen, with such a cap, you might well be driving everyone to unload
portfolios at exactly the same time and exacerbating actually a liquidity crisis or indeed a sub-sectoral crisis, so we think that, in that respect, what you need is not an intervention at the fund level with a rule, you need a discretion, a supervisory power for the regulator to deal with the fund manager about their strategy in various scenarios as they develop, so there are some aspects like that which need to be changed and the Directive needs to be refocused, we think.

**Q230 Lord Trimble:** In your evidence, you say that providing regulators with huge volumes of information about systemically insignificant alternative investment funds would be counterproductive, so the question then arises: how would you propose to limit the data collected and how do you think that data should be used by regulators to ensure that systemic risk is reduced?

**Mr Waters:** What we have done, as I mentioned before, is develop this hedge fund manager survey. What does that do? That gathers information at two levels. For fund managers whose assets under management are smaller than £500 million, we get aggregate information about all their funds. What is that? Information about their aggregate levels of leverage, information about their footprints in particular sectors of the market, how much of the daily trading volume do they account for, which, I can tell you, would be very, very small, information about their liquidity—so the liquidity profile within the fund, how liquid are the fund investments, what are the terms and conditions on which investors can exit, what are the funding arrangements and then what are the triggers about that and how does that all add up, so does that add up to something that is flexible enough to meet demand and meet requirements reasonably flexibly and where are the counterparty risks, where are there prime brokers, etc. For the bigger funds (over £500 million) though, we get that same information on a fund level and we have been piloting that work. That gives you very, very important information, especially when you aggregate it, about the presence of funds in particular sub-sectors of the market and also about their leverage. We are working with the SEC now because together, between ourselves and the SEC, we account for a very, very substantial part of the global assets under management in hedge funds, and we are working with them to come to a kind of common position on what is the right information. In the best of all possible worlds, you would like that kind of flexibility and that kind of focus of information to be in the Directive and to be in the hands of the regulator who is the one who needs to aggregate it, to analyse it and to understand it. What we do not want is a whole load of generic information about everybody just sort of pouring in the door and then we have to sort our way through it. It is quite important to get the right information upfront and we have been testing this survey. We have been through several layers of testing with the industry to say, “Can you get it? If you can’t get it, how can you? You need to get it because we think it is important”, and how much that will cost and then develop the system to do that. It is very important to get the right information to the right regulator at the right moment really.

**Q231 Lord Trimble:** I am very interested to hear you say that you are co-ordinating what you are doing with the SEC in the United States. Between yourselves and the SEC, presumably you are then capturing the majority—

**Mr Waters:** The vast majority of funds under management in hedge funds, yes.

**Q232 Lord Trimble:** Is not the obvious thing then for this European Directive to co-ordinate itself with what you and the SEC are doing?

**Mr Waters:** Indeed. One hopes that the Directive will adopt a sensible approach along these lines in gathering the right information and having the regulators have the right powers to use it. Then there is the wider question about how does that get captured and shared, and we intend to do that with the SEC, and then there is the wider question about whether it would be the Financial Stability Board where that happens, would there be arrangements between the Fed, or whatever the entity is in the US because the US of course is changing its arrangements as well, linking with the new European institutions as they develop; those international linkages need to be made.

**Q233 Lord Trimble:** You say that you want to get the Directive to collect sensible information. To what extent does the Directive at the moment not look sensible?

**Mr Waters:** Well, at the moment there is quite a lot of power in the hands of the Commission and it is sort of a prescriptive power setting things ex ante, if you like, which we do not think is the right approach. We think the right approach is that the supervisory authorities over the relevant hedge fund managers can take a consistent approach and gather the right data and gather it themselves, then you have arrangements for sharing that data and then you have powers for the supervisors to deal with it, if they need to.

**Q234 Lord Trimble:** That is the supervisors rather than the Commission?

**Mr Waters:** Yes, we think these are supervisory issues. These are not ex ante, to intervene in the structural aspects of funds, this is about the supervision of the hedge fund managers.
Q235 Chairman: Nothing could be more interesting given the fact that we are going to Brussels tonight to see various bits of the Commission, and we will put this to them.
Mr Waters: Excellent.
Chairman: Lord Trimble, have you got to the end?
Lord Trimble: I think so. I just thought that, by talking about the SEC and the FSA, we were being effectively global.
Chairman: I think that is right.

Q236 Lord Renton of Mount Harry: I would like to come back to the question of leverage, and the word has already come up a lot over the last half-hour. It is really of course at the heart of whether a hedge fund can pay off its debts or not. You say in your evidence that hard leverage limits are inappropriate and that local regulators should have the power to use leverage limits, where appropriate. I would very much like, Mr Waters, to have your definition of a hard leverage limit, at the same time putting the point that is not a local regulator always likely to be put under a lot of pressure from the local hedge fund that the assets that they are offering are probably rather better than others might think?
Mr Waters: Well, the definition of hard leverage is not entirely clear from the Directive, but, in principle, the way we understand it would operate is that the Commission, by some process, advised by the regulators or not, would set ex ante a limit on leverage for different hedge fund strategies of two to one, or three to one, or one to one, or some other number like that, and the fund would have to manage itself to that limit, no matter what. The problem with that of course is that you then immediately have a sort of herding behaviour for all of the funds in that sub-sector and everybody kind of knows that that is where they are, which creates an odd dynamic in the market, to say the very least, and, if market circumstances were to develop in such a way that all of them were then suddenly put in a position they might never have expected, but they were all in breach of their limit, they would all then have to unload at the same time, which does not seem to us to be a very sensible place to end up, so, in principle, we do not think that is the right approach. The better approach is, as I have already said, to give powers to the local authorities to deal with what they think might be developing systemic issues in respect of a leverage of a particular fund or a fund manager’s portfolio, and by “systemic”, that could be either a fund that was sufficiently large that it might actually be systemic in the classic sense and that you would you see coming over a long period of time, so it is not going to appear overnight, or, perhaps more likely, in a sub-sector of the market you might have a number of funds with a certain degree of leverage which together had a major footprint in that sub-sector and you might then want to address yourself to each of those. I think you raise an interesting point about the relationship between the local regulator and the regulated entity and the risk of a sort of capture in that relationship. That is a risk and any regulator, like the FSA, which has a relationship management basis to its work, must be alert to that kind of issue, and we have internal rules about how frequently we change our supervisors and all of that. Having said that, if we are in a position to have a view of that sub-sector of the market in the example I am talking about, we are in a different position from the hedge fund manager.

The hedge fund manager may, with all the best will in the world, think that they are doing something that is very sensible, their portfolio is being managed in a way that is within its risk appetite and according to its risk management principles, and they do not understand where we are coming from. The position of course we are in is rather different because we see the rest of the market and we see the other issues. I think it is easier then for the regulator to say, “This is not necessarily a criticism of your particular strategy, but this is information to you that there is an issue here which, we think, needs to be addressed”.

Q237 Lord Renton of Mount Harry: I can see why you do not want everyone to collapse at the same time, but what goes into the leverage? Is there not a great difference as to whether you are putting gilt-edged in, for example, or the Chairman’s estate as a property asset? Is there a real definition yet of what is good value in what is being put forward for leverage?
Mr Waters: That is a very different question. You are then talking about what are the asset classes of the strategy.

Q238 Lord Renton of Mount Harry: Yes, of course.
Mr Waters: There are property-based funds and there are funds with all sorts of different asset classes in them, some of them quite volatile and difficult, distressed debt, for example, emerging markets, et cetera. One of the reasons that we think leverage caps are just such a blunt instrument is that the range of investments in which hedge funds are able to invest now is really quite broad, and the decisions that investors take to expose themselves to those assets are decisions that are taken by investors from a portfolio point of view who will have exposure to all kinds of different assets and who will be looking for non-correlating assets to add to their portfolios. Some of those might, to us, look rather exotic and indeed we would not be very happy for them to be on offer to the retail market, as I have already said, but that does not mean that those asset classes, if properly managed in a sensible risk management structure of an authorised hedge fund manager, ought not to be something that an institutional investor could wish to have exposure to.
Q239 Lord Renton of Mount Harry: I understand that, but you could argue, could you not, that, if it were gilt-edged, you would only need to have a leverage ratio of two, but, if it were property, you would need, say, five times simply because the ability of property to go up in value and down in value is much greater than that of gilt-edged stock?

Mr Waters: I am not a fund manager and I am not going to sit and speculate on what my strategy would be in terms of levels of leverage in different kinds of funds, but it is true to say, as you have pointed out, that different fund strategies are characterised by different levels of leverage, and I think that is right and you are absolutely right, that the level of leverage in those different strategies is linked to a return that is an attractive level of return and in some strategies the leverage can be quite high or the exposures can be quite low.

Q240 Lord Renton of Mount Harry: Lastly, do you believe that higher capital requirements on the prime brokers might provide the result, in effect, of direct supervision of the hedge funds and their leverage?

Mr Waters: I do not think it is a question of their capital actually. What it is a question of is a better understanding of their risk management, of their exposure to their hedge fund clients, which is why we have been doing a prime brokerage survey for the last four years now. We know where they are and we know the level of their exposures to the different major hedge fund managers in the UK. It is interesting to note that, even through this very, very significant crisis, many hedge funds closed their doors and returned such assets as they still had to their investors, and there were losses, but the prime brokers did not lose money, but they managed those assets in the way that we expected, so it is not really a question of their capital, that is a much broader question about the overall standards of the institution, but it is how do they manage the risk exposure of the lending that they have with these hedge funds, and that is something we are very interested in.

Q241 Chairman: So the prime brokers, in short, at least in relationship to hedge funds, did not contribute to systemic risk and, as it turned out, they had that risk managed and it was the customers of the hedge funds who lost money?

Mr Waters: The customers of the hedge funds lost money, but, you know, that is in a world where, to be blunt, if you are prepared to take those kinds of risks, then those risks have great returns and there can be risks of loss. Those funds, as I said, closed and those losses occurred without a systemic disruption to those who had lent it, to the prime brokers who had lent that money.

Chairman: That is very interesting and useful, thank you.

Q242 Lord Moser: This goes in a rather different direction now. I must apologise as two of us have to go to a memorial service for a colleague in a moment, so I will be fairly quick. On the question of the marketing of funds beyond the EU area, we have had some discussion with other witnesses about the whole question of demanding equivalence and then the three-year gap and all that, so does the FSA have a particular view on this whole issue of the marketing beyond the EU itself? It is rather important.

Mr Waters: It is extremely important and we do have a view. The Directive offered the substantial carrot of the idea of passporting third-country funds in Europe. The price for that passport is very, very high and, we think, actually does not in fact work, so where do we land? First of all, the European passport is very valuable, and one of the most attractive things about this Directive which the UK has long wanted is a European passport for European-based fund managers, and that is an important thing to achieve, but the price of this third-country passport is far too high. The disruption to legitimate business models imposed by these extraterritorial applications on delegation, on valuation, on capital and everything else, we think, cannot be justified. We think a much more sensible place to land, and there is movement here, is that national regimes, in respect of the sale of third-country funds, should be able to continue, and those funds will not passport, but investors in the UK, pension fund investors in the UK who want to buy a pension fund in the US that is managed either in London or indeed in the US can still do that. We see no case for closing the door to those kinds of investments and, if it means that they do not passport, well then so be it, they do not passport, but the price for that passport is so disruptive that, frankly, it is not worth it.

Q243 Lord Moser: I do not quite understand. Is the Directive helpful on the equivalence issue?

Mr Waters: It is not helpful because the hurdles that are set are far too high and they will not be achieved. You will find very few countries able to clear the so-called ‘equivalence’ hurdles.

Q244 Lord Moser: Why do you think the Swedish notes have not helped, the Swedish comments on this particular proposal?

Mr Waters: The Swedish Presidency, I would just say for the record, has done a superb job in working through this very complicated process and taking on technical propositions all over the place to try to differentiate this fund, so where we tend to be focusing now is that national regimes will continue. That, we think, would be a very good place to end
up and that would not disrupt, as I have said, legitimate investment, for example, in the UK in third-country funds, whether they are managed here or managed abroad. It is a completely different question about having a European passport. Within Europe itself, that is a jolly good thing to have and we would like to have that.

Q245 Lord Haskins: I am just slightly confused as to why the Commission has made this proposal. What was their argument for making such a proposal?  
Mr Waters: I think you will have to ask the great Commission that question, if I may say!

Q246 Chairman: We will.  
Mr Waters: The idea of a global passport for what are essentially private funds, as they are called in the US, or sophisticated investor funds is attractive. It may be an idea whose time should come, but, if it were going to come, it should be done on the basis of internationally agreed criteria of information-sharing and equivalence that are rather different from what the Directive has put forward.

Q247 Lord Renton of Mount Harry: In his evidence to us, and I do not know if you have had the chance to read it, John Chapman, who I would not say was a great lover of hedge funds, suggested imposing a tax upon buying and selling by hedge funds “to level the playing field between hedge fund and other investors”. To me, as an interested outsider, the difference in the playing field at this stage is quite extraordinary, is it not? To invest in equities, there is regulation effectively, but, if you invest in a hedge fund, there is not regulation. Do you think there is any sense in this suggestion or any possibility that it might work?  
Mr Waters: Well, if I just may say, the idea that there is no regulation if one invests in a hedge fund is really not our view of what reality is like. We regulate the managers of hedge funds who are the controllers of the investment strategies, the leveraging and all of that of those funds. We have relationship managers for the biggest firms, just like we have relationship managers for banks and insurance companies and other big asset managers. They are regulated and the investor tax arrangements are just the same, so I do not think Mr Chapman likes hedge funds very much, but actually some of the factual predicates of what he has said are just not right. I am not going to comment on tax in general because that is not my job, that is a matter for the Treasury, but the notion of there not being a level playing field, I think, is just not accurate.

Q248 Lord Renton of Mount Harry: You do not want to make any comment on tax?  
Mr Waters: I do not.

Q249 Chairman: So what you are saying is that he is not accurate to say that there is not a level playing field in terms of regulation?  
Mr Waters: In terms of regulation of the hedge fund managers, they are regulated as fund managers and, in a way, that is as rigorous as we regulate any other fund manager, in my view.

Q250 Chairman: It remains for me to say thank you very much indeed, Mr Waters, for coming. You have given very clear evidence and it has moved us on a lot.  
Mr Waters: Thank you very much, my Lord Chairman; my pleasure.

Memorandum by UK Foundations including the Church Commissioners, Esmée Fairbairn Foundation, Nuffield Foundation, Paul Hamlyn Foundation, The Henry Smith Charity, and the Wellcome Trust

1. As some of the major charitable foundations in the UK, we would like to highlight our concerns about the potential impact of the proposed EU Directive on Alternative Investment Fund Managers. Our combined investment portfolios are worth an approximate £19.5 billion, and together we spend in the region of £0.9 billion for public benefit each year. Our funding interests range from medical research and education, through to support for the Church’s ministry and to address social inequality. We are concerned that the Directive as currently drafted will significantly restrict our ability to generate funds to pursue our charitable missions and thus reduce our impact for public good.

2. We welcome the intention behind the Directive—to improve regulations and safeguard investors—and we support those provisions of the Directive that aim to ensure greater transparency and expose conflicts of interest. However, we are concerned that some provisions of the Directive will have significant unintended consequences. The following issues are of greatest concern to us:

3. Limitation of Choice of managers and funds (Article 35, 38 & 39): To maximise the returns on our investments, we must have freedom to select the best investment managers and funds, and to select the investment ideas that best meet our individual needs.
4. The Directive as currently drafted will severely restrict our access both to non-EU funds and to non-EU fund managers. This will impact access to private equity funds and to hedge funds. For example, up to 95% of global hedge funds are currently either not domiciled in the EU or have non-EU managers. Similarly, many private equity firms are likely to be situated in the market in which they invest. We believe there is a significant risk that many of the best will stop raising capital in Europe rather than attempting to comply with onerous EU regulations. This will significantly restrict choice for European investors, limit the scope and potential return of our investment portfolio and hence reduce our charitable spend.

5. Restrictions on access to international assets through limits on depositaries (Article 17): Diversification of an investment portfolio is a core principle of good portfolio management. A key area where diversification can be obtained is by investing internationally. Such a strategy can produce increased returns while reducing the risk of excessive concentration in particular countries.

6. The draft Directive will require all funds under management to have a depositary that is an EU-authorised credit institution. This will introduce significant barriers to owning international assets, and will particularly limit our access to emerging markets. Again, this will reduce the returns on our investments and therefore reduce our spend for public benefit.

7. Uncertainty on whether investment strategies involving leverage will be permitted (Articles 22–25): Many investment strategies employ leverage. From an investor’s perspective, leverage can be a useful tool to adjust the return and risk profiles of a particular investment, and allow the maximum benefit to be obtained by the investor.

8. The leverage limits proposed in the draft Directive are not adequately defined. Greater clarification is required, both about the level of the limits and the mechanisms that would be used to enforce them. This lack of clarity is destabilising and makes it likely that certain investment strategies will not be made available to European investors. As stated above, we regard this restriction of choice as likely to reduce the returns on our investments and, in turn, to reduce our spend on our charitable purposes.

9. We support measures to address systemic risk that arises through excess leverage. It seems to us, however, that systemic risk can better be addressed through a proposal that deals with leveraged organisations as a group, rather than specifically addressing investment funds.

10. In our view, the issues described above should not be dealt with by imposing restrictions, which will have the effect of reducing our freedom to invest in a way that maximises the benefit we can provide. We advocate that one of the Directive’s existing principles, transparency, should also be the approach here. Professional investors should be provided with proper information about the regulatory regime(s), depositary/custodian arrangements and use of leverage of the funds that they propose to invest in, to enable them to make a judgement on these issues as part of their investment process.

11. We note that the Swedish Presidency has released an Issues Note on 2 September 2009 which recognises some, but not all, of these concerns.

12. Maximising the returns on our investment portfolios is an essential part of delivering our Foundations’ missions, for the benefit of society. The draft Directive, while well-intentioned, threatens this goal. We encourage the Committee to take into consideration the potential impact of the Directive on all European investors as part of its inquiry.

September 2009

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Estimate by the Alternative Investment Management Association, the global hedge fund body Submission to House of Lords EU Committee inquiry on the European Commission Directive on Alternative Investments Fund
Q251 Chairman: Welcome, Mr Truell, and thank you very much for coming. We have lost a couple of members of the Committee because it is Lord Dahrendorf’s memorial service, so at least two of our Committee have vanished, but there are still plenty of us and plenty of questions to ask. You have had the list of questions and you know what we want to ask. Would you like us just to run through them or would you rather make a general opening statement?

Mr Truell: My Lord Chairman, I would prefer to make a general opening statement. I sometimes feel that perhaps the interests of charitable foundations, their size and their scope, are not always understood by both regulators and legislators. I speak today solely for Wellcome, although, as you know, other UK foundations joined us in submitting written evidence to this Committee, and we have worked closely with a number of other EU foundations in providing similar evidence directly to the European Union. As background, I am the Chief Investment Officer of the Wellcome Trust. We have about £14 billion worth of charitable assets. This is all our own money, we do not have any clients and, therefore, we can take a long-term view as to what we do without any conflicts. Just to put it into perspective, about 50 per cent of those assets or £7 billion are invested in non-EU alternative investment funds, and that is a key reason why this Directive is so important to us because charitable foundations have different investment objectives and models from those of other institutions in which alternative funds play a very important part, and it is our evidence that the public good would be adversely affected if we and other EU foundations were, directly or indirectly, restrained in our choice of investments, as is currently being proposed. There are other elements of this Directive which are significant, but they are secondary in importance to us. Just as background, according to the European Foundation Centre Wellcome is the largest of 55,000 EU private independent charitable foundations. They have been endowed by generous philanthropists and they have funds in total of £160 billion. We charitable foundations employ over half a million people across the EU and each year we give away £50 billion which benefits the public; these are large sums of money. The largest 50 foundations in the EU have 50 per cent of these assets. We are among the most sophisticated investors and we recognise that our ability to give money to charity is solely a function of our investment skill. We have no sponsors, we have no governments standing behind us and, unless we can use that skill, I think that will not merely restrict existing foundations, but it will also, unfortunately, deter wealthy individuals from setting up new foundations. I think you know that Wellcome are a medical research charity, and last year we gave away £700 million to medical research both in the UK and internationally for a whole range of causes from Alzheimer’s disease to malaria to genetics. We last received a gift in 1936, so we have been cashflow-negative now for 73 years and, therefore, our investment portfolio is the only way, as I say, that we have to generate revenues. We sold down all our pharmaceutical investments and we are now invested fully in financial assets. As a sign of our stability, we are now the only UK organisation that still has a stable triple-A rating from both the major credit agencies. So why are these alternative investments so important? I think you have only had one witness from the Association of British Insurers who has represented asset owners, and Peter Montagnon said that their alternative investment was “not a lot because it is a bit at the margin”, and that is understandable. Pension funds and insurance companies have defined liabilities and, therefore, their starting point would be to have sterling bond-like assets to match those liabilities, and we see that the NAPF evidence shows only four per cent of UK pension fund assets invested in private equity and hedge funds. We have 70 per cent of our investments in non-EU assets, we have 60 per cent of our investments in alternative assets and we have 50 per cent invested in non-EU funds, and we currently have interest in 494 funds, of which 382 invest principally outside the EU. This is a really major undertaking. We are not just the largest single UK owner of non-EU funds, but Wellcome is also the largest UK owner of hedge funds, we are the largest UK owner of private equity buy-out funds and we are the largest UK owner of venture capital funds. Our biggest risk, in contrast to insurance and pension funds, especially given that we exist in perpetuity, or aim to, is that our real spending power is eroded by inflation and that means that we need to hold a globally diversified range of investments with no innate geographic bias which provide positive real returns after inflation and not to be over-exposed to the cult of the equity. Therefore, we are indifferent to the vehicles that we use to access these, we are indifferent between non-EU and EU, and our risk experience has been that we are running at about 60 per cent of risk of equities. We have tried to assess what impact the Directive would have if it were implemented on our returns, and we have looked back to 1985 when we floated our pharmaceutical company. If we had taken that money and we had invested it in UK equities, we would have had a pretty reasonable return, we would have made ten times our money, which is just over ten per cent a year. Our actual returns, and they have been very much helped by our investments in private alternative funds, we have made 25 times our
money rather than ten times our money, and that is close to 15 per cent a year. To put that into perspective, that means that, rather than spending £700 million a year, we would have been able to spend about £275 million a year, so these are big amounts. The other thing about funds is that funds are not substitutable. I am pleased to say that Wellcome, over the past three years in all the nine asset classes that we have invested in, has achieved positive returns. A lot of that is driven by the partnership that we have with the people who manage these funds and the information and the dialogue we have with them about macroeconomic conditions, microeconomic conditions, all the conditions that have been a challenge in the past couple of years. Now, what is going to happen if the Directive is to go ahead in its existing form, from talking to our partners who run these funds, is that, unfortunately, given that less than 20 per cent of their investors come from the EU, essentially these funds are not going to be open for us, and it is not just for Wellcome, but 420 UK charities invest in the Absolute Return Trust for Charities, which itself is a charity and it is a fund of hedge funds, many of which are outside the EU. So that would not just affect people with our resources, but actually it would be even harder for some of the smaller charities. There are clearly constructive elements in the Directive, and the previous speaker referred to those. Of course we want transparency, we want information, we want good regulation, we think the EU passport for funds would be very beneficial, better disclosure is clearly something we support and we support how the Swedish Presidency worked on this. However, we are concerned about this non-EU fund question and also we have little information as to what will happen to the 494 funds in which we are already invested. What I would say is that we think that the negative impact of the Directive on charitable foundations, not just here, but across the EU, is probably inadvertent. We do have genuinely different objectives and models by which we invest. We hope you would agree that charitable foundations in the EU are actually a systemic force of good not just in terms of our charitable spend, but we are the longest-term stabilising forces and we do give the money away. Therefore, our conclusion would be that, absolutely, we believe that qualified, professional investors should be given the information they need to make properly informed decisions and that then we can make the investments that best match our requirements for return and risk. This has already been recognised in previous legislation in the EU, the MIFID legislation point, that retail and professional investors should be treated differently, and we find it hard to understand why this Directive would adopt a different stance and believe that that would not benefit the public good. Thank you for your indulgence.

Chairman: Thank you very much. I think you have answered the whole of my first question about the impact of the Directive on the Wellcome Trust’s investment activities, and you have probably answered quite a lot of questions that Lord Trimble wanted to ask, but is there anything to mop up there, Lord Trimble?

Q252 Lord Trimble: You made reference to welcoming greater transparency and all the rest of it, but is there anything that you want to add to that about how, in particular, that benefits your fund and similar funds?

Mr Truell: I think, Lord Trimble, that many professional investors, including ourselves, who have been partnered in many cases for many years with the people who manage our funds have established a level of trust which means that we feel generally comfortable with the levels of transparency. We do not want to overload ourselves with information which actually has no use, but we clearly want to have a clear idea of what managers are doing and particularly at times of stress, and I think it is at times of stress where the fact that a regulator is also taking an overview of the manager and the investments is something that provides comfort to us, so I think the key to your question is that it is transparency to the regulator that gives us comfort in addition to the transparency which, we feel, generally exists for us as professional investors.

Q253 Lord Trimble: You would obviously, from what you have said, be very unhappy with the provisions on non-EU funds.

Mr Truell: I am pleased you got that point!

Q254 Lord Trimble: On passports, the equivalence test, we heard from the FSA that they feel that the equivalence test could not be met and, consequently, the passports will not be available. Would that be your view also?

Mr Truell: We would not be in a position to be able to take the view as to exactly how the Directive develops in that regard. Clearly, at present most funds can come to the UK and I think, as a general point in terms of promoting the EU investor and other interests in their funds, that their ability to actually take their funds to other investors in the EU would probably be generally beneficial.

Q255 Lord Trimble: But, as long as the existing arrangements whereby you can invest from the UK in non-EU funds, as long as that position is
preserved, then you and similar funds will be able to manage it?

Mr Truell: That is what is most key to us. As I say, we are ambivalent between a fund which is a non-EU fund or a fund which is an EU fund.

Q256 Lord Renton of Mount Harry: I listened to your opening statement with very great interest and I just wish I could buy some shares in Wellcome, having heard what you have to say, and congratulations on your performance over the years; fantastic! You were here when our previous speaker was here, Mr Waters, and you will have heard what he had to say which was essentially against the EU Commission setting down fixed leverage limits and possibly saying that local nationals should do it rather. What do you think about that? You say in your written evidence that measures to address systemic risk through leverage limits are a possibility and that you rather support, I think, the ideas coming from the Commission. Is that right, and would you like to talk to us about leverage?

Mr Truell: I think Mr Waters put it much more coherently than I could. I think what we said in our written statement was, first of all, that the leverage limits needed to be better defined, but the key was in point 9, where we say that we support measures to address systemic risk that arises through excessive leverage. We have, and we have put this in our annual report for a number of years, been very reluctant to invest with managers where we perceive that excessive leverage is a major function of their returns. I think, where it is important for the regulators, is that it is one of a series of risks which can create systemic problems. If one looks back to the problems that many hedge funds did face in 2008, and I think Lord Myners put it very coherently in his evidence to this Committee, I think the biggest problem was, what he called, 'the crowded trade' where lots of funds, probably independently of each other, decided that they were going to take positions on certain securities, whether they were long or short, and use leverage to them, and those were the situations when these funds were forced to de-leverage because their investors wanted to withdraw assets from them and they were all forced either to sell or to buy back at the same time. That is something where, I think, only a regulator can actually take a view, so, as I say, I think that the object of the regulator is not just to look at leverage, but to look at the range of risks that exist in the system.

Q257 Lord Renton of Mount Harry: I think what one forgets sometimes, does one not, that in all the difficulties of the last two or three years, there are a number of hedge funds that have survived and made a great deal of money for their investors. It is not as if systemic risk hit everyone down. I think that the difficulty that we have is how to go along with these proposals of the EU, which get sort of mild support from you, without actually binding up the market too much.

Mr Truell: Well, I am pleased to say that we are invested in 50 hedge funds and none of them failed.

Q258 Lord Renton of Mount Harry: Congratulations!

Mr Truell: But there are a lot of hedge funds out there which did fail. I think that part of the response is in the regulator and part of the response has actually got to be from investors who, in some cases, did get carried away with, what they perceived as, these new alternatives and probably invested with people with whom they would not invest again today, so, providing that we can be confident that systemic risk is being prevented in the system, I think that there is a case that individual investors must make their own decisions and, importantly here, that is one where it is appropriate for professional investors to take their decisions even if we get it wrong, but I would agree with the FSA, that retail investors should be protected who do not have the same information or expertise and that, I think, is the key distinction in this case.

Q259 Lord Renton of Mount Harry: That is a very good point of view, but do you think it is possible to stop excess leverage without reducing choice? Probably not.

Mr Truell: I think the number of instances in which an individual fund takes on such leverage as to pose a risk to the system will be very few and I think it is appropriate that, in that instance, the regulators do step in to prevent it, even if that is marginally limiting choice.

Q260 Lord Renton of Mount Harry: So to put it in a phrase, you are, therefore, relatively happy and content with the proposals about leverage in the draft document that we are looking at?

Mr Truell: I know that the Swedish Presidency made a lot of progress in terms of some of the technical aspects of those, which has taken the focus away from EU-wide leverage limits. There is probably some more work to be done, but we are more comfortable with that part of the Directive as the Swedish Presidency have proposed that it be amended than the part that we referred to earlier on non-EU funds.

Q261 Lord Haskins: So the nub of the issue, you have with this, is about the inability to source non-EU funds. You have made all these points to the Commission, but what has the Commission’s
response been or have they responded? We are going to Brussels tonight, so we will be able to ask them the question on your behalf, but what is the Commission’s response? I am really baffled and I, like Lord Renton, am pretty impressed by your argument.

Mr Truell: Well, I think it is fair to say that the Swedish Presidency was doing a lot of work on many of the technical aspects of this. The foundations have been there and we have certainly had an audience, but I think one of the things, Lord Haskins, is this education programme almost that, for so many investors, these alternative funds are three or four per cent of their portfolio, so it has not really gone as far up the radar screen as it might, and it is educating people that the foundation model is, I think for quite appropriate reasons, very different. As I said at the beginning, it is one of the reasons I am very grateful that you have invited me to give evidence today, that sometimes in these things the interest of a foundation are, not deliberately, but inadvertently, rather ignored, and we have seen that in examples of previous legislation which is why, we felt, it was appropriate to be proactive here, so we very much hope, if you sympathise with some of our views, that you will be also be able to raise it when you go to Brussels.

Q262 Chairman: I think really you have answered our question about the level of retail investment. Like colleagues, I feel that this is a whole new series of thoughts to note. There are institutions, and they are probably not even only charities, for whom the kind of investment track record you have been able to achieve with no incoming donations would be extremely useful. If the hedge funds, about whom so many people speak in a derogatory way, had been able to achieve this for you, if that is only achievable by alternative investment, we need to keep an eye on that. Do you have conventional investments?

Mr Truell: No. At the moment about 40 per cent of our money is in equities. Some of that we outsource to other people to manage and some of that is managed in-house at the Wellcome. Then we have about 20 per cent in hedge funds. We have about 20 per cent in private equity, and a lot of that is venture capital in healthcare and technology rather than in some of the private equity which took on too much leverage. Then about ten per cent of it is in property, but most of that is owned directly by us, so our largest asset is the 1,800 freeholds in South Kensington around the Onslow Square area that we own that has been a very good investment for us. We have some smaller investments elsewhere. What is important to us is to try to get this diversified series of returns. Clearly what concerned us in 2005-06 was the number of different parts of the portfolio where leverage was being used, whether that was excessive leverage in a hedge fund or too much leverage in buying a retailer and taking it private or too much leverage being employed by a small public company. We disposed of £5 billion of our assets where we felt that leverage was there and that has been quite helpful in terms of maintaining our performance over the last three years.

Q263 Lord Renton of Mount Harry: I see that you joined the Trust in 2005.

Mr Truell: I did. I am not going to tell you what I was doing before.

Lord Renton of Mount Harry: Goldman Sachs.

Q264 Lord Trimble: I am interested that you were disposing of assets that you thought were too highly leveraged in 2005-06, in other words before the storm really hit. It was quite acute of you to spot that.

Mr Truell: I think one of the advantages of being a foundation is that you can take the long-term view and that long-term view is very much in the DNA regardless of when individuals joined. We floated our pharmaceutical company at a very opportune moment in 1986. At that time I think bond yields were about 12 per cent and by 2006 they were down to four per cent. We took the view that looking out over the next 20 years they were unlikely to fall another eight per cent and, therefore, what we have been trying to do is rebalance our portfolio so that we are taking advantage of some of the longer term themes. Not entirely appropriate for the EU Directive, but the four long-term themes we are thinking about are ageing, what is happening to all of us and what are the economic opportunities, scarcity of resources, the shift in Europe and the US from service-based to knowledge-based economies, and also the new New World, the new parts of the world, like Africa and Latin America, where there are great investment opportunities. One can only do that with a time horizon, but I am afraid we can also only do it if we are allowed to use non-EU funds.

Q265 Lord Haskins: I think it would be helpful if we got copies of the financial reports of the Wellcome Trust. Could we have those?

Mr Truell: Yes, we are very happy to provide those.

Q266 Lord Haskins: It might be helpful for us to take that statement you made at the beginning to Brussels.

Mr Truell: My colleagues will ensure you get them this afternoon.
Chairman: Thank you very much, that would be extremely helpful. I have a general question. Appearing around the sides of the Directive is a general feeling that hedge funds have an unfair trading advantage compared to other investment funds and this may blur the question of whether they contributed to financial instability, which I think is the only one the Commission ought to be interested in. You can see there is a general perception about hedge funds having an unfair trading advantage. Do you feel that yourself, that hedge funds have an unfair trading advantage compared to conventional funds? You invest in both.

Mr Truell: One of the things I feel as an asset owner is that if you partner with the right people you do not then want to go and impose significant restrictions upon them. If you do that you are not partnering with the right people. The advantage of the hedge fund community is not something that is actually conferred on them by external forces, but they say they make it very explicit that they are not going to permit people who invest with them to constrain them. They will give you the idea of what they are doing and be sufficiently transparent, but essentially if you put your money with them it is because you have confidence in their ability to do that. Many conventional fund managers, and I have in my past been one of those, suffer from the problem that they have not established that level of trust with their investors and, whether it is their investors or the consultants to the investors, they end up imposing constraints on them, the purpose of which is not always evident. If hedge funds do have an advantage it is because of that lack of constraint, not because they benefit from a tilted playing field. That is why also they may not be appropriate for all investors.

Chairman: That is interesting. Thank you very much for a particularly interesting session, it has been very useful and we shall use it in Brussels. Thank you.
1. Preliminary Comments

— Although the AIFM directive addresses a number of different types of funds, the answers will focus on the two main categories, i.e. hedge funds (“HFs”) and private equity funds (“PE”).

— While “calls for evidence” are of course a useful way to collect information, the House of Lords should be wary of the fact that under standard “regulatory capture” theory, the industry which is potentially most affected by proposed regulations will commit the highest level of resources to provide lawmakers with the best crafted arguments in order to achieve the result they desire. In our case, a good example of this may be seen in the huge quantity of work recently produced by the financial industry to present its case in the most favourable light and avoid any meaningful regulation.

Question 1 “What economic benefits arise from Alternative Investment Funds? What risks to financial markets arise from Alternative Investment Funds? Will the Directive help reduce these risks?”

2. Economic benefits arising from HFs are small (if any) and not clearly substantiated.

Allegedly, HFs (i) provide absolute returns (not linked to market conditions), which may be an interesting option for investors, and (ii) contribute to the well functioning of the markets through an increased liquidity and a reduction of market failures. However, both claims have been hard tested during the financial crisis: (i) absolute returns have turned into substantial losses and (ii) the impact of HFs’ activity on the market has been significantly pro-cyclical as a result of both massive sales (resulting in part from inadequate matching between the liquidity of the investments and the liquidity granted to investors in HFs) and recourse to short selling (included “naked” short selling).

More generally:

— From a historical standpoint, HFs have been in existence since the late 1940s, and have had a succession of booming times and depressed periods (when they almost completely disappeared): it is difficult to make a case that financial markets are more efficient when HFs are active.

— From a wealth creation standpoint, it should be noted that the benefit to the economy of HF activity is by its very nature very limited in scope: HFs (when successful) take money from less sophisticated investors’ pockets (such as individual investors) and put it into more sophisticated investors’ pockets (such as high net worth individuals or institutional investors). For instance, a pension fund investing 5% of its assets in HFs and making an extra “abnormal” return on this investment will probably, at the same time, incur a more limited return on its other investments as a result of HF activities. The net impact of this effect is not clear and, in any event, does not give rise to a strong case that HFs are useful to the economy as a whole, to any significant extent.

3. Economic benefits arising from PE are not clearly substantiated.

Allegedly, PE is a way to increase the dynamism of the economy through the injection of long-term capital in companies whose management is incentivized to deliver higher value to investors. This increased shareholder value is then deemed to correspond to an improved state of the economy.

However, the measure of the impact of PE on the economy is a major subject of debate:

— There is a clear lack of reliable evidence regarding the actual performance of PE firms (and of the companies they control). This results from the fact that there is no duty to collect and aggregate information in a standardized manner. Thus, most studies rely on information sources provided by the industry itself, without independent control. In addition, a significant number of studies are also made by researchers paid by the industry. Independent sources are thus scarce—which leaves decision makers with a duty to be cautious.
Independent studies have shown that the shareholder value delivered by PE firms were not as high as claimed. In addition, higher returns to investors, when they exist, mostly result from a combination of low interest rates and high leverage. The added value to the companies themselves is not established.

In the event higher value is delivered to shareholders, there is a long way from this statement and the conclusion that this is good for the economy. It may be good, it may be bad. It all depends on a number of factors, such as: how the higher value was created (from a more efficient productive system or from a transfer of wealth to shareholders from other stakeholders), whether this increase is sustainable or results in higher risks, etc.

4. There are some clear risks associated with HFs.

Financial risks are clear:

- HF's have had a pro-cyclical role in the crisis (see above).
- They have participated to the creation of an increasingly complex financial system developing outside any regulatory context, which is one of the general causes of the crisis. They have in particular contributed to asset price inflation and the rapid growth of structured credit markets.
- HF's have developed a tendency to indulge in improper conduct, such as “stealth acquisitions” (where sophisticated financial instruments are used to by-pass legal requirements regarding transparency of ownership in listed companies—a practice now banned by the FSA but still possible in a number of other European jurisdictions), “empty voting” (a practice to vote in a company whilst making sure that the potential negative effects of the vote are not suffered by the voter), “short selling” in connection with potential market abuse, activist “herding” in connection with potential insider trading, etc. Although HF's are not the only investors to act in this way, they do have a serious track record in this respect.

It is likely that, without any appropriate regulation, HF's will continue in the same general direction, using new financial tools for the same old goals, thus creating the risk of new crises and continued misbehaviour.

5. PE firms create a number of issues for the economy as a whole.

There is some evidence that PE—controlled companies create less jobs (or destroy more jobs) than other companies. In addition, a substantial portion of these companies use their cash-flow to reimburse the debt taken on by the acquisition vehicle to buy them. In a number of cases, this leads to a diversion of resources away from useful investment and growth. From a macro-economical standpoint, PE results in a higher level of debt throughout the economy (the total LBO debt is estimated around USD 1,000 billion) and the corresponding risk has been well identified for a long time. In addition, through the use of CDOs, the debt linked to leveraged buy-outs have been disseminated in the economy.

6. Generally speaking, one of the critical questions linked to the activity of AIFs is whether the financial sector has not “swollen beyond its socially useful size”, as Lord Turner put it.

There is nothing wrong with financial activities per se. But with hyper-dominance comes hefty arrogance and its ensuing string of self-indulging conducts and self-serving habits. Being close to financial flows seems to be the main reason why the financial sector has been able to obtain compensation packages whose amount are in no way comparable to the social usefulness of the activity of their beneficiaries - and this is true however one measures “social usefulness”. In other words, society is about checks and balances. More room should be made for those whose economic talents thrive in different areas, such as research or product innovation, and more resources should be allocated to them.

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1. Some studies show that the true performance of PE funds is much lower than generally claimed (see “The Performance of Private Equity Funds”, L. Phalippou and O Gottschalg, October 2006).


4. See for instance the FSA Discussion Paper, 06/6, “Private equity: a discussion of risk and regulatory engagement”, where the risk was clearly identified.
7. The AIFM directive, although not sufficient, goes in the right direction. In particular, the following principles are correct:

— No financial sector should be left outside the scope of regulation. Otherwise, new “financial innovation” is likely to grow unnoticed and lead to new unexpected crises.

— There must be more information provided by AIFMs. This information is needed for investors and regulators, but also for employees and the public at large. There is a strong need to know what is going on both to mitigate risks and to assess the impact of AIFM’s activity on a sound, unbiased, basis.

— There must be some control on the level of risks taken by the industry. To this effect, provisions regarding leverage are useful.

Question 2 “To what extent is there a need to create a single regulatory regime for Alternative Investment Fund Managers in the European Union? Does the Directive achieve its objectives? Should the objectives of the Directive be modified?”

8. A single regulatory regime for alternative investments is the logical consequence of the cross-border nature of these activities. In an integrated EU market, it makes more sense to have EU regulations. In particular, it should be noted that:

— Regulation is in particular needed as so-called “self-regulation” and “soft law standards” have proven to be a failure.

— In the absence of EU regulation, some Member States are likely to try and take advantage of regulatory competition in order to attract business away from jurisdictions that will have set up an enhanced regulatory regime. This “race to the bottom” may, in the setting of the aftermath of the crisis, result in new crises and improper conduct, thus strongly undermining confidence in alternative investments.

9. A single regulatory regime for AIFMs will help standardize processes and bring down the costs and thus the fees, to the benefit of investors. One may wonder why the profits derived from financial activities have been so high for so long: with transparency and competition, prices usually go down and profit is reduced to standard levels. The financial sector, including alternative investments, has been able to resist this downward trend. Although the reasons for this are probably complex and go beyond the typical framework of neo-classical analysis, it may help to have a unified regulatory regime in the EU, for the following reasons: (i) it will simplify processes and thus allow for scale economies and (ii) it will provide more transparency and thus will help investors to take advantage from enhanced competition between AIFMs.

10. The proposed directive does not go far enough to achieve its objectives; however, there is no need to modify such objectives significantly. (See question 3 below).

Question 3 “What risks arise from Alternative Investment Funds? Is the Directive proportionate given the role of AIF in the financial crisis? Will the Directive introduce over-stringent regulations or does it not go far enough?”

11. The directive is proportionate, considering both the role of AIFs in the crisis and the magnitude of the crisis. The magnitude of the crisis is almost unprecedented. Its short term consequences are, in wealthy countries, a huge recession and rapidly rising unemployment, and in other countries, at the other end of the spectrum, increased diseases, malnutrition and ultimately death. Long term consequences of the crisis include a very large debt incurred by most countries, with high risks associated with (i) sovereign debt defaults, (ii) hyper-inflation as a way out from heavy debt loads and (iii) strategic concerns raised by the submission of indebted States to the will of creditor States (beyond a certain level, debt is as much a question of power as one of finance). Such a crisis calls for a tough reaction: as AIFs were an active component of the overall system that led to the crisis, they must be regulated. There must be a good faith attempt to create a watertight regulatory scheme whose goal is to avoid a new crisis.
12. The directive does not go far enough.

Any reform should make sure that the focus is kept on the most important issues. Regulation should be made in view of long term sustainable growth and promote social cohesion. To this effect, it should address consumer protection, investor protection, market integrity, market stability (and prevention of systemic risk) and social externalities. The following issues should be addressed either by the directive or by other EU legislative instruments:

- **Funds are left out.** (See paragraph 13 below).
- **Dangerous exemptions.** (See paragraph 18 below).
- **Access for third countries.** Third countries will have a very large access to the EU under conditions that will make it difficult to ensure the proper enforcement of the rules provided by the directive.
- **Leverage.** The proposed control of leverage is too weak and capital requirements are not addressed.
- **Information.** Information is not sufficiently detailed and periodicity is not frequent enough.
- **Employee rights.** Companies in which funds (such as PE funds) invest need to be informed and consulted (Directive 2001/23/EC of 12 March 2001 needs to be made applicable).
- **Remuneration.** Remuneration of fund managers needs to be addressed: it has to be based on long-term results, computed on the basis of cash actually received (and not potential accounting profits based on fair value accounting).
- **Improper conduct.** A major gap in the proposed directive comes from the fact that hedge funds located outside of the EU will remain able to carry on with the type of conduct that has destabilized European markets. Such improper conduct needs to be curbed: this includes speculative short-selling (and naked short-selling), empty voting (which allows short term activism at little cost) and stealth acquisitions (acquisitions of large stakes in companies without required notifications to the market and the company through the use of cash-settled derivatives).
- **Public Interest Entities.** EU banks, UCITS, pension funds, insurance companies or listed companies, to the extent they have collected funds from EU retail investors, need to follow specific rules when investing in alternative investment funds.
- **Taxation.** Taxation issues need to be addressed: taxation of leveraged acquisitions and taxation of fund managers (the carried interest is to be subject to income tax).
- **Social cohesion.** Promoting social cohesion should lead to sharing benefits of PE transactions with employees.

**Question 4** “Is it appropriate to regulate Investment Fund Managers, rather than the Fund itself? Does the Directive contain appropriate provisions to distinguish between different types of alternative investment? Does the scope of the Directive create a danger of unintended consequences?”

13. Funds should also be regulated, in addition to fund managers.

The reasons are the following:

- In general, regulating managers does not permit an easy “indirect” regulation of funds. For instance, in the UK, the FSA acknowledged that they do not review the exposure of funds as “they are located offshore”.\(^5\) This is clearly insufficient.

- More specifically, as has been acknowledged by the Commission, “the AIF may be located (…) in an off-shore jurisdiction for reasons of tax efficiency”.\(^6\) Bringing the funds on shore would make it possible to address taxation issues properly.

- Direct regulation of the funds would also permit to introduce effective capital and liquidity requirements.

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\(^5\) IOSCO, Technical Committee, March 2009, p 63.

\(^6\) Impact Assessment, p 5. In the UK, the Investment Manager Exemption provides that managing an offshore fund from the UK will not bring it onshore for tax purposes.
14. The distinction made by the directive between HFs and PE is appropriate to address certain issues. The concept of having a general framework for all non-coordinated UCITs and, within this setting, specific rules addressing identified issues is a correct one.

15. Unintended consequences may result from the proposed thresholds. (See paragraph 18 below).

Question 5 “What is your evaluation of the Commission’s consultation in the preparation of the Directive?”

16. Preparatory work has been extensive and it is now time to act. The “Impact assessment” of the directive describes at length the preparatory work which has been done. General principles which need to be applied are clear and there is time now to discuss more detailed measures (and, when appropriate, to leave them to “level 2” legislation).

Question 6 “Will the passport system help create a single market in investments funds within the EU? How will the passport system established affect the EU and the UK industry and particularly their position in the global market?”

17. The passport system will obviously help achieve a single market and thus strengthen the position of the EU industry. However, the directive leaves open a number of loopholes permitting unregulated third countries managers to market funds in the EU—the rules should be tightened in this respect, in the interest of all concerned.

Question 7 “Is the threshold for defining ‘systemically relevant’ Alternative Investment Funds appropriate? Should the Directive include provisions on capital requirement? Does the Directive contain appropriate rules on leverage? Is the requirement for independent valuation agents and depositaries for Alternative Investment Funds adequate?”

18. The proposed de minimis exemptions are not appropriate as they would exempt most managers and are likely to lead to unintended consequences. A threshold of €100 million implies that roughly 70% of hedge fund managers, more than 50% of managers of other non-UCITS funds, would not be covered by the directive. This approach is wrong as it leaves out a majority of funds and will lead to a multiplication of small funds who will delegate management to third parties to the fullest possible extent—this may jeopardize the quality and accountability of management. In addition, having more small funds is likely to lead to less efficiency. There should be no blanket de minimis exemption.

19. The proposed directive should include provisions regarding capital requirements and leverage. This would be the most efficient way to limit risks. In addition, limits to leverage are most needed in connection with acquisitions made by PE firms. The directive is paradoxical when it defines PE in connection with the absence of leverage: if no leverage is used at the level of the fund, massive leverage exists at the level of the acquisition vehicles (or the target itself, in the event the debt is “pushed down”).

20. The provisions regarding independent valuation agents and depositaries go in the right direction. They will provide a better protection for investors and help create a quality label for EU funds. Confidence of investors and the public at large will be increased.

Question 8 “Will the provisions strengthening disclosure requirements help to create a more transparent market or do they go too far?”

21. Transparency provisions are much needed and do not go far enough. As the saying goes, “Sun is the best disinfectant”. The industry has managed for much too long to avoid appropriate disclosure, casting a general doubt on its activities. There is now an urgent need for enhanced transparency, to the benefit of investors, regulators and the public.
Question 9  “What effect will the Directive have upon the position of the City of London and the EU as a whole as a leading location for Investment Fund Managers? Could it cause many hedge funds to relocate outside of the EU? What impact would the Directive have upon professional investors and institutions?”

22. Setting up a single market for alternative investment and providing for a high quality regulatory environment should help managers develop healthy practices and competitive businesses. There is much to gain for managers in the proposed directive. However, the directive needs to be sufficiently comprehensive in order to be approved.

Question 10  “How does the Directive compare to existing or proposed regulation of Alternative Investment Funds outside of the European Union, particularly that of the United States? How will the Directive affect the position of EU Alternative Investment Funds in the global market?”

23. Regulation is changing; the EU should act quickly to show the way. There would be not much use to wait for other jurisdictions to adapt their rules, only to find afterwards that these changes do not suit EU countries. Setting the pace of reforms provides an advantage when discussing changes in international forums dedicated to financial regulation.

Question 11  “What effect will the Directive have on flows of capital and financial innovation?”

24. Investors are looking for a minimum of security, which would be substantially enhanced by the directive. Investors do not like uncertainty and lack of transparency. As a result, it is likely that flows of capital will be increased as a result of the directive.

25. “Financial innovation” is a concept that should be better defined; in any case, proper financial innovation should not be affected by the directive. So-called “financial innovations” have often proven to be little more than old techniques repackaged under a new guise. Finance has extensively used marketing techniques to sell old soup in new pots, mostly to attract higher fees. True financial innovation also exists, but its effect has often been to create unnecessary and often dangerous complexity—leading to the current “flight to simplicity”. It is thus important, when deciding how to regulate financial activities, not to give an undue emphasis on so-called “financial innovations”. Value results as much from a stabilized, clear and efficient regulatory environment than from short-lived “innovations”.

September 2009

Examination of Witnesses

Witnesses: Mr Ernst Stetter, Secretary General, and Mr Christophe Clerc, Expert, Foundation for European Progressive Studies, examined.

Q268 Chairman: Thank you very much for coming to see us. I do not know how familiar you are with our proceedings, but we take a full transcript of whatever you say and you get to look at it to sort out if the grammar has come unstuck. We are a committee of the House of Lords and our interests have been declared to you. In fact, our Members who are actually involved with hedge funds or private equity funds have withdrawn themselves from this inquiry so those of us around the table have tangential interests only. I am a Director of the London Stock Exchange, but it is a fairly tangential interest in the context of a hedge fund. You have seen the questions. We can either start asking them and working our way down or if you would prefer to make an opening statement first, please do.

Mr Stetter: First of all, thank you very much for inviting the FEPS foundation. We are honoured and very happy to be considered as an organisation that can present some views to the House of Lords. We are a very new foundation, a new progressive think-tank. We were founded one and a half years ago. This is part of a policy of the European Parliament to give the capacity and the possibility to the different political families to have respective reflection. That was why we started one and a half years ago. It occurred in the sense that while there was the financial crisis and all of these problems coming up, this was a duty for us but also a big chance for us to get involved in these kinds of questions. We started a large programme of thinking concerning the regulation of financial markets, what is the way to come out of the crisis and what is the purpose for the whole liberalised capitalist system. That was why we created an expert group, and one of the members of this expert group is the lawyer, Christophe Clerc, who has done tremendous work for us, together with others. We have started a reflection on this question
of hedge funds and regulation. We presented our evidence to the European Commission for the first draft of the proposal that they did at the beginning of this year, and in the meantime we have presented some comments on the assessment of the development of this proposal from the spring. There was a proposal from the Swedish Presidency that came out in October and we have also presented a comment on that. That is a general statement on the FEPS foundation and our work. I am very happy that Christophe has agreed to be with us this morning because he is the expert. I am not an expert in these kinds of things. I am just the humble Secretary General who has organised a bit of homework on it. Thank you.

Chairman: Thank you very much, Mr Stetter.

Q269 Baroness Northover: Turning to the matter in hand, what systemic risks do you think Alternative Investment Funds pose? It has been suggested that they did not play a key role in the financial crisis we have come through, and obviously that is something that has been somewhat debated. Looking forward things might be different, obviously. I would like to ask the overall question of what systemic risks they might pose.

Mr Clerc: First, a general comment. There has been a huge crisis, which is basically a financial crisis, and hedge funds and private equity funds are part of the financial system. So the way we see it is the following: when there is a need for regulation, there needs to be a regulatory scheme which is watertight: there should be no crack in the dam, so to speak. Generally speaking, as the general system has somehow failed, we believe there should be some regulation. More specifically, on the point of the systemic risk, we should make a distinction between hedge funds and private equity. We agree with the statement that neither of them alone created the crisis but our view is that they have been participating in that crisis in several ways. Regarding hedge funds, in the de Larosière report, they have been described as a “parallel banking system”. We know from history that unregulated banks always end up in huge collapses. Regulated banking is not collapsing. What is collapsing is unregulated banking, so regulation is useful in that respect. There are also some theoretical works, for instance by Professor Minsky in the US and Professor Aglietta, which describe how technically speaking those hedge funds are part of the systemic risk. If I wanted to turn to a more detailed explanation, I would look to what the European Central Bank described as being the risk. They said that traditionally there would be three types of risk. There is the failure of a large individual fund, or large group of funds, typically the LTCM effect. There would also be the contingent effect, the effect that this failure would have on the overall market. Then they also talked about the instability that could be initiated through the impact of hedge fund activities such as short-selling. I have found an analysis going back as early as 2006 where the ECB was describing further risk due to the expansion of hedge funds and they identified three risks. The first of them was that the hedge fund strategies have become more and more correlated over time and that in itself is creating a systemic risk. I think this is linked to the success of hedge funds. When they were only a small niche activity they could have different types of strategies and make a significant amount of money out of that, and that was fine, but, when they became very large they had to use the same strategies because there is not an unlimited number of strategies. This is one risk. The second risk identified by the ECB was that hedge funds were investing in increasingly illiquid positions and that creates a risk of mismatch between the assets they invest in and the short-term financing that they resort to. The third risk was that in certain market conditions, significant investor redemptions were to be expected. This is what the ECB said in 2006. They also noted, at that time, that important risks may be developing related to credit transfer markets in which hedge funds have become increasingly present. This is the role of hedge funds in disseminating more risky products such as credit default swaps. To summarise the risk on hedge funds, I would say there is a risk that they resort to short-term resources and invest in assets which are not that liquid, or in a crisis period are not that liquid. This is a type of transformation of short-term resources into long-term assets and this is really banking’s job and should be regulated. I know there is an argument put forward by some hedge funds, which says that they do not have this maturity transformation issue because they have the right to gate, the right to say to the investors, “Please do not withdraw the funds”. I do not think this is a really appropriate answer because if we were to apply this rule to banks, it would be exactly the same as saying that banks should not be regulated provided they have the right to say to people depositing funds, “I don’t have the funds to provide to you at this time, please wait”. This would be the only regulation applied to banks. In the same way, the gating rule is not satisfactory as the only rule to prevent systemic risks for hedge funds.

Q270 Baroness Northover: Even if they are dealing with different categories of people in the banks or if they have institutions investing in them and so on, you do not see that as a significant distinction?

Mr Clerc: Not for that purpose. For other purposes, yes, certainly, but, for that purpose, if big institutions need the money back, they are the same as everybody
else. If banks, insurance companies or pension funds need their money, they will need it because people have invested in them. There is a whole chain here which is at work. I do not think this really matters in that case.

**Q271 Lord Moser:** What you have said is very interesting. Does it amount to the view that although hedge funds did not cause the crisis or the systemic risks that we are talking about, because they set bad examples which the banks then followed the effect was indirect because of what the banks then did? Is that basically what you are saying?

*Mr Clerc:* This is one of the elements of their role. I would not say it is the only element. Certainly hedge funds have been leaders in a number of practices.

**Q272 Lord Moser:** Which were bad news in your view?

*Mr Clerc:* Some practices are just good innovation, I would not say everything is bad, but some of the bad practices come from some of the hedge funds.

**Q273 Chairman:** Can I just pick up on that. I do not quite follow the reasoning that says it is not legitimate or contributes to financial instability for hedge funds to be able to say to some of their customers, “No, you may not have your money back” in some circumstances because, after all, their customers are big institutions who do not have more than a quite small percentage of their money with hedge funds. You would think that an insurance company could operate with the knowledge that ten per cent of their money might not be available to them at any one moment.

*Mr Clerc:* My point was not that it is not legitimate for hedge funds to proceed in that way. I think it is. My point was this is not an answer to the claim they sometimes make that they do not contribute to the systemic risk because they have those provisions. You need to be regulated if you act like a bank and I think they do act like a bank and this single provision is not enough to say this is the only regulation they should have.

**Q274 Chairman:** I do not think they would argue they should not be regulated. I am wondering whether this particular aspect of hedge funds contributes to financial instability. I know of no hedge fund who says they should not be regulated. Does the fact that you restrict your ability to repay contribute to financial instability?

*Mr Clerc:* No. I did not convey correctly the point I was trying to make. My point was I believe they should be regulated for systemic risk and I have read the previous contributions made to your Committee, but maybe I misread it, and there was an answer saying, “Well, we are not contributing that much to systemic risk because we have those gating provisions.” My only point here was a side issue to say I do not believe this is the correct answer.

**Q275 Chairman:** It is not an argument for not being regulated.

*Mr Clerc:* Exactly. That was my only side issue.

**Q276 Lord Jordan:** When you define a risk and the need for it to be regulated you normally have to say, “The reason it needs to be regulated is this risk, because if we do not this disaster will happen, this accident will happen”. What examples have you used in the course of the discussions to show that hedge funds have produced these disasters or bad consequences?

*Mr Clerc:* I’m not sure that there needs to be a disaster. There doesn’t need to be a major failure like LTCM to have a risk. If you have 100 or 1,000 small failures which do not attract that much attention, this creates a risk to the economy—this is the whole purpose of having a systemic macroeconomic view.

**Q277 Lord Haskins:** As my Lord Chairman said, nobody would argue about the need for regulation, I think the argument is about the quality of the regulation and how good it is. I am slightly struggling with your analogy with banks because there are two differences between hedge funds and banks. First of all, banks have got a lot of retail customers and hedge funds have no retail customers, so you could argue those large investors can look after themselves. Secondly is the issue of leverage. There has been no evidence in the crisis that any hedge fund actually went bust. The shareholders lost their money but because of their much more cautious liquidity ratio they did not actually go bust whereas the banks’ ratios were totally different. What I am concerned about is to make sure that when we regulate, we regulate intelligently and do not kill the golden goose in the process.

*Mr Clerc:* I fully agree with what you are saying. Regulation has to be appropriate. The purpose is not to say that these activities are wrong and we should kill them, the purpose is to look at the impact of those activities on finance, on the economy and on society.

**Q278 Lord Haskins:** So better and bad.

*Mr Clerc:* Yes, for better and bad, and then try to have appropriate regulations. Regulation that happens through the approach of systemic risk is a good one but it is not enough, there are other issues which are larger and which should be addressed. This is one of the two aspects we have here.

**Q279 Baroness Northover:** Of course you have to be very careful, as has been recently debated, that you put in place such protections for those investing in it...
that there is no risk to them and, therefore, the bankers or whatever know they are going to be free to do whatever because they are going to be bailed out and supported and so on. You do not want them to get to the position where they are going to need that kind of bailing out and support, you do not see that as being part of how you would address this regulation and risk in terms of the hedge funds?

Mr Clerc: I do not think regulation will go as far as suppressing any risk. Risk will remain and is a normal part of their activities. The question is the level of control you have over excessive risk and the information you give on that level of risk. Those would be the two main concerns.

Q280 Lord Haskins: You mentioned LTCM, which has come up before and is quite an interesting issue. The Fed actually bailed out LTCM, so the system worked. Your concern in the future is that this size issue could become a real problem. Therefore, are you saying that size should be regulated down? Without saying they are too big, you are saying because they are so big you are going to regulate them all.

Mr Clerc: Yes, that is one of the points. If they are too big, or there are so many of them that the overall hedge fund industry is becoming very big, there is a need for more regulation. As long as it was a small market, I think the need for regulation was small, to the extent it was only high net worth individuals investing. These investors can fend for themselves and take risks. We now have institutions massively investing in hedge funds and these institutions, such as pension funds or insurance companies, have a public interest, so there is a much broader public interest than just individuals.

Q281 Lord Haskins: You are saying they need protecting?

Mr Clerc: I think they need protection. One of the lessons from the crisis is that big institutions which were supposed to know well the products they were buying proved that in effect they did not know these products that well, so just relying on their ability to understand what is going on has proven not to be enough in the recent crisis and we should try and avoid that in the future if anything good can come out of that regulation.

Baroness Northover: The argument has also come through that you need to take it back to those investors, that they take responsibility and do more in terms of due diligence than was the case. They were all relying on the ratings agencies which often were paid for by the people—

Q282 Chairman: Sorry, hedge funds worked. This does not have to do with hedge funds. Can I shift back to alternative investment. If I may paraphrase, I think you are fundamentally making the point that you want to regulate any system which looks to have to do with banking.

Mr Clerc: Yes.

Q283 Chairman: And the more important because this particular sector of the banking system has grown and is now very much more important. For all that it is inhabited purely by professional investors it is a large part of the system.

Mr Clerc: Yes.

Q284 Chairman: To what extent do you think the Directive as drafted is going to improve the macroeconomic prudential oversight of Alternative Investment Funds and the detection of systemic risks? Even if the hedge funds really did not have a lot to do with the last crisis because, in fact, the people who lost money were the hedge fund investors, just like they were meant to, to what extent do you think the proposals as presently drafted will prevent a future financial crisis?

Mr Clerc: I think there are two good things in the draft Directive. One is there will be much more information and reporting. At the present time there is an obvious lack of information. That will be good for supervision purposes. If I may add as a side issue, it is also good generally speaking because hedge funds and private equity have been seen largely by the public as something which is bizarre. One of the reasons for this is the fact that they are not well-known because they have always tried to be hidden from public view. If they provide more information and tell us more of what they are doing, that would be good for the public at large, that would be good for them because they will be better accepted, and that would be good for regulators and legislators because we would know exactly how to legislate them appropriately. Information in itself is a key element and it is very good. On the basis of that information, regulators will be able to set limits on the risk which they may take, so there should be principles for those limits in the Directive and then the details of how to achieve that protection against risk should probably be left more to technical decisions, Level 2 legislators or regulators. I am not saying there is a best way to do that but it is certainly very technical and I do not think one broad rule will capture all the types of risk. In that respect probably the Directive could be improved to give more power to regulators to provide these types of limits. These limits could be on the leverage but also could be more specifically on maturity transformation. They could be on liquidity. They could capture more than just leverage, which is an important item but not the only one. In that respect I think the Directive is useful.
Chairman: Would you like to comment on the role of the newly constituted European Systemic Risk Board? Will this help?
Mr Clerc: I think they should have a part to play in this type of regulation, but exactly what part I am not able to comment on because it is going to be very technical. Certainly they should be involved. If we have a central place for regulation, we should use it.

Lord Moser: The phrase “one-size-fits-all” has been raised. Most of our witnesses we have seen in our meetings in London have made quite a point of criticising the Directive on this very point, namely that it is at fault because it just treats everybody the same as if there were no different categories of funds. Interestingly enough, I think you might take a slightly more balanced view. You see the advantages of that because you think that if it were not like that then novelty, innovation, however you describe it, etcetera, might be at risk. What is the balance of view?
Mr Clerc: I think the general principle, ie that the Directive should capture everything which is not regulated at present, is a good one. In that sense, having one instrument to capture that is good. It could be several instruments, but having one saying nothing should be left unregulated is a good one. In this regulation, there should be distinctions made and I believe there are some distinctions made in the proposed Directive. Maybe not in sufficient detail but they do make a distinction between private equity and hedge funds, for instance. I have nothing against the fact that there may be further distinctions made if necessary and it is probably the case that it is necessary. The only point is when we make those further distinctions we should keep in mind the following principles. We should not create opportunities of regulatory arbitrage within the Directive by having a high number of highly technical rules and the ability for funds to pick up the best rules in the system. We should have clear-cut rules and the ability for funds to pick up the best rules and the ability for funds to pick up the best rules and be appropriately regulated”, so I would not have a very detailed view on that. You have several categories of funds which may need to have specific regulation, and that is fine, but each of them should ask for what they need.

Lord Moser: My Lord Chairman, you may tell me that this question is improper, and if so I will shut up, but I would love to ask you, you said you saw the Commission and have spoken to the Commission, is that right?
Mr Stetter: No, we have not spoken to the Commission. The Commission asked us and we gave evidence.
Lord Moser: Then my question is neither proper nor improper; it is irrelevant. I was going to ask you whether you found that on some of these issues minds had been made up beyond discussion and on other of the issues there is still flexibility.

Chairman: I imagine that we are talking to people here, Mr Stetter, who talked to the Commission very early in the game and were in some sense influential in the original thinking behind this Directive.
Mr Stetter: One can say that in our surroundings, let us say in the social democratic, socialist and labour family, while there has been a development concerning this Directive and the proposal of the Directive there was parliamentary work done in the last legislative session, and I know you are talking to Mr Rasmussen this afternoon.

Lord Moser: Could you summarise in two sentences what the main development has been?
Mr Stetter: The main development has been that the question has been raised. This had never been raised on a European level concerning the regulation of these kinds of financial instruments and I think it was very good that the Parliament did this last year and urged the Commission to do something. That is the main purpose of that.

Lord Haskins: We have obviously had lots of people lobbying us about the problems they are going to encounter and we have to listen quietly whilst they make their case. One case has been that as the Directive stands at the moment it would provide less choice and added cost to potential investors without actually achieving what the Directive sets out to achieve. Would you like to comment on that?
Mr Clerc: Yes, certainly. I have a number of points. First of all, if you regulate more you will probably end up having more cost because regulation has a cost, so the question is whether this regulation is useful or not. Going back to my example of banks, if banks were not regulated they would be cheaper
probably and we would all be happier, but that is not what we want to happen.

**Q292 Baroness Northover:** Or completely bankrupt!  
**Mr Clerc:** Or completely bankrupt, that is true. That means when you are talking about more cost, the question is whether you have more immediate cost or total cost. Total cost would include the cost of bankruptcy. When you take the overall cost into account, I am not sure there will be more total cost. That is another point. The third point is there would be more costs for investors, which I think is a fair point, but as legislators we may take into account the fact that the right metric is not only protection of the investor, so the total cost should be the total cost to the economy. We should never forget that finance is a part of the overall economy, so the total cost should not be a cost on the investor, it should be a cost on the economy. When we take into account failures, this has a cost to the economy and society at large, so that should be taken into account also. When there is a claim that there will be higher costs, it struck me before the crisis that even for the investors the cost of using hedge funds or private equity was very high. A two per cent uncapped management fee and a 20 per cent reward above the hurdle rate is a very high fee. That fee is a cost to the investor. Before there was any regulation, the cost was already quite high.

**Q293 Lord Haskins:** They are not exactly going to reduce as a result of the regulation.  
**Mr Clerc:** My point is while regulation may add a little extra cost, that should be seen against the high costs that were imposed on investors before.

**Q294 Lord Haskins:** I do not think there is any argument that regulation costs more, it is whether we are going to get appropriate benefit from the costs. That is the issue.  
**Mr Clerc:** You are definitely right. That goes back to the whole point of whether it is appropriate or not. The argument on costs should be viewed from that perspective.

**Q295 Lord Haskins:** The issue of choice?  
**Mr Clerc:** I would like to better understand why the Directive would lead to less choice. What is the argument?  
**Lord Haskins:** Somebody will have to tell me the answer!  
**Chairman:** It is thought that the Directive, which is slightly protectionist in as neutral a sense as I can use that word, will be protecting some investors from being able to invest.  
**Lord Haskins:** Into non-EU funds.

**Q296 Chairman:** The issue that comes up very sharply, which was the question I was going to interject here somehow, is the third party rules, the non-EU based funds, is one that the hedge funds we have talked to are finding particularly difficult because they say that really is going to exclude investors from their products.  
**Mr Clerc:** It is really the question of passporting and its relation to non-EU investors.

**Q297 Chairman:** It is non-EU investors that worries us most. I think they are beginning to believe that passporting is very desirable and we would all like to have it but hedge funds can live without passporting provided there is a prospectus regime.  
**Mr Clerc:** Provided there is a prospectus regime so there is an easier way to market the products. They are saying, “We don’t need the passport but something which is functionally more or less equivalent”.

**Q298 Chairman:** They think, on the whole, the bar has been set too high and the costs for them are going to be too high in the passporting regime, attractive though everybody finds it. The real question is, is that a restriction?  
**Mr Clerc:** I think having a passport with stringent rules would have several effects. One of them is that it creates a label for a European product as being well regulated.

**Q299 Chairman:** Very attractive.  
**Mr Clerc:** That may be very attractive for the industry itself, in addition to the interest for investor protection. That would in effect help export European products. Regarding imports of products, or the ability of investors to buy or use non-EU funds, I think that the EU market is too big to be ignored by funds, so if there is more regulation, funds will manage to comply with that regulation and provide investors with what they require, because that will be in their interests. As a first step they may say, “It’s too complicated, so we’re not going to do it”, but then they will say, “We’re losing a great deal of money not doing it”. Even though there is a small extra cost to do it, they will still earn some money. I believe the regulation that is proposed will not kill the business, it will still be a profitable business even with extra regulation, so there will be a big incentive for everybody in Europe to continue coming in and selling products because they will earn money on that. In the end, I think there will be as much choice probably. With the passport, it will be easier for non-EU funds to be sold throughout Europe because now they have 27 legislations and there will be only one set of rules. I am not sure that the net effect will be a reduction of choice, it may be an increase of choice in
the end after some time to adapt, which may take a few years. The net effect is not that clear in my mind.

Mr Stetter: There have been long discussions developing concerning these questions about the passport and the whole group was in favour of passporting the whole system.

Q300 Chairman: That is one of the areas which has caused most difficulty for, as it were, the customers of the hedge funds, for the alternative investment people, and that is why I am picking away at it because I take it we are talking to the people who did some of the original advice on this Directive and why it should look like this. The particular difficulty is the assets cannot be based here. The funds may be here but the assets are elsewhere, and that is going to be difficult for them.

Mr Clerc: The question is having the funds onshore but not the assets, the assets will still be throughout the world, which is fine.

Q301 Chairman: In the Caymans.

Mr Clerc: Having the funds in Europe has several effects. It is easier to control funds which are at hand. Basically, if you have any litigation, any enforcement issue, enforcing it against a fund in Europe is easier than a fund in the Cayman Islands. Another issue which may be raised is taxation. If you want to have your own taxation rules it is easier to have them when the funds are in Europe. The third interest regarding the equivalence rule which has been proposed is that it is a way to bring the Cayman Islands and similar places to enter into tax co-operation agreements with EU countries. I think it is a desirable objective to have those types of agreements entered into. As a tool to reach that objective, I think it is a side-effect of the Directive which is very interesting and beneficial. If we do not have that, what is the incentive of those countries to enter into tax co-operation agreements? Almost none, except political pressure which exists now but may disappear in a few years. If you tell them, “You can only participate in the European market if you have this co-operation agreement in place” and you have a good tax co-operation agreement, which may not be the case with those proposed by the Directive, this is beneficial for everyone.

Q302 Chairman: This is, however, a much wider and more generalised aim than ensuring financial stability.

Mr Clerc: That is correct. Our view is to take the wider position on that issue. Just to take one step back and be slightly theoretical for one minute, I would say we have a view that there are three main categories in the economy: you have work; you have property and you have speculation. If you take the analysis by John Locke, he says that property is based on work. The legitimacy of property ultimately is found in work, and I would adhere to Locke’s view on that. If you go to John Maynard Keynes, he describes quite interestingly the relationship between speculation and property, which is a play on property, so ultimately a play on work. Every regulation which has to do with financial activities and speculative activities, which is not all financial activity, ultimately has to do with a play on work, so we need to take the wider view to take that into account.

Baroness Northover: It takes me back to my political background.

Q303 Chairman: I had forgotten about social democracy! Wow!

Mr Clerc: I think we should stand behind our ideas.

Q304 Chairman: What is so interesting to me is that it is these ideas which seem to be partly, at least, forming the Commission’s Directive. I think I had better persevere and ask the other half of this question, which is if all this comes to pass a lot of the people who have given us evidence think that rather than participate in the way that you hope—move onshore, domesticate the Cayman Islands—the EU market as a whole will be seriously disadvantaged in relation to other world markets and we will find ourselves well and truly out of step. Do you have a view on this?

Mr Clerc: My view is that politics is about choosing between two bad options. We can foresee everything but the future. I see the point you are making but it is very difficult to assess whether this position you have stated is right or the position I stated before will be the right one.

Q305 Chairman: But they will adjust.

Mr Clerc: I think they have a great ability to adjust and, if anything, hedge funds have proved that they are very flexible and willing to do some business and earn some money. This will still exist after the Directive has been passed, if it passes.

Q306 Chairman: I wonder if we have not hit the final snag, which is tax. I am sure that Alternative Investment Funds are very willing to adjust, but to put themselves in the way that you hope—

Mr Clerc: The tax regime has not been unified so far and is not proposed under the current Directive.

Q307 Chairman: Nor could it be.

Mr Clerc: So in that sense there will still be regulatory arbitrage between the various European countries and you will find a great number of countries which will provide safe harbours and tax havens for the hedge fund industry.
Q308 Chairman: Ah, Bulgaria has saved the deal rather than the Caymans.
Mr Stetter: They are a member of the European Community.

Q309 Chairman: They are indeed, why should they not be a safe haven.
Mr Clerc: This risk is right theoretically but I do not see it as a real risk in the near future.
Lord Jordan: There is a certain European arrogance about this position, is there not, “We’re so big, if we think you are bad then we’re going to regulate you and you will have to put up with it” and you are virtually saying you do not think they will all leave. It is a big world out there, is it not, there is America and the growing power of other countries.
Baroness Northover: China and India.

Q310 Lord Jordan: Not only is there a real risk that valuable money that acts in the way it does now within Europe could emigrate, but that the people who are here who participate in it will find ways of emigrating with it rather than put up with your system of what they see as unnecessary rules.
Mr Clerc: I fully understand your point. There is no way to take a final view on that because it is really about prediction.

Q311 Lord Jordan: The truth of the pudding is in the eating.
Mr Clerc: When you look at how capital markets work in the US, they have been able to impose on the whole world very stringent rules just because people were saying, “We need to have a presence in the US”. Europe, as a whole, is an economy which is very comparable in size to the US, so I do think there is a reason for everybody to be willing to adjust and sell products in Europe even with that Directive, which I believe will add some constraints but not to a point where everybody will say, “We don’t want to be there”.
Lord Jordan: I agree with what you are saying. America was arrogant and now you are saying Europe can be as well!

Q312 Chairman: America paid a very high price for deciding to impose its rules on the rest of the world as Sarbanes-Oxley. I speak as a member of the London Stock Exchange and, my goodness me, we have benefited from that belief of America’s that a very restrictive rule could be imposed even on their own people. They all came over to London.
Mr Clerc: You are quite right. This is why regulation needs to be there and needs to be appropriate. Sarbanes-Oxley was probably too much, it is just a question of where you put the right level.

Q313 Lord Haskins: Sarbanes-Oxley was bad regulation. It was introduced too quickly and was not thought out. The danger is we will do the same. Is there not a compromise going around on this passport issue that non-EU funds can be regulated by national regulators and it is for every individual country to regulate incoming funds but that cannot be done across the EU? Is that not the compromise that we are hearing?
Mr Clerc: That may be a possibility, yes.

Q314 Chairman: That is the individual prospectus regime.
Mr Clerc: Yes.

Q315 Lord Haskins: Right through this whole debate when we have looked at financial regulation and reform, the problem is where the power lies in regulation, the great home-host issue, and at the end of it all what we are talking about today will have to be enforced by national regulators. The power will still remain with national regulators.
Mr Clerc: That is right.

Q316 Lord Haskins: Because there is tax involved in it, in reality there still has to be a strong national element as to how we regulate the financial markets, including hedge funds.
Mr Clerc: That is true, yes.
Chairman: We cannot behave as if we were America and had the Federal Bank; we do not. We have the ECB but we do not have a European budget large enough to enforce what we are thinking about.

Q317 Lord Haskins: This compromise that we are hearing about may be a way through it all.
Mr Clerc: If you talk of only Europe there is also the question of the eurozone, the British pound and the other currencies. You do not have a real common European monetary market at the moment.

Q318 Chairman: We do not have agreement that one country must bail out the mistakes in another, which fundamentally the Americans did. I think the better way of asking this question is to say should we perhaps wait and see what the G8 or the G20 are going to do? Or, on the whole, do you believe that Europe should go ahead?
Mr Clerc: I think the belief is Europe should go ahead. I fully appreciate the argument that there should be international co-operation, and mainly with the US to be practical, that is a very valid point, but the question is how you achieve that and what is your negotiating position with the US. I believe that if we have a strong view about what we want in Europe and come to an agreement on that, our position to negotiate with the
US would be far better than if we just wait for the US to agree with us and our position will be very weak because they will pick out the individual country they want to have an agreement with and we will have a weak position. The US is a great partner, and negotiating with them is fine, but we should also defend our own European interests in that respect, or our own view, which may be good for the US also.

**Lord Haskins:** I agree with that but the trouble is once you have got a Directive in place there is not much negotiation.

**Q319 Chairman:** That is the law.

**Mr Stetter:** That is the law.

**Mr Clerc:** It will take some time.

**Q320 Lord Haskins:** There will be plenty of scope.

**Mr Clerc:** There is plenty of scope to do both at the same time.

**Q321 Lord Haskins:** That is very reassuring.

**Mr Stetter:** Politically, G20 is just at the beginning of implementing rules and going on, so we will have one year of G20 and if we are bringing together the whole experience of Europe there could be a stake for Europe to come in in the G20 negotiations.

**Lord Haskins:** It would be unrealistic to get a G20 agreement on how you regulate hedge funds. It is quite realistic to get an EU-US agreement on how to regulate hedge funds, with that you capture somewhat 90 per cent of the hedge funds.

**Q322 Chairman:** And to explain what a hedge fund is in some cases. I have lost control of this meeting because I know Mr Clerc has to go!

**Mr Clerc:** I can stay for another ten or 15 minutes.

**Chairman:** Then I am going to try and pick off the absolutely key questions.

**Q323 Lord Jordan:** Can you explain further your view that funds should be regulated in addition to fund managers? It has been the argument of people who have met us that the fund is an inanimate object that is animated by the fund manager. In other words, you need to regulate the person whose finger is on the trigger.

**Mr Clerc:** First of all, regulating managers will capture a good deal of what we want to achieve. You could make the same argument for companies. Companies are an inanimate object and you could say you should not regulate companies but just the chairman and CEO of the company and that will be enough. In fact, you do regulate companies so why not regulate funds? This view that only managers should be regulated is the typical US and UK view and that is very relevant because the vast majority of fund managers are located there. In almost all of the countries funds are regulated. I will just go through the list, although you will know it: Australia, Brazil, Canada, France, Germany, Hong Kong, Ireland, Italy, Japan, Jersey, Luxembourg, Mexico, the Netherlands, Portugal, Spain and Switzerland all regulate funds. They probably found a reason to do that. They are not doing that just for the sake of it. Technically speaking, I see two reasons to regulate them. First of all it is easier to have them at hand when you are going to enforce regulation. If you just regulate managers but the issue is located within the fund, what happens if you have to enforce that in a far away country. The second issue is taxation. If at some point you want to post taxes, it would be easier if it is onshore. I am not saying that taxation will happen in the near future, on the contrary it is very unlikely, but at least you will have the ability to have this debate whereas at the moment it does not exist because it is just offshore. It will be empowering Europe to decide on its destiny.

**Lord Haskins:** The British and American position is based on the fact that all of these hedge funds are sitting in the Cayman Islands.

**Baroness Northover:** And therefore difficult to regulate.

**Chairman:** That is where they all are.

**Baroness Northover:** The FSA was arguing yesterday that at least the fund manager was, as it were, to hand in the way you say whereas for tax reasons the fund itself may be some place else and, therefore, difficult to regulate.

**Q324 Lord Haskins:** On the question of leveraging hedge funds, do you think there should be any regulatory enforcement or powers over the leverage of hedge funds as there clearly is under Basel I and II with banks? Do you think there should be a leverage restriction?

**Mr Clerc:** I think so. I made a point about that earlier. One of the main purposes of the Directive is to have this type of regulation so in the case of crisis or risk you not only know that the risk is upcoming because you have information but you can also do something about it, and doing something about it means having regulation on leverage or the ability to impose a restriction.

**Q325 Lord Haskins:** It will be a one-size-fits-all leverage?

**Mr Clerc:** No.

**Q326 Lord Haskins:** That is where it gets problematical.

**Mr Clerc:** That is where it becomes very technical, but I do not think it is impossible. Regulating banks is also very technical and complex and has been achieved. Regulating leverage on hedge funds, if need be to prevent crises, will be achievable.
Q327 Lord Haskins: The leverage levels in the hedge funds are so tiny compared with the banks and there is no evidence the hedge funds have been over-borrowing in that sense. During the crisis they were able to become liquid very quickly.

Mr Clerc: There are two answers to that. First of all, it is true that the average level of leverage in the recent crisis was not very high. It was much higher ten years ago. At the end of the 1990s it was much higher.

Q328 Lord Haskins: Why did it come down?

Mr Clerc: On average it was six times the value of the assets and it has come down to two or three.

Q329 Chairman: Why did it come down? It is odd because people do not usually give up leverage.

Mr Clerc: I do not have the answer to that. Those are the statistical figures I have read.

Q330 Lord Haskins: At a time when the banks were taking more and more risks the hedge funds were getting more and more cautious.

Mr Clerc: Maybe that was a crude view of leverage where these figures, and I am not sure, did not take into account the implied leverage in the products they were using. Maybe that is not a complete view of leverage. The point is, if we want to have regulation, then leverage may have come down or been small or not that big, but it may come up again. The whole purpose of regulation is, if there is a risk, there should be a way to address that risk.

Q331 Baroness Northover: The FSA was talking about this yesterday and if I understood them correctly what they said, as you did too, was that it is extremely important to have the information coming to them. They did not necessarily want to put a cap on leverage because they wanted to be able to look right across the whole system and see where there were problem areas which an individual hedge fund would not be aware of because they would not have that comprehensive view, and they then wanted to be able to take action. They felt that if there was a cap they could have a number of hedge funds close to that and then suddenly all having to take action together with a sort of catastrophic effect, therefore they wanted the flexibility of being able to act on leverage. Not to ignore it by any means, but based on the information about the whole system they wanted to be able to act. What do you make of that, if I have got that right?

Mr Clerc: I would agree with that view. The only point I would make is the ability to act on leverage is not sufficient, maybe you need other types of rules, rules relating to liquidity or a mismatch of liquidities. You may need to have more sophisticated instruments. The only point is you need to have those instruments available when you need them to act upon information.

Q332 Lord Moser: Or risk assessments totally different from the normal leverage ratios, is that what you are saying? Do you have anything particular in mind?

Mr Clerc: No.

Q333 Chairman: I was wondering if the sharp way to ask this question is, is it your view that leverage should be left in the hands of regulators or should it be set by the Directive?

Mr Clerc: In my view that is a difficult question. The Directive should have a broad concept limiting the ability to have too high a leverage when it becomes risky, but when you go into the details those should be left to regulators.

Q334 Baroness Northover: Is it a matter of putting sufficient power in the hands of the regulators so that they can act and that would be the way through? If you are trying to pick up risk and deal with it you have just said, in effect, those regulators may have a better grasp of it and they need to be able to enforce what they say.

Mr Clerc: To be more specific in my answer, we want to avoid regulatory arbitrage. If we just leave regulators in complete control of what measures they can take, we could have some regulatory arbitrage to set up funds in jurisdictions where those measures would be very weak. We want to have a concept in the Directive that regulators should take the appropriate measures when there is a risk based on hedge fund activities, so there is an obligation to act and some guidelines on how to act, but when it comes to effectively implementing that, it should be left to the regulators. That is a two-tier system.

Q335 Lord Haskins: Is not the reality that all this financial regulation, including hedge funds, is only creating a framework, if you like guidelines, for national regulators to follow but the enforcement power would still have to remain with national regulators for the reasons we have explained. Therefore, on these issues it will have to be left to the FSA in Britain to decide in practice what to do with a hedge fund which they are worried about.

Mr Clerc: Within a framework which is defined, yes. Hedge funds should not be able to pick out a country where they know the regulator will not do anything because there is no obligation to do anything. This is why we have a two-tier system. It is not that complex a set-up. Technically speaking it is complex, yes, but conceptually I do not think it is.
4 November 2009
Mr Ernst Stetter and Mr Christophe Clerc

Q336 Lord Haskins: Constitutionally, how do you force the Bulgarian authorities to do something they do not want to do?
Mr Clerc: I will leave that question to you.

Q337 Chairman: Can I ask one more specific question. Do you believe that high capital requirements on prime brokers would result in effective indirect supervision of hedge funds’ leverage?
Mr Clerc: Yes, it would be helpful because prime brokers are very important in relation to hedge funds, but it is not sufficient because they do not have the full picture. One hedge fund may have several prime brokers and no prime broker can claim he has a full view of an individual hedge fund, so you have an information problem. Regulation has to be enforced by regulators ultimately, so we need to be sure that regulators can do the work properly because it is not the work of prime brokers to regulate, they have their own interests.

Q338 Chairman: No, not at all.
Mr Clerc: Yes, it is helpful but not sufficient.

Q339 Chairman: I think we have to let you go or you will be late for your next appointment. Thank you very much indeed for coming and for your most useful evidence.
Mr Stetter: We do hope that we have brought something to you.

Q340 Chairman: Indeed you have.
Mr Clerc: If I may quote one line which I found in Galbraith, *A Short History of Financial Euphoria*, published in 1993, which I found interesting. “Nothing is more remarkable than this: in the aftermath of speculation the reality will be all but ignored”. Then he explains why nothing changes after a crisis, which has been the truth in the past and my only hope is that this will be proved wrong now.
Lord Haskins: So far I am afraid Galbraith is proving to be right.

Q341 Baroness Northover: Also, as you say the most difficult thing is to foresee the future, so you address what has happened in the past in your regulation and not what is going to happen in the future. That is a real difficulty.
Mr Clerc: That is the beauty of your job, if I may say so, that you are in charge of that.

Q342 Baroness Northover: We can be held to account!
Mr Stetter: It may be helpful to present you with a study we have published from Mr Aglietta who is one of the most famous economists in France. He has done a study for us on a systemic approach to financial regulation and the European perspective.
Chairman: That is most helpful, thank you. Thank you very much indeed.
WEDNESDAY 4 NOVEMBER 2009

Present
Cohen of Pimlico, B (Chairman)
Haskins, L
Jordan, L
Moser, L
Northover, B

Memorandum by the European Commission

1. What economic benefits arise from Alternative Investment Funds? What risks to financial markets arise from Alternative Investment Funds? Will the Directive help reduce these risks?

Alternative Investment Funds (AIF) are investment funds which use investment strategies that differ from those of traditional (mutual) investment funds. However, besides this crude distinction no agreed definition of this very heterogeneous group of investment funds exists. Broadly speaking, the benefits of AIF lie in providing investors access to specific market segments (eg real estate) or investment strategies (eg absolute return) and thereby allowing them to diversify their portfolios and in providing liquidity to those specific markets. Dynamic trading and short selling techniques can impact on market functioning, especially in smaller markets. Certain types of AIF have exhibited considerable appetite for credit derivatives and asset-backed securities (including mortgage backed securities) and thus have contributed to the rapid growth of these markets. AIF, in particular hedge funds, have also been central to the ongoing debate about the impact of certain trading practices on the integrity of financial markets. In particular, curbs on short-selling in several jurisdictions reflected unease over the impact of such activities.

The proposed Directive will increase disclosure and improve coordination in supervision among competent authorities in the EU and other jurisdictions. This will put supervisors in a much better position to spot and react upon developments that might pose a risk to specific markets or even systemic risks. Improved transparency towards investors will allow them to better monitor the risks resulting from the activities of Alternative Investment Fund Managers (AIFM).

In addition, the draft Directive requires that all AIFM are subject to appropriate authorisation and registration requirements in order to ensure that no relevant entity escapes supervision. Greater transparency of AIF should also help to reduce risks to financial markets.

2. To what extent is there a need to create a single regulatory regime for Alternative Investment Fund Managers in the European Union? Does the Directive achieve its objectives? Should the objectives of the Directive be modified?

The creation of a single regulatory regime for AIFM in the EU will help to improve the supervision of AIFM which are active in various Member States. Information about these funds might therefore be of importance not only for their home supervisor. The proposal will help improving the coordination among supervisors. The creation of a single regulatory regime benefits both the industry and its investors by providing them cross-border access to investors and funds, respectively. This will widen choice considerably especially for investors domiciled in smaller Member States/markets.

By focussing on activities instead of legal structures the proposed “all-encompassing” approach combines the benefits of a broad scope with the flexibility needed to do justice to the specifics of the different business models.

The principal objectives of the proposal have almost unanimously been supported by stakeholders and Member States.

The specific objectives of the draft Directive, namely:

— to ensure that all AIFM are subject to appropriate authorisation and registration requirements;
— to provide a framework for the proper monitoring of macro-prudential risks;
— to ensure the proper monitoring and limitation of micro-prudential risks;
— to provide a common approach to the protection of professional investors in AIF;
alternatives to public accountability of AIFM holding controlling stakes in companies;

— to develop the single market in AIF;

— to ensure that actions are proportionate to the risks posed and appropriately differentiated to take account of differences in AIFM business models;

should all contribute to the over-arching objective to create a comprehensive and effective regulatory and supervisory framework for AIFM in the EU. There appears to be no reason for modification.


It should be noted that the proposal is not (only) intended response to the current crisis, but as a forward-looking measure. This is also reflected in the variety of objectives the proposals aims at.

As regards the risks posed by AIF:

(a) **macro prudential (systemic) risks**, relating in particular to the use of leverage: Direct exposure of systemically important banks (as the providers of leverage) to the AIFM sector; pro-cyclical impact of herding behaviour, risk concentrations in particular market segments and (“forced”) deleveraging on asset prices and market liquidity;

(b) **micro prudential risks**: Possible weaknesses in internal risk management systems with respect to liquidity risks, market risk, counterparty risks (credit and settlement risks, especially in the case of short selling) and operational risks;

(c) **investor protection**: Gaps in investor disclosure on investment policy, risk management, internal processes etc as barrier to effective due diligence; Conflicts of interest and failures in fund governance, in particular with respect to remuneration, valuation and administration;

(d) **impact on market for corporate control**: Lack of transparency when building stakes in listed companies (eg through use of stock borrowing, contracts for difference), or concerted action in “activist” strategies; and

(e) **acquisition of control of companies by AIFM**: Potential for misalignment of incentives in management of portfolio companies, in particular in relation to use of debt financing; lack of transparency and public scrutiny of companies subject to buy-outs.

More information can be found in the Commission’s impact assessment report


4. Is it appropriate to regulate Investment Fund Managers, rather than the Fund itself? Does the Directive contain appropriate provisions to distinguish between different types of alternative investment? Does the scope of the Directive create a danger of unintended consequences?

We think that it is. In most AIF structures it is the fund manager who is taking decisions and actions that could pose the risks described above to investors, markets or (other parts of) the economy. Furthermore, the function of the manager is more similar across fund types than the fund structures themselves. Finally, the share of funds that is domiciled in the EU is lower than the share of fund managers based in the EU.

As any other piece of legislation the proposed Directive carries the risk of having unintended consequences. We, however, see a much greater danger of circumvention if the Directive was limited to specific types of fund. The negotiation process in the Council and the European Parliament as well as level 2 work should help to reduce the risk of unintended consequences even further.
5. What is your evaluation of the Commission’s consultation in the preparation of the Directive?

The Commission has relied on a number of consultation exercises and external studies on related issues carried out in the previous months. Especially the work on a European private placement regime produced a wealth of relevant information about the current market situation, etc.

**Major Steps and Inputs in the European Commission’s Preparatory Work**

| Expert groups on alternative investments | January—July 2006 |
| Public consultation on expert group reports | July—October 2006 |
| Comparative study on investment powers | December 2006—January 2008 |
| Study on the retail distribution of non-harmonised funds | December 2007—September 2008 |
| Expert group on open ended real estate funds | July 2007—February 2008 |
| Open consultation on the report of the expert group | March—June 2008 |
| Call for evidence on private placement | April—June 2007 |
| Workshops on private placement | January—February 2008 |
| Open hearing on non-harmonised retail funds | 8 April 2008 |
| Consultation on hedge funds | December 2008—January 2009 |
| Conference on hedge funds and private equity | 26—27 February 2009 |

**Regulatory Aspects**

6. Will the passport system help create a single market in investments funds within the EU? How will the passport system established affect the EU and the UK industry and particularly their position in the global market?

As the consultation and workshops on a European private placement regime as well as the expert group report on open-ended real estate funds have demonstrated it is very difficult if not impossible to market non-UCITS funds across borders in the EU. The draft Directive will not only considerably facilitate cross-border marketing of AIF within the EU. It will also allow AIFM to manage AIF domiciled in Member States other than his domicile. This will lead to an integration of AIF markets in the EU. This greater market will in turn be more attractive for AIFM currently domiciled outside the EU. This increase in competition and choice will greatly benefit EU investors and strengthen the EU/UK industry’s position in the global market.


The threshold for the coverage of the Directive was the result of an impartial desk research based on a comprehensive third party database. It is, however, not intended as a threshold to define “systemically relevant” AIF.

It is rather motivated by the argument that the administrative burden resulting from the application of the Directive to all AIFM would not be proportionate for both smaller AIFM and supervisors. It would not contribute significantly to the main objectives of the Directive (improved macro-prudential oversight, investor protection, and internal market integration).

Smaller AIFM in themselves do not pose systemic or market risks. The likelihood that a number of smaller AIFM follow identical or at least very similar strategies and thereby affect international markets adversely can be regarded as relatively minor.

Smaller AIFM are usually more focussed on the local market. Therefore, it is also appropriate that investor protection is being ensured by the national supervisor under domestic regulatory framework. Cross-border supervision would also be of lower importance. If smaller funds should be interested in cross-border business the rights granted by the Directive would provide a strong incentive for them to opt-in and to comply with its obligations.

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It is a standard practice to oblige *fund managers* to retain capital for investor protection reasons. It shall enable investors to claim damages in case of fraud or other wrongdoing by the manager. The capital should also ensure business continuity in case the AIFM should face financial difficulties.

The financial crisis has underlined the importance to investors of robust asset safe-keeping arrangements. We consider it vital that the institutions responsible for holding fund assets are appropriately regulated and capitalised; and that the liability for those assets is clearly defined.

8. **Will the provisions strengthening disclosure requirements help to create a more transparent market or do they go too far?**

In the beginning of the current financial crisis many supervisors and central banks struggled to get hold of all relevant information about the situation. As speed is crucial in fighting the adverse effects of a crisis it is imperative to improve upon the current situation, in particular when cross-border issues are involved.

**IMPACT**

9. **What effect will the Directive have upon the position of the City of London and the EU as a whole as a leading location for Investment Fund Managers? Could it cause many hedge funds to relocate outside of the EU? What impact would the Directive have upon professional investors and institutions?**

We are convinced that the Directive will have a beneficial impact on the EU as a location for AIFM. As explained above, the proposed single market for AIF and AIFM should attract business.

A survey by openeurope.org showed a marginal net effect on the location decision of hedge funds.8 The survey among hedge fund managers produces a mean estimate of annual compliance costs for EU hedge funds of about 5.5 basis points and one-off costs of about 15 basis points. It seems unlikely that this would result in a major dislocation of the industry. Yet, it has to be admitted that improved investor protection and disclosure and mitigation of risks come with a cost.

The proposed Directive will help especially smaller professional investors to get appropriate information needed to take investment decisions and to conduct effective due diligence. It will also lower organisational risks, etc.

10. **How does the Directive compare to existing or proposed regulation of Alternative Investment Funds outside of the European Union, particularly that of the United States? How will the Directive affect the position of EU Alternative Investment Funds in the global market?**

The proposal outlined by the US Treasury goes in the same direction but has not yet been spelled out in detail. The US administration recently announced their plans for the registration and regulation of alternative investment managers. While the proposals have not yet been scrutinised by Congress and in some areas lack detail, the signs are that the proposal will have much in common with the EU proposal (all-encompassing approach, manager registration requirements, enhanced regulatory reporting). However, the EU proposal appears more comprehensive and prescriptive in relation to ongoing operational and organisational requirements (eg risk management, conflicts of interest, liquidity, asset safe-keeping).

11. **What effect will the Directive have on flows of capital and financial innovation?**

The creation of an internal market for AIF should support both capital flows and financial innovation by creating a vast market without limiting product design.

We also would welcome your views on any other aspect of the Commission’s draft directive.

For further information on the above and other issues please consult the impact assessment report that has been published together with the proposal (http://ec.europa.eu/internal_market/investment/docs/alternative_investments/fund_managers_impact_assessment.pdf).

21 October 2009

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Examination of Witnesses

Witnesses: Mr Martin Power, Head of Cabinet for Commissioner McCreevy, and Mr Ugo Basst, Head of Unit, DG Internal Market and Services, European Commission, examined.

Q343 Chairman: Can I welcome you formally. It is very good of you to come. You have done this before, Martin, you know the rules. We are going to take a transcript, show it to you and you can remove any infelicities.
Mr Power: Or incoherences!

Q344 Chairman: We have got 50 minutes, which we shall use. We arrived to find that the whole thing was going slightly faster than we had perhaps quite understood from our peaceful eyrie in the United Kingdom. Quite a lot of our questions are going to be directed to where we are and where are still the problems. We started out quite theoretical but we are turning to a rather more practical point. Unless you want to make a statement I am going to start asking questions.
Mr Power: No, please go ahead.

Q345 Chairman: You note in your written evidence that the proposal is not only intended as a response to the current crisis but, of course, it is meant to be future-proofed to some extent. What systemic risks does the Commission believe that the Alternative Investment Funds pose and what did they do in the recent crisis? Where did you think the evidence came in the recent crisis?
Mr Power: My Lord Chairman, if I could perhaps go back a little bit further because you have to divorce this from the systemic risks that have happened in the whole system during the past 12 or 18 months. The raison d'être for this proposal came very much from a political initiative taken in the European Parliament. There was a conjuncture of events around this time last year that led the Parliament to use a provision in the Treaty under Article 192 which enables the European Parliament to call on the European Commission to bring forward proposals that it considers are necessary. This is not something that Parliament uses very often but it is something that it has used before in the past. What is more rare is that it has cross-party support. This was a quite detailed resolution prompted by reports prepared by Mr Lehne and Mr Rasmussen dealing with hedge funds and private equity. In this resolution there were very strong calls for the Commission to bring forward regulations in this area. This might have been handled in the normal course of events if it was not for the financial crisis and if it was not for a perception that the regulation of financial markets was too light touch and that there was a need for hard regulation. There was enormous pressure put on the European Commission to bring forward a proposal in this respect. President Barroso formally engaged the Commission in a reply to the European Parliament in December saying that the Commission would bring forward regulation before the end of the mandate of the European Parliament, so effectively before May. This left the Commission services having to work quite quickly, much quicker than we would normally have done on such an issue, to produce a proposal. So, the raison d'être for the proposal came from a political imperative identified by the European Parliament which required the Commission to react quickly, which we did. It was not to address a specific identified concern about the systemic risk of hedge funds and private equity at that particular time. There had been a long history going back over previous years about whether or not there needed to be greater oversight, greater regulatory control of hedge funds and also on private equity. If you followed any of the debates that took place around the elaboration of the Lehne report and the Rasmussen report you will have seen where the political memorandum for all of that came from. We brought forward this proposal. We did an open consultation period of six weeks which is shorter than normal and we held a public hearing here in Brussels and on the basis of that we formulated our proposal. What we tried to do in addressing it was to say that we recognise regulators should have access to more information, but at the same time we want to try to create opportunities for the industry in the European Union to be able to avail themselves of something that did not exist already, and this is where we have this passport that we have devised to allow funds to be raised throughout the European Union. When we came to deal with the specific point that you have raised—where was the systemic risk—at the time hedge funds were not the source of the crisis, and neither was private equity quite clearly, but there was the necessity to equip regulators with access to information which we have tried to do. We do not pretend that they were the causes of the crisis. There were certain actions taken by hedge funds during the course of the crisis that probably accentuated events in the market and that is something we have tried to encapsulate in the proposals, but the raison d'être for them was not their systemic risk at that time.
Lord Haskins: You have just answered half our questions!

Q346 Chairman: In terms of future-proofing, do you feel the proposals address that?
Mr Power: I am long enough in this game to know that when you design something you can never fully predict the future, you are always basing it on past experiences and what you think will happen next, but we can only see so much into the future. Things will be different. One of the things across the whole
financial services sector that we are trying to do in the
reform, whether it is through the new proposals for
the setting up of the European Supervising
Authorities or through the European Systemic Risk
Board, is making sure that supervisors and those who
have to make decisions about risk have sufficient
information available to them. What this Directive
tries to do is make sure that regulators have a
minimum amount of information that may allow
them to draw certain consequences or may highlight
where excessive risk may be built up in the system
which they may be unaware of today. To that extent,
where we are trying to put the focus on enabling
systemic risk management is having more early
warning about where risk may be in the system and
this is a part of that process. In terms of future-
proofing, I do not think any of us can future-proof
how financial markets will evolve. I would hope that
the more positive sides of this proposal, namely the
creation of this European passport, will open up
investment opportunities in the European Union. I
would like to think that at the end of the co-decision
process—this is one of the more crucial aspects there
will be—we can have a regime that is open in Europe
and allows funds for investment to be developed and
harnessed.

Chairman: Lady Northover, I think I managed to ask
much of your question.

Q347 Baroness Northover: You have indeed, but the
answers raise some questions in my mind and I
wonder whether I can put some of those. You have
just said that it was done rather fast and the
consultation period was very short which implies that
you are sensitive to the feeling that this Directive may
not yet be in the form that it needs to be. I wonder if
you could outline the areas where you feel that it is
not doing what it needs to do in terms of regulating
these in the future bearing in mind the points that my
Lord Chairman has made. Obviously regulation is
about trying to protect against systemic risk not only
now but into the future, so where do you see the
problems? Do you feel the Swedish issues note
highlights and addresses those? Where are you going
on this?

Mr Power: You will appreciate I have to be sensitive
in my remarks here. The Commission has brought
forward a proposal and from an institutional point of
view the ball is now in the Council of Ministers and
the European Parliament. In the co-decision process
it is up to those institutions to put forward
amendments to the proposal and then the
Commission, as part of this process, can decide
whether or not it is willing to join up to those. I would
not like anything written today in black and white
because this process is going to take place over a long
period of time. (The answer was continued off the
record)

Q348 Chairman: Can you talk to us about
thresholds?

Mr Power: We have 500 million euros for, let us say,
private equity funds. Is that balance correct? That is
something the co-decision people will have to advise
us on in terms of further information that we will
gather. The fact that we have included all types of
funds in it, is this the right approach? There will be
potential family investment funds that could be
covered by it, industrial holding companies. What
clarity do we need to give to say what fund is covered
and what fund is not covered? There are all kinds of
questions about equal competition for similar types
of funds that are structured in different ways but may
be operating in effectively the same way in the
market. Those are things that I would like to see the
co-legislators spend time going through to make sure
we have got what we want to try to achieve in that
aspect. I think it is very important that we get the
third country aspect as well. The European Union
has responded effectively to this crisis. The legislation
that has been put forward has been proportionate
and necessary. In an area such as financial services
you have to always operate on an international basis.
In that context we have positive events in that the
G20 has worked extremely well and the follow-up
through the Financial Stability Board seems to be
working in the same vein. I am certain, if I take the
US and ourselves, that by the time we have finished
all the initial phases of legislation there is going to be
a need to bring these together. The very positive thing
I see at the present time is we are all going in the same
direction. I do not see anything that is happening in
Europe or the US that shows we are taking
diametrically opposed positions in relation to
legislation. I am absolutely certain that when we both
stop there will be things that need to be addressed,
and this is where I see the equivalence provisions as
being very important because that allows us the
flexibility of declaring certain things are equivalent so
as not to block access to each other’s markets.
That is something we are trying to preach to our
American friends as well because in the House of
Congress they are not as familiar with the
equivalence provision. It is important that both of us
give ourselves the wiggle room over the next couple
of years to be able to join up what happens on both
sides of the Atlantic.

Q349 Lord Haskins: Are you talking to your
opposite numbers?

Mr Power: Yes, we are.

Q350 Lord Haskins: That has been co-ordinated?

Mr Power: That has been fed into the system, but
like all legislative systems I am not too sure what is
going to come out at the other end. There have been
regular discussions at high levels with Tim Geithner
and his people. They understand the issues but their ability to make sure the legislation reflects that is limited in the same way as with all fine parliamentarians who have to make the final decisions in this matter. It is something that we need to keep continually pushing.

**Lord Jordan:** Are you reasonably confident that this evolution will take place because we pressed our previous witnesses on the point about the risk of frightening away potential investors, and you said we do not want to keep money out of Europe, and they were a little bit laid back about it. If I may summarise, it was, “Look, we are Europe, they will come to us”.

**Chairman:** People have to be here.

Q351 **Lord Jordan:** “They will come to us”.

**Mr Power:** That is not a view shared in the European Commission.

Q352 **Lord Jordan:** I am pleased to hear that because it sounded a bit worrying.

**Mr Power:** That is certainly not a view shared in the European Commission. Just to mention an institutional matter. The European Commission now has a full seat at the G20. President Barroso is around the table at the G20 the same as everybody else. We have signed up to the international understandings that the G20 have put in place. We are full members now of the Financial Stability Board where much of the follow-up to the G20 work is being undertaken. Mario Draghi, who is the Chairman of the Financial Stability Board, has been at pains to try to make sure that in the implementation of our respective responses to the G20 we stay as close to what each other is doing so we do not leave big gaps and make it more complicated for people to do business. Also, from a regulatory point of view that we do not open opportunities for regulatory arbitrage between various systems which will inevitably happen if there are big gaps in the system. It is the first thing I would expect any decent company to do, to try to exploit holes in systems.

Q353 **Chairman:** I am very interested in your statement that there were two aims to this Directive, not entirely because that is what we have really been looking at, to promote financial stability and encompass what may have looked like an unregulated outlier to the banking system but also for the more creative purpose of creating a European market. It is this bit that is worrying us because only yesterday Dan Waters of the FSA, whose views I am sure will be familiar to you, said that he thought passporting was just impossible, that it was going to be too high a price to pay. Everybody wanted the passporting but the equivalence rules were too high a price to pay. American colleagues have also been saying equivalence is just impossible.

**Mr Power:** We have undertaken equivalence in a number of other areas; equivalence is not impossible, it is a question of willingness to recognise it. Our American colleagues have less experience of doing equivalence with third countries. We must not say that unless things are regulated in exactly the same way for example in the US, it cannot be considered as equivalent to the EU. What we have to do is look at the outcome. Do we get an equivalent outcome even though the process by which we get there might be different? That is the real issue you have. We are talking about the effects of regulation. We all want to see high levels of prudential oversight, supervisors having the necessary powers, but they are not going to be exactly the same in all jurisdictions and it is unrealistic to even think that is going to happen. What you have got to assess is, *grosso modo*, are these the same? Are there big holes on one side or the other? If the answer is ‘No’ then we are happy to consider our respective systems are equivalent. You are right, in the Directive it is not clearly specified yet how these equivalence procedures will operate. That is something that will have to be thrashed out during the co-decision process. At present, if my memory is right, we have envisaged some of this being done at Level 2 in the follow-up afterwards. If it is felt in the co-decision process that it would be better to have clearer rules at Level 1 and that is something we would be open to because what we want to have is certainty for operators on how the legislation is going to operate. I understand that people may say, “But if this thing is left over to Level 2 there will be a degree of uncertainty in the process and we will not be able to plan in terms of what is going to happen”. One the one hand, if during the co-decision process it is proposed that equivalence is based on the following three or four points, and they want to put this into the legislation we will not be opposed to it provided the criteria is sensible.

**Mr Bassi:** If I can just add a word on equivalence which, as you rightly pointed out, is a source of concern. We have been very clear right from the beginning that equivalence is not identity. As you said, if it is going to be successful it will be outcome based, so comparable objectives and outcomes. It is not going to be an identity check. That is what we are trying to explain to our American friends when talking, and we do talk a lot about it. If I can give you a view of the criticism that we have received on this equivalence issue. It was quite surprising that many Member States when we discussed this at the Council were concerned about equivalence but for opposite reasons. There are some Member States
that fear in the end we will adopt so strict conditions for equivalence that none of the other jurisdictions will be considered equivalent, not even the US, which as Martin clearly pointed out is not at all our objective, on the contrary. Other delegations do fear that we will be under such political pressure that we will end up considering everyone equivalent, including non co-operative jurisdictions and other cases like that, for example. This is a crucial issue and it is very important to get it right. We are available and open to put it at Level 1 if we find a formula which makes clear what the result will be, but if we get this equivalence system right then our third country regime will be probably the most open and most efficient way to deal with third countries. At the moment we have not seen any other alternative proposal which would be as open as our proposal aims at being.

**Q354 Lord Moser:** I did not quite understand your first sentence. You were not just saying that equivalence will be dealt with in a rather flexible way, you were saying something else, that it will be assessed. Could you just repeat how you started?

**Mr Bassi:** It will be an outcome based assessment in terms of results. We are not checking the formal identity of the provisions but the outcomes that the regulation of the home country will aim to achieve.

**Q355 Lord Moser:** So it is the aim of outcomes. You cannot use outcomes as a criterion before the day, so to speak, in advance.

**Mr Bassi:** You cannot do it in advance, you have to set up some criteria against which—

**Q356 Lord Moser:** What they plan to do with it. What exactly are you saying?

**Mr Bassi:** We envisage the way it will work is once the Directive Level 1 is adopted, assuming it will be adopted as such, there will be a Level 2 decision and this means basically the comitology procedure, so it will be a process led by the Commission but with the participation of all the relevant players, including the Council through the committees and the Parliament, so it will be a European decision in a way to set up the criteria against which the equivalence will be checked. That moment in time will be very important because we will have to set up the criteria, but how do we see that now, things like does the regulation of the home country offer the same kinds of guarantees in terms of supervision, does it offer the same reporting and disclosure requirements in order to allow the supervisors to take actions if needed. These kinds of answers will be the ones that we envisage at this stage. As I have said, these are the kinds of criteria which will be set up later on with the Level 2 technique, which is a European process, not the Commission.

**Q357 Lord Jordan:** There will be many in the European Parliament who fear that you are going to water down or level down the regulations just to harmonise with America and others who want much less regulation than Europe seems to be aiming for at the moment.

**Mr Power:** That is one of the crucial issues that certainly the new Commission will have to deal with along with the American administration in trying to make sure that in the outcome of all this regulatory response to the financial crisis we still manage to keep our respective systems on a converging path. It will be a challenge. I have no doubt about this, but we have a very good track record of addressing such issues. For the past number of years, as this Committee has touched on previously, we have had in-depth discussions with our American colleagues every quarter at least to discuss where our respective regulatory approaches are going and finding solutions. In the context of the response to the present crisis, the American administration has little control over what is going to come out of Congress at the end of this process. We both recognise and they recognise there may be things we will have to do on both sides of the Atlantic so as not to make it more difficult for European investors or European financial institutions doing business in America or for US firms operating in the EU. People are aware that the issue is there and it will have to be worked on. The most important thing—I come back to it again—is that I have seen nothing on either side of the Atlantic that shows our regulatory responses are moving in diverging directions. Quite the opposite. What we will need to address is any gaps at the end of the process.

**Q358 Chairman:** Will reinstating private placement regimes work?

(The answer was given off the record)

**Q359 Chairman:** Mr Power, lots of people have expressed real concerns about equivalency, but evidence has been given to us which suggests that a national private placement route would be something that they would not find difficult and they could get on with life and go on working. Would you like to tell me what the Commission sees as the disadvantages of the private placement route?

**Mr Power:** In the context of the proposal we have put on the table we have tried to provide an instrument that can be used throughout the European Union in providing a single passport for all investment fund managers and investors who will be able to avail themselves of this new facility that will be offered. If we stick to a private placement regime the danger is
that nothing will change because those countries will say, “Fine, we have private arrangements with particular funds based in certain countries, ergo we don’t want to change this” and it would strengthen considerably the hand of those who would say, “Really and truly when we are talking about a new European investment fund, what we would like are funds based in Europe managed only by European fund managers”. I think that is the wrong signal that we would be sending out from Europe in terms that we are creating something new in Europe but we are not going to give people from outside of Europe access to this new facility. That is what has to be thought through when people talk of private placement, how that would reconcile itself with the idea of creating this Alternative Investment Fund passport.

Q360 Lord Haskins: The follow-up question on that is people have expressed concern that EU investors will be limited investing in non-EU funds. How do you get round that?
Mr Power: By getting this legislation right that we have a clear equivalence agreement that would allow us to have these equivalence arrangements with all major jurisdictions around the world that would give investors in the European Union access to funds being managed in those countries.

Q361 Lord Haskins: So it is critical that the regulatory regime in the United States, for example, is compatible with ours?
Mr Power: (The answer was given off the record)

Q362 Chairman: I think you have said before that you do not think equivalence is as difficult as people are making it. Do you see a problem with jurisdictions like the United States of America? Where will the problems come, if they come?
Mr Power: On a personal basis I would say with any large modern jurisdiction that is following international rules from institutions such as Basel, IOSCO. I would not see equivalence being a major problem there. Certainly some of the smaller jurisdictions would have work to do to move their prudential standards and other co-operative arrangements with the European Union up to a level that will be necessary, but I think it is something that is achievable over time. This piece of legislation to my mind, in the best hypothesis, will not be agreed before 2011. There will then be a lead-in period of at least a couple of years and there may be extra flexibility built into it after that. We are talking about a period of five or six years even before this legislation will start to impact.

Lord Haskins: In time for the next crisis!

Q363 Lord Jordan: There are lots of elements to all of what is going on. How important are leverage limits in controlling systemic risk? We have had a lot of evidence that says it is not the leverage itself but it is what is being leveraged that is the real problem.
Mr Power: Yes.

Q364 Lord Jordan: I am wondering to what extent you feel leverage needs to be regulated to make a safer system.
Mr Power: Well, I have to speak under the control of my Commissioner here because he has made various statements in respect of leverage. You also have to put this in the context that these are decisions that the next Commission will have to pronounce on. We had hoped to bring forward a further modification to the Capital Requirements Directive which would have provided a number of things, one of which was leverage. Mr McCreevy believes in very simple metrics for measuring risk because one of the things he feels has come out of this crisis is we had all got far too sophisticated on how risk was being measured with a reliance on internal models to such an extent that people had no way of understanding the real risk involved. That was why originally he proposed to put in this five per cent retention for securitised products because he felt that if banks or whoever originated these products were to hold part of the risk they would be doing more due diligence. Equally, while leverage is a very crude method, and you are right, it depends what it is based on, at the same time it does provide something that is easily measurable for supervisors to then ask questions if alarm bells go off and say, “Here is a leverage of”, whatever it is, “we should now be doing something on that basis.” Personally, I believe leverage will stay on the table because everybody is grappling with this “too big to fail”. What happened from the last crisis when Lehman’s went down was the interlinkages in the system showed that one bank failing could cause systematic risk. We have some very large financial institutions and there is not one method that is going to be able to solve this “too big to fail” but you will see a range of measures coming in through additional capital requirements, closer supervision, living wills, how you might more quickly wind down the activities of these, and things like the leverage ratio are going to be there that is for certain.

Q365 Lord Jordan: Do you see a relationship between the higher capital requirements and effective supervision of hedge funds’ leverage?
Mr Power: I would divorce the two things in my mind. There is the requirement that when we are setting up a European system to allow fund managers to market funds throughout the European Union there have to be certain criteria that will foster confidence in the people who will be marketing these
investments. One of the things is they will a certain amount of capital behind them. It is not regulatory capital in the traditional sense that would cover losses the lot but they will have to show a certain solidity in their organisation. There will be tests of being fit and proper, whether they meet the right criteria and things like that. That is one side of it. The other side is whether or not in terms of funds that are highly leveraged you need to have more onerous requirement for those funds. Our proposal is presently saying for highly leveraged funds we believe you need additional requirements in place.

Q366 Lord Haskins: This question relates a little bit to when we came here six months ago and discussed financial regulation generally and the de Larosière compromise meant that effectively enforcement lies with national states. It seems to us that one of the things behind this Directive is you have the power to provide the national regulator with plenty of information for them to respond, but at the end of the day the response has to be theirs rather than the EU’s. Some people have said the volume of information that is going to be there is going to be so big they are not going to be able to pick through it. Presumably your argument is, “Let’s have it all on the table” and you work out what elements you need.

Mr Power: I would not go as far as that, Lord Haskins. I think what we are trying to provide is that regulators and supervisors have access to certain key information. The last thing we would want to do is suggest that supervisors and regulators have access to trades, positions and things like that. What they need to have are gross figures to know where risk may be building up in the system. If I link this into what we are trying to do on the follow-up to the de Larosière work, we are setting up this new European Systemic Risk Board which will have as its leitmotif this question of trying to identify where risk is. The Systemic Risk Board will be empowered to request information from European supervisory authorities, from national regulators and bodies like this to allow them to build up pictures of where risk could be emerging. Some of the information, that could be made available through the AIFM proposal, might be relevant for the European Systemic Risk Board so as to allow them as part of their surveillance work to identify if there are sectors or particular issues that are starting to flash red lights. I do not believe that regulators will be overwhelmed by information. I hope that the information we are requesting to be provided will prove to be appropriate for regulators in terms of enabling them to identify where potential risks occur.

Q367 Lord Haskins: There is always the question that when the European Systemic Risk Board get all of this information back, what are they going to do about it?

Mr Power: I do not believe they will go on fishing expeditions, that is not in their mandate, but in analysing information they may start to highlight concerns of build-up of risk in a sector or Member State. Let us say, for example, that there is increased volatility in some markets that are starting to cause concern. The ESRB will address themselves to supervisors and say, “What is happening?” “What kind of information do you have available?” “What kind of risk is being built up?” The European Systemic Risk Board, on the basis of this information will be able to determine whether inappropriate risk is building up and what, if any action, may be needed. where they are starting to get information that things are starting to overheat, will be getting that and getting that information out.

Q368 Lord Haskins: Getting the information out in itself will solve half the problem.

Mr Power: Part of the problem that we have all faced is that supervisors often do not have access to the relevant information.

Chairman: It is one o’clock. Thank you very much indeed.
WEDNESDAY 4 NOVEMBER 2009

Examination of Witness

Witness: Ms Sharan Bowles, Member of the European Parliament, Chair of the Economic and Monetary Affairs Committee, European Parliament, examined.

Q369 Chairman: Can I welcome you cordially to this meeting. You have seen us before and know what we do. We take a full transcript that we will let your office have a copy of so that any infelicities can be ironed out. You have seen the questions. There is a declaration of interests that you will have a copy of. In fact, two members of the Committee, one of whom is a director of hedge funds and one of whom is on 2 PE funds, voluntarily took themselves off the Committee, so they are not with us. That is Lady Hooper and Lord Browne. They are not taking part in this inquiry. My own interest, which is the Stock Exchange, is slightly peripheral and, therefore, I felt I could go on with this inquiry. I will tell you who we have seen today. We have seen the Commission, which was extremely interesting. We have seen the think-tank FEPS, which was extremely interesting. We got one shade of view there. We have seen your rapporteur who gave us quite clearly to understand that all sorts of bits of the Directive were going to change and were moving, even if we are not precisely clear about how or in which direction. What we thought we might start with is to ask you what is happening on this Directive. Which bits of it do you feel are going to be changed, moved or may come out rather different or have caused problems?

Ms Bowles: I think the answer to that is just about everything is likely to be amended. The Swedish Presidency divided it up into six sections. I am sorry, I did not bring a copy of their latest proposal but maybe you have got one anyway. They have divided it up and made proposals within each of those sections. When I first cast eyes upon the original document I said I could see the Parliament producing about a thousand amendments as a minimum starting point because that is the kind of number of amendments it might take to change it because we have to deal with it in an amendment format unlike they do in the Presidency or, indeed, in the US where you almost write another Bill. I think it is going to be very changed. I cannot tell you yet in terms of the Parliament where the centre of gravity of that is because we would not really know until first of all we have the report from Jean-Paul Gauzès, which he is just beginning to put together now so that we can discuss it at the beginning of December, and then we will have until the end of January for other MEPs to introduce their amendments and, indeed, the rapporteur himself may introduce some more at that stage. According to our timetable our deadline for amendments after his report is 21 January. We will then discuss all of those amendments in the week of 22 or 23 February. We will probably have another go at it in our next committee week, 16-17 March, aiming for a vote in committee on 12 April. Obviously between our discussions in February and March, which are in the public committee, we will also tend to have compromise amendment meetings where we will try to see where we have got common ground and where we will just have to vote it out one way or the other politically in committee. If we achieve this, if we have got a position voted in committee on 12 April, we will then go into the trilogue stage with the Council and the Commission starting in May, hoping that gives us enough time to reach a common position with them that we can vote in the Parliament in July and the Council can also correspondingly vote. That is if we achieve it and if a first reading agreement in our opinion is still doable. There have been some members of the committee who have already said do we want to try to do a first reading agreement or would it be better if we went for two readings. I would say we have an open mind on that. Originally we agreed we would try to do a first reading deal. As long as we do it slowly and methodically that should be all right. The time when first reading agreements cannot go wrong but the Parliament can sometimes feel it is pushed to one side a bit is if there is a huge amount of time pressure to get something concluded for some legitimate reason. That pressure does not appear here now so we should be able to take our time. We will have a new Commissioner, of course, in the middle of all this who may decide to put it back in and have another look at it, who knows.

Q370 Lord Haskins: He or she can do that?

Ms Bowles: The Commission can withdraw it at any time.

Q371 Lord Haskins: Really.

Ms Bowles: I am told that there have been murmurings just this last week that the Commission is saying now the Swedes are changing it so far from
the original proposal maybe it would need to be withdrawn, but whether this is part of the power play or a legitimate proposal I do not know. I would tend to say the normal process in Europe is we get something that is not very good, and it happens more and more, and both the Council and the Parliament change it sometimes unrecognisably so that the end product is rather more like it should have been in the first place. That is what I am hoping we will do with this. Now we have got our teeth into it and our heads round where we are going, and we will be rewriting it substantially, likewise for the attachés who are negotiating under the Swedish Presidency, we do not really want it taken away and have to start again. It sounds attractive to some people in some ways, but if it is a way of backing off then I am not sure that it would necessarily be helpful. There is the FSA impact assessment and then there will be the ones done by our committee, which may have a serious impact on thinking.

Chairman: That is our next question before we start picking away at where the changes are happening.

Q372 Lord Moser: I gather it is now published or available, although of course I have not read it. Looking back a bit, could you explain to the Committee why you went down this road in the first place because it is not the usual way of doing business in this place and you set out on one or two impact assessments? Why did you go down this road?

Ms Bowles: In the first instance we were not satisfied with the impact assessment that the Commission had done. We know that the legislation was issued in haste, although some of it had been brewing for a long time. If one looks back to the notion of having some regulation for hedge funds, that was something that was in the Purvis report, as I think we told you last time we met, in the Parliament before last and some of those thoughts were followed through in the Rasmussen report which then asked for everything to be regulated. Despite the fact that these ideas were not new, the way this was cobbled together by the Commission was done quickly and under a variety of different pressures of some people having it as part of their election campaign for reappointment in the Commission, and there was undoubtedly public clamour. There may be excuses for haste or there may not, but there was haste and we were not satisfied. Several people mentioned this when we debated it in committee and because there was enough money in the budget we decided that we would have an impact assessment of our own. It could not be a huge one because we do not have such a huge budget. It is not the first time it has been done. It is unusual but not unheard of. Then, again, we were faced with the timetabling problem, which is why there were two, so we said could we have a first one which picks off some quick points that can be available as it is today, and I have not had time to read it either yet, and would be available before the rapporteur came forward with his report so he would at least have time to see that. The second one that will come out later will still be available in time for us to have a look at it.

Q373 Lord Moser: What is the relationship between the first and the second ones?

Ms Bowles: The first one, which is the one published today, looks at marketing and distribution, which includes private placement and disclosure to investors. It looks at third country issues for EU and non-EU investors in the funds, including consequences for investors’ choice and the cost of compliance. It looks at the depositories issue and leverage and what would be the impact on price, efficiency and volatility and the behaviour of the market, counterparty exposure and maybe as far as supervision and financial stability. That was broadly the remit of the first one. The second one, which will be completed at the end of November, looks at a cost benefit analysis of the changes proposed by the AIFMD resulting through implementation, so that includes things such as impact on the real economy, competitiveness and employment, looking at whether there would be a level playing field after the AIFMD was implemented, what is the effect of one-size-fits-all regulation and what would be the impact on sectors already covered in other directives, especially UCITS and MiFID, and then what is the assessment of the risk of capital flow from the EU to non-EU countries as a consequence of regulatory arbitrage, what are the risks posed by offshore provision of valuation, what are the justifications for the de minimis threshold and the impact on AIFMs domiciled in third countries. Then if they have got time they will also look at the risk posed by non-regulation of funds as opposed to regulation of managers, but it is not clear whether they will be able to cover all of that in the time.

Q374 Lord Moser: Between them they cover the whole shooting match more or less, do they not? Was this independent or in-house? I do not know who does this kind of thing here.

Ms Bowles: It is not in-house, it has to be tendered for and done by independent experts.

Q375 Lord Moser: Is it fair to ask you—perhaps it is not because it is only out today—I cannot ask you about the impact of the second one because that is not due out for weeks, but do you already have a feeling on the first one or is it too soon?

Ms Bowles: Alas it is too soon because I suspect most people are in the same situation as me and they have not had time to read it yet because we have had
committee meetings and other meetings going on. That goes to the weekend reading pile that we will have to do. Next week we do have quite a full week of committee and hearings and a workshop on the AIFMD, therefore it makes sense for those of us who are highly active on this portfolio to have considered it. You are a week early for an answer on that, I am afraid.

Q376 Chairman: Before I bring in Lady Northover, who has a supplementary, can I just ask a question? You are doing an impact assessment literally on the Directive as proposed, and not in relation to any amendments or changes that might be agreed?

Ms Bowles: The point is there are no changes that are agreed yet.

Q377 Chairman: No, of course not.

Ms Bowles: So we are a little in the same situation as you in that we are looking at an impact assessment of a document that inevitably will be very substantially changed, nevertheless it may well point to the way forward in terms of how those changes should be. Hopefully it does not just say, “Proposal X is rubbish”, it says, “but maybe if it was like this or that . . .” I do not know what they are going to come out with because I have not seen it yet. In order to be sensible proposals as to how if it perceives a problem that problem might be fixed would well either be there or be pointed to. I have not read it yet so I do not know.

Q378 Lord Moser: It will influence your thinking and your committee’s thinking. Is it meant to be the sort of document that will influence the whole of your Parliament, the Commission, everybody?

Ms Bowles: One would hope so. Primarily it is meant to inform us for our work because the Parliament should be independent and not just rely on the information that comes its way from various sources that are also working on it. Of course, we get information from Member States, from industry, from the Commission, but we quite like to have some of our own independent information that may well cross-reference some of these other things. Reports are often influential. If you look at climate change, the Stern report was influential well beyond the UK. I expect the impact assessment that was commissioned by the FSA, which we did not know they were doing when we commissioned ours, will be read and looked at beyond people in the UK and the FSA. All of these things come together.

Q379 Baroness Northover: This is just following up on the questions about who did this. You put it out to independent tender, but who actually did do this? Who won that?

Ms Bowles: I cannot remember. I will let you know.

Q380 Baroness Northover: Can you remember where they were based?

Ms Bowles: I cannot remember a great deal about it because it is not done by me, it is done by the Secretariat. Perhaps I should have these things committed to memory but, unfortunately, the world has been very interested in seeing me so I have been scheduled 24/7 since July.

Q381 Baroness Northover: I am just anticipating, as you are obviously, that those who do not like the conclusions in it will say, “It has come from here and, therefore, they would say this, wouldn’t they?” et cetera. That was why I was wondering.

Ms Bowles: I should have got my office to look that out. I can let you know.

Chairman: Perhaps we can now start picking at the things which we know to be causing difficulty. We saw the Commission this morning so we know where they started from, and we have seen a lot of hedge fund investors, so we know where they are starting from. We just wonder where it has got to. Lord Haskins, would you start?

Lord Haskins: This is a little bit to do with process and the Lamfalussy procedure arising out of the Directive on financial regulations that we talked about last time and the way Directives are going to be implemented in this particular area. Are we working on the basis that whenever a Directive comes out it is going to be establishing, as it were, general standards and leave it to national supervisors to implement partly in line with national circumstances or is the intention of this going to be a pretty hard centrally driven Directive?

Q382 Chairman: Perhaps specifically with reference to the question of leverage. Is leverage going to be prescribed or left to the discretion of supervisors?

Ms Bowles: I think I am going to have to give you a variety of different answers here. You are right, it is a Lamfalussy Directive so it should have Level 1, which is the broad framework, and then implementing measures that are more detailed. Indeed, there would normally be things that then went off to the Level 3 committees of the supervisors to do other more nitty-gritty detail. Of course, now it would get mixed in with the new supervisory system that is also under construction where the Level 3 committees morph into agencies with more powers and set a common rulebook. Members of the FSA have said, “Well, we don’t mind a common rulebook as long as it is our rulebook”, to which my reply is, “It should be something that is at least as good as your rulebook”. It may even be that there are some supervisors in other countries who have got some ideas that are worth implementing. Let us look at this with a glass
half full. We should have a common rulebook, the idea being that we do not get regulatory arbitrage and different regulations in different countries. Normally speaking, the EU when it makes its legislation does have due regard to the expertise that is available. There is no escaping the fact that on all things financial London has a lot of expertise. There is also no escaping that people say, “Look what you have done to us”.

Q383 Chairman: Cowboys!
Ms Bowles: We get it both sides. It is not going to be that the UK can run off and do something that is different from Spain, different from France or different from Germany; we do not want that any more. We do want a good level of supervision but we want it to be sensible and workable. That leads on to what are we going to do about leverage. Certainly I would belong to the school of thought that says you need different leverages in different circumstances and, therefore, you really cannot fix it in stone, it should be something that is dealt with in accordance with the circumstances of the entity being supervised because it will depend on all kinds of things to do with asset classes and so forth. Whether such a line will appeal to the Parliament as yet I do not know. If we had put this before the Parliament I can certainly see that there would have been some factions very strongly trying to get something written in stone. We have a committee now with 75 per cent of the members who are new. That does not mean they are devoid of expertise by any means, there are some very good people on it, but we are a mixture of political groups, national cultures and bright people with independent ideas, and quite how that is all going to mesh together I cannot tell you yet. I am sorry if it sounds like a bit of a mystery tour. The only thing is we are all determined to be quite thorough and approach it in an intelligent way. If we go back to this rulebook, which will come up in all legislation now, not just this, we have to be quite careful as to what levels of flexibility we do leave ourselves. I have just come back from a very productive trip to Washington doing a bit of compare and contrast of our swath of legislation with theirs and where we want to make sure we are joined up and it is quite clear that they are building in certain flexibilities because they will probably get to an end result before we do in Europe and they are keeping an eye on what we do because maybe they want to gain a little bit from any regulatory arbitrage that is going on. We do not want to find ourselves too painted into a corner that we have no flexibility in response. That is something I am conscious about. I have to say, the majority of the people I spoke to were saying they do not want any regulatory arbitrage, which is a good thing, but that does not mean to say we do not have it in the back of our minds.

Chairman: Exactly. If we can start picking away at a further difficulty which we know is the prime difficulty about passporting, Lord Jordan would you like to ask about that?

Q384 Lord Jordan: The AFG argue that the passport system will help to develop a truly single market in investment funds within the EU as long as it is limited to EU funds and managers. If the AIF passport were to be extended to non-EU funds and managers the collapsing of a non-EU AIF would force the European investor to go before a non-European court to try to recover its money, creating legal and potentially political risk. Conversely, we have received evidence criticising the third country marketing provisions as protectionism. Would you give us your opinion on those two positions?
Ms Bowles: I suppose I am probably on record as having called the proposal protectionist. The irony of it is if you take the proposal as written with all its flaws it ends up being both fortress Europe and prison Europe in that funds cannot get in and money cannot get out and, generally speaking, is a total disaster. The people who lose out in the end will be pensioners who do not get decent yield and as a consequence we are then stuck with a macroeconomic problem as to how do people provide for themselves and I think this is understood in some quarters. The notion that you just have to contain everything within otherwise you are subjected to somebody else’s legal provisions does not hold water. Are we looking outwardly, are we globalised or are we not? If you take that view then because our legal systems are not co-ordinated and common within the EU, and many aspects of them still will not be, then what is the point of the Single Market. It does not wash. The same argument that is turned outwards against the rest of the world I think you can turn inwards on the Single Market. I do not buy it at all. There are other quite significant problems as well in that does this mean Europe is never again supposed to invest anything in any developing country. There are lots of people who might want to do the equivalent of environmental investment, ethical investment, or development-type investment and it would appear we cannot do that either. There are big problems here. Recently in a meeting that we had with Commissioner McCreevy he did say there was never any intention for these things to happen so basically they have to be addressed.

Q385 Lord Jordan: How strong and how widespread is the feeling amongst parliamentarians that we must do the right thing and we are big enough to bear the disadvantages? If we do this money will not necessarily flow away permanently and might
symbolically disappear for a short time but then have to come back to us. Do you accept this?

**Ms Bowles:** I am not sure I entirely follow your line of questioning. I think the majority of the members of the committee would fall along the line that we have to be open and not closed.

**Q386 Lord Jordan:** I did specifically say the whole of the Parliament, if this matter went to the final resolution as an issue to the whole of the European Parliament.

**Ms Bowles:** It is not normal for the Economic Committee to be second-guessed by the Parliament. I do not know yet in this mandate, but the arguments and details are usually such that there are not big changes. Of course, many of the people who are on the Economic and Monetary Affairs Committee, perhaps even more so now, are big-hitters within their parliamentary groups because it is known that this is the focus and for the next two and a half years this is the “it” committee so people have been trying to get on to it. I do not think we are going to do something that is out of the mainstream thinking.

**Q387 Chairman:** We had the Commission this morning and they really waxed passionate about the idea that you must persuade the world, as it were, that the equivalence idea is very important, that the passporting idea which we all find so tempting must go through and must be accompanied by equivalence, which lots of people find very difficult, but were less keen on the possible alternative which has been put to us by the hedge funds of national private placement rules. In order to enable us all to get on with life, which is how the hedge funds put it to us, one might go for national private placement. I do not know where your committee stands on this because, of course, national private placement rules are a way through even if they rather abandon the original third country passport ideal.

**Ms Bowles:** It is an argument that we have quite often in terms of talking about 28 regimes, as they call it, where you have national systems and then you can have a European one that you could say is a motorway system or has some additional benefits. There have been a lot of people thinking around this and in order to get through it has certainly been discussed at the Council level that if we cannot get everything we want in European legislation then the buy-off to get a majority to go for it is that we do not destroy the national private placement regimes. That is a pragmatic solution. People who want everything to be the same come what may will be against it, and there will be a fair number of those within the Parliament, but they can only win on that if they make the common proposal that we all sign up to satisfactory. The other way you could look at it is to use the passporting system as a reward for good behaviour or as my colleague, Wolf Klinz, put it when he was speaking that you kind of make an AIFM brand in the same way that we have the UCITS brand. I do not know whether he was specifically thinking in terms of the private placement but he was saying there may be ways of layering this. There are various thoughts out there but how those are going to come through in the parliamentary thinking I do not know. That might be another solution that would run parallel with the idea of maintaining national private placement so that it is not you have got a non-Single Market thing, it is just that you have also got a gold standard thing and hopefully people would migrate to something that was the gold standard. There are some interesting ideas there. I suppose the downside of it is if you are totally against national private placement schemes it also indicates that means supervisors do not trust one another. We are on very dangerous ground here where we absolutely must move in the direction of exchanging sufficient information and understanding supervisory systems across the EU such that we do trust them. That is on the EU side of it. In terms of equivalence, it depends what yardstick you are using for equivalence, if you are looking at outside countries coming in. If you take it that they are subjected to regulation that has similar kinds of objectives that is one way of defining it and can work quite well, but what is still worrying me is how do we invest in this fund in Africa. If every country adopted the attitude, “We can only invest where there is equivalence” then we would never invest in Africa. There would be ways because presumably you might be able to go through a fund of somebody else who had done the investing, but is that really what we want? It cannot be. That is one of the arguments I put forward in the very first committee meeting on this: what are we saying about developing countries in our outward investment?

**Q388 Chairman:** That looks to be an area of the original Directive that is going to be subject to some considerable adjustment somehow.

**Ms Bowles:** I think so. None of it can work as it is at the moment. It is exercising our minds. I do not see how, as yet, we can tick all the boxes without having compromises. You cannot just stand on an absolutist line here, I do not see how that is going to work, because the people who will suffer are going to be either our citizens or other worthy people.

**Q389 Baroness Northover:** Before I come on to the question I have got in front of me, what was the reaction when you pointed out that they would not be able to invest in Africa?

**Ms Bowles:** Several members of the Committee realised it and, in fact, it was mentioned again in a subsequent committee meeting so it is something that we are aware of. I cannot say that anybody has
specifically come back to me on this point from the Commission or elsewhere. We have to make up our minds about it. To some extent we take the view that the Commission has had its go and it is our go now.

Q390 Baroness Northover: I suppose this is also about a large mallet. The problem of one-size-fits-all is something that has been put to us and it does seem to me from the way you have drawn the remit from the impact assessment that all sorts of the issues that we have had brought to us are being looked at there. I wonder if you could say a bit about what your thinking is about the Directive as far as that is concerned.

Ms Bowles: I suppose the starting point for saying everything has to be regulated from the Parliament side is one would go back to the Rasmussen report where, indeed, we did say that everything should be regulated but we did also say according to risk, so we did not actually say in a one-size-fits-all way. I think we indicated that maybe there should be certain minimum regulations and on top of that you layer other things according to not just risk but methods of business and so on. I still think that is the way we have to go otherwise it will not work. A lot of people originally thought this was just about hedge funds and private equity, and in fact if it were it would be a lot easier because you would almost go through the Directive saying, “That’s for hedge funds and that’s for private equity” because although it is difficult in particular to define a hedge fund you can make the division between hedge funds and private equity quite easily, but we have got everything else in there as well. In a way, to my mind it is a safety net because by the time we have made it workable for the myriad of investment funds and others that are valid we have made it workable overall. Therefore, I think that implies it has to be amended in a way that is flexible. Sometimes you cannot actually work out who is the fund manager because the functions are split between different entities, so we have to fix that problem. As you start to look at it in that way, to my mind you start thinking more about functionalities rather than things that are specifically pinned down. I do not know if that answers your question. One-size-fits-all just does not work, unless it is something so loose that I think people will object there is not enough in it. At some point a certain amount of tailoring will have to be done. The whole idea of trying to do it through, if you like, a governance level of the fund manager is that then you do not have to keep changing it when some new type of fund comes along. It should, therefore, follow through that it is done on a principles basis because principles should not change even if types of funds do. Somehow that message has got a bit lost in it.

Q391 Chairman: Your rapporteur, Mr Gauzés, suggested, and I think you more or less told us, you were going to have to think about hedge funds, private equity and property funds separately. Might this mean that when it comes out the Directive will be differentiated by types of activity or have you just told us that it really cannot because people will invent new ones?

Ms Bowles: It depends how you define it. You can work out, I suppose, whether it is a fund where you can make withdrawals or not and there may well be certain sub-categorisations like that that will work. I am not quite sure whether the rapporteur is specifying hedge funds, private equity and property funds for the same reasons that I might single them out. There is a lot of political pressure to be seen to do something in some countries on hedge funds and in other countries on private equity, and then property funds seem to be also trying to claim that they are different. You may need some broad-brush categorisation, yes.

Q392 Chairman: I am using my terms loosely. I do not think he was necessarily talking about funds. He may easily have been talking about fund managers, that you would have different requirements on people who ran hedge funds and people who ran private equity. I would not wish to hold him to that.

Ms Bowles: For example, you might want to say something about funds that engage in using derivatives compared with those that do not. If I hark back to what I was learning last week in Washington, where a lot of people complain, “Well, the US isn’t going to regulate hedge funds to any significant amount”, they have a very lightweight registration process, or what Europeans would see as lightweight, coming along but then their Stability Council will single out institutions that they think are going to have systemic risk to be regulated specifically by the Fed. It may be argued whether it is the Fed or not, but at the moment that is the proposal. Talking to the Fed, they definitely said this would easily include the largest hedge funds, so then they come under quite strong scrutiny. Then if you go over to what they are thinking of doing in terms of derivatives, hedge funds are going to have to register as a major swap user. There are other ways in the States that hedge funds, for example, are going to end up being regulated and you could have some of that kind of process coming in here. Again, it is a function, is it not, are you doing something long-term, are you doing it short-term, are you using leverage or are you not using leverage? This was something it tried to do in the leverage ideas but I do not think was developed in a mature enough way. Ultimately, to stay flexible some of it will have to be down to supervisors.
Q393 Chairman: It is all sounding a lot less definitive than it did at first. I suspect that is what happens when you have a fairly quickly drafted Directive and Parliament starts to get its claws on it. Do you think the end product is going to be something that says we are leaving a lot of it to Level 2?

Ms Bowles: I do not know is the answer there. I did float that idea at one point and, of course, the Parliament still has a role in implementing regulations. It is quite easy to talk about these things in broad-brush terms of, “We’ve got to fix it this way, do it functionally that way”, but I do know that when you look at the words and start trying to draft amendments it is a lot harder than just saying, “We will distinguish between this and that”. If we do have to make more nitty-gritty distinctions we have to make them somewhere where it is also perhaps easier to change. That is what comitology is for. Where in the Directive and all the way through it says “there shall be” regulations made, I think there are a lot of places where “shall” could be changed to “may” because you do not want them just for their own sake but certainly want to have the ability to do it when necessary.

Q394 Lord Haskins: I am intrigued to get from you, although you might be reluctant to give me a view on this, what the sort of psyche of your committee and the Parliament and all the players in this is going to be. We got into this thinking that the debate was about the impact of hedge funds on systemic risk and I think everybody has told us that is not really the debate, the issue is way before that. On the one hand, lots of people think hedge funds are unfair, the people who operate them are greedy, they are short-termist, secret, they are even crooked, and there is an aura around that which has a political impression, and the other side of it is it appears they are hard to regulate, they do encourage risk taking where others might not take risks which are worth doing, they wake up sleepy companies, they are a new income stream for pension funds, very attractive for pension funds, they pay their taxes, although some people would question that, whether they pay them properly or not, they are big employers, and critically when things go wrong the people who suffer are the owners and the shareholders and managers rather than the outside depositors. There is no evidence that the outside depositors have suffered so far at all. In the psyche of all that and the complexity of regulating them, how are you going to work through the politics of all this? Are people’s prejudices about hedge funds going to prevail over the regulatory problems or are the regulatory problems going to be worked through carefully?

Ms Bowles: It is a problem because, as you say, there is a lot of prejudice against hedge funds.

Q395 Lord Haskins: Some justified.

Ms Bowles: Also against private equity and a lot of it is grossly exaggerated. Interestingly, you can read reports in newspapers now suggesting the best place for risky traders is actually in the hedge funds where they belong and not in the banks where the taxpayer bails them out. I think the comparison you draw there is a very valid one. It is our job that we have to counter the prejudice with facts and reports. We have had studies and have heard Trichet say that hedge funds did not cause the problems but, of course, he will not actually say that they could not. Although it is recognised that the problems lay in other places for the current crisis people say nevertheless they could still brew up the next one in the hedge funds and there is a general feeling that everybody wants to know more about what is going on and to understand things. I suppose to have more light shone on everything has to be a good thing. If there were some elements of reporting and greater understanding I would not go against that. It is difficult. I heard similar arguments on venture capital when we were doing the Rasmussen report and in Germany they really dislike private equity and regard them as locusts and asset strippers and say we need laws to stop it. They have laws to stop it in Germany that they have never used, so why they think a European law would be used instead of a German one I do not know. Sometimes, especially when politicians are up for elections, it is very difficult to break through these populist barriers. It is a bit like arguing the case for bankers at the moment, it is a very difficult thing to do politically and I am one of the few people who have tried to put their side on some of these issues and not got much thanks for it. There is quite a bit that is wrong too. That is why we are a specialist committee and hopefully we will come to at least some of the right solutions and the Council will come to some of the right solutions and we can stick them together and agree a package that is workable. I doubt that we will get it 100 per cent as everybody wants it, that is impossible, but we should be able to achieve something that is workable.

Q396 Lord Haskins: You have given a deadline of July and that seems a pretty short period to get all of this complicated stuff organised. What is the problem of saying, “We will take another six months or 12 months”?

Ms Bowles: There is not a problem. If we cannot do it then we can extend it. That is the minimum baseline for if we want to do it before the summer recess. If we find that when we are discussing the
amendments everybody has put in that we cannot find enough common ground we can extend that.

Q397 Lord Haskins: Is it your committee that decides that?
Ms Bowles: The timetable is run by the rapporteur really. As Chair I also have some influence on it but I cannot make the rapporteur go quicker than they want. I suppose it might be possible to seek from the committee the thought that maybe they want to have more exchanges of views, but it is not the talking in committee that will actually resolve this, it is the negotiations that we have between the committee meetings as to whether we can find a way forward. Of course, we are not doing it in isolation, we do keep up with what the Council is doing and we will be having meetings with them where they tell us not just where they have got to, because we will have their documents, but possibly the areas where they think they can see a compromise beginning to form and can tell us things that are not necessarily public and we can do similarly to them. There is a kind of ongoing process, so we should be able to analyse whether we think we can go at this speed or not.

Q398 Lord Haskins: Listening to the rapporteur before you came in it seemed to me that he was searching for help in quite a number of areas and was saying “We have lots of areas, we are not quite sure what the way through is”. My concern would be that at the end of the day this will end up as a political horse deal and the principles of good regulation, which is what business people would want out of this, may go to the wall when push comes to shove.
Ms Bowles: I would not be as pessimistic as that. I have worked with Jean-Paul on several things before and in his first report he tends not necessarily to try to deal with everything in just the same way as in the Council. The Presidency starts with its first shopping list of major points, “Can we resolve these?” and then progressively refine it. The rapporteur will come out with a report that will probably concentrate on the things that seem to be the biggest and hottest issues and then he will wait to see what response he gets on that from other members when we discuss it and, as I said, he is likely to put more amendments in at the amendment deadline as well as other MEPs doing so. It does go through a process of refinement. Because of the way the Parliament has to vote in the end, we do it on an amendment by amendment basis, we are capable of voting something that is silly or contradictory, as has happened before, whereas the Council tend to have a “nothing is agreed until it is all agreed” process, though even then they can still have things in it that are silly. When we get to the trilogue and we have the three columns in front of us of the proposal from the Commission, the proposal as amended by the Council and the Parliament, then we have a fourth column in which we try to write what is the best solution all round, that is a “nothing is agreed until it is all agreed” document and the juris linguists and various other people have a go at it, so hopefully some of the problems get ironed out. It has been my experience in the past that many people look at the Council text and think, “Oh, the Council has got this bit right” and then they get really upset when the Parliament ends up with different wording, but that should not really matter because at the end of the day the final column will take the wording that is best as between Council or Parliament, or invent a third one that is better than either.

Q399 Lord Moser: I am left at the end of not just today’s discussions but also a lot of the meetings we have had with one kind of discomfort. On the one hand, coming back to Lord Haskins’ questions, there is no question that there is a lot of public prejudice, as you might call it, or distrust of hedge funds, partly because of their behaviour, the bonuses and the fact that they were partly responsible for the bad financial behaviour of banks, and I was a bit surprised how strongly you rejected that point by saying there is so much evidence that the prejudice is unjustified. Leaving that on one side, everybody agrees that regulation is necessary and yet regulation depends on having criteria for regulating. In other words, “This hedge fund is going over the top, this one is okay”. From all the discussions we have had there is no clarity anyway, back to leverage ratios, et cetera, on how on earth you are going to regulate these things. That double discomfort worries me.
Ms Bowles: I think you cannot pin down all of those criteria exactly, especially not in Level 1 because you would come with the same problems of having a leverage ratio in Level 1, which I do not think is the right place for it. You need to be able to assess what are the behaviour and the risk posed by pooled assets of a particular nature. On top of that, if they are of a substantial size you may also want to add on are they also of systemic risk. There is the side of regulating in order to make it safe for the investor and regulating in order not to put the system at risk. We have previously said the professional investors should be able to look after themselves, so the only concern there should be systemic risk. The trouble is professional investors have recently shown themselves incapable of making those judgments. We have had some pretty poor judgment all round in funds, in banks, by regulators, by auditors, by everybody. Nobody comes out of this with clean hands. The instinct is to try and fix it so that those things cannot go wrong, and then you try to fix it too far and you think we have now regulated the markets away and there is no market in which to have a crisis. We have to try and get back to an even keel. There was competition between hedge funds and some of
the proprietary trading in investment banks and maybe we could not necessarily distinguish them, but then we have had a large insurance company—AIG—having a part on the side behaving like a hedge fund and we have had Porsche behaving like a hedge fund. This is why you cannot do it by defining the name of the thing, it is the activity. Have you got too large a position in some derivatives? Are you being excessively speculative? Those are the judgments that ultimately have to be made.

Q400 Lord Moser: How would you judge “excessively”? That has to be defined, does it not?
Ms Bowles: It may be that if we get the derivatives legislation right in terms of going through central counterparties you do not have to put the question as I did then because you have brought in the safeguards by other mechanisms.

Q401 Chairman: I do feel that the Derivatives Directive has got a lot to do with all of this. We hope to do derivatives as the next inquiry after this one, as soon as there is something to do on it.
Ms Bowles: Of course there is the Commission’s consultation paper out and the results of the previous consultation.

Q402 Chairman: Yes, we could do that.
Ms Bowles: Before long we will maybe have a clearer idea of what the US end solution might be if the Senate gets its version of the Bill done.

Q403 Chairman: Privately I think it might be a more fruitful field if you are really trying to tie off financial risk rather than AIFM, but that is a matter of judgment.

Ms Bowles: I agree with you entirely, which is why to some extent I deviated on to some of the things I was doing and learning about in Washington because it joins up in different ways. It also means that it is another reason why at some point it might be decided should we take a little bit longer over this AIFM Directive because some of the areas where we are having a bit of a problem trying to solve it, the solutions are coming in elsewhere. At the moment there may be something where people will say, “I don’t want to take that out because we need to do it”, and will discover it is covered elsewhere. There is huge overlap between this Directive and a lot else besides, and some of it pre-empted things that were supposed to be coming up in reviews in the UCITS depository issue and in MiFID. As a committee Chair I took a little bit of a dim view of a Directive coming out with pre-empted solutions to reviews that we are yet to do. I did not think that was right either. We have got those issues on the table and noted as well.

Q404 Chairman: That is very interesting. I have not been able to escape a feeling throughout all of this that this particular Directive is a cuckoo in the nest and it has come in the wrong order. We are where we are and you have got to deal with what you have got to deal with. I think derivatives is the other great hole in the financial system, a great potential area of risk.
Ms Bowles: I look forward to evidence on that because it is very interesting, but I am sure when we get round to doing that we will discover there is another hole beyond that. We will not go down that track because it takes a long time.

Q405 Chairman: I do not think we should because I feel we should thank you very much for giving us a whole hour. Thank you, we have found that most valuable.
Ms Bowles: I hope it has been useful. Thank you.
Chairman: It has indeed. Thank you.
TUESDAY 10 NOVEMBER 2009

Present  Cohen of Pimlico, B (Chairman)  Northover, B  
          Haskins, L                              Renton of Mount Harry, L  
          Jordan, L                               Trimble, L  
          Moser, L                                 Woolmer of Leeds, L

Examination of Witness

Witness: LORD MYNERS, a Member of the House, Financial Services Secretary, HM Treasury, examined.

Q406 Chairman: Minister, we were in Brussels last week and wrestling with the business of third country marketing of alternative investment funds, and quite a few of our witnesses told us that keeping national private placement regimes in place will provide a solution to those problems, which was the short way out. However, there are those in Brussels who regard this as a betrayal and announced that it would lead to a two-tier system where EU funds would have to meet the costs associated with a passport whilst third country funds would not. Where are we on private placement regimes? Do we see it as a useful development?

Lord Myners: The Government’s position is that we strongly support an internal market for third country funds, particularly where the fund manager is established in the EU. In the UK we have historically had an open approach to trade in financial services and it has enabled us to develop as a global centre to the benefit of the UK and Europe. We have successfully allowed non-EU funds to be marketed in the UK for a number of years and I think that has been good; it has provided access to a wider range of investment skills than otherwise would have been the case, and it has also exposed the UK fund management industry to the discipline of global competition. I would say that in the same way that that has been good for the UK it should be good for Europe; and that therefore Europe should welcome the admission of non-EU funds into the European market place. This view is not shared by all Member States. Other EU Member States have different traditions and take a different approach to this issue. A number of Member States have concerns about providing a passport for third country funds. As a consequence an alternative has been suggested which is to keep national and private placement regimes. This in essence would be the status quo; each Member State would be setting their own standards for permitting the marketing of third country funds into their jurisdiction. We do not believe that maintaining the status quo would lead to fortress Europe, but we do feel that this would be a missed opportunity to enhance trade and investment across Europe. However, our top priority on this issue has been to protect the UK’s right to maintain an open market and this will be achieved under a compromise proposal currently being proposed by the Swedish Presidency.

Q407 Lord Jordan: Following on the theme, in Brussels we were told that two very divergent opinions on equivalency could be achieved. On the one hand some Member States raised concerns that equivalency would be too easy to achieve and so in effect the status quo of non-EU funds operating in the EU would remain. On the other hand, and they were perhaps the more vehement, some witnesses told us that equivalency will be impossible to achieve with the US, let alone third countries. Can you comment on these opinions and could you tell us does the British Government look at any of the Articles—and I am thinking in particular of 4, 35 and 39, that could perhaps do with amendment that would bring this equivalency a little bit nearer? And are your ideas any different or better to those that emerge from the Swedish suggestions?

Lord Myners: Assessment of equivalence of third country regimes will depend upon how you define and determine equivalence. It was never clear to me from the Commission’s proposals whether this equivalence test was to be an assessment of the consistency with high level principles, similar to those set by the G20, or equivalence to the detailed approach set out by the EU, and I would add there that the EU approach is a very detailed one. The G20 declaration following the summit here in London stated that hedge funds or their managers should be registered and required to disclose the appropriate information on an ongoing basis to supervisors. This would include information on leverage, portfolio concentration and any other source potentially of a systemic risk. They would also be subject to oversight to ensure that there was adequate risk management. This would seem to me to be a sound and proper basis for determining equivalence from the perspective of systemic risk and I think we need to remind ourselves that this exiguous Directive is proposed in the name of financial stability rather than investor protection. I think that the G20 proposals provide a good basis for that. I think if we use the G20 principles, Lord Jordan, then equivalence is an achievable goal.
However, if equivalence was an assessment of whether a third country had implemented the identical, very precise and at times narrowly defined rules that are proposed in the draft Directive, then achievement of equivalence would be much harder, if not impossible, to achieve, including for funds based in or managed from the United States. So our very strong view would be that if an equivalence test is maintained it should be one that is based on the G20 principles.

Q408 Lord Jordan: Are you going to take specific proposals to force specific amendment to what is presently there or are you going to back any of the suggestions that have already emerged?  
Lord Myners: I think the proposals that are emerging from the Swedish Presidency (and I would like to say in parenthesis that Sweden, and in particular the relevant minister, Mats Odell, has done an absolutely first-class job on this Directive) have managed to produce a way forward for what I say is a very exiguous document, flawed in construct and poorly informed in many respects, into something which I think would represent a workable and practicable step forward. So we find ourselves broadly aligned with the direction that the Swedes are taking. I would add that I recently visited Madrid and met with the relevant minister there. Spain is taking the Presidency of the EU with effect from 1 January and I believe that the Spanish view is very similar to that now being proposed by Sweden. So I think we will come up with a solution which, from the perspective of the UK investors, will allow them to continue to access the best fund management products in the world and do so in a way which is consistent with careful management of systemic risk. But I would strongly prefer an open passport to non-EU funds throughout the EU as long as they complied with the G20 principles for the purposes of equivalence.

Q409 Lord Renton of Mount Harry: That is a very carefully balanced statement by yourself, Lord Myners, and I like the use of the word exiguous—I am not quite certain what it means! Can I turn to the matter of hedge funds? As you know, almost every witness has talked to us about hedge funds on this subject over the past few weeks. What I think we do not know is how the draft Directive compares to the proposals for the regulation of hedge funds currently under consideration in the United States. I wonder if you could inform us on that.  
Lord Myners: The US Treasury proposals, which were tabled in July I believe, are going to be subject to amendment before implementation, but the core of their proposals is firstly a requirement for all managers with more than $30 million under management to register with the SEC. Secondly, substantial regulatory reporting requirements on assets, leverage and off-balance sheet exposures; thirdly, a clear conflict of interest and anti-fraud provision; fourthly, the provision for oversight of managers by the SEC; and finally, the funds to establish a comprehensive compliance programme. What the Committee will note is that there is nothing there which is terribly novel as far as existing UK practice is concerned; we are in practice doing all those things already with FSA regulation which focuses on the manager. The FSA incidentally has some of the most thorough regulations for investment managers, including alternative investment style managers, found anywhere in the world and it has not done the UK industry any harm—in fact it has increased our share of the global alternative investment monetary market over the decade. The American proposals have much in common with the Alternative Investment Fund Managers Directive, including the focus on regulation of the manager rather than of the fund, and the placing of significant reporting obligations on those managers. The way that the AIFM Directive goes further than the US proposal is in its imposition of relatively detailed conduct of business and marketing rules on managers. The US proposals have much less in this area although that partly is because that is an area which is subject to a different US legislative structure, where most of the detailed rules on conduct of business and related matters are made by the SEC.

Q410 Lord Renton of Mount Harry: Are you yourself in favour of where we are getting to on the EU Directive? Do you think it is reasonable?  
Lord Myners: Yes. I think we are in a much better place than we were when this Directive was first produced. Of course it is regrettable that it has taken as much time and effort by national regulators, governments, the industry and clients to make the case because if the EU had followed its own best regulation practices and had carried out detailed consultation, as it did on the UCITS Directive and the MiFID Directive, and it had carried out a proper impact assessment then some of the failings, shortcomings of the existing draft Directive would have been headed off at a much earlier point. The Directive still suffers from the fact that it seeks to confine a myriad of different investment approaches into a single set of rules and practices, which are at the moment very detailed. But I think that the Swedish Presidency has taken this back towards higher level principles. It is probably a rather longer answer than you expected, but I would say I think I am much encouraged by the progress that has been made, but it has taken a lot of hard work.  
Lord Renton of Mount Harry: A very interesting answer; thank you.
Q411 Baroness Northover: Sharon Bowles, who is, as you know, the Chair of the Economic Committee in the European Parliament told us that third country provisions as drafted could have the effect of blocking investment from the EU in developing countries and I wondered if you could comment on that suggestion. Could I widen it further, partly in the light of what you have just said, where you are supportive of what the Swedish Presidency has brought forward. Obviously there are the three elements: there is the Commission, the Council and Parliament and the parliamentary scrutiny is underway. Do you feel in looking at that that the direction of travel is similar, to use your expression from earlier on?

Lord Myners: Let me first of all take the point made by Sharon Bowles about reducing EU investment in developing countries. I think it is very good that she has raised this point. There are two ways in which the Commission’s current draft Directive could reduce EU investment in developing countries. The first is through its restrictions on EU investment in funds managed outside the EU. Secondly, through its requirement that all the assets of EU funds should be held in custody in the EU. The investment restrictions would not necessarily have prevented investors from investing in developing countries since many funds investing in those markets are managed from the EU and a very high proportion from here in the UK, in Edinburgh and London, and therefore would not be affected by the restriction. Nevertheless, it would certainly have been harder for EU investors to access local fund management expertise in developing country markets and I am thinking here, for instance, of Africa, where there are the beginnings of a nascent professional fund management industry, interestingly targeted on private equity and unlisted investments rather than listed securities, and I think it could only be good that developed countries’ capital is going into what are assessed to be commercially viable investment opportunities in Africa and other parts of the developing world. The second restriction on custody could actually have a much more severe impact. In many developing country markets it is necessary to hold investments in local custody. While the investment fund has beneficial ownership the actual title has to be held locally to comply with national rules. The Commission’s draft, as it currently stands, will prevent AIFMs from investing in this way and making it possible to invest in those markets. That must be an unintended consequence of poor drafting and I have the highest degree of confidence that that will be remediated through the process. The European Parliament has I think adopted a very constructive approach to the Directive. I met this morning with one of our MEPs to discuss the Directive, amongst other matters, and indeed I have met with British MEPs from all political parties to discuss the Directive. The Parliament has commissioned its own impact assessment and a pretty devastating report it produced. The process of considering the draft Directive is likely to lead to over 1,000 amendments being considered by the Parliament. I am sure that that will involve certain negotiating processes which will home in on a coherent Directive and I believe that the dialogue between the Presidency and the Parliament gives us grounds for hope that they are working towards a common goal. There is no doubt that a Directive in this area will be helpful, so I do not think anybody is suggesting that this is an area which is so devoid of risk that it should not be subject to the Directive, but that Directive should strike an appropriate and proportionate balance in its requirements against the likely risks, and we should not lose sight of the fact—going back to Lord Trimble’s earlier observation about where the problem started—that there is not a lot of evidence that either hedge funds or private equity played a central role in the global financial crisis. So I support the EU’s involvement in this area and the Treasury has consistently done that; but we do not support the draft Directive as originally tabled.

Q412 Lord Moser: I would like to ask a supplementary question. We keep on coming up against this question of public opinion about the hedge funds and most public opinion probably thinks that they are rather bad news. We all understand that they did not cause the crisis and in fact in our Brussels’ discussions they were at pains to explain to us that the Directive had its birth long before the crisis occurred. I think there was a German worry, was there not, five years before the crisis. However, the crisis then came and that led to the Directive. One question is, given that there are 1,000 amendments ahead, do you still feel that on the whole the Directive is going in the direction of lessening, reducing and eliminating systemic risk, so that we can be fairly optimistic about the future? But secondly, going back to my supplementary, the role of hedge funds in all of this, nobody would argue that they started it or that they were the major influence, but on the other hand they set bad examples in banking behaviour possibly to banks, so they have been indirectly involved. So do you therefore feel that or is that just popular thinking?

Lord Myners: I think that the Directive as drafted is likely to be modestly additive to our ability to manage away systemic risk, but I do not think it is in any way central. What is very clear—and this applies to both hedge funds and private equity—is that the optimal way of managing systemic risk relating to debt finance should be through the regulation and supervision of the lender rather than the borrower.
The taxonomy of hedge funds is so extraordinarily wide that it is very difficult to generalise. They extend from the macro funds which take very large bets on big swings in currencies and interests rates and markets and commodities to very micro specialist funds which may be long-only or long-leverage or long-assured and may be activists in the sense of very concentrated portfolios where the manager seeks to influence corporate strategy and transactions, risk arbitrage and takeovers, so I find it very difficult to generalise. But what I would say is that my experience in fund management is that for hedge funds—and this is a community in which I work, and I think I can be fair here because I work both in the traditional and in the alternative areas—generally speaking the more talented managers are in the alternative area, and not altogether surprisingly because the fees are higher and therefore the rewards are higher; that is an incentive effect which is what the clients appear to wish. I also think that hedge funds managers are more attuned to risk than conventional managers. In a very simple way the hedge fund managers, rather than exploit volatility they are actually trying to manage away volatility; they are trying to take the tops off mountains to fill in the valleys; they are trying to produce absolute predictable returns, but they are not perhaps as good at doing that in the light of the experience of 2008 than they previously would have asserted. So I am not one who signs up to the view that all hedge funds are bad and that they are pregnant with risk—I think there is a lot of talent and a lot of skill in that area—but that is not to say that there are not those who fall short of the skills or behaviours that were judged to be appropriate. I would make a similar generalisation, Lord Moser, about private equity. It is broadly a beneficial and good way of running money, of accessing new investment opportunities, but we clearly saw that they became rather over-addicted to leverage as a result of which some rather good companies at the moment are struggling with rather inappropriate capital structures, but I would not dismiss private equity as being something which was therefore fundamentally bad and should be impeded in the future as a form of ownership. **Lord Myners**: I think that setting leverage caps in advance could, in certain circumstances, increase systemic risk by forcing a fund or a manager to sell assets—and this was a feature common to a number of managers and funds; you could anticipate a downward spiral in valuation. The potential for such perverse outcomes means that a high degree of judgment, I believe, is required from supervisors over this whole question of leverage, rather than the simplistic leverage cap, and this is the basis for the new system of monitoring and controlling hedge funds and markets which the Government and the FSA has been developing. I cannot pretend that getting the judgments right on how to employ these powers is easy. The FSA will have to weigh competing risks—on the one hand acting too early and on the other of being too late; so we need to develop more understanding and the FSA’s knowledge in this area is really extraordinarily high. Mr Dan Waters of the FSA, has appeared before you in the past, is a world expert in the regulation and supervision of this area. There are two main types of risk that excessive fund leverage can cause. The first is the risk of market disruption when hedge funds are forced to unwind—they are forced to de-leverage too quickly. This risk, as I have already said, will be addressed through regulation and hedge fund managers and judgments around that. The second risk is that highlighted perhaps most clearly in recent memory by the experience of long-term capital management in 1998 and a firm that was run by a series of Nobel prize winners in economics, a model which others, I suspect, are still trying to emulate; and indeed the man behind long-term capital management managed to raise two funds after that, at least one of which had a very similar poor outcome for investors to the original LTCM fund, which just shows that one should always be alert. But the risk of that sort of very high leverage for an individual fund, which could in systemic terms compromise a bank’s solvency, must best be controlled through effective regulation of the prime brokers. In most cases the prime brokers are parts of major banks and are subject to banking regulation and, as I said earlier, no other banking regulation of which I am aware is one where we try to control the risk of reckless lending by regulating the borrower. We regulate the lender and I think there is no reason why that should not also be the case for hedge funds and other private equity.

**Q413 Lord Trimble**: We heard from previous witnesses that there were circumstances where leverage caps could in fact increase systemic risk. The question would be how should leverage limits be used to reduce risk and do you think that higher capital requirements on prime brokers could indirectly impact on hedge funds’ leverage?

**Q414 Lord Trimble**: We were told that it was long-term capital management; that a rescue was organised and the people who constituted the rescue made a huge amount of money out of it. **Lord Myners**: I think they did but the investors did not because from recollection the banks who were obliged to step in did so on pretty favourable terms,
and I think that the poor original investors in long-term capital management stayed there forever and lost the vast majority of their investment, but it did not stop Mr Meriwether raising two subsequent funds.

**Chairman:** I am now pushing my luck, Minister, but do you think I could get our question asked and answered on balancing the Directive.

**Lord Woolmer of Leeds:** One of the criticisms early on in the Directive was that it was a one-size-fits-all approach. Can you update the Committee on whether this argument has been accepted in Brussels and how has the Directive been amended to help alleviate this problem?

**Lord Myners:** The Committee made this observation earlier and I commend the Committee for its conclusion in that respect. The argument that one size fits all is an inappropriate approach to this Directive has gained near unanimous support in Council. I also believe that many MEPs in the European Parliament who have also taken a view on this have reached the same conclusion. However, the question is of course one of how to tailor the Directive to ensure that it does indeed fit all sizes and this is where the debate continues to lie. There are a number of small but important amendments which have already been broadly agreed. First it will be made clear that the requirements for assets to be safe-kept by an independent depositary will only apply where this is practicable in the view of the assets concerned. So it will apply, for instance, to listed shares and bonds but not for derivatives, unlisted, illiquid shares or for real estate. This is a very important adjustment for private equity and real estate fund managers. The requirement for an independent valuer is also likely to be significantly relaxed. This requirement was inappropriate for private equity funds where interim valuations do not determine returns to investors or the manager’s fees. Equally it is quite clear that the liquidity rules should not apply to closed-ended funds, and investment trusts—something of which Britain—Scotland, England—can rightly feel enormously proud—and should not be required to comply with a liquidity rule when shareholders have no right to redeem their shares. We expect that requirement to be dropped as a consequence of the Swedish proposals. We are also pushing very hard to have different capital requirements for private equity managers, reflecting the lower risk of their disorderly failure and systemic risk potential. This is an area where it has been harder to secure support from some Member States, which already impose high capital requirements on private equity, but we argue that those capital requirements are inconsistent with the nature of the funds and that is a view that is certainly shared by the Swedish Presidency and by a number of the MEPs with whom I have met in Brussels and here in London. So I think we are making very good progress across a wide number of areas. In particular, if I did a list several months ago of the principal concerns of the hedge fund community on the one hand and private equity on the other, I think we can report considerable progress on their primary areas of concern. The one which I think is continuing to be very challenging is the one we addressed right at the beginning, which is the third country funds and passporting, where I think we will get an outcome which is more than acceptable from the perspective of UK investors, pension funds and others, but not one which is in the best interests of Europe in terms of stimulating competition and offering the widest possible choice for investors throughout the European Community.

**Chairman:** We have another question about data and what the regulator is provided with, but you offered us an hour and a half and you have given us rather more and I would be happy to accept a written answer on that one.

**Lord Myners:** I would be delighted to provide a written answer. I now need to go and refresh myself for my engagement with you in two hours’ time!

**Chairman:** Minister, you will see us all again very soon. I did feel that you might have had enough. Thank you very much; that has been most useful. I did feel that you might have had enough. Thank you very much: that has been most useful. I am sorry that we had two different subjects at once but this has been very helpful in terms of the debate tonight and extremely helpful in terms of our deliberations on the AIFMD.

**Lord Myners:** I always enjoy meeting with this Committee and I hope that my answers have been helpful. I certainly on many occasions have left the Committee either with strengthened views or revisited some of my arguments in the light of the questions, and so I appreciate the support that the Committee has provided to the process on the AIFM Directive. Thank you very much.

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**Supplementary letter from Lord Myners, Financial Services Secretary, HM Treasury**

I would like to thank you and your Committee for the recent opportunity to discuss the AIFM directive. I am writing now to answer the questions we did not have time to get to in the evidence session.

Your first covers data collection by supervisors, how to limit it data which are systemically relevant and the role of the ESRB.
Deciding exactly what information fund managers should provide to their regulator is one of the questions the FSA is grappling with in developing its hedge fund survey. So far, the survey has focused on the larger funds that have a greater potential impact on the effective functioning of markets. The FSA is seeking to refine its approach as it develops the survey. The Commission’s proposal as drafted would mean that all UK fund managers would be forced to provide the prescribed information to the FSA—irrespective of whether the FSA believes that the information is important for the monitoring of systemic risk.

The Government wants to ensure that the FSA can target its market monitoring as effectively as possible. There are clearly a large number of funds with little or no systemic relevance. We consider that a fund manager should only be required to make available the prescribed information to its supervisor. This would allow the FSA to request all the information it needed to monitor markets but not force it to waste resource collecting irrelevant data. This approach would be achieved by the latest compromise text prepared by the Swedish Presidency. All AIFM would provide basic summary data to their supervisor. These basic data would allow supervisors to make an informed assessment on which managers they needed to subject to more intensive oversight. The directive would provide for them to collect detailed data from these managers.

Supervisors should use the information that they collect to monitor the impact of a fund’s activities on systemically important markets and to decide whether and how to intervene to avoid systemic risk.

The ESRB is being set up to better identify risks in the financial system. There are provisions in the legislation that enable the ESRB to collect the information it requires to fulfil its tasks—from the new European Supervisory Authorities, national competent authorities and, in exceptional cases, individual institutions. It is only right that the ESRB has the information it requires in order to build up a wholesale picture of the EU financial system, to enable it to identify any emerging risks.

This information is subject to a number of confidentiality conditions. In addition, ESRB requests for further information than that which is readily available in collective form must be reasonable and proportionate.

Your second question is how can a fair balance be struck in the Directive between guiding principles (level 1) and implementing measures (level 2)? Deciding what elements of the legislation are incorporated in Level 1 or Level 2 is not always straightforward. Level 1 should establish the core values and framework for the legislation. Level 2 is the vehicle for implementing measures fleshing out the principles in the Level 1 legislation.

This directive includes a large number of level 2 provisions—no fewer than 23 to be precise. We believe on balance that too many level 2 provisions have been included.

In particular, we believe that there should not be a Level 2 provision giving the Commission power to propose quantitative liquidity thresholds which would require different types of funds to hold pre-determined shares of their total assets in cash or liquid securities.

Given the broad range of fund types covered by this directive, we do not think it will be possible to set appropriate thresholds covering all cases. The focus should instead be on requiring managers to have appropriate policies for managing liquidity risk and ensuring the liquidity of their funds’ assets is consistent with those funds’ redemption policies.

Another example of a level 2 provision that we disagree with is the Commission’s power to set ex-ante leverage caps on funds.

Your final question was in relation to the fact that the latest Swedish draft would impose a bonus cap on fund managers and you wanted my comments on this proposal.

I must first say that the Swedish proposal does not to impose a cap on bonuses. However, it does address limiting the amount of bonus that can be taken immediately and what should be deferred for at least three years (40% or 60%) where the bonus is a particular high amount relative to the fixed income. It also covers the need for greater public transparency of higher earners.

As the G20 leaders agreed in Pittsburgh, it is necessary to impose appropriate controls on remuneration at all significant financial institutions. In this context, the Government has already taken steps to ensure that remuneration paid at systemically significant financial institutions is commensurate with a prudent approach to risk and leads to long-term value creation.

The FSA code, which comes into force on 1 January 2010, includes requirements for deferral and clawback from significant banking and other institutions. In addition, the Government is taking legislative measures in the Financial Services Bill that will strengthen the FSA’s hand and enable improved disclosure of remuneration, which in turn will facilitate better shareholder oversight of risk.
However, the rules in the AIFM Directive should recognise that the majority of fund managers are not systemically important. We also consider that it is inappropriate to simply copy across the policy on this in the Capital Requirements Directive that was agreed for banks (the genesis of the requirements proposed by the Presidency). So we believe that some further tailoring to the Swedish proposal is necessary. We have been successful in achieving some of these changes in subsequent drafts of the Presidency compromise. For example, it now no longer requires disclosure of the individualised amount of remuneration but rather aggregate data. However, we continue to argue for change so that the timetables for deferral of bonuses should reflect that investment funds have different time horizons.

I hope that my answers have been helpful to your deliberations.

7 December 2009
TUESDAY 24 NOVEMBER 2009

Present Cohen of Pimlico, B (Chairman) Trimble, L Haskins, L Woolmer of Leeds, L Northover, B

Memorandum by Citadel Investment Group

QUESTION 1

(a) What economic benefits arise from Alternative Investment Funds?

Benefits to the UK economy
Lord Myners has already outlined the benefits to the UK economy deriving from Alternative Investment Fund Managers (“AIFM”). Based on International Financial Services London research, 20% of global hedge fund Assets under management (“AUM”) in 2008 were in Europe. Of this 20% London accounted for circa 18% of global AUM (thus close to 90% of European AUM). As a share of the number of managers, London had two-thirds of European managers at the end of 2008. The economic benefits of tax revenues and direct and indirect employment speak for themselves. For this reason, our submission focuses on the economic benefits to markets and investors.

Investment choice
AIFM provide sophisticated investors with investment choice. AIFM are able to respond quickly to investor demand for specific products. Demand for such products and investment return will increase in Europe given the ageing demographic and consequent pressure on pension funds to achieve high returns. A number of Dutch pension funds, for example, have raised these concerns stating that “the current Directive may reduce investment opportunities and risk diversification, lead to higher costs and lower returns”.

Capital provision and risk transfer
AIFM play a significant role as capital providers and in facilitating risk transfer in modern economies. They are a major source of risk capital in certain sectors (like convertible bonds and mezzanine debt) that are not well served by either depository institutions or traditional asset managers. In addition, they are an alternative source of liquidity and contribute to well functioning capital markets. Both of these activities lower the cost of capital to companies and consumers.

Liquidity
AIFM have traditionally been a major provider of liquidity in equity markets. AIFM are willing to take offsetting positions and provide liquidity to market participants. By developing superior hedging technology to manage their risks, AIFM require a smaller price concession to provide liquidity. This has lowered transaction costs for regular market participants and investors.

Exchange platforms
AIFM have been key players in the post-MiFID landscape both as major liquidity providers on traditional exchange platforms along with the new generation of Multilateral Trading Facilities (“MTF”) that offer platforms that seek to increase competition in equities execution. AIFM have also been able to act as providers of capital to a number of these new platforms. An example of this is Citadel Securities’ recent investment in the Equiduct platform that operates a pan European electronic trading platform for the Borse Berlin AG, a Recognised Investment Exchange. The Equiduct platform seeks to provide an all-in-one solution for trading equities in an increasingly fragmented European market. It also assists market participants in satisfying their best-execution obligations to their clients, by providing price transparency and price improvement across a number of European markets.
Technology provision
As other markets like foreign exchange and the trading of government debt have migrated partially to electronic markets, AIFM have extended the technology to these markets, benefiting a broader group of investors.

Price discovery
Similarly, AIFM devote significant resources to undertake research about companies and the broader economy. By making investment decisions based on the findings of their research, AIFM help ensure that prices reflect the true economic prospects of a company. For example, CDS provide a far better gauge of a reference entity’s creditworthiness than ratings that do not reflect this depth of analysis and are paid for by issuers.

Market efficiency
Investment organisations are becoming increasingly specialised in providing either market exposure (Beta) or superior investment performance (Alpha). This separation of “Alpha” from “Beta” is demanded by investors so that they can monitor risk and performance in a transparent manner. There are natural limits to the scale at which “Alpha”—capture organisations can operate. If they are large relative to a sector, they cannot execute their ideas efficiently. In contrast, most traditional financial institutions (banks, insurance companies and “Beta” replicating investment firms) benefit from increasing returns to scale. In fact, the financial crisis has resulted in increased concentration in investment banking and money management. This has reduced competition in these markets and in the long run leaves us more vulnerable to systemic risk. While prudent regulation can help mitigate the systemic risk, AIFM can play an important role by providing competition to the financial supermarkets thereby increasing market efficiency without posing macro economic risks. In short, AIFM reduce risk concentration and drive down transaction costs.

(b) What risks to financial markets arise from Alternative Investment Funds?
We firmly believe that no AIFs in today’s market place are large enough to pose systemic risk by themselves.¹

Herding behaviour
It is possible that, if the activities and positions of certain AIFM are known in the marketplace, herding behavior can result in many participants having identical or similar positions. Such herding behavior can magnify price volatility both as prices move up and even more dramatically in declining markets due to forced de-leveraging. There are two complementary ways to address this problem:

First, transparency
If all AIFM are required to report certain position data to a regulator, the regulator can aggregate data across institutions to assess the concentration of risk. The UK Financial Services Authority has been piloting a questionnaire that seeks to gather such data. The challenge is to ensure that the information is meaningful, “like for like” and treated with an appropriate level of confidentiality at a firm level.

Secondly, by requiring a centralised clearing house
For standardised contracts (versus bilateral clearing) regulators can reduce the risk of forced de-leveraging caused by uncertainty about the credit worthiness of counterparties. Furthermore, encouraging the migration of trading to electronic exchanges with centralised clearing can preserve anonymity of trading thus minimising the herding behavior that is at the root of this source of systemic risk. Centralised clearing of products will also help address the transparency issues. Additionally, as contracts are standardised and move to a centralised clearing house (increasing price transparency and making it easier to transact in such instruments), liquidity increases and the Bid Offer spread decreases. This reduces costs for all investors including corporations, pension funds, insurance companies and AIFM.

¹ Long Term Capital Management (“LTCM”) is often cited as a contrary example. Nevertheless, the systemic risk in this case related not to the positions in LTCM alone but primarily to the high level of correlation between LTCM and other large financial institutions.
Need for risk-management processes

AIFM can create “micro” risks for their investors by not having a systematic investment process or ignoring prudent risk management principles. Most institutional investors expend significant resources in ensuring that the managers they select have rigorous investment processes in place. However, not all institutions have the scale and expertise to conduct a thorough due diligence of the mechanisms and technology that an AIFM has in place to manage liquidity, market, counterparty and operational risks. The proposed Directive can be helpful in conjunction with national regulators in ensuring that risk management is taken seriously (the Directive requires separate reporting lines for risk management and investment teams) and meets a certain threshold of accountability. Similarly, guidelines in disclosure and reporting can ensure a level of transparency between the AIFM and the investor.

(c) Will the Directive help reduce these risks?

The Directive, as drafted, does little to address the risks of herding outlined above. Moreover, by adversely impacting AIFM, there is a risk that the Directive could reduce the benefits which AIFM provide, namely investor choice, reduced concentration risk, and provision of capital and liquidity. These benefits are more important than ever at a time of recession. AIFM are part of the solution. They will provide capital to economies that need to recover.

QUESTION 2

(a) To what extent is there a need to create a single regulatory regime for Alternative Investment Fund Managers in the European Union?

It is generally agreed that AIFM were not responsible for the financial crisis. This was highlighted in a number of the reports that have been carried out following the crisis including the Turner Report and de La Rosiere report. As such we believe it is critical that any regulatory response directed specifically towards AIFM is proportionate to the risks posed by AIFM.

Nonetheless, we agree that AIFM based in the EU should be the subject of appropriate and proportionate registration and authorisation requirements. Many AIFM based in the UK have been the subject of regulation by the FSA for a significant period of time. Whilst enhancements, particularly surrounding transparency, may be required, we would underscore the effectiveness of this regulation. The creation of a level playing field with respect to AIFM regulation across Europe is a desirable outcome for a free and open European market.

We believe that the proposed EU Directive on Alternative Investment Fund Managers (the “Directive”) should focus on issues of financial stability and systemic risk, based on proposals for transparency and disclosure. We do not think it appropriate for the Directive to seek also to introduce a single EU passport for the marketing of AIFM, although we accept the advantages of such a passport in the longer term. For now, we believe that Member States should be able to maintain their private placement rules, either in parallel with the Directive, or pending full consultation surrounding the appropriate form of regulation to support an EU-wide passport for the marketing of AIF.

(b) Does the Directive achieve its objectives?

We welcome the general objective of the Directive, which is to achieve a complete and consistent framework for the supervision and prudential oversight of AIFM. However, we are concerned that the Directive as drafted will not achieve its stated objectives, or will do so in inappropriate or disproportionate ways. We have a number of specific concerns.

Legislative simplicity

Financial services within the EU are already governed by a number of EU Directives stemming from the Financial Services Action Plan, for example MIFID. It is important that a new AIFM Directive does not cut across existing legislation.

Scope

Investment funds are managed by a wide range of different institutions. It is important that the Directive treats all types of institution equally. We are concerned that some of the provisions put AIFM at a disadvantage vis a vis other regulated financial institutions in the EU. For example the imposition of particular disclosure and short-selling provisions in the Directive are applicable only to AIFM.
Any European requirements must, however, be seen in the broader global context. We are concerned that the Directive is being adopted in the EU under an aggressive timetable that does not take into account global regulatory initiatives, for example, those proposed by the G20.

Impact assessment

An impact assessment was prepared by the Commission in respect of the Directive, but it is widely acknowledged that it falls well short of the EU “Better regulation” principles and what could reasonably be expected given the likely effect of the Directive. The Commission’s own Impact Assessment Board raised concerns about the first draft of the impact assessment and expressed reservations even about the latest version. In particular, the assessment does not attempt to estimate the economic impact of the measures contained in the Directive, either on financial markets or on the economy more broadly. We therefore support calls for a revised impact assessment which seeks objectively to measure these effects.

Depositaries

The provisions in the Directive relating to depositaries are unworkable in at least three important ways.

— First, the Directive places strict liability on the depositaries of AIF assets. This will either deter many existing providers from offering depositary services, or vastly increase the cost of doing so.

— Second, as drafted, the Directive only permits EU Credit Institutions to act a depositaries for AIF. As a result, large numbers of international prime brokers would be potentially excluded from the AIF space in Europe thereby significantly reducing competition and increasing risk concentration in the institutions still able to provide these services.

— Third, the requirement to use EU credit institutions as depositaries will effectively limit the ability of AIFs to invest in emerging markets assets, since such assets need to be held with local depositaries outside of the EU.

The impact of these provisions on depositaries will ultimately be borne by end investors, who will experience both a knock-on increase in the costs of investing and reduced investment choice. We applaud the objective of increasing investor protection, but we believe that many of the concerns surrounding depositaries stem from national insolvency laws. As a result, they are better dealt with at a national level, rather than in this Directive.

Independent valuator

The requirement for an “independent” valuator runs the risk of adopting legal formality over substance. AIFM are varied in their size, structures and operations. As such, they are not conducive to a single one size fits all approach with respect to independence. IOSCO’s Principles for the Valuation of Hedge Funds, in contrast to the Directive, identifies nine principles that should apply to hedge fund portfolio valuation. These principles focus on the importance of consistent valuation procedures that are applied consistently and in a transparent fashion. At the same time, it recognises that hedge funds are varied in their size, structures and operations and as such stops short of mandating a particular approach with respect to independence. We support IOSCO’s approach which is in line with the approach taken by AIMA and the HFSB.

Cross-border marketing and third-country funds

Of particular concern to us is the cross-border impact the Directive would have on AIFM. Citadel is a significant global alternative investment manager which was founded in the United States and is structured on an international basis. The model we adopt is similar to that adopted by many international managers who generally operate funds based outside the EU. Such international managers, many of whom have a significant presence in the EU, will be affected by a number of the provisions of the Directive, particularly those relating to marketing third country funds and the delegation of certain functions outside of the EU (for example valuation, administration and depositaries).

Whilst the creation of a single market for the marketing of AIF to institutional investors in the EU is a commendable objective, we are concerned that the provisions as drafted could operate to preclude third-country funds from EU investors. This would disadvantage international groups that are less likely to be able
to re-structure to bring their funds on-shore. Also, and more importantly, it would limit access by EU investors to a significant number of sophisticated international AIFM. According to the ECB August 2005 report, some 91% of AIF were domiciled outside of the EU, accounting for 89% Global AUM.\(^2\)

The provisions bite particularly hard on international firms that choose not to have a presence in the EU. EU investors will simply be denied access to these AIF, notwithstanding the sophistication of the individual investors. This amounts to a closure of the EU capital markets to large number of investment opportunities that are currently open to them under existing national private placement rules. We do not believe the equivalency provisions that are currently contemplated by the Directive will operate to address this issue. Whilst these are a good idea in principle, historical efforts on mutual recognition are clear evidence that this approach is exceedingly difficult to implement in practice.

In addition, we are concerned about the ability of EU-authorised AIFM to market offshore funds after the transition provisions have fallen away. The marketing of such funds is subject to the existence of a tax-sharing agreement between the AIF domicile jurisdiction and the member state in which the fund in question is to be marketed. It is completely inappropriate to tie the marketing of funds to the implementation of a tax initiative in this Directive which relates to financial services. Any Directive in taxation should be dealt with as such. It is also hard to see how this particular provision falls within any of the objectives of this particular Directive.

Finally, we do not believe that institutional investors are seeking the type of regulation and protection that aspects of the Directive are mandating.

**Transparency**

The objective of proper monitoring of macro-prudential risks is key to enhancing regulatory oversight of the financial markets as a whole. We therefore welcome enhanced transparency, subject only to the caveat that the information collated is meaningful and treated with an appropriate level of confidentiality at a firm level.

**Leverage limits**

The provisions of the Directive that provide for the setting of hard leverage limits, combined with the ability of regulators to intervene at times of market turmoil to reduce leverage, could, in our view, work against the Directive’s stated objectives and increase macro-economic risks. Firstly, it is unclear how leverage should be defined. Secondly, a firm that has locked in robust lines of liquidity, negotiated on a commercial basis, could be forced to de-leverage when its liquidity profile is not compelling it to do so. Regulatory intervention to force such deleveraging, which would presumably occur only at times of market stress, could backfire. This is because the threat of forced deleveraging could increase uncertainty, enhance the risks of fire sales and encourage irrational behaviour.

(c) _Should the objectives of the Directive be modified?_

We do not believe that the key objectives of the Directive require modification. As outlined above, we are very concerned about the mode of implementation that certain aspects of the draft Directive has adopted.

**QUESTION 10**

(a) _How does the Directive compare to existing or proposed regulation of Alternative Investment Funds outside of the European Union, particularly that of the United States_

Historically, the US has required the registration of publicly offered pooled investment funds (referred to in the US as investment companies) but has exempted most private funds, including hedge funds and their managers, if certain conditions are met. The US is now proposing to register virtually all fund managers, but not the underlying funds. The leading US proposals, discussed further below, do not impose detailed regulatory rules on private funds comparable to the regulations applicable to investment companies.

Below is a simple table highlighting some key differences between the US and EU approaches. We attach an Annexe giving more detail. We would be happy to give oral evidence on this issue.

<table>
<thead>
<tr>
<th>Issue</th>
<th>US</th>
<th>EU</th>
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<tbody>
<tr>
<td>Registration for fund manager/adviser</td>
<td>Yes</td>
<td>Yes</td>
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<tr>
<td>Registration for fund</td>
<td>No</td>
<td>?</td>
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</tbody>
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\(^2\) ECB, Occasional Paper Series, No 34 August 2005 “Hedge Funds and their Implications for Financial Stability”.
Alternative Investment Fund Manager Directive: Evidence

<table>
<thead>
<tr>
<th>Issue</th>
<th>US</th>
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<tr>
<td>Leverage limits</td>
<td>No*</td>
<td>Yes</td>
</tr>
<tr>
<td>Liquidity management rules</td>
<td>No*</td>
<td>Yes</td>
</tr>
<tr>
<td>Minimum capital</td>
<td>No*</td>
<td>Yes</td>
</tr>
<tr>
<td>Independent valuation</td>
<td>No**</td>
<td>Yes</td>
</tr>
<tr>
<td>Independent custodian</td>
<td>No**</td>
<td>Yes</td>
</tr>
<tr>
<td>Cross-border marketing restrictions</td>
<td>No***</td>
<td>Yes</td>
</tr>
</tbody>
</table>

* Current proposals would impose such requirements on advisers and funds that are systemically significant.
** There are no explicit requirements for independence but proposed rules would impose certain verification obligations.
*** As long as funds are marketed privately and only to investors meeting certain eligibility criteria.

Annexe

US Fund Regulation

Current Regulation

— The US has typically approached regulation of pooled investment funds through requiring registration either of the fund itself or of the fund manager unless an exemption or exception is available.
— Most private funds have been excepted from registration because they have not made a public offering and either are owned by a limited number of investors and or are owned solely by sophisticated investors. Private fund managers have not been required to register in the US if they do not offer their services publicly and have fewer than 15 clients (each fund is considered one client and the fund’s underlying investors are not counted for these purposes).
— Unregistered private funds and managers are subject to prohibitions against fraud and manipulation and all of the market conduct rules that apply to investors generally.

Current Practice

— While managers are not explicitly required to do so, and funds are not explicitly required to do so unless they are sold to non-accredited investors, private fund managers typically provide potential investors with certain disclosures about the fund similar to what would be required if the fund’s securities were registered, such as how the fund operates, fees, potential conflicts of interest, and permissible investment strategies.
— Broad discretion is generally retained by the manager with respect to investment strategies.
— Investors typically receive performance information, risk analysis, and portfolio profiles.
— Most private funds retain auditors to conduct independent audits using generally accepted accounting principles, and to provide some independent review of the fair value of fund assets. This is not explicitly required by US law.

Regulatory Proposals

— The leading regulatory proposals in the US would require registration of virtually all fund managers. They would not regulate the funds themselves but fund managers would be subject to comprehensive reporting, recordkeeping and examination requirements.3
— Managers also would be subject to other requirements in the existing regulatory regime for registered advisers, including the adoption of compliance policies and procedures and some limitations on advisory fees.

3 In addition to the proposal submitted by the Obama Administration, which would require registration of private fund managers who have more than US$30 million in AUM, two other bills are pending in the US Congress that would require registration of managers. The “Hedge Fund Adviser Registration Act of 2009,” introduced in January in the House of Representatives by Michael Capuano and Michael Castle, and the “Private Fund Transparency Act,” introduced in the Senate in June by Senator Jack Reed both would require registration of private fund managers. A bill introduced in January by Senators Charles Grassley and Carl Levin would require registration of funds (rather than managers) with at least US$50 million in assets or AUM. There is considerably more support in the US, however, including from the SEC, for registration of managers rather than of the funds themselves.
Under current proposals, only fund managers determined to be systemically significant because of the combination of their size, leverage, and interconnectedness with other critical market players would be subject to any capital, leverage, liquidity, or investment strategy limitations.

**The US vs the EU Approach**

- **Leverage, Liquidity, and Capital.** Unlike the Directive, the US proposals would not impose limits on the leverage that fund managers could employ, appropriate liquidity management policies and strategies, or impose minimum capital requirements on managers.

- **Valuation of Assets.** The US effectively requires that a fund manager’s written compliance policies and procedures address valuation. But the law does not specify how or by whom assets should be valued. The Directive, on the other hand, would require independent valuations of assets managed by fund managers.

- **Custody of Funds.** The US does not currently require that all registered advisers use an independent custodian or that a custodian be a particular type of entity.
  - The US Securities and Exchange Commission has proposed rule changes that would impose additional obligations where the custodian is not independent of the adviser. In such cases, the adviser would need to obtain verification from an independent registered public accountant and a written report of an independent, registered public accountant on the custodian’s internal controls. If the custodian is not related to the adviser, only verification by a public accountant would be required.

- **Marketing.** The US securities laws do not limit non-public cross-border marketing of private funds as long as investor eligibility criteria are met.
  - With some exceptions for smaller funds with few US customers, the proposals would require non US fund managers to register in the US in order to market their funds to US customers. However, they would then be subject to essentially the same restrictions as registered US fund managers.
  - The Directive, on the other hand, would only permit marketing under a passport in the EU for the first three years by EU-regulated managers with respect to EU funds. Offshore funds, even those managed by EU-regulated managers would not be able to rely on the passport and after the first three years would have to satisfy the tax information sharing provisions to be marketed in the EU under the passport.
  - Non-EU—for example US—managers would be required to wait for three years and prove equivalence of regulatory schemes before being able to market their funds in the EU.

September 2009

**Examination of Witnesses**

Witnesses: Dr Patrik Edsparr, Chief Executive Officer, and Miss Rebecca Fuller, General Counsel, Citadel Europe; and Mr Adam Cooper, Global General Counsel, Citadel Investment Group, examined.

Q418 **Chairman:** Good morning. Thank you all very much for coming. May I begin by explaining that we are all being recorded and you will be sent a transcript of the session in order that any infelicities can be looked at and straightened out. You are, the last witnesses but for the fact that we are seeing a prime broker next week. We have already talked to a number of people including various people in Brussels and our own ministers. There are two ways that we can go with this. You have seen the questions and indeed have attempted written answers to some of them. Would you like us to begin with the questions or is there a general statement that you would like to begin with? Whichever you would like to do will be fine.

Dr Edsparr: Thank you. I want to express our gratitude for being asked to participate in these proceedings. These are obviously contentious topics and we really appreciate the time the Committee is taking to explore fully the subject. My name is Dr Patrik Edsparr and I am CEO for Citadel Europe. To my right is our General Counsel who is based...
in Chicago, Mr Adam Cooper, and to his right is my General Counsel in the UK, Miss Rebecca Fuller. Thank you very much.

Q419 Chairman: Perhaps I could begin by asking you for your view because you are the first Americans we have seen, we have only seen European-based hedge funds so far. What systemic risks do the alternative investment funds propose and to what extent do you think the hedge fund industry is systemically significant?

Dr Edsparr: I think that something that gets lost in a lot of the debate is how heterogeneous and diverse the so-called hedge fund community is. You are talking about, I believe, in excess of 6,000 different funds with strategies that vary from different rates based relative value strategies to distressed debt. It is really, I would argue, more diversity across the spectrum that was labelled hedge funds than almost in anything else, certainly compared with the big banks which all tend to have a very similar business model. I would not rule out that there could be certain position concentrations across hedge funds—traditional banks, traditional asset managers, insurance companies and so forth—and I think that there is a legitimate need for a regulator to know what some of those position concentrations can be but, as an industry, we largely represent something very diversified and act as a safeguard to not being exposed to too many of the "too big to fail" risks and systemic breakdown. I think that it is important to note that, despite the massive gyrations in the market and the stress on the system, not a single hedge fund demise—and there were thousands of them, literally—caused any systemic disturbance to mention. I think that the issues are very, very different for the alternative investment community than they are for the major banks.

Q420 Chairman: I suppose that the thing about the alternative investment community is that it has grown so much in the last 20 years and we have had some anecdotal evidence to suggest that the hedge fund community is now so big that, in the ordinary course of business without doing a single thing you could frown on, they are big enough to destabilise some of the big investment banks if they all withdrew funds at once as I believe happened.

Dr Edsparr: I think the causality goes the other way. The reason that there was some strain on the hedge fund community was that the big banks withdrew the funding, because obviously the whole financial system is based on the central bank providing emergency liquidity to the major banks, and when the banks do not intermediate in that liquidity extension then the people who are beholden to the banks as intermediaries are exposed. That may be a separate subject matter, but I think that there is a legitimate question about how the liquidity provision in today’s marketplace should take place and it may not be optimal that it always just goes through the window and through the major commercial banks. I think that the hedge funds are at some level dependent on the financing arrangements that largely happen through the banks. If the banks have access to liquidity from the Bank of England or the ECB or the Fed but the banks start to hoard cash and start to cut all the financing lines, it does not matter whether you are a hedge fund or if you are a corporation or if you are an individual because, if those financing lines disappear, most of those participants have no other source of financing. It is absolutely correct that that would cause some strain for some people including us but I think that systemically the demise, because of that withdrawal of liquidity and withdrawal of financing, actually did not any cause any systemic threat.

Q421 Chairman: I think that we were reasonably convinced that the banks had not suffered, but the banks had, on the whole, got their money back from hedge funds and hedge funds have gone down. Are hedge funds in a position of holding large deposits with banks that they withdraw or can withdraw or might have withdrawn?

Dr Edsparr: I think that this ties to the prime brokerage issue. I think that any well-managed hedge fund will have a very significant proportion of their assets in an extremely liquid form and, for a number of hedge funds, that means holding cash on deposit with their prime broker. I think that the demise of Lehman Brothers was disturbing to a number of people because they could not access that cash/liquidity reserve. It is absolutely part of prudent risk management to keep a very substantial portion of your assets in cash or cash equivalence to be able to meet short-term troubles.

Chairman: Indeed.

Q422 Baroness Northover: Picking up on My Lord Chairman’s first question which was, had they grown to such a size that they could have a systemic effect, you then turned that around and said that actually they were affected by what happened. If they do indeed hold large deposits in the way that you say, if funds were to decide to withdraw these deposits, that could have a systemic effect, could it not?

Dr Edsparr: I do not think that hedge funds represent any significant portion of the deposit base for the banks. That is very, very marginal. The hedge funds are net recipients of financing. On average, hedge funds own more assets than they have equity, so they need financing on some of those assets, and that is where the banks typically play a role. The only area where hedge funds can significantly contribute to systemic risk is if one particular position, let us say...
the insured Bank A versus Bank B, if it just happens to be that a lot of hedge funds at the same time as many of the banks and as maybe many of the traditional players, assets managers, insurance companies and so on, if they all end up having the same position, maybe out of coincidence or for whatever reason, I think you can argue that that can create technical pressures in the market.

Q423 Baroness Northover: Of course that was something which was seen and addressed, was it not, that short selling seemed to be undermining institutions where there was some sort of a question mark?
Dr Edsparr: My view, and speaking as a trained economist I guess, is that short selling is actually one of the few safety valves we have against bubbles. I find it intellectually very disingenuous, on the one hand, to say that we want to prevent bubbles, we want to prevent excessive speculation and risk taking, which are largely driven by long positions, borrowing to buy more and keeping the asset values going up and, on the other hand, to say that when those bubbles correct the short sellers are the damaging force. Short sellers keep those asset bubbles within some rhyme and reason when you have a bubbly market.

Q424 Baroness Northover: What pops the bubble?
Dr Edsparr: There is a combination of technical factors and fundamentals that pop bubbles. I cannot say that I have any secret insight as to when that happens, whether it is tulips in Holland or real estate in the US suburbs or, as a Swede, I guess I have a little bit of perspective from the Swedish real estate prices in the early 1990s. I do believe that short sellers play an extremely valuable function in forming efficient prices in the marketplace and I think that there is a crucial difference between saying that, in one particular name and at one particular time, the number of positions add up to too much, so that it is justifiable for a regulator to say, “Well, let’s stop now in this name” as opposed to any kind of blanket restrictions.

Q425 Lord Haskins: The logic of what you said about the hedge fund reliance on the banks for their cash would suggest, if you regulate the banks properly, that is where the systemic risk arises and, if you do that properly, then the banks themselves would be the regulator of the hedge funds because they are the ones who provide the money and, if they are providing money in an irresponsible way, then it is the banks who pay the price. You could argue that there are other reasons for regulating hedge funds but systemic risk does not appear to be one.

Dr Edsparr: I would largely agree with that. I think that the key in this equation is the capital structure and the regulatory regime around banks and obviously that filters through to the access to leverage and financing for other participants. I would say that it is the regulatory regime around banks on the one hand and the access to emergency liquidity from the central banks which are the two macro-levers that, as regulators for setting the stage for the financial market, I believe are the two key features.

Q426 Chairman: I was trying to establish whether hedge funds are now large enough that if, in the normal course of business and perfectly legitimately, they remove all their cash deposits from the banks because they are worried about the banks, they would be large enough to destabilise the bank? I think you thought not, Dr Edsparr.
Dr Edsparr: I do not believe so. Also, remember that, if you do not keep any cash on hold, you will not be able to borrow anything against your assets. Effectively, if you want to do that on a bigger scale, you would basically just collapse your business.
Mr Cooper: If I might add in response, the US regulators in particular are looking at enhancing the capital requirements applicable to banks so that they are required to post more capital, maintain more equity against their balances. What I think we found in the fourth quarter was that the system was under-capitalised and the banks had not reserved sufficient equity capital against their obligations and certainly great scrutiny is being put into that right now.

Q427 Chairman: They were, in short, relying too much on their depositors?
Mr Cooper: Yes.

Q428 Lord Trimble: There are US proposals as well as the EU proposals which we are looking at. I wonder if you could give us an indication of how the two sets of proposals differ.
Mr Cooper: Broadly speaking, I think they have similar goals of enhancing investor protection and guarding against systemic risk. The approach that the EU takes vis-à-vis these issues as compared with the US approach is, however, slightly different. The US approach—and again these are all just proposals now that are being considered—is based more on transparency, information and disclosure. I believe that the EU proposals are more prescriptive and rule based in nature.

Q429 Lord Trimble: If the EU proposals are more prescriptive rather than just being on the questions of transparency and disclosure, could this then result in a situation of these two regulatory structures developing in the way you have said, which is actually then going to be a commercial advantage for New
York based businesses and, consequently, EU businesses might suffer as a result?

Mr Cooper: You may be getting at the notion of, should there be some form of equivalency among regulatory regimes? I am not aware and I am not privy to the inner thinking of the regulators in this. I do not think there is any notion that they are trying to create a regime that would encourage regulatory arbitrage. I think what we saw more than anything in the fourth quarter of last year was the absence of harmonisation in communication among international regulators exacerbated. I think that there is a great drive now to harmonise the approach. You do not want to have the culture of a prudential regulator in jurisdiction A impacting a decision of where a participant goes if the culture of a prudential regulator in jurisdiction B is different.

Q430 Lord Trimble: If we are going to harmonise the regulatory structures and we have US proposals that are concentrating on transparency and EU proposals that are a little more rigid in terms of their operation, how is one then going to harmonise?

Mr Cooper: I think that there is a process in place where the regulators speak to each other. It is an aspiration; it is not necessarily something that can be achieved. I think that the best outcome though is an outcome that permits alternative investment fund managers to operate efficiently and smoothly in multiple jurisdictions. We are an international institution, we operate all over the globe, and it is important for us to be able to continue to keep doing so rather than to be arbitrarily precluded from one particular jurisdiction because of the absence, for example, of equivalency.

Dr Edsparr: I would add, also, that the ultimate decision makers obviously are investors. It is the investors, whether they sit in Asia, the Middle East, Europe or the United States, in terms of tax treatment and in terms of legal treatment. There are all kinds of reasons why you can only operate efficiently in one environment and I think that, in all these proposals, the devil is in the detail.

Q431 Lord Haskins: If we go into a little more detail on the two approaches to regulation, basically the proposal that the EU are putting forward and, you know much better than we do, the proposal being discussed in America. It seems to us that there seem to be three or four areas where they differ and I would like to get your comment. One of them is possibly different leverage requirements of the two regimes; the second one appears to be very important and is a moving scene and that is third-country investment and even the EU will tell you it is changing its position day by day on that; and the third one is a little related to that and that is marketing and scope of hedge fund activities.

Mr Cooper: I will speak briefly and then turn it over to my colleague, Miss Fuller. The EU proposal, as you suggest, would prescribe leverage, marketing and third party services in third countries as well as depository and marketing limitations. The US provisions that have been proposed do not prescribe or address any of those issues in the same way that the EU does. There are no mandated leverage limits or restrictions under any US proposal. There are some slight proposals with respect to marketing but, by and large, EU managers can market freely in the US their investment products provided that they become registered as investment advisers as US managers must.

Q432 Lord Haskins: Is that easy to achieve?

Mr Cooper: Yes, I believe it is. These are just proposals, but I am confident that the US will pass legislation requiring investment advisers to register and I think that the rules and the way in which they are satisfied will be equally convenient or applicable to US and non-US managers, and then we permit them to freely market within the US provided that they maintain compliance with various marketing and private placement rules that exist. These are all private investment funds, so it is not a public offering to retail.

Q433 Lord Haskins: Do you think that, if the proposal goes through, the gap in approach between the two regimes is widening or narrowing? We keep hearing that it is important that hedge funds can trade freely across the world. Is the gap in approach widening between the two regimes or narrowing?

Mr Cooper: I would like to defer again to Miss Fuller with respect to the EU Directive, but some of the prescriptions of the EU Directive I think would make it very challenging for an international institution to freely deploy capital throughout markets in the EU.

Q434 Lord Haskins: Including the recent Swedish compromise on third country private placement? Miss Fuller: I think that the third country private placement under the Swedish compromise text is definitely a step in the right direction. What remains unclear though is the ability of offshore managers to continue to market through the private placement regime into the EU and, just standing back, conceptually, nevertheless it is still going to be more difficult for third-country funds to be marketed in the EU. The Swedish text is definitely a step in the right direction but it is still a move away from the status quo which relies purely on the national private placement rules.

Mr Cooper: If it is harder to market, I think it is ultimately the investors in the EU who suffer the consequences of that with the absence of alternatives in deploying their capital.
Q435 Lord Woolmer of Leeds: Picking up that point, 80 per cent of funds managed by alternative investment fund managers are outside of Europe, overwhelming through the United States. I suppose that one could say that United States fund managers can do without Europe but European fund managers might find it not quite as easy to do without the United States and the rest of the world. In other words, if Europe has a regime that is tighter and much tougher and more regulatory than the United States, that could result in relative damage to investors in Europe compared with elsewhere in the world. First of all, is that a fair assessment of the way in which things could be going in Europe compared with the United States? It would be helpful to know that. Secondly, coming back to the point of arbitrage, if there are real differences, taking up Lord Haskins’s point, will the result be arbitrage or simply less business and less opportunities and choice for European investors, pension funds and so on?

Dr Edsparr: I believe that there are two aspects to this and you touched on both of them. I think there is one question of where you can conduct business as a hedge fund and the second issue is where you can attract capital from. If I may start with the latter one, I think it is clearly one of the issues in the current draft EU Directive to what extent international funds can market and engage European investors. Ultimately, the concern that I have as a European is that sophisticated institutional investors in Europe will not have access to some of the state of the art investment products. Obviously, 2008 and early 2009 created an enormous strain on the system and hedge funds, along with a lot of assets, went through some extreme gyrations, but I think the basic premise that they provide value-added returns with relatively low correlation with the other major asset classes is still the outcome and it is the common conclusion based on any kind of statistical econometric analysis. I think it would be very unfortunate if the European investors, the pension funds and the rather larger more sophisticated investors, were not to have access to those products because of the regulatory regime. I think that there is a second discussion obviously where you can conduct that business and, yes, in order to protect your investors, you have to find a reasonable regime to operate under.

Q436 Chairman: May I ask again about the latest Swedish draft. If the private placement regime remains in place—and I appreciate that in the present version private placement, as in the Swedish Presidency’s draft, remains in place—accepting that it is not as good for American investors as the existing regime, will it drive away hedge funds provided the private placement regime remains in place? I think it is the general European assumption that while the Commission would rather have a proper equivalency regime, if that is not possible the maintenance of national state private placement regimes will enable hedge funds to go on operating.

Miss Fuller: My view is that the maintenance of national private placement regime is the pragmatic solution on the table with respect to the marketing issue. However, I do think that we need to be somewhat careful with respect to what the Swedish draft has and has not achieved, though certainly a number of steps in the right direction. However, it remains unclear whether managers who are based outside of the EU managing funds outside of the EU will, going forward, be able to avail themselves of the private placement regimes. Certainly for managers who are based within the EU managing off-shore funds, the private placement regime will be maintained to an extent, although I note that the Commission is due to review that three years into the operation of the Directive. So, I think, yes, as an outcome, maintaining private placement regimes is a good result, but we have to be somewhat careful with respect to the detail.

Q437 Lord Woolmer of Leeds: The latest Swedish draft of the Directive suggests or proposes certain restrictions and conditions on the payment of bonuses in the alternative investment fund management field. What is your understanding of the current position as proposed by the Swedish Presidency and would you care to comment on the proposal as you understand it?

Dr Edsparr: My belief is that this is something that is very much at the heart of the discussions between investors and fund managers and I think that fee structures for different products are intensely debated between investors and managers on an ongoing basis, along with a range of other issues, and are very much negotiated in the context of that relationship. There is a huge difference between privately held institutions dealing with sophisticated international investors determining what is fair compensation for different services and, let us say, the remuneration debate around institutions that received explicit government aid. I feel that there is a legitimate desire from investors to have a tight link between the timing of realisation of profits with the timing of the remuneration. I think that is something that permeates the hedge funds and private equity communities and I believe that all the events of the last couple of years have made those links tighter and much more precisely defined. What I am referring to is, obviously, that if you make an investment today and the realisation happens three years from now, people should primarily get compensated on the ultimate resolution of that, not on some intermediate mark. Personally, I believe that most of the excesses which took place in the system were when that close link between realised profits and remuneration was
broken because positions were kept on the books for a very long time. I do not see that it is appropriate for a regulator to dictate that. It is a very dynamic environment and it is, as I say, negotiated on a daily basis.

**Q438 Lord Woolmer of Leeds:** You know that the public are greatly concerned about the issue of reward and excessive reward which is apparently related to excessive risk taking. What is your answer from the point of view of the alternative investment fund industry because they would say, “We hear what you say, nevertheless these are tough times and there should be seen to be some restraint”?

**Dr Edsparr:** My answer would be that, unlike banks and large public institutions, most of the principals in major hedge funds have very significant amounts of, if not most of, their net worth tied up in exactly the same product as their investors. There is no misalignment of interest between the investors for whom you work and your own remuneration. It is not as if, I can book things in a non-market to-market bank book (available for sale—AFS) that sits on the books, for ten years while I will get my bonus in a year or two. Most senior principals in the hedge fund community have a total alignment with their investors through their own pocket books. It is a simple discussion between serious experienced investors and serious investment professionals to determine what is a fair compensation structure for different services/different products and it is very much at the heart of these discussions.

**Q439 Lord Woolmer of Leeds:** Are there any proposals in the United States to cap, restrict or regulate payments of bonuses in the alternative investment fund industry?

**Mr Cooper:** There are none.

**Q440 Lord Haskins:** Following on from that, two interesting points have been made. There is a significant difference therefore between hedge fund managers who are putting their own money in alongside the investors and many of the main banks where the executives were not putting their money in alongside, and therefore they were risking other people’s money without risking their own. I think that is what you are saying.

**Mr Cooper:** That is right.

**Q441 Lord Haskins:** Then you said another remarkable statement that hedge funds, like banks, were paying bonuses before profits had been realised. Were they paying bonuses on anticipated profits? How could you pay a bonus without profit having been realised?

**Dr Edsparr:** Let us say that you do an underwriting deal for Company A. I am a big bank and I underwrite this deal and I book $10 million in fees that year but, in order to get that deal, I also need to lend money through more traditional banking relationships, maybe a ten-year loan. Maybe that loan is actually quite risky and, five years into the loan, the company defaults. Well, you only got the underwriting deal that generated the $10 million profit that is accounted for in your income statement day one because you kept on that exposure for ten years. That is one example. The other one would be, let us say that I design a structured note, so some form of derivative overlay, very, very popular products among wealthier affluent individuals in Europe. So, as long as the pound and the euro move in a certain band, I get a ten per cent coupon. If it moves outside of that band, I get a zero coupon. That derivative has a certain embedded profit that is booked through totally transparent gap accounting in the income statement of the bank today. You have the risk management, the operational responsibilities to manage that derivative structure for maybe five years. Let us say that there is a hiccup in the risk management or that there is a drastic deviation from any of the assumptions, that results in a big loss. Obviously, a third example are these credit tranche tradings where companies like some of the big banks, AIG et cetera, would effectively insure some of the risks; they would charge a certain premium to take losses above a certain level; they were priced at one level and then, five years later, you take a big loss on that. The people who booked those transactions going in could presumably have got a bonus based on what was booked and would reside on those books for a long time.

**Q442 Lord Haskins:** In the first example you gave where you might have a ten-year exposure, are you saying that the manager should have to wait for ten years for his money?

**Dr Edsparr:** I am not trying to state what is a fair trade off. I am simply stating that there is a very big difference between, taking one extreme, a private equity investor who buys a company, restructures it and sells it out five years later, and the investor manager who invests in liquid products and gets paid his bonus when he realises the profits on that investment.

**Q443 Lord Haskins:** That is at the end?

**Dr Edsparr:** That is at the end as compared to traditional banking business where you have many things that are intertwined and many of the risks linger for a very long period of time, whether it is explicit economic risk or operational risk and so forth, and I think that most of the big losses that
came happened through exactly those types of positions.

Q444 Baroness Northover: May we come back to the process in the United States. I wonder if you could fill in for us what the process would be for the US proposals to become law and when you expect that to come into practice.

Mr Cooper: The first is probably easier to answer than the second. In the US, the executive branch of the sitting government can make recommendations but laws are drafted by and derived from both Houses of Congress. There was some publicity about what was referred to as the Treasury Draft; it was a proposed draft piece of legislation that the US Treasury on behalf of the President’s administration submitted to Congress as sort of an informational matter to let Congress know what they were thinking. Each House, the Senate and the House of Representatives and especially the committees within each House that have a jurisdiction over the subject matter of regulatory reform, that is the House Financial Services Committee chaired by Barney Frank and the Senate Banking Committee chaired by Senator Christopher Dodd, have now at this point drafted pieces of legislation. Generally speaking, both of those bills are similar to the administration’s initial draft but do differ. Within the committees themselves, there will be hearings, debate, amendments and fleshing out very specific details relating to the legislation. Structurally within each House, these processes are proceeding in a different way. In the Senate, you may have read that Senator Dodd introduced what was called the Discussion Draft of a comprehensive 1,100 page bill addressing every aspect of regulatory reform. The provisions relating to alternative investment fund managers were just one chapter of that massive Omnibus Bill, as it is called. In the House of Representatives, in the financial Services Committee, the legislation that is proposed with respect to alternative investment fund managers stands alone, by itself, but it is anticipated that Chairman Frank will wrap it all up into an Omnibus Bill. Right now, we are in the process of the committees debating and discussing the issues and holding some hearings. What happens after the committees have drafted, and amendments are made is that the legislation will be called to vote. If it is voted out of committee, it then goes down to the floor of the relevant House for debate and discussion. There is an interim step that may take place where other committees that have interest in the subject matter, principally in this case the agricultural committees because of their oversight of the derivatives markets, may have the opportunity to formally weigh into some of the legislation, but then it just goes down to the floor once the committees have concluded their drafting for a vote and is put to a vote. If passed in each House, these bills, which will not be identical, are then submitted to a joint committee whose sole job is to reconcile the differences between the two bills. That then goes back down to each House for a final “yes” or “no” vote. If both the Senate and the House of Representatives vote in favour of the legislation, it then goes to the President for his signature and the President has the ability to veto that legislation. The rules of each House sometimes make it more challenging than not to move quickly on legislation. Right now, there is a great deal of debate about healthcare legislation in the US and that is consuming a lot of band width; it is consuming a lot of floor debate time. If I were to guess—and I caution that it is really nothing more than that—I would say that it is unlikely we will see final legislation that is ready for a vote until late in the first quarter, possibly into the second quarter of 2010, and perhaps much later than that. Remember, these are massive regulatory reform issues; it addresses consumer finance laws and banking laws and derivatives laws as well as alternative investment fund managers. I cannot predict what the final provisions of the bills will say, but I will say that one of the draft provisions in the AIFM comparable legislation in the US calls for a one-year transition from passage to registration. For example, if the bill were passed into law let us just say on 1 January 2010, which it will not be, it would go into effect the year following. So, in addition to the process, the bills themselves typically contain transition periods, dates on which the law will become effective, and that is rarely immediately.

Q445 Baroness Northover: But it is actually potentially moving faster than the EU one where they are looking at July for bringing the various elements together, the Commission, Council, Parliament and so on. You have mentioned the dialogue that we hope is happening between the EU and the US. What dialogue is happening with other parts of the world? Mr Cooper: That is a very good question. I cannot tell you that I can specifically identify any dialogue that is going on. Earlier on, I know there were reports, though I do not have first-hand knowledge, of discussions between US regulators and the Hong Kong officials for example. Certainly we all know that G20 nations have met and regulatory reform has been a very significant piece of the debate, first in London and then in Pittsburgh. So, I would imagine, through those forums, there are ongoing discussions.

Q446 Chairman: Can I pick up something from an earlier question about the Bank Holding Company Act and the extension of that to alternative investment funds. What is your view? Do you have a view on that? Do you think that you ought to be in or out, as it were?
Mr Cooper: Out. The way in which it would be implicated, if at all, under current proposals is that if a hedge fund or alternative investment fund manager were deemed to be systemically significant. It is only when there is a determination of systemic significance would the Bank Holding Company Act provisions then apply and, quite candidly, I believe that trying to apply the Bank Holding Company Act provisions to alternative investment fund managers is like trying to fit a square peg into a round hole. It is a regime that is designed to prescribe activities and capital and the integrity of depository institutions that in part have a federal guarantee of the deposit base. It is in a completely opposite position to the business model and the goals of private alternative investment fund managers. It would essentially preclude the hedge fund manager from continuing business if they were subject to the Bank Holding Company Act, which does not permit non-banking activities except in very narrow circumstances.

Q447 Lord Haskins: It is clear that what is developing here is a very different approach towards alternative investment funds between US legislators and EU legislation—your description about a small proportion and Senator Dodd is all to do with this alternative investment funds—and it is becoming a very big issue here in terms of what the Parliament certainly thinks and how the Commission has responded. If the present arrangements as proposed by the Commission went through, how would it affect Citadel's attitude towards doing business in the EU and what significant changes in the present proposals would you be really looking for if you had to choose one?

Dr Edsparr: It is very hard to speculate at this stage because I feel that the devil truly is in the details and we are obviously deeply committed to our businesses in Europe. I personally believe that hedge funds through the innovation and the constant experimentation, if you will, of the business model are very much a positive force in finding systemically more robust solutions in the marketplace. An example could be OTC derivatives and how to separate them from the major banks and to create a robust market structure where any one institution can go down without jeopardising the whole market place. I think that separation of these roles is crucially important if you believe in free markets and I think that hedge funds and other alternatives really represent the only other solution to, at this point, an extremely consolidated banking sector. Whether that has to migrate in products on to exchanges, having to lower the barriers of entry for individuals as well as former players in terms of execution, I like to think that we as a firm are at the forefront across a whole range of those activities and they are all part of, or could be part of, systemically more robust solutions than actually alleviate the ‘too big to fail’ problems. I think that we have to evaluate what businesses we can be in given any regulatory regime and we have touched upon a couple of the key themes. One is, will we be able to market to European investors, and I think that it is fair to say that we could go on without a European investment base but it would be far from ideal and I believe that it would be very unfortunate for European investors. I think that, in terms of where you conduct your business, you want to be as close to the markets that you are involved in and that it would be represent a serious deviation from all our thoughts so far not to be operating within the EU.

Chairman: Did that answer your question?

Lord Haskins: I think so.

Q448 Lord Woolmer of Leeds: Why do so many hedge funds within Europe centre in London?

Dr Edsparr: Theoretically, I think that it is a very interesting problem. It is sort of, why are all the bookshops located on one street and why is Silicon Valley, the computer industry, centred in one place? There is obviously a body of literature on that subject. I think that a great deal of it is tied to the labour market. If you find a spot where business conditions are good and the skilled labour tends to congregate, it is a lot easier for both customers and employees to be in the vicinity of each other. If I need to hire another operations manager, well, there are plenty of skilled people around. That does not mean that those relationships stay forever. If a certain location becomes too uncompetitive, then obviously you will see migration. You have seen Singapore emerge as much more of a centre, if you will, for innovation over the last maybe ten years, but I think that London became competitive early through language, through predictable regulatory and legal regime and espousing general free market values. That is where most of the European financial creativity ended up and obviously, if you go back 20 years, there was a much more vivid debate between Frankfurt, Paris and London as to where the centre of European finance would be and I think that largely London won.

Q449 Lord Woolmer of Leeds: Many people, who do not necessarily understand the business, have suggested that equivalency would be a good thing and others have said that it might be a good thing but it is very difficult to achieve, not least, as you have said, because of two rather different approaches. Is equivalency an issue worth pursuing?

Mr Cooper: No. I think that the concept that existed before is an attractive principle but in practice is virtually impossible to achieve. I think that, given the events of last year, the fourth quarter of last year, and the volatility that we saw in the marketplace and the real opportunity to drive thoughtful regulatory
reform efforts, I would hate to have the perfect be the enemy of the good here.

Chairman: There is a prevailing view inside at least the European Commission that we must go for equivalency because everybody will have to do it because they need to operate in Europe. I would be interested in the views of a really substantial American hedge fund on this point.

Mr Cooper: I do not want to oversimplify the issue and I hope I am responsive, but the cultures within the regulators, the prudential regulators, who must oversee and execute and implement the rules that are generated within the United States and jurisdictions in the EU are very different and that is not a bad thing, it is just a fact. The cultures have evolved over years and years. To try, if you will, to force a regime that has equivalency that is identical regulation, is challenging, but I think that to think then that the application of those identical rules by regulators who have very different histories, perspective and impact is a dangerous combination. I hope that has been responsive.

Chairman: I turn to my colleagues and see if I have suppressed anybody or failed to get the question answered. Lord Haskins?

Chairman: On that pessimistic note, Lord Haskins, perhaps we should conclude. Thank you all very much for coming and for giving so generously of your time.
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present with us today, we have agreed to take a co-
Association for Financial
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Market division we allow financing in more than 90
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Deutsche Bank is very actively involved with the
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was recently released. I would first of all say that
Deutsche Bank, as well as every other bank with
a large prime brokerage division, has been working
with bodies such as the Alternative Investment
Management Association, AIMA, who you have
heard from, and the Association for Financial
Markets in Europe, AFME, in relation to this
Directive. Accordingly, given that AFME are also
present with us today, we have agreed to take a co-
ordinated approach to questions to allow for an
organised and properly flowing examination of this
subject. While we very much applaud the European
Commission's aim of reducing systemic risk,
protecting investors and creating a more effective EU
regulation, the proposed Directive will not, in our
view, deliver those benefits. Instead, in its 30 April
2009 form, the Directive concentrates and hence
sharply increases risk, limits the choice available for
EU investors and would reduce the return they would
make on their investment. Let me be very clear at the
outset: there is a high level of consensus across the
industry about concerns over the Directive in its
original form. Deutsche Bank today adds its weight
to that and makes four points, which you will have
heard before. The entire prime brokerage industry
agrees on these points, which can be summarised as
follows. Depositaries: the very large concern is that
the depositary will be fully liable for risks and losses
it cannot control. This will lead to a withdrawal of
providers, much higher costs and loss of investment
access to many non-EU markets. By a significant
margin, this is where investors will be most harmed.
On marketing equivalence criteria, EU professional
investors, who serve pension funds and hence EU
pensioners, would be cut off from a large proportion
of the best managers in the world. On delegation,
restrictions would reduce investment opportunities
and cut access to local expertise. Lastly, leverage
restrictions, which is relevant, of course, to your
opening question, would create a competitive
disadvantage for EU managers and any perceived
benefits in relation to market stability would be very
limited. Given that our perspective is that of a
European bank, we thought it may assist the
Committee in its deliberations to hear some general
points on Deutsche Bank, the hedge fund industry in
Europe and the UK perspective on the Directive’s
specific objectives, regulation generally and the
Directive, Deutsche’s participation in the
consultation process, an explanation of prime
brokerage and management of credit risks, and a
comment on the Swedish compromise proposal that
was recently released. I would first of all say that
Deutsche Bank is very actively involved with the
hedge fund industry in almost every aspect of the
business, and we hope the following context is useful.
As it relates to Deutsche Bank, we are a leading
global investment bank with a strong and profitable
client franchise, we have 80,000 employees around
the world, the bank is a leader in the UK, Germany
and Europe, and is growing rapidly around the rest of
the world, and in prime finance, through our Global
Market division we allow financing in more than 90
per cent of the investable markets around the world.
As it relates to hedge funds in UK and Europe, you
have heard from Andrew Baker of AIMA before but
I want to reiterate some of the organisation’s
statistics, because I think they are so important and
so relevant. The European hedge fund industry has
more than 250 billion of assets under management,
employs 50,000 people and generates 4 billion in
annual tax revenue. Most of the industry is in the UK
and the vast majority of the money that is invested in
hedge funds does not come from wealthy individuals
but from institutional investors representing pension
funds generally. Deutsche Bank has extensive
institutional contacts in the industry and these institutions have told Deutsche Bank that they have been pleased with how the hedge fund industry has handled the crisis and they plan to invest more in this asset class in the future. Some perspective on the objectives of the Directive: in relation to the reduction of systemic risk objective, based on previous testimony you have heard, you do not need to be reminded that the de Larosière Report and the Turner Review have concluded that the hedge fund industry neither caused the crisis nor played a significant role in it. The other primary justification for the Directive is the important goal of increasing investor protection. This is critical. It is therefore very concerning that the investor community feels that the proposed Directive does not achieve this. For example, APG, the largest pension fund manager in Europe, told the European Parliament on November 10 that alternative investments make up a large part of its investment portfolio and add significant value to the pension funds it manages. It clearly said a number of aspects of the proposed Directive would be very damaging to investor interests. This is the group that the Directive is supposed to protect, yet they have major concerns. Further, the concerns noted by APG were the same as those that AIMA, the FSA and Lord Myners have already expressed to you. Deutsche Bank very much concurs with these views. In relation to regulation generally, let me be very clear here. Deutsche Bank is extremely supportive of good regulation and encourages its development through active participation in the consultation process. I would also say that the interests of Deutsche Bank and the hedge fund industry are very much aligned with regulators, governments and the customers they represent, i.e. investors. An important component of our business is to lend to hedge funds. Making sure that those loans are repaid requires good regulation. Our interests are very much aligned. There are also many positive points in the Directive and we would specifically point to registration of hedge fund managers, disclosure of systematically important data to regulators, enhanced transparency and the EU passport. Deutsche Bank’s participation in the consultation process and the AIFMD has also been very significant. As the largest European prime broker and one of the leading global prime brokers, Deutsche Bank has actively endeavoured to make a meaningful contribution to the process. The criticality in ensuring the Directive delivers on its objectives cannot be over-stated and, commensurate with that concern that Deutsche Bank has, we have allocated a great deal of resources to this project. I note just a few points and examples. We have held more than 100 meetings with MEPs, attachés, clients, investors, consultants and lawyers; worked extensively with groups such as AFME and AIMA, who have done a terrific job in relation to the Directive; we have hosted the European Commission for a full day at Deutsche Bank in London; we sent a Deutsche Bank delegation with AIMA representation to the German Ministry of Finance; we participated in detailed education sessions in Brussels with AFME; and we presented at the ECON public hearing on 10 November. I now move to an explanation of prime brokerage and management of associated credit risks. What is prime brokerage? It is a general term describing a range of financial services. These services include clearing, custody, asset servicing, client reporting, financing, securities lending and in more developed cases capital introduction, risk management advice and consulting. Broadly, the commercial focus for a prime broker is to earn a reasonable return while ensuring that the client fund can repay the loans. Accordingly, like any other lender, the prime broker has a major focus on monitoring lending and has large teams dedicated to this purpose. Throughout the financial crisis losses from prime brokerage lending—and this is critically important—were very small, hence those controls can be seen to have worked very well. Like an investor, a prime broker is very focused on ensuring assets are controlled properly and good regulation will gradually assist in this regard and Deutsche, along with the industry, fully supports measures that increase investor protection, regulate competence and reduce systemic risk, because that helps ensure that our loans are repaid. Let me make a quick comment on the Swedish compromise proposal. We were very pleased to see that on November 13 the Swedish presidency published a compromise proposal that is consistent with industry comment. Apart from some new provisions on remuneration, which need to be thoroughly reviewed, there were some very positive developments in relation to one, marketing, where national private placement regimes would continue to apply; two, delegation, where there is a wider ability to delegate various functions; three, leverage, which allows leverage setting at a national level; and depositaries, where liability provisions, which I mentioned before were a major concern, move closer to global market practice although the inclusion of additional fiduciary duties to monitor legal and regulatory compliance are concerning. Time has not permitted us to provide any detailed commentary on the Rapporteur’s recent report, other than to say it does contain some helpful proposals, particularly in relation to aligning the Directive to G20 Pittsburgh principles and is further evidence that the original proposal was deeply flawed. That concludes my opening remarks, my Lord Chairman.

Q455 Chairman: Thank you very much, Mr Byrne. We will pick off the various bits that you have left unanswered in the questions, if we may. If I may start,
is it important to have a single regulatory regime for AIFM in the EU?

Mr Byrne: I think the benefits of creating a single regime are very similar to what Lord Myners said to you in his previous testimony. The benefits really are that it allows for a uniform and consistent market and it allows firms all over Europe to distribute their product. It also enables regulators to collaborate and make sure they can monitor systemic risk on a holistic basis. Those are two very positive benefits.

Q456 Chairman: Thank you. You have also talked a bit about the G20. Is it going to be important to have a globally consistent regime?

Mr Byrne: It is very important. The importance is absolutely critical. I want to restate the ECB position because it is an independent position from European interests. In October they urged the Commission—and I will quote directly—“to continue the dialogue with its international partners, in particular the US, to ensure a globally coherent regulatory and supervisory framework” and they further said, once again quoting directly, “an internationally coordinated response is necessary given the entirely international nature of the industry and the consequent risks of regulatory arbitrage and evasion.”

Q457 Chairman: I have a further, possibly slightly googly question. We all know what the United Kingdom Government thinks because you see it shouted from everywhere. What does the German Government think? You are, after all, a bank headquartered in Germany. Is the German Government supportive of your position?

Mr Byrne: I am not aware of what their position is. I have had a lot of meetings with MEPs and staff within the German government. They have not made their position public but they have certainly been open and receptive to listening to Deutsche Bank’s views.

Q458 Lord Jordan: There is a perception of hostility towards hedge funds by continental Europe. In Britain we are a bit more relaxed about it. This pre-dates the last financial crisis. Has your institution any views on why this is the case?

Mr Byrne: I think there are some challenges to understanding exactly what hedge funds do, and that creates some concern. I do think, given that the industry has performed well through the financial crisis, that concern is somewhat moderating but there is a concern that continues to exist and will continue to exist for some time.

Q459 Lord Jordan: Why are they pressing ahead in the way that they are with things that you are now complaining about? What is behind this drive to tie down hedge funds, or control? Where do you think it comes from?

Mr Byrne: It is very hard to put a finger on it but I think it is a lack of understanding about the value that hedge funds add to markets—the liquidity they provide, lowering transaction costs, all of those things. I think it is a real misunderstanding. It is perhaps the way they are presented in the press as well. It is a real challenge for the industry to get over. The only way we think we can contribute to that in a meaningful way is by providing as much transparency as possible, as much education as possible, and very much moving in line with what AIMA and the Hedge Fund Standards Board, are doing, which is advising hedge funds to make as much disclosure as possible. I think that would be very helpful but it is a significant challenge.

Q460 Lord Moser: Just following Lord Jordan, it was impressed on us when we were in Brussels the other day that the trouble felt in Brussels about hedge funds well preceded the crisis and that when it started, well before the crisis, it came from Germany. Can you remind us why Germany in particular, of all the countries, was so hesitant about the hedge fund industry?

Mr Byrne: Clearly, I cannot speak for the German Government or the German people. I am a representative of Deutsche Bank, but there were certainly some unhelpful comments in the press in relation to some large UK-based hedge funds and some of the corporate governance agendas they had in relation to particular German companies that may have been one of the contributory factors, and I think a general lack of understanding and acceptance of the industry is prevalent across the Continent. We are doing everything we can to basically improve that situation. I would point back to across the Continent there being a variety of views. APG, and indeed the Association of Dutch Pension Funds, is very, very positive in that regard and, as I said before, Deutsche Bank in terms of its institutional investor contacts is very much seeing an increasing acceptance of hedge funds as adding value to portfolios, so I think that will continue to increase over time.

Q461 Lord Moser: It is striking, looking back on our Brussels meetings, where we were told repeatedly that the trouble made in Brussels about hedge funds preceded the crisis and came from Germany, and so I was struck in your presentation just now that you went out of your way in the middle of your remarks to give them very high marks indeed for good behaviour.

Mr Byrne: I think, relative to other investment classes, they have performed very well throughout the crisis and my perspective on knowing many managers and many investors as part of my role at
Deutsche Bank is that they have very good risk management, very good investment governance and have very much acted in their investors’ best interests.

Q462 Lord Trefgarne: I should preface my question by saying that I am a brand new member of this Committee, so please forgive me if my question is either naïve or ill-informed or both. You talked about the importance of a globally consistent regulatory regime. Am I not right in thinking that the overwhelming majority of hedge funds are based either in the United Kingdom or in the United States, and therefore a consistent regime between those two countries of course is desirable but incorporating the others is less obviously important?

Mr Byrne: That is very true, and I would say that actually the vast majority of the hedge funds are outside of the EU. Most of them are in the US. One of the characteristics of the industry is that we see not only that capital is mobile but also human capital, and therefore fund managers are mobile in terms of where they can locate themselves. So if we do not have a globally consistent system, as the ECB said before, it is quite possible that you will have some sort of arbitrage or movement of hedge fund managers to where the most favourable regime is, and that is not desirable. We would like to have a globally consistent regime which really does address some of those very valid concerns in relation to investor protection and systemic risk.

Q463 Lord Trefgarne: Given the overwhelming importance of London within the European context anyway in this area, would you not detect a degree of envy in the other capitals?

Mr Byrne: I cannot comment on that directly but it does seem that the UK, perhaps because it has a larger industry, has a better understanding of what the issues are.

Q464 Lord Haskins: I have fresh in my mind some of the comments you made in your introductory statement, which were breathtaking in a way. The first one I would like you to elaborate on is this. You said the very people who the Directive is aiming to protect do not think it is going to offer them protection. I would like you to elaborate on that. The second one is, I thought, a strange comment but no doubt right, that the Directive increases risk and may reduce returns. I can understand the reducing returns but how would it increase risk? The whole purpose of it would be to reduce risk. On your basis, the Directive is a farce.

Mr Byrne: I can actually answer both questions in one, if I give an example. In relation to the depositaries point, depositaries in effect are prime brokers and custodians. In the original draft the depositary was liable for any failures of its delegates, so if a sub-custodian in the Middle East or Asia was to fail, the custodian or depositary would have to make good to the investor. That is not something that the depositary can control and in normal market contractual arrangements that is not something that they would agree to do. If they were forced to do that, the number of suppliers, the number of prime brokers, would very significantly reduce and as a result, rather than being able to diversify your assets and hold them with three or four prime brokers, for example, you might only be able to hold them with one or two. Therefore you have a very sharp concentration of counterparty exposure and if there were to be some sort of insolvency event, it would be far more troublesome for the underlying fund. That is an example of where risk is concentrated and therefore increased, and that is one of the big issues at APG.

Q465 Lord Haskins: The Directive has changed a bit.

Mr Byrne: It has—well, we hope it has changed. The compromise proposal has softened the liability provisions and if it does that such that it comes closer to a reasonable requirement to exercise reasonable skill and care in selecting providers such as sub-custodians and having a reasonable ongoing review process for them, then that would be very, very helpful and improve the position very materially. This is by far the most important point. The other issue that the APG mentioned was in relation to the marketing and equivalence criteria. More than 85 per cent of the manager population is outside of the EU, and if they were not able to have access to those managers, then their choice would be substantially reduced. Therefore we believe, and certainly conventional theory on portfolio management would say, that their risk would increase or their return would reduce, or probably a combination of both, and that is why they feel so strongly about it.

Q466 Lord Haskins: Does the private placement option help in any way there?

Mr Byrne: The national private placement rules certainly help, yes, and we are very supportive of those. As I said in my opening remarks, the provisions in relation to a marketing equivalence criteria and this national private placement regime, being essentially at the discretion of the home country, is very, very positive and we would be very supportive of that, as would AIMA, the FSA, and the prime brokerage industry.

Q467 Lord Marlesford: I declare an interest as an adviser to Sit Investment Associates in Minneapolis but I advise them of world events, not on fund management, of which I know nothing. I am also a new member of this Committee, like Lord Trefgarne.
I was interested in your remark about the location of hedge funds. You were saying where a regime is most favourable is one of the criteria. Two things really: however much unification there may be, standardisation with the G20 or inside the EU, presumably none of that would have the slightest effect on people who wished to be somewhere outside those areas, exotic places, whether they be Bermuda or Mauritius or wherever. So I really would like you to tell us why hedge funds are located where they are and, as a subsidiary to that, are there, beyond pretty basic levels, any economies of scale in hedge fund management?

Mr Byrne: In terms of the determinant of where they are, it is a combination of factors. It will be matters such as their ability to retain staff, to get office premises, the rule of law in the particular location, the tax regime—which has obviously been very topical in the press recently in the UK—it will be where the investors come and visit them. They will need to have a reliable infrastructure generally. All of those things will be major considerations. In relation to exotic locations, generally the funds are domiciled in tax-friendly jurisdictions, and that is not so as to avoid tax. It is to avoid double taxation. Those arrangements are in place and are fully disclosed and local regulators and tax authorities are fully aware of those arrangements and will endorse them, provided they make sense. In relation to economies of scale, there clearly are economies of scale in terms of having groupings of hedge funds in the one place. It makes it easier for investors to meet large numbers of hedge funds at the same time, it makes it easier for them to make comparisons, it is easier for service providers to come together and do conferences, research-based activity on equities, for example. All of those things make a positive difference. In summary, I would say that there are groupings of hedge funds in the same place because the infrastructure, and the legal and regulatory framework makes it a place that is easy to do business. That is why you see aggregations of fund managers in the UK and in the US as well.

Q468 Lord Trimble: In your opening statement, which was very useful and covered a range of things and described the role of prime brokers, you criticised the Directive and commented on the changes that have come as a result of the compromises suggested by the Swedish presidency. I wonder if I can just go forward a little bit from that point. Are there any further changes to the proposals that you would like to see? We are now in a position where the European Parliament is considering the matter and it is going to come to the Council quite soon. Do you think the changes that you have commented on favourably are going to actually be accepted by the Commission and the Parliament and if not, what are the areas that worry you most about the decisions that are going to be taken fairly soon in Parliament and at the Commission?

Mr Byrne: In relation to changes that we would like to see, if I could go through each of the different areas, as I said before, there are four major areas. I do think the national private placement regime is a practical, positive step. I recognise in terms of the way these things are negotiated there are challenges to doing that, so I think that is a very positive step. On the wider ability to delegate functions, this has moved materially forward and we think that is very good. Leverage—we do not think that is actually a requirement to set leverage limits at all, so we think that is a very positive step but we would say that there are no needs for leverage limits. Certainly in the US they have not decided that is a requirement. On the depositary provisions, we think that they should be right where market practice is at the moment, so we would desire even further softening. There is one particular issue I would raise there, and that is that they put in place additional fiduciary duties to monitor compliance with constitutional and regulatory requirements. That is duplicative, it is unnecessary. Prime brokers and depositaries will not necessarily be resourced to provide those services and that may lead to a requirement for suppliers or service providers to pull back from the market as well. There will be increased costs and a lot of extra work which will not add a lot of value. Investors in the industry already feel that they are well served. One of the developments since the financial crisis is investors placing more importance on an independent administrator, but the market has naturally got to that situation—and we are of course dealing with professional investors here, and therefore they are very well placed and resourced to make those decisions on their own.

Q469 Lord Trimble: On the question of what you think is likely to happen in the remaining stages of this, you obviously have been doing quite a lot of lobbying and so on, and I am assuming you will have picked up some sort of sense about what is likely to come out of the Parliament and the Commission.

Mr Byrne: Most of our lobbying has been on education, and we have not been involved in the direct negotiations and discussions. We feel, as I said before, that it is an industry that is very complex and difficult to understand and therefore we place most of our efforts in relation to educating and making sure the various constituents understand how the industry works, why it has benefits not only for the industry as a whole but basically benefits for investors and benefits for the EU. That is where most of our focus has been, so it would be very difficult for me to comment on where this will finally come out.
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Lord Moser: This is a question about regulation. We have obviously spent a lot of time discussing regulating hedge funds and private equity, and you are very much part of that world. The question is, what kind of regulation would be appropriate, or perhaps exists in relation to you as a private broker?

Mr Byrne: The industry is already regulated. We are regulated as a bank and there are provisions for broker dealers as well. Every prime broker is highly regulated and they are also subject to regular inspections. For example, in Deutsche’s case we have the BaFin, the SEC and the FSA, who regularly discuss what we are doing, where the industry is going, and what our control programme is. Within the bank it is also a regulatory requirement that we have a very well resourced internal audit department that regularly meets with us and performs reviews. On a quarterly basis, for example, I will meet with the external auditors, in Deutsche Bank’s case KPMG, and they will do a review and have a long discussion with us, and most of the focus for them is where we might have risk, and that is mostly in the category of lending money to hedge funds, therefore most of the discussions are focused on that particular area.

Lord Moser: What about the future? As you undoubtedly know, there is a lot of talk about tightening up supervision and regulation within the country, within Europe, globally. Do you expect a major change as far as you are concerned?

Mr Byrne: As it relates to regulation for prime brokers? I think one of the misunderstood areas of prime brokerage and lending and the crisis is that throughout the crisis—and I am speaking for the industry as a whole—there were very, very small losses incurred from lending to hedge funds. Capital is held as a buffer to losses and what the crisis actually showed was that the risk controls, the credit departments, the margin management teams and the technology that sits within a prime brokerage department—I am speaking across the industry here—has worked very effectively. Deutsche Bank has somewhere between 60 and 70 analysts, technologists and margin experts who are focused on managing risk for hedge fund lending at any point in time. So we have big resource allocations, and the management team and, I think, regulators are quite pleased with the way we have come through this crisis and have not had any major problems from lending to hedge funds.

Sideways question. Your presentation gives the hedge fund industry extremely high marks for behaviour and so on, which is fairly widely shared but not universally. Some of our witnesses have said that side of the behaviour has been excellent but they have set very bad examples to the banking world in bonuses, general behaviour, etc. Do you share any of that or do you think that is just public opinion being silly?

Mr Byrne: I think there is some portion of public opinion that has that view, and I cannot comment directly on that, but I do think it comes from a lack of understanding about exactly what hedge funds do, exactly what sort of disclosures they make, how transparent they are in relation to what they tell investors and what they advise they are going to do, what risk disclosures they make. I think it is a very misunderstood area. There is a wide variety of different types of hedge funds. Many of them are very complex, many of them involve financial methodologies which are difficult to understand, and accordingly, when the public does not understand something, they are naturally sceptical. I feel it is Deutsche Bank and the industry’s duty to do more work to try to improve understanding of the industry, and I really believe, and Deutsche Bank believes that they can make a meaningful contribution to society in the EU: they generate a lot of taxation revenue, they employ a lot of people, they are very active in financial markets, which increases liquidity and reduces transaction costs, they are very strong in innovation, and therefore they add value in many different ways.

Lord Moser: Following on that, we have not mentioned that the Swedish presidency has introduced a rather controversial element recently, which is the need to look at remuneration. I would be interested in your views on that, particularly the difference that may arise between remuneration in the private equity markets compared with banking. With private equity markets, as we understand, most of the managers have a heavy personal investment in them themselves, and therefore their own money is at risk rather than somebody else’s money, which is one point that seems to differentiate them. The other point is of course that the deals in hedge funds and in private equity clearly have a closing point, where the deal is complete and whoever is picking up the spoils can do it, whereas on the banking side, a lot of the bonuses did not have a clear closing point and one of the arguments is that there should be a five-year delay before bonuses are paid out. How is Deutsche Bank going to respond on both fronts, if you like, on the one hand your own executives being regulated in this area and on the other hand your customers, i.e. the hedge funds?

Mr Byrne: I am very sorry but I am not in a position to comment on Deutsche Bank’s remuneration policy or our views on that particular point. I apologise for that. I do understand that it is an issue that is publicly sensitive. My presentation today is to talk about my area of expertise, which is prime
'Mr Byrne: As I say, my expertise is really about ensuring that the prime brokerage services are as complete and as good as possible and that we basically make a reasonable return for our clients.

Q475 Lord Haskins: You have commented that you were encouraged by changes in the Directive with regard to leverage. I would like you to elaborate a bit on that. Of course, as you say, national regulators have some power to apply leverage caps. How does this work in a complicated industry like alternative investment funds, leverage that is so critical according to the nature of the risk and the nature of the investment? How is this going to work?

Mr Byrne: The first thing I would say is that leverage and risk are very misunderstood concepts. Leverage is not a good proxy for risk. The impact of leverage on risk within a portfolio is much more affected by the underlying assets within the portfolio, and actually it is possible to increase leverage by hedging but actually reduce risk. That is very critical. It is also very difficult because of the wide variety of funds out there, and the strategies they adopt mean that classification and compartmentalisation of leverage limits is very difficult, and indeed, the number of strategies that are available to invest in is actually increasing as time goes by. So what we would advise and the way that Deutsche Bank does its risk management is that it has a very detailed set of internal procedures, it has a set of rules that it gives to its hedge funds which are more than 20 pages in length. A good proportion of those 60-70 staff that monitor risk are actually involved in building very complex technology systems that can understand the offsets and the different risks associated with different asset classes, different assets and how they interact with each other. So it is a very difficult area. The industry performed very well through the crisis and the lenders lost an immaterial amount of money in terms of lending to those hedge funds through the crisis, which indicated that actually those procedures as they exist right now work very well. My view—and I think this is the US view as well—is that there is no need for specific limits on leverage.

Q476 Lord Haskins: You are saying the prime broker is effectively the regulator of these funds?

Mr Byrne: Yes, essentially. They are the ones who are incurring the risk and therefore, if they are to do that in a sensible manner, they need to make sure they are properly equipped to do so. That is a very serious business. Certainly it is an area where I spend most of my focus, particularly during the crisis, I worked through what was a very tumultuous period and I think those systems held up very well. I think the hedge funds behaved very well during that period as well.

Q477 Lord Jordan: Of the two most popular criticisms of hedge funds, one we have talked about, that they grossly over-reward themselves, but the other one has been their secrecy. You earlier on recognised this when you said you thought it was a good thing that we need more transparency and we should have it. In view of what you have said about that transparency, what is your view on the provision of systemically important data from hedge funds and other market participants being given to supervisors?

Mr Byrne: I think it is a very good thing. We fully support further data provision and reporting. That said, I think very careful attention needs to be paid to usefulness, proper aggregation and presentation to avoid unfairly harming investors. It should be noted that managers already provide very significant levels of risk information to investors and AIMA and the HFSB fully support that approach. Good risk disclosure not only helps in fending off systemic risk concern but it also means that investors understand more about what they are investing in and what those risks are, and therefore it is good for the industry and, I hope, good for investors as a result.

Chairman: Thank you very much. It remains for me to thank you very much, Mr Byrne.'
and then get into the questions. I am a Managing Director at the Association for Financial Markets in Europe and I act as Secretary of its Prime Brokerage Committee. Deutsche Bank, as you have heard, is an active member of the committee and Mr Byrne and I have visited Brussels on a number of the trips which he mentioned. AFME is the successor to LIBA, the London Investment Banking Association, which I know you know from your work, among other things, on the structure of European regulation. Our view on the Directive is straightforward. We welcome the proposal to register hedge fund managers, disclosure for macro-prudential purposes and the EU passport but we remain concerned about some aspects of the proposals. We have limited our involvement to the areas which affect prime brokers rather than trying to tackle all aspects of the Directive. Our four main concerns are, first of all, depositaries, and we think the proposals here demonstrate the difficulties of applying a regime developed for one product directly to another. As you have heard, the market is evolving away from a single prime broker model, where one hedge fund has one prime broker, to a model in which funds operate through multiple prime brokers, and the key difference between the UCITS world—that is units in investment schemes—and the hedge fund world is that in the UCITS world the depositary holds the assets in custody and executes the clearing and settlement of instructions, whereas in the prime brokerage world, because the prime broker provides finance, the assets of the fund are pledged to the prime broker and therefore they are held in his account and not in the fund’s account. So prime brokers will find it very hard, as required by the Directive, to act only in the interests of the investors in the fund, since their own interests, particularly as a counterparty to the fund and provider of finance to it, are engaged as well. The presidency has proposed helpful new language in recital 12, and a new Article 2.1(b) also helps. 2.1(b) permits a non-EU fund with an EU manager not to have a depositary so long as it is not marketed to investors under the passport. In its original form, the Directive would have cut off EU investors from access to some of the best managers in the world. The proposal to retain national private placement regimes helps here but clearly, equivalence should be read in the sense of equivalent application of the G20 protocols and not detailed, side-by-side mapping of specific individual local requirements. The third point is delegation. The restrictions on delegation would adversely affect managers’ ability to obtain access to specific national expertise, investing outside the EU in Africa, in Latin America, for example, though again this has been somewhat improved in the latest Swedish text. Limits on leverage or, in English, gearing; we believe that at level 1 it is important not to be too prescriptive but it must be right to supervise the providers of finance as well as the borrowers, as indeed the FSA and other leading regulators do. As Anthony Byrne mentioned, the prime brokerage industry is concerned to minimise and actively manage its risks and we have found FSA regulation of hedge fund managers to be helpful in that regard. I should also mention that even before FSA regulation of hedge funds was introduced, the LIBA Prime Brokerage Committee developed with the FSA and implemented a questionnaire on prime brokers’ exposure to hedge funds as counterparties. The results of that are not publicly available but I am sure you can get extra information on that from the FSA if you want to. Given the concentration of hedge fund managers in the London market and under FSA supervision, we think the results of that work are very persuasive. I would just mention one or two other things in closing on the role of the prime broker. Hedge funds access financial markets through the brokers who execute their business and prime brokers offer additional services, primarily the lending of securities to cover short positions and money to finance long positions. Prime brokers also offer custody services and act as the fund’s settlement agent. Hedge funds allow prime brokers to re-use the securities which the fund pledges to the prime broker in a process called rehypothecation. So the broker can thus pledge the securities to obtain the cash which he then onward-lends to the fund. We have talked at some length about depositaries, which was the other aspect of my prepared remarks but perhaps we can leave that as I am sure the point will come out in questions.

Chairman: Thank you. I think I am going to skip my question because alternative investment funds clearly can be systemically important, and ask Lord Jordan to ask his question.

Q479 Lord Jordan: There has been criticism that the activities of hedge funds, certainly when they are collective, can provoke mass movement of capital, and that in itself is destabilising. That is one of the criticisms. You may say whether that is right or not but could I ask you specifically, do alternative investment funds present any risks to the stability of financial markets and if so, what are they?

Mr Serocold: I think the primary risk that alternative investment funds pose is the notion of the crowded trade. If you put a trade on which you have researched for yourself, and is very attractive to you, your ability to get out of that trade at the other end will be affected by the number of other people trying to exit that trade at the same time. So the difficulty is you do not know how many other people there are in the room with you. In a crowded room, you say, “This room is unpleasantly crowded and I will leave now.” In a crowded trade, you need very sophisticated market intelligence to work out
whether you believe that trade is crowded, but, as a lender to somebody who is participating in a crowded trade, that is exactly the sort of market intelligence that you have an incentive to gather and monitor.

Q480 Lord Jordan: That is the only danger, you say? Mr Serocold: I think that is the primary danger. I think that the role of hedge funds in pushing the boundaries, if you will, in applying advanced financial techniques and in putting on trades in large size has been to some extent exaggerated. I would pause there.

Q481 Chairman: I suppose the other way in which a hedge fund presents a risk is by borrowing a great deal of money. Mr Serocold: Yes, and I think Bear Stearns had borrowed approximately $30 for every $1 of shareholders’ equity at the time of its demise. If I correctly remember the figures from the April FSA survey, the levels of gearing are approximately $2 or $3 for every $1 of fund holders’ equity in the case of hedge funds.

Q482 Chairman: But presumably it was the prime brokers who had lent the money to Bear Stearns? Mr Serocold: It was the banks who had lent money to Bear Stearns but, again, a great deal of Bear Stearns’ lending was collateralised. They put out securities as collateral for the cash that they borrowed and in that situation, that is partly why people felt comfortable running that level of gearing with Bear’s.

Q483 Lord Haskins: So mathematically, on that two or three to one gearing, that means that the stock market, for example, investing in equity, would have to drop by more than 60 per cent before an investor would have a problem. Would that be right? Mr Serocold: That would be right if you were running a long-only fund. If your only position was that you had bought 100 shares in Vodafone and you had bought £4 worth of Vodafone, £1 of your own money and £3 of the bank’s money, that would be right, but clearly, what you will actually do in a hedge fund is you will not just have that trade on; you may have a derivative trade on and in addition you may have a short position in Vodafone to hedge the long position, and so on.

Q484 Lord Trimble: Thank you for your opening statement, which covered a lot of the ground in terms of what prime brokers do, the original Directive, and the compromises that have been suggested by the Swedish presidency. Are there any further changes that you would like to see? Have you any views about what the outcome is going to be? Are these compromises that have been suggested by the Swedish presidency going to be adopted by the Parliament or the Council or are they just ideas which will fall by the wayside, with a reversion to some of the original Directive proposals? I am asking you to try and assess what is likely to happen. Mr Serocold: If you will forgive me for saying so, making predictions is difficult, and it is particularly difficult if you are making predictions about the future! European politics are Byzantine in their complexity, with the overlapping interests of Member States and the different political groupings. I think there is a reasonable chance that the Directive will be significantly improved as a result of parliamentary scrutiny as the Council discussions begin to come to an end—and I put it like that because there is to be a Council working group towards the end of this week and after that it will be in the hands of the Spanish presidency. As the Council deliberations begin to come to an end, the focus turns to the Parliament. We have the first draft of Gauzes report, we are thinking now actively about whether to put in a number of further amendments to improve the text further, and the main areas that we will be concentrating on are the ability of the depositary to delegate safekeeping, primarily to cover the ability of EU investors to invest in third countries where there is not an EU authorised institution, and on limiting the liability of the depositary in the way that Mr Byrne referred to. Those are our two main areas of focus and I can go into more detail if it would help.

Q485 Chairman: Are prime brokers always banks or does there exist a prime broker that is not actually a bank? Mr Serocold: Yes, there are prime brokers which are not banks.

Q486 Chairman: Who are they? Mr Serocold: The most obvious names in the trade are Goldman Sachs and Morgan Stanley, which are regulated as investment firms under MiFID and not as banks. That is essentially in this case a difference of form rather than substance. As a MiFID firm, the same capital adequacy requirements deriving from the Basel Committee and the same conduct of business rules deriving from MiFID apply to them, so one might almost say it was a distinction without a difference but, because the first draft of the Directive was very specific on limiting the depositary role to EU credit institutions, which is their word for banks, we were very insistent that it should be EU credit institutions or appropriately authorised investment firms under MiFID in order to level that playing field.

Q487 Chairman: It was a good shot at getting Goldman Sachs out of the business.
Mr Serocold: Yes.

Chairman: How very interesting. Thank you.

Q488 Lord Haskins: This is the long hop I gave to Mr Byrne and he smashed it away with great aplomb. On the prime brokers, do you think prime brokers have key responsibility in ensuring stability in this area? In other words, the question is, if you regulate the prime brokers, you are regulating the alternative investment funds indirectly.

Mr Serocold: I think it is much better for regulators to do the regulating and business people to do the business operations, if I can put it like that. I think there is a responsibility for lenders to lend responsibly as regulated entities and I think there are systems and controls in place at the firm level to do that. I do not think that you can place responsibility for the system on an individual bank because they cannot know what is going on in the system; they only know what they know about their clients and their business and the markets in which they operate.

Q489 Lord Haskins: Should regulators be worried if prime brokers lose a great deal of money? Surely, regulators tend to be interested when retail customers lose money. If prime brokers are grown up enough to be able to make their own decisions, if they get it wrong, they get it wrong.

Mr Serocold: Yes, and that will have an impact on the rest of the bank because a loss in prime brokerage is going to burn resources which would otherwise be available for the other business sides, so at the group board level, the group board is incentivised to take a great interest in this business and make sure they get all the answers they want.

Q490 Lord Haskins: And supervise these as well as they supervise their own banking activities over the last two or three years.

Mr Serocold: Or even better perhaps.

Q491 Chairman: It is an interesting question as to why the prime brokers did not lose money and the rest of the bank did.

Mr Serocold: Yes, it is. I would have to write to you on the detail but the short point is, because they were deliberately undertaking low-risk activities to high-risk customers. The customer was risky and it was managed by taking collateral and by sometimes being able to say, “No, you can’t have any more money for that. I’m sorry.” That is an important part of it.

Q492 Lord Marlesford: Just following up this very interesting subject of risk, if we look at the financial crisis and take some obvious names, if we took HBOS, RBS and Northern Rock, they did not lose money through any fault of hedge fund management, as I understand it.

Mr Serocold: I would not be completely specific on Royal Bank of Scotland because their operations include the former ABN-Amro businesses, which are more in my field of wholesale finance, but it was certainly open to those institutions to hedge their exposure to interest rate risk. Whether they did it or not I do not know. Some of them may have done so. The primary difficulty at Northern Rock was that they were using another advanced financial technique called securitisation, so they were building up a stock of mortgages which they were then able to re-sell the risk on, and it was that last stock of mortgages which they were not able to re-sell which caused the crisis of confidence which led to the exit of the retail deposits and then the events with which we are all familiar.

Q493 Chairman: If Northern Rock had a prime brokerage—and probably they did not—I am trying to pick away at whether the prime brokerages were better run than the rest of the banks.

Mr Serocold: I think the short answer to that is they probably were, because their customers at the hedge funds were amongst the most demanding customers on the planet. The hedge funds are also relatively generous payers of fees and avid consumers of multiple investment bank services, so if you are allocating quality people in the internal labour market in the bank, the prime services business will naturally be able to pay up for talent and will be an attractive place for determined, ambitious people to work.

Q494 Lord Marlesford: Am I right in thinking then that hedge fund managers and prime brokers who service them need a great deal more information because they are dealing in much more uncertainty? They try to limit the uncertainty by the hedging operation itself but they do have to evaluate, and the uncertainty is greater because they are, as it were, hoping for bigger moves than the ordinary person. In a sense, what Northern Rock and people were doing was an operation that they should have been hedging, whereas they were doing it without any sort of protection and probably without the basic analysis for saying if you lend too much money to somebody who cannot pay it back, you might have a bad debt.

Mr Serocold: I think, if I may, Lord Marlesford, I will leave the Northern Rock aspect out of this. I think the point about hedge funds is they take a very advanced analytical attitude to the risk business. Sometimes some strategies involve making a very small sum of money very regularly on a unit basis and then putting a great deal of resource into it. So it is the advanced analytical techniques applied to risk which are then overlaid with advanced financial techniques in relation to the use of gearing and the use of derivatives, combined in one place, which is really the characteristic of a hedge fund.
Chairman: Very interesting. It is the good customer who makes a good supplier.

Q495 Lord Moser: In your introduction you stopped short of talking about depositaries. One thing that some of our witnesses have referred to—I believe it is Article 17—is this business of insisting that the depositary should be a credit institution in the EU, not outside, not offshore, etc, and the criticism has been that that is all very well but it may increase costs and not even reduce risk. So it is bad on both fronts. Do you have a comment on that?
Mr Serocold: Yes, I think the original position was very flawed because there are only a very small number of EU banks—credit institutions, in the jargon—with the willingness and the ability to act as depositaries in this way. The heavy liabilities restrict that pool further, so that means you are fishing in a very small pool for depositaries. In many non-EU jurisdictions there may be no EU credit institution able to carry on the local business of holding the assets. So that would mean, without the power to delegate, that you simply could not invest using alternative investment funds in parts of Latin America, perhaps in Japan, in Africa, because you could not use a local depositary to hold your shares in those countries because they did not have an EU licence. There is that aspect. The inclusion of MiFID firms has broadened the pool materially in a helpful way, as has the ability to delegate, but that ability to delegate will only work in practice if the responsibility of the depositary for bad behaviour by its delegate is limited to things which ought reasonably to have been foreseen, the English law negligence standard or what French lawyers call “obligation de moyens” as opposed to “obligation de resultat”.

Q496 Lord Moser: I do not have this article in front of me obviously but would this mean, in your view, getting rid of the article and having no restriction whatever?
Mr Serocold: No, I do not think that is practical politics, my Lord. As a matter of practical politics, it is a question of working through Article 17, removing the most offensive bits, adding bits, refining the language to make clear what the policy intention is, and so forth. I think that is feasible, although I do not have any illusion that it will be easy.

Q497 Chairman: Can I ask if you are reasonably satisfied with the emerging decision of the European Parliament as set out in Mr Gauzes’ report?
Mr Serocold: My Lord Chairman, it is a good start. There is considerable further work to be done, particularly and most obviously in respect of Article 17 on depositaries, but there are some attractive features of the Gauzes report but I would not want to comment further; as I say, we are still working on our analysis.

Q498 Chairman: I just wanted to get a jump start on yours. I think colleagues, unless I have suppressed anybody, we must thank Mr Serocold very much for coming. You have been most helpful. It is very good of you both to give your time. Thank you very much. Our report will not be published until well into the New Year but we are sending a letter which reflects our main conclusions to the Minister to help him negotiate.
Mr Serocold: I think that will be very helpful.
Written Evidence

Memorandum by Allenbridge Hedgeinfo

— We are cautiously optimistic that the eventual solution will be beneficial for systemic security.
— We call for less regulation and more oversight.
— Punishing innocent managers while leaving the guilty unregulated doesn’t make sense.
— The industry needs a sensible onshore tax regime.

INTRODUCTION AND SUMMARY

In principle, we are cautiously optimistic about the EU AIF Directive, that the right regulation will strengthen the hedge fund industry and increase security for investors. But the draft as we have seen it casts a cloud over the financial services industry and indeed the EU legislative process.

We consider that regulation and oversight are key concepts that are important to differentiate. Managers need proportionate regulation and oversight. Funds need proportionate oversight. In effect, the regulation should be the least that we can get away with without disrupting innocent and beneficial market flows.

Under the Directive as proposed by a narrow group predominantly representing France, Germany and the PES, the cast of winners is as predictable as the cast of losers, the UK and US. This is gunboat diplomacy and does the EU no favours.

If we are to regulate market participants that pose the most risk, then let us at least deal with issues such as the market abuse, excessive leverage and short squeeze performed by Porsche in its raid on VW and hedge funds in 2008. Also if we are to step up monitoring, then the fraudulent trading by Jérôme Kerviel at SocGen would be a good place to start. However both of these major systemic incidents fall outside the remit of the AIF Directive.

Systemic risk comes from all types of market participant, and consequently, risk monitoring should encompass companies, family offices, sovereign wealth funds, [currently] regulated funds as well as alternative funds. Instead, the proposed approach appears to be driven by prejudice and partisan interests, focusing on alternative funds that played a minor part as canary in the mine, and victims in the credit crisis.

The main reason alternative funds operate offshore is that they are at a taxation disadvantage compared with other funds, so a key step for the UK would be to enable these funds to operate onshore rather than force them onshore.

QUESTION 1

What economic benefits arise from Alternative Investment Funds? What risks to financial markets arise from Alternative Investment Funds? Will the Directive help reduce these risks?

It is sometimes difficult to define exactly “Alternative Investment Funds” are, so perhaps we can firstly suggest some of their characteristics.

— Some observers define alternative funds by the mindsets of the managers. In other words, some types of people (“alternative managers”) will always seek to do things that are alternative and not mainstream. This interpretation is not mainstream, but it is at least consistent with the term “alternative”.
— Alternative Investment Funds are more conventionally identified by a number of specific product characteristics which may include some of the following: unregulated offshore structure, aligned incentive fees, investment flexibility, absolute return, hedged exposures, use of derivatives, short-term trading, arbitrage and leverage.
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<th>Benefits</th>
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<td>Alternative approach</td>
<td>Encourages innovation. Diversifies market risk for investors. Diversifies fiscal revenues. New products drive expansion of economic activity.</td>
<td>Often misunderstood</td>
<td>Innovators will always be one step ahead of regulators</td>
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<td>Offshore fund structure</td>
<td>Tax-neutral at fund level, so tax is paid in the hands of investors at their own rate wherever they are. Tax neutrality facilitates global trade.</td>
<td>Legal framework may not be so clear. Multiple jurisdictions problematic. Fund service providers need to be non-UK if the investment manager is UK-based to avoid corporate tax treatment instead of fund tax exemption.</td>
<td>Opacity of ownership brings uncertainty.</td>
</tr>
<tr>
<td>Aligned incentive fees</td>
<td>Managers are paid based on results, which encourages them to perform better. Higher fees charged by onshore managers and staff bring fiscal benefits. Alignment of interests with investors.</td>
<td>Reduces potential investment returns but investors will only invest if the returns are still attractive net of fees.</td>
<td>Poor structure of incentives can result in excessive risk taking and short-term performance</td>
</tr>
<tr>
<td>Investment flexibility</td>
<td>Nimble approach to opportunities.</td>
<td>Uncertainty over investment strategy</td>
<td>Some managers may be tempted to trade instruments or styles they have little experience with: “style drift”</td>
</tr>
<tr>
<td>Absolute Return</td>
<td>Provides greater investment certainty, which is especially important for return targeting investors, such as Pensions and Insurance companies</td>
<td>None</td>
<td>None</td>
</tr>
</tbody>
</table>
### ALTERNATIVE INVESTMENT FUND MANAGER DIRECTIVE: EVIDENCE

<table>
<thead>
<tr>
<th>Benefits</th>
<th>Disadvantages</th>
<th>Risks</th>
<th>Directive Effects</th>
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</thead>
<tbody>
<tr>
<td><strong>Use of shorting</strong></td>
<td>Aids efficient markets by price discovery and liquidity. Promotes efficient allocation of capital by highlighting underperforming companies. Required for arbitrage.</td>
<td>Perceived immorality of profiting from others’ losses</td>
<td>Risk of loss in shorting is theoretically unlimited.</td>
</tr>
<tr>
<td><strong>Use of derivatives</strong></td>
<td>Precise risk control and exposure can be constructed. A sharp knife can be used for saving lives in surgery.</td>
<td>All derivatives sound complex, many actually are complex. A sharp knife can be used for stabbing people.</td>
<td>Derivative construction and faulty ratings may hide risk. Mis-valuation.</td>
</tr>
<tr>
<td><strong>Short-term trading</strong></td>
<td>Increases market liquidity. Does not affect long-term prices.</td>
<td>Very high frequency trading may be unfair</td>
<td>Exposures tend to be lower</td>
</tr>
<tr>
<td><strong>Arbitrage</strong></td>
<td>Classic market efficiency benefits.</td>
<td>None</td>
<td>Theoretically riskless, but this is not the case.</td>
</tr>
<tr>
<td><strong>Leverage</strong></td>
<td>Increases economic activity</td>
<td>Cost of leverage creates asymmetric return profile.</td>
<td>Can cause systemic risk</td>
</tr>
<tr>
<td><strong>Unregulated managers</strong></td>
<td>Not true. EU managers are regulated and the FSA’s principles-based approach has been successful at maintaining order at funds through the managers.</td>
<td>In the US, unregulated managers have caused problems.</td>
<td>Minimal with UK regulatory framework.</td>
</tr>
</tbody>
</table>

**Question 2**

*To what extent is there a need to create a single regulatory regime for Alternative Investment Fund Managers in the European Union? Does the Directive achieve its objectives? Should the objectives of the Directive be modified?*

The objectives section of the draft leaves us in some doubt as to what the objectives are. But we have no hesitation agreeing with the idea that the Commission should “...extend appropriate regulation and oversight to all actors and activities that embed significant risks.” However, it is implicit in the statement that we should avoid inappropriate or unnecessary regulation and avoid applying regulation in areas that do not
pose significant risks to the system or to investors. In that sense, there is some doubt as to whether the draft Directive meets these objectives and there is clear evidence of “scope creep”.

However, in principle, we support the idea that regulation of non-systemic issues be included in the Directive for market order and harmonisation purposes. In fact, we would support a wider objective, for example: “…to extend best practice financial oversight and regulation across the EU to ensure proportionate oversight and regulation of all financial market participants, and allow secure intra-EU AIF business.”

We make a sharp distinction between oversight and regulation. For example, we see no reason why any AIF manager should be exempt from oversight (eg registration of individuals and reporting of positions), but that more intrusive regulation should be primarily principles-based, and focused on systemic risks only. The FSA has a policy of registration for all hedge fund managers and light-touch regulation for all except those who are large enough to pose a systemic risk. We endorse this approach strongly, however, we believe that oversight in the form of position reporting for risk aggregation purposes is important, and to be effective and fraud-proof, needs to cover all the managers’ trading counterparties irrespective of location for reconciliation purposes. In the sense that US investment banks were able to jump to enormous levels of leverage since 2004, and the hedge funds’ liquidity problems were instigated by the banks’ deleveraging, the biggest systemic risk may arise from those counterparties.

Philosophically, we are concerned that further increased globalisation and harmonisation leads to greater correlation between markets and therefore greater risk. As we have seen in the credit crisis, whereas previous crises have involved perhaps just one country or area at a time (eg Russian debt crisis, South East Asian Crisis, etc) correlation between countries has increased global risk. And perhaps the well-documented benefits of global trade may at some point be outweighed by the increased correlation risk.

As drafted, we don’t think the Directive achieves:

— the appropriateness test, as it increases costs and administrative burdens on small managers who pose no systemic risks; or

— the harmonisation test, not least because it potentially exempts Deutsche Bank and SocGen’s hedge fund managed account platforms, which would make it very easy for them to operate hedge funds and very difficult for everyone else. It also closes the market to non-EU funds for three years.

We shall shortly be publishing a more in-depth discussion paper of what the aims of the EU could or should be in making the markets more secure.

**Question 3**

*What risks arise from Alternative Investment Funds? Is the Directive proportionate given the role of AIF in the financial crisis? Will the Directive introduce over-stringent regulations or does it not go far enough?*

Please see Q1 for risks.

We believe the Directive is a disproportionate reaction, which attempts to paint AIFs as part of the credit crisis problem rather than innocent bystanders caught in the crossfire between over-leveraged banks. As a secondary banking system, they were actually part of the solution. There is universal acceptance that AIFs played a minor role in the crisis, and their involvement primarily was as a direct result of the withdrawal of funding by lenders who had over-extended themselves.

There is a danger in the draft Directive that AIFs are being singled out for more stringent restrictions and regulation than other market participants. For example, why should innocent hedge fund managers be tied up in red tape, while Porsche and SocGen be left alone, when they caused significant systemic risk by market abuse and fraudulent trading respectively?

In some areas, the draft Directive is over-stringent, and in others, it does not go far enough. We suggest that the solution is simpler than most people think:

(i) Enable an onshore tax neutral environment for investment funds, so that returns are taxed in the hands of the investor irrespective of origin or tax status. This way, administration and the vehicles themselves can be brought onshore voluntarily.

(ii) Follow the FSA principles-based blueprint, adding increased confidential data gathering, reconciliation and algorithmic risk analysis.

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1 “Scope creep” is where the objectives of a project expand without proper control. This is evident from the difference between the statements in the February 2009 de Larosiere report: “The Group considers that appropriate regulation must be extended, in a proportionate manner, to all firms or entities conducting financial activities which may have a systemic impact …”, the Commission statement of March 2009: “… appropriate regulation of all financial actors …” and in the April 2009 draft Directive: “… extend appropriate regulation and oversight to all actors and activities that embed significant risks.”

2 http://www.realclearmarkets.com/articles/2009/02/the_sec_killed_wall_street_on.html
(iii) Maintain management and enforcement at a member state level to avoid regulation from ivory towers.
(iv) Share individual member states’ anonymised exposure data with all other states’ regulators.

**QUESTION 4**

*Is it appropriate to regulate Investment Fund Managers, rather than the Fund itself? Does the Directive contain appropriate provisions to distinguish between different types of alternative investment? Does the scope of the Directive create a danger of unintended consequences?*

In a principles-based regulatory environment, it is the activities of the manager that need regulating rather than the vehicle. In fact, by attempting to micro-manage individual authorisations and types of alternative investment, the draft Directive expressly casts aside the statement in the Rasmussen Report (A6-0338/2008) “... principle-based regulation is an appropriate approach to regulating financial markets as it is better able to keep up with market developments...”

The draft Directive contains significantly more measures than would be suggested by previous reports, and even the defined goals of the Directive. But we are reluctant to conclude that all of these additional consequences are entirely unintended.

However, in the event of sensible data gathering, then risk bucketing needs to happen per fund as much as per manager. Providing the registration and reporting is just that, and not “authorisation”, then it should not be onerous.

**QUESTION 5**

*What is your evaluation of the Commission’s consultation in the preparation of the Directive?*

We note that the Commission says³ that “In April the Commission will bring forward initiatives already in the pipeline on hedge funds, private equity and remuneration structures. Following an impact assessment, the Commission will put forward to the June European Council a detailed timetable for further measures based on the de Larosière report.” We think that implies that they knew the draft was rushed, and they proposed doing a consultation on the impact after publication of the draft.

There does appear to be some political interference, and a notable lack of consultation with the UK, which houses the vast majority of EU AIF managers and has the most effective hedge fund regulation already.

And it seems like the most extraordinary coincidence that France and Germany, the two countries pushing the Directive most strongly have, as part of their national flagship banks, SocGen and Deutsche Bank respectively, the two largest hedge fund managed account platforms. With minor modifications these platforms could be entirely outside the scope of the Directive.

The behaviour of the Commission plays into the hands of Eurosceptics, as this Directive highlights the unavailability of public debate in Brussels and the vulnerability of the process to political capture. This means that there is little confidence that the implementation and application of many of the unspecified parameters will be free of political interference. This will be especially significant for countries like Ireland which will inevitably be somewhat marginalised once the presumed “yes” vote is safely in.

**QUESTION 7**

*Is the threshold for defining “systemically relevant” Alternative Investment Funds appropriate? Should the Directive include provisions on capital requirement? Does the Directive contain appropriate rules on leverage? Is the requirement for independent valuation agents and depositaries for Alternative Investment Funds adequate?*

No, the “systemically relevant” threshold is not appropriate. The FSA has not publicly defined the criteria for hedge fund managers warranting specialist oversight, but it is widely believed to be based on a combination of a risk assessment, number of people and funds under management, with the threshold probably in excess of $1 billion.

The Turner Review⁴ contains very sensible recommendations on capital requirements and leverage in pages 75 and 76. In summary, it focuses on the need for data gathering and monitoring in case risks should arise, because hedge fund leverage is typically quite low.

⁴ [http://www.fsa.gov.uk/pubs/other/turner_review.pdf](http://www.fsa.gov.uk/pubs/other/turner_review.pdf)
Independent valuation agents should be used where possible; this is a very important function, and in most cases, this is best performed at the administrator level. Because the valuation of many instruments is not clear cut, we would advise including a provision for funds to crystallise performance fees only on sale of investments.

The provision for depositaries is overly burdensome. We consider that segregation of assets is more important than compensation, and the responsibility for due diligence should fall on the investor, not the depositary.

**Question 9**

*What effect will the Directive have upon the position of the City of London and the EU as a whole as a leading location for Investment Fund Managers? Could it cause many hedge funds to relocate outside of the EU? What impact would the Directive have upon professional investors and institutions?*

As it stands, the draft Directive would be completely unworkable, but if it did come in unchanged, much of London’s alternatives business would switch to Paris and Frankfurt, under the Deutsche Bank and SocGen managed account platforms. EU investors would no longer be able to invest with many US managers, and the extra costs associated with compliance would increase the fee burden to investors, potentially making EU funds less attractive to overseas investors.

The Directive would cause managers to base parts of their operations in different locations, partly to conduct as much business as possible in low-tax, low-interference jurisdictions. It is unlikely that managers would close their offices in London or elsewhere in the EU entirely. They are more likely to keep their options open.

Professional investors and institutions would have to pay more for less choice of emasculated hedge funds.

**Question 10**

*How does the Directive compare to existing or proposed regulation of Alternative Investment Funds outside of the European Union, particularly that of the United States? How will the Directive affect the position of EU Alternative Investment Funds in the global market?*

This question is something of a moving target. The Directive could be described as “pro-cyclical”, “unilateral” or “gunboat diplomacy”. We have a perfectly good framework for alternatives in the UK, which is in danger of being lost.

In the US, hedge fund regulation is light years behind the EU and especially the UK, but they are probably still smarting from the over-reaction to Enron that turned into Sarbanes-Oxley, and demolished much of New York’s role in the global financial markets. They won’t make the same mistake again, and we shouldn’t either.

9 September 2009

**Memorandum by Appleby**

Appleby is a law firm which advises on the laws of the Cayman Islands, Bermuda, the British Virgin Islands, Jersey, Mauritius, the Seychelles and, with effect from 1 October 2009, the Isle of Man. A substantial part of our practice is the establishment of alternative investment funds (“AIF”), principally in the Cayman Islands. We make this submission as experts in the field of AIF structuring and establishment.

We have confined our submission to areas which directly impact on the jurisdictions in which we are established and the structures which we see established by the industry. Using the numbering in the Call for Evidence:

**Question 1**

1. The majority of the World’s hedge funds are established in the Cayman Islands. AIFs will only be established in jurisdictions where the AIF itself suffers no tax. That will either be a centre such as Cayman which has no tax or somewhere such as Ireland or Malta which exempts AIFs from tax. The majority of AIFs are established in Cayman and, whilst the fund itself is not taxed, investors will bear tax in their own jurisdictions in respect of their holdings. In addition, as most Cayman Funds are managed either in London or New York, the substantial management and performance fees are taxed in the UK and USA. Therefore, in addition to the economic benefits resulting from the general activities of AIFs, the UK benefits substantially in terms of revenue from the most-widely used model in Europe—a Cayman Islands AIF managed by an FSA-regulated manager in London.
QUESTION 4

2. The focus on managers is appropriate in addressing the concerns set out by the EU relating to risk, transparency and leverage as the manager is in control of such issues as management of the assets is delegated to it. However, the Directive as drafted misunderstands the relationship between the Manager and the AIF. The manager has no control over the other aspects of the AIF’s operations such as appointment of other service providers such as administrators, custodians and valuators. Indeed it is the AIF which appoints the manager in the first place. AIFs should be set up in jurisdictions which have the necessary professional expertise and appropriate regulation, which can be demonstrated to the EU’s satisfaction. Once over that hurdle, AIFs from such jurisdiction should be on a level playing field with those from inside the EU.

QUESTION 6

3. Under Cayman corporate law, which is based on English companies law, the fund has the control over its own assets. It delegates responsibility to manage the assets to the manager, valuation and administration to the administrator, and so on. It seems that if the EU wishes to ensure that AIFs are meeting a certain standard, they should set criteria for those funds. Countries can ensure they have the relevant regulation in place and directors of Funds can ensure that they are established and operated correctly. That the criteria or rights available to an AIF should vary hugely depending on whether that AIF is domiciled inside or outside the EU has no justifiable basis in regulation or supervision, is irrelevant to the matters set out in the explanatory memorandum and seems to be explicable only on the grounds of protectionism.

4. As there are to be no restrictions on AIFs such as investment policy etc, the EU is looking at a product which can be the same across the World. This contrasts with UCITs where, in order to gain access to retail investors in the EU market, there are limits on the funds. That is not the case here. The EU is looking for disclosure, transparency and certain basic requirements such as the appointment of a valuators etc. These can be just as easily imposed on a non-EU AIF (as outlined above) as one domiciled in Rumania or Malta. However, given that 80% of the world’s AIFs are domiciled in Cayman, why exclude this British Dependency from the new order? It would seem appropriate that the EU should have a list of requirements, largely along the lines of those set out in the current draft, with which the AIF must comply if it is to be passported into Europe. The domicile of the AIF is not relevant if it is complying with the objective requirements of the regulations.

5. Concerns with regard to tax treaties are irrelevant to the question of regulation. Nowhere in the Explanatory Memorandum to the directive is there reference to tax collection. However, it is understood that this is a concern of governments within the EU. It would seem reasonable to allow governments from outside the EU a period of time to conclude relevant treaties before funds from their jurisdiction are barred from marketing, rather than starting with a ban and then being allowed back in after three years under certain conditions.

QUESTION 10

6. The reference to “EU Alternative Investment Funds” in the question is misleading. Ordinarily, one looks to where the manager is based, not the domicile of the AIF itself. “EU Managed AIFs” would make more sense. For AIFs with EU managers to continue to be able to play a major role in the global market, regulation should be aimed at what happens with the money, which is determined by the manager. The global market is comfortable with Cayman and it serves its purpose in this hugely important are extremely well.

9 September 2009

Memorandum by Mr Robert Macrae, Arcus Investment

I am managing director of a small alternative investment firm employing six people in London and five in Japan. As is common for London AIFMs, many of our clients, funds and investments are based outside the EU. These opinions are personal, but I believe them to be reasonably representative of views common among small AIFMs.
1. What economic benefits arise from Alternative Investment Funds? What risks to financial markets arise from Alternative Investment Funds? Will the Directive help reduce these risks?

1.1 In order to make profits, AIFs must on average sell securities at a price higher than they buy them. High prices are associated with an excess of buyers and low prices are associated with an excess of sellers, so when AIFs are making profits they must on average be trading in the opposite direction to the balance of market participants. This must on average stabilise prices. Like any market participant an AIF may hurt stability if it collapses. However this risk should be considered in the context of AIFs’ otherwise beneficial role in market stability and liquidity.

2. To what extent is there a need to create a single regulatory regime for Alternative Investment Fund Managers in the European Union? Does the Directive achieve its objectives? Should the objectives of the Directive be modified?

2.1 The great majority of European AIFMs are based in London. A major reason for this in my opinion is that the FSA provides the best regulatory environment in the world for alternative managers. In the US the odd combination of legalistic but lax regulation leaves too much scope for fraud, while Japan and most European jurisdictions focus too much on form and paperwork rather than substance. Things the FSA does right include:

— rational, risk-based approach,
— principles-based regulation (rather than over-detailed and always- obsolescent rules),
— focus on senior management responsibility rather than box checking.

2.2 In the banking area it is obvious with hindsight that FSA and all other regulators have been asleep at the wheel. However this should not be allowed to obscure FSA’s highly effective role in alternatives. As FSA sets a high standard I am confident that centralisation will make regulation less effective.

2.3 Conflicts between UK and European regulatory models

2.4 In mainland Europe banks dominate all areas of investment activity. In the UK by contrast there are many different kinds of specialist investment company including banks, insurers and fund managers. Many of the oddities of the AIFMD when it is applied to UK entities seem to arise from this difference in investment cultures, as AIFMD appears to have been drafted on the assumption that all regulated entities are banks and takes no account taken of the different needs of non-banks.

2.5 This is most obvious in the implicit assumption that the appropriate level of investment risk is low in all cases, which is not correct for investment managers in equities and alternatives. Where a high level of risk is an explicit part of the service offered it is appropriate for the AIFM and its staff to be incentivised to take risk. It is what they have been hired to do and AIFMD should not obstruct this.

2.6 From the relative amounts managed out of London and other European centres it is clear that the UK model is by far the most successful. It would be perverse if AIFMD forced the UK to conform to the less efficient approach.


3.1 The nature of the crisis is that banks had used enormous leverage and took risky positions in an imprudent manner, sidestepping regulations intended to make the use of such high leverage relatively safe. Despite longstanding expectation to the contrary AIFs played almost no role.


While our regulation was not the root cause, our financial regulatory and supervisory system aided and abetted the super-bubble. It did not stem the flow of leverage through the financial system.

Hedge funds and private equity were the poster-boys of the new finance. They surfed the wave of abundant liquidity and cheap credit. Now as the financial system crumbles, they are easy scapegoats for more deep-rooted problems. Before we rush out to point the finger of blame we should not forget that hedge funds and private equity have not been central to the crisis, and it is not just me that says so.
Any policy responses that seek to tackle wider problems by targeting hedge funds and private equity will fail.

This does not mean that policy intervention should lack ambition. But it should be proportionate and targeted on clearly identified market failures.

3.3 It is unfortunate that AIFMD ignores this eminently sensible analysis.

6. Will the passport system help create a single market in investments funds within the EU? How will the passport system established affect the EU and the UK industry and particularly their position in the global market?

6.1 Over the years various attempts at passports have been tried and have failed, founder on issues of tax issues such at the UK “distributor status” concept and its overseas analogues. The key problems are in tax not regulation so I do not believe AIFMD will achieve much of value here.


7.1 The gross assets of the Lehman group were roughly $628 billion. Clearly there are many systemic issues associated with the failure of complex entities on this scale. However hedgefunds are much simpler entities, and collapses such as Amaranth ($6.6 billion) and Peloton ($1.8 billion) suggest that closing portfolios of $10 billion or more presents no real systemic issues. Even the collapse of LTCM ($4.6 billion) did not cause real problems despite it operated with a degree of leverage that would not be possible today. These numbers suggest that €1 billion would be a highly conservative threshold, and €100 million is far too small.

7.2 The AIFMD requirement for an independent valuation agent is sensible, and its lack is the biggest problem with the US approach to AIFMs. However the proposed rules are over-prescriptive, going far beyond what is required for this reporting and anti-fraud role. Rules which force custodians to be based in Europe have an obvious protectionist appeal, but should be resisted.

7.3 Gold-plating the custody function as AIFMD proposes forces custodians to take on unnecessary responsibilities. This is attractive to custodians because it increases the value added of the custody services that must be purchased by other investment firms, and also to integrated banks because it makes it harder for specialist firms to compete with banks that can provide all roles in-house. However like all protectionism this results in inefficiency, loss of competition, and a worse deal for the investors who pick up the bill. European investors have no choice but to bear the unnecessary costs but non-European investors will vote with their feet. Overall the European fund management industry will lose business that is driven offshore as a result.

9. What effect will the Directive have upon the position of the City of London and the EU as a whole as a leading location for Investment Fund Managers? Could it cause many hedge funds to relocate outside of the EU? What impact would the Directive have upon professional investors and institutions?

9.1 The Directive makes London a less attractive environment for AIFMs. In the unlikely scenario that it is adopted in its current form the strictures on managers are so arbitrary and onerous that mass relocation would be the likely consequence. To be specific, my company would not be allowed to manage its existing funds from London on terms acceptable to our clients and so would be forced to relocate outside the EU.

9.2 In the more likely scenario that the most protectionist and discriminatory elements are removed, the directive will still substantially increase the cost of doing business in London while achieving nothing of obvious value. This will increase the relative appeal of Geneva, Singapore and Hong Kong for new managers. My guess is that the most likely result of AIFMD is the gradual sidelining of London as a centre for alternatives as new managers make the rational decision to locate where costs are lower.

9.3 A recent survey of London managers suggests AIFMD as by far the most likely reason for managers to relocate away from London. Only 22% were prepared to rule this out, compared to 51% who rule out relocating to reduce tax burden.

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6 Fund manager migration and redomiciliation, International Fund Investment.
11. What effect will the Directive have on flows of capital and financial innovation?

11.1 Attainable objectives and effective regulation

11.2 When considering an appropriate regulatory response to the crisis it is important to remember the timescale over which regulation will need to be effective. As a guide, over the last couple of centuries financial crises have occurred at intervals of 20 or 30 years, probably because this is long enough for a new generation of decision-makers to decide that the lessons of the past are no longer relevant. The long timescales involved mean that to be effective changes must be robust to competitive pressures over an extended period; if they are not, then by the time the rules are needed they will have been weakened or else new structures will have been created that will make them ineffective.

11.3 Therefore effective rules should not seek to eliminate any profitable activity, and specifically should not seek to eliminate risk-taking. If they do, the inability of most market participants to indulge in this activity will create immense profits for those that can, and the resulting pressure for evasion or rules changes will mean that the rules are ineffective many years before they are needed. This is the likely fate of AIFMD in its current form.

11.4 To be effective regulation should focus on measures which increase systemic robustness. Greater transparency and bankruptcy-remote custodians are constructive avenues to pursue, and rules should seek to ensure that risk is taken in appropriate vehicles in a well-disclosed manner—for example in AIFs—rather than being concealed in obscure special purpose vehicles controlled by banks.

11.5 Where there are profitable activities such as the proliferation of OTC swaps that give rise to systemic risks then regulation should seek to promote alternatives which carry smaller systemic risks, rather than to proscribe the problem activity. Increasing transparency and competition reduces margins and so does not give rise to the strong incentive for evasion that is created by prohibition.

11.6 Alternatives and innovation

11.7 The alternatives industry should represent the cutting edge of financial innovation. The combination of informed investors, simple business models and expert and appropriately incentivised managers makes it ideal for this role. The industry is often criticised for obscurity, but in fact much of this reputation arises simply because of the lack of advertising and public marketing activities. Alternative investors are generally much better informed on what funds do in their name than are, for example, the account holders at the banks that are at the centre of the current crisis.

11.8 For much of the last decade this role in financial innovation has instead been taken by banks in a much more obscure way and in spite of regulations intended to prevent this. The experiment has not been a success, and the crisis is the result. It is greatly in the interests of financial stability to have risks taken out in the open where they can be seen rather than to have them hidden away.

11.9 The rational objective for AIFMD and for all regulation that seeks to address the financial crisis would be to ensure that good standards of transparency and regulatory oversight are met rather than to impose rules which will proscribe current, healthy practice. Because it does not it will stifle innovation until new and obscure ways can be found for innovation to be carried out. Unfortunately AIFMD’s proscriptive approach will plant the seeds for the next crisis rather than achieving anything constructive.

9 September 2009

Letter from the Association Française de la Gestion financière (AFG)

The Association Française de la Gestion financière (AFG) welcomes the House of Lords’ call for evidence regarding the proposal for a Directive on Alternative Investment Fund Managers.

For your information, the Association Française de la Gestion financière (AFG) represents the France-based investment management industry, both for collective and discretionary individual portfolio managements.

Our members include 409 management companies. They are entrepreneurial or belong to French or foreign banking or insurance groups.

AFG members are managing 2,500 billion euros in the field of investment management, making in particular the French industry the leader in Europe in terms of financial management centers for EU collective investment funds (with nearly 1,500 billion euros managed from France, ie 22% of all EU investment fund assets under management), wherever the funds are domiciled in the EU, and second at worldwide level after the US. Taking into account global asset management (ie funds and mandates), France ranks second in Europe after the UK.
In the field of collective investment, AFG represents—besides UCITS—the employee savings schemes and products such as regulated hedge funds, regulated funds of hedge funds as well as a significant part of private equity funds and real estate funds.

AFG is of course an active member of the European Fund and Asset Management Association (EFAMA) and of the European Federation for Retirement Provision (EFRP). AFG is also an active member of the International Investment Funds Association (IIFA).

We wish to express the following views on the AIFM proposal released by the European Commission.

1. What economic benefits arise from AIF? What risks to financial markets arise from AIF? Will the Directive help reduce these risks?

AFG regrets that the Commission proposal was not properly submitted to public consultation beforehand, contrary to the usual practice. We are also concerned that this proposal was launched in a very highly political context (G20 plus European Parliament requests), while a smoother way of preparing the proposal would have avoid too intense and unnecessary debates once the proposal was released.

We were advocating for a directive in this field (“alter-UCITS”) for a very long time. If we had been heard—but we were not, as many players from other countries (including in the UK) were against any text—there should have been enough time for in-depth consultations.

From a pragmatic perspective, now that a Directive is going to be adopted sooner or later because of this political context and because we think a directive is necessary anyway, we consider that if rightly amended, the AIFM Directive will bring two main advantages from a European point of view—which is the natural point of view to take into account when assessing a European piece of legislation.

First, through a so called “European passport”, it will make the Single Market a reality for those European AIF funds who will choose to follow the Directive’s requirements, while today such a Single Market does not exist. Currently, only so-called “UCITS” funds covered by the UCITS Directive are allowed to be passported throughout the EU. The new, complementary, passport for AIFs would bring both additional business opportunities for European management companies promoting such funds and a widening of investment choices for European investors as they will see a wider range of funds actively marketed to them.

Second, this new piece of legislation will facilitate the development of a worldwide brand for European AIFs, as for instance the UCITS Directive helped developing a worldwide brand for EU UCITS.

Regarding the risks to financial markets that you mention, we don’t see how or why this Directive could/would bring additional risks. But we regret that systemic issues are officially mentioned as a reason for proposing such a Directive, as we don’t consider that most AIFs imply systemic risks that are not already caught. We think that to a large extent this systemic dimension “pollutes” the real issue for AIFs from a European perspective, which is to set up both a Single Market and a worldwide brand for them.

2. To what extent is there a need to create a single regulatory regime for AIFM in the EU? Does the Directive achieve its objectives? Should the objectives of the Directive be modified?

AFG has been calling for the creation of an AIF passport for years (“alter-UCITS”). Indeed, most European management companies wish not to limit their activities to national boundaries; therefore the ability to passport their funds within the Community will help them reduce their costs, which will in turn benefit consumers. Competition will increase and investors will have a broader choice. Besides, the creation of a single regulatory regime at EU level will reduce regulatory arbitrages and decrease legal uncertainty, and thus will directly enhance investor protection. Finally, we believe that, like the UCITS passport, the passport for European AIFs will encourage the development of the AIF industry in the EU and the creation of a recognised brand that will be more easily exported to third countries.

However, like the UCITS passport, the AIF passport should be limited to EU-domiciled funds and managers. There is a crucial need to restore confidence in investors’ minds. If the AIF passport should be extended to non-EU funds and managers, it would imply that a fund domiciled anywhere in the world could be actively marketed throughout the EU. One tricky point is that in case of blowing out of a non-EU AIF, the European investor would have to go before a non-European judge—where the fund is domiciled—to try getting its money back. There is a high risk of non-recovery, and therefore any scandal could harm the whole investment fund industry at large, without making the difference between the European industry and the others.
A crucial point is to take into account the new profile of European professional investors—which are the investors to which AIFs could be actively marketed. According to a recent FSA study, more than 80% of investors in Hedge Funds are institutional investors—for instance pension funds—and not high net worth individuals. Through pension funds or municipality funds, the risks are spread indirectly to final investors which may be retirees or local tax-payers. As AFG is very concerned about keeping investor confidence in the long run, we want to avoid taking such a legal risk (which may ultimately lead to a political risk in some cases) and therefore we think that the EU passport should be limited to EU-domiciled funds and managers.

As a complementary element to this EU passport limited to EU funds, we suggest keeping the existing national private placement regimes in place, in order to keep national flexibilities in active marketing of non-European funds to local investors. Said more clearly, EU countries should remain free to grant a “national visa” (which is different from a passport) to non-EU funds that they thought could be authorised to be sold to or bought by their national investors. The only caveat is that it could, if it is felt necessary, be decided that the possibility to grant these “visas” will in the future be restricted to non-EU AIFs registered in jurisdictions applying IOSCO rules and principles.

Thus, we think that European professional investors (if, of course, their own sectorial regulations make it allowed) should be kept free to invest in non-EU funds if their wish to do so, but on their own initiative and under their own responsibility.

Last but not least, in terms of legislative approach, we think crucial that as far as possible the AIFM Directive provisions be similar to the UCITS Directive ones, in order to ensure a level playing field between UCITS funds and AIFs. Our aim is to avoid any circumvention of the UCITS Directive, ie the risk to see some providers changing slightly the characteristics of a UCITS fund in order to make it non-compliant anymore with the UCITS Directive and to make it benefit from the AIF passport which could be less onerous.

3. What risks arise from AIF? Is the Directive proportionate given the role of AIF in the financial crisis? Will the Directive introduce over-stringent regulations or does it not go far enough?

As a complement to what we mentioned in our answer to Question 1, AFG would like to highlight the fact that alternative funds do not necessarily imply excessive or speculative risks, even though some alternative funds may use speculative techniques. Many strategies for Hedge Funds for instance—such as Long/Short strategies—do not necessarily entail higher volatilities than direct investment by investors in equities.

In addition, in the context of the recent financial crisis, hedge funds have been pointed at; however, it has been shown that they were not responsible for the crisis.

As we mentioned in our answer to Question 1, the Directive was hastily drafted in times of strong political pressure. It was designed with two specific types of funds in mind (ie hedge funds and private equity funds) but structured in such a way as to encompass all management companies managing all types of funds apart from UCITS funds. Hence, some inconsistencies it resulted in particular in inconsistent rules for the different types of funds potentially covered.

A way to amend the Directive on this point could be to let purely national AIFs out of the scope of the Directive, making it mandatory nonetheless that all national funds and asset managers are subject to the oversight of a national regulator.

4. Is it appropriate to regulate Investment Fund Managers, rather than the Fund itself? Does the Directive contain appropriate provisions to distinguish between different types of alternatives investment? Does the scope of the Directive create a danger of unintended consequences?

We are not opposed to the fact that regulation concentrates on Managers rather than on Funds. To a large extent such an approach makes sense as an over-rigid regulation of the Funds themselves would not fit with the raison-d’être of hedge funds or private equity funds for instance, which require a high degree of flexibility by nature.

However, we believe that for some specific provisions the Directive should contain appropriate provisions to distinguish between different types of AIF and allow for particular considerations regarding specific AIF (for instance real estate funds and private equity funds). For example, we think that the provisions on leverage are not appropriate to be applied to private equity funds.

5. What is your evaluation of the Commission’s consultation in the preparation of the Directive?

As already said in our answer to Question 1, AFG can only regret that stakeholders were not publicly consulted by the Commission beforehand on a draft proposal for a Directive—contrary to what is usually done. At the same time it should be recognised that many of those who are now complaining about this situation were, not so long ago, completely opposed to any EU regulation and thus not very open to debates or consultations—although the Commission did organise workshops and hearings on the subject in the past few years.

6. Will the passport system help create a single market in investments funds within the EU? How will the passport system established affect the EU and the UK industry and particularly their position in the global market?

We are fully convinced that the passport system will help to develop a truly single market in investments funds within the EU as long it is limited to EU funds and managers. It will increase cross border business and reduce costs. It will also widen the choice of investments for European investors. In addition, we strongly believe that it will facilitate the growth of the European AIF industry out of Europe by creating a recognised brand (in the same way the UCITS Directive encouraged the development of the UCITS industry). Conversely, if the benefit of the AIF passport were extended to non-EU AIFs and non-EU managers (but it does not make sense to grant a European passport to non-European entities or funds), the active marketing of non-EU funds to European investors, such as European pension funds and municipality funds, would create legal risks and potentially political risks as well in case of blow out.

7. Is the threshold for defining “systemically relevant” AIF appropriate? Should the Directive include provisions on capital requirement? Does the Directive contain appropriate rules on leverage? Is the requirement for independent valuation agents and depositaries for AIF adequate?

Definition of systemically relevant AIF

AFG agrees with introduction of thresholds. We feel that the thresholds are low enough to encompass the vast majority of AIF while leaving small entities that do not present systemic risk out of the scope of the Directive (these entities may nonetheless choose to opt-in), but we are not against further discussion on their level and scope.

Provisions on capital requirement

The provisions set by the Directive on capital requirement are generally aligned on those set by the UCITS Directive. However, the maximum amount of capital required in the UCITS Directive should also apply to AIFM. Besides, we are of the opinion that the inclusion of delegated portfolios in the portfolio of an AIFM is not justified, as these portfolios are already taken into account in the portfolio of the delegating AIFM. The legal risk relating to the delegated portfolio lies with the AIFM that delegated its management. This is the approach taken by the UCITS Directive and it should be adopted by the AIFM Directive.

Rules on leverage

The provisions on leverage contained in the Directive are not appropriate.

First and foremost, we believe that these provisions on leverage should not apply to Private Equity funds.

In addition, the Directive does not give a sufficient definition of leverage and how it should be calculated. Indeed, the definition of leverage is complex and should perhaps be described in further detail in level 2 measures.

For instance, AFG feels that a threshold of 2 is arbitrary and too low. In any case, we believe that the level of leverage can only be appreciated with regards to the liquidity of the assets in the portfolio. Also, the limits imposed to AIF should not be more stringent than limits imposed on banks (there is a risk of creating an unlevel playing field if this is not the case).

More importantly, these limits should anyway not be set by the Commission, as it is not a regulator. Rather, limits—if they were finally considered as necessary—should be decided by Member States’ regulators, but only in exceptional and temporary circumstances and in collaboration with CESR in order to ensure a similar application for the whole EU. Conversely, on a permanent basis, there is no reason to limit leverage: the flexibility of the leverage is a major characteristic of AIFs.
Finally, AFG believes that the disclosed information regarding systemic risk needs to be centralised at a European level, as the scope of vision regarding systemic risk will not be wide enough if it remains at national level. We therefore suggest that CESR should be the co-recipient of information on leverage, along with the home Member State regulator, or receives automatically this information from the home Member State regulator.

Requirement for independent valuation agents

We strongly contest the requirement of an independent valuator set by the Directive. Indeed, the notion of “independent valuator” is contrary both to the existing regime of the UCITS Directive and to many national regimes regarding non-UCITS funds. No market failure would justify a change from the current regime. According to the UCITS Directive and such national regimes, the Management Company is the single entity responsible for this valuation, even though it may outsource the valuation function.

For instance, the competence of real estate or private equity fund managers resides in their professional skills to valuate real estate or private equity or to confirm the valuation done by an external valuator. In many cases, the establishment of the value of the assets acquired by the AIF relies on the knowledge of the AIFM and this exercise cannot be done without the involvement of the AIFM.

In addition, the use of an independent valuator could increase the final risk for investors as it will legally imply an additional player in the value chain and will reinforce the uncertainty for the respective responsibilities of all these players.

Moreover, the notion of “independence” is ambiguous. Does the Directive refer to legal or capitalistic independence? The Directive explains that implementation measures will be taken but this leaves room for interpretation and at this stage we can not be assured of the final result.

Finally, if the Management Company were not responsible for the valuation, there would be a risk that it might care less about the valuation’s accuracy, which would be prejudicial to investors.

As a conclusion, we firmly believe that valuation should be a function, not an entity, and part of the management function (in the same way Annex II of the UCITS Directive includes valuation as part of administration and in turn management services). It could be carried out by the AIFM itself or outsourced under the responsibility of the AIFM. If carried out internally, the valuation should be made by a function autonomous from the investment management function. However, the principle of proportionality should apply depending on the size/nature of the AIFM. If needed, level 2 measures could provide for relevant conduct of business rules.

Requirement for depositaries

First and foremost, AFG believes that there is an urgent need to take into account the Commission’s consultation on UCITS depositaries, in order to ensure consistency between the two regimes, if not identical regimes. The provisions of the Directive should definitely incorporate the findings of the Commission’s consultation on the UCITS depositary function, in particular the definition of safekeeping and the need for a unique depositary.

Second, we think that the provisions of the Directive should be aligned on those of the UCITS Directive as far as possible. The differences between the Directive and the UCITS Directive related to depositaries should be solved if they do not appear justified. An identical treatment is necessary in order to ensure a level playing field between the regulation applicable for UCITS and AIF.

AFG notes that, contrary to the UCITS Directive, the Directive does not include any control function in the list of tasks performed by depositaries. We therefore suggest assigning control functions, in addition to safekeeping, to depositaries of AIF.

Furthermore, the Directive establishes de facto a depositary passport which currently does not exist for UCITS. In practice, the AIFM Directive would allow for EU AIFs to get a depositary domiciled in another Member State than the fund domicile. We are not opposed to the principle of such a depositary passport, but it should be introduced only when a similar depositary passport is offered to UCITS funds in the UCITS Directive (which is not the case today).

Third, the Directive should tackle the subject of the role and responsibilities of prime brokers. The role and responsibility of the depositary can only be examined in light of the activity of prime brokers. Indeed, the Directive does not take their role into account at all. But it is crucial that it clarifies how the roles of the AIFM, the depositary and the prime brokers will articulate, especially if prime brokers are located outside the Community.
8. Will the provisions strengthening disclosure requirements help to create a more transparent market or do they go too far?

AFG believes that some of the information disclosure requirements imposed to AIFM managing AIF which acquire controlling influence on companies are disproportionate. The Management Company should not be required to provide information to employee’s representatives, but rather to Management, who may then pass it on to employees’ representatives.

In particular, the obligation to disclose the development plan to shareholders and representatives of employees does not make sense. This is confidential information and it should be kept within the company and not publicly disclosed (this might distort competition). This is not required in other areas of the industry so why should it apply to AIF? We need a level playing field between AIFs’ and other shareholders’ disclosures.

9. What effect will the Directive have upon the position of the City of London and the EU as a whole as a leading location for Investment Fund Managers? Could it cause many hedge funds to relocate outside of the EU? What impact would the Directive have upon professional investors and institutions?

We strongly think that the AIFM Directive will enhance the position of the EU—including the UK—at global level, both by facilitating the passporting of AIFs throughout Europe and by setting a brand complementary to the UCITS one for worldwide distribution. Of course it will not prevent competition to continue between the different current financial management places (London, Paris, Frankfurt, etc) but we are not afraid by such a continuing competition, as in any case we will all of us take benefit from a developing AIF market both at EU level—thanks to the passport and a wider offer for EU investors—and at global level—thanks to the new worldwide brand given by the Directive to European AIFs.

But it implies obviously that the benefit of the passport is limited to EU funds, as otherwise it could create legal risks for European investors (see our answers to Questions 2 and 6 above) and no EU brand could be set up (national entry visas to non-EU funds obeying IOSCO rules and principles should anyway still be granted by countries who wish to do so).

10. How does the Directive compare to existing or proposed regulation of AIF outside of the EU, particularly that of the US? How will the Directive affect the position of EU AIF in the global market?

Currently the US is preparing a regulation of Hedge Funds managers, with a higher degree of requirements than today. Although the details of this forthcoming regulation are not known yet, it shows that both sides of the Atlantic are taking to some extent the same orientation.

From a competition perspective, the crucial issue for the EU is to make sure that the EU Directive will find the best mix between light touch regulation and investor protection (especially taking into account the growing part of EU investors composed of retirees through pension funds and taxpayers through municipality funds). But the ultimate aim of the Directive must be to set up a framework for EU AIFs which is able to compete in the best way with non-EU ones—as it was successfully found with the UCITS Directive, which facilitated the worldwide selling of European mutual funds.

11. What effect will the Directive have on flows of capital and financial innovation?

It is clear that EU financial innovation will be stimulated by the Directive, if it is properly drafted of course, as there will be new business opportunities at stake for EU AIFs, both within the Single Market (thanks to the EU passport) and at global level. But conversely, if the passport were extended to non-EU funds and managers, the Directive would have a negative impact on the development of the EU AIFs, as non-EU AIFs as easily as EU AIFs to European investors: sooner or later a blow out from non-EU AIFs would harm EU investors and ultimately create prejudice to the whole investment fund industry, without differentiating EU funds and non-EU funds.

9 September 2009
Memorandum by Association of Investment Companies

1. The Association of Investment Companies (AIC) welcomes the opportunity to provide written evidence to the Committee’s inquiry and would be pleased to provide oral evidence to explain its position in more detail.

2. Investment companies are an important part of the UK’s investment landscape. They offer competitive costs, independent governance and access to alternative asset classes. Their shareholders include pension funds, insurance companies, unit trusts, wealth managers and retail investors. They invest in publically traded equities, private equity, property and debt. Some employ hedge fund strategies. (See annex 1 for industry overview.)

**Headline Concerns**

3. Recent market turbulence, and its broader economic impact, creates a case for updating the regulation of “alternative investment funds” (AIFs). However, in pursuing this agenda, European policymakers should seek to deliver well targeted, effective and proportionate regulation—not simply more regulation. Unfortunately the AIFM Directive (“the Directive”) does not achieve this.

4. **Targeting:** The Directive fails to target its regulatory ambitions primarily because it focuses on regulating particular market participants, namely AIFs, rather than abusive activities. For example, the Directive includes measures to increase transparency where EU companies are bought by private equity funds. Whether this is appropriate is debatable. However, if this is an appropriate regulatory intervention, it is not clear why the measures are not relevant for, say, private equity funds which are not governed by the Directive, sovereign wealth funds, rich individuals and conglomerates who, as the measures are currently constructed, will not have the same obligations. Similar issues arise throughout the Directive, for example in relation to investing in securitised assets. The failure to target behaviour which causes regulatory concern contrasts with, say, the Market Abuse Directive, which identifies damaging behaviour (insider trading etc.) and seeks to control it regardless who is involved.

5. **Effectiveness:** Where the Directive does impose regulatory obligations it fails to do so effectively. For example, it creates obligations regarding depositories and gearing which purport to reduce risks in the financial system. Unfortunately, instead of controlling these risks these measures threaten to increase them. The proposals on depositories envisage these functions only being carried out by EU credit institutions. At the moment other entities, including for example, American banks, carry out these roles. Limiting these activities to EU credit institutions will ultimately concentrate, and increase, counterparty risks. A crisis for one EU bank could have more significant implications than if these activities were spread more widely.

6. Risks are also increased by the proposed leverage cap. Recent market events highlighted problems of procyclical asset sales, where investors sell assets into falling markets which magnifies market movements. A hard leverage cap, enforced through regulation, creates the prospect that funds with exposure to a particular market sector could be obliged to sell assets where the price of those assets was falling and this raised their relative gearing levels. They would then sell assets to raise funds to reduce their debt. Caps would therefore encourage asset sales into falling markets, which is just the situation policymakers have expressed concerns about. Hard leverage caps applied on a formulaic basis across markets do not represent an effective regulatory intervention.

7. **Proportionality:** The Directive is not proportionate because it threatens serious, negative consequences for all investment companies without providing compensating regulatory benefits. These risks arise regardless of the company’s size, assets, domicile or the market on which they trade their shares. Problems include:

   - Preventing share issues, which would stop existing companies managing their share structure in the interests of shareholders and new launches.
   - Stopping boards having full control of the company’s activity by creating competing regulatory obligations for the external fund manager. This will create conflicts within the structure and compromise the board’s ability to ensure the consumer interest is paramount.
   - Stopping investment companies from using non-EU suppliers (which prevents the employment of managers with regional investment expertise) and non-EU domiciles (which will prevent them offering investment strategies on a tax-efficient/commercial basis).
   - Duplicating existing obligations (where the Directive overlaps with other EU legislation ie the Transparency and Prospectus Directives etc).

8. The first three problems identified above could fundamentally undermine individual investment companies. The last threatens to unnecessarily increase costs to investors. Any of these outcomes should be unacceptable. The goal of regulation should be imposing effective and proportionate controls—not preventing some AIFs from operating at all. The Directive threatens the sector’s ability to meet investor needs. Its
potential impact is far greater than for some other affected vehicles which only face additional compliance burdens and commercial restrictions.

9. The AIC is wary of predicting catastrophic outcomes, as concerns about regulation are often overdone and are normally ruled out by a careful policymaking process. In this case, a lack of consultation and understanding of investment companies’ unique characteristics mean that profoundly damaging outcomes are a real threat unless the proposals are adjusted.

RESOLVING PROBLEMS WITH THE Directive

10. The priority should be identifying how the proposals can be improved to deliver better regulation. This should involve integrating the Directive effectively into the existing regulatory context and refining specific proposals to ensure they are appropriate ie targeted, effective, proportionate etc.

11. Integrating the proposals into the existing regulatory context: Many of the Directive’s problems could be resolved by co-ordinating it with existing regulatory obligations which have proven to be effective. For example, the Market in Financial Instruments Directive (MiFID) and Undertakings for Collective Investments (UCITs) Directive have provisions on delegation. These have been tested over time. These models should be used for the Directive, which at the moment offers an alternative approach which is problematic in a variety of ways.

12. Existing regulatory mechanisms should also be used to resolve problems the Directive creates for investment companies. Specifically this would resolve the threats the Directive poses to the current governance structure. The AIC is advocating that the regulatory objectives of the AIFMD be applied to investment companies using existing regulatory mechanisms (ie the Listing Rules, Prospectus Directive, Transparency Directive etc) to deliver equivalent obligations for EU listed investment companies. This would involve tailoring those Directives to add-on necessary obligations where there would otherwise be regulatory gaps. This approach would then allow listed investment companies to be safely removed from the ambit of the AIFM Directive, which would resolve key problems. This approach would:

— deliver equivalent standards of regulation for investment companies regardless of their asset allocation or domicile;
— avoid any potential for regulatory arbitrage while using a proven route to deliver regulatory control;
— remove problems with applying the AIFM Directive to funds which are not led by an AIFM and recognise the diversity which exists in the AIF market; and
— allow investment companies to compete with other funds without undermining the ability of the structure to deliver shareholder benefits.

13. Utilising existing regulatory mechanisms, including adopting an alternative regulatory approach for listed investment companies, will allow significant improvement of the Directive. It will also demonstrate policymakers’ commitment to proportionality and desire to deliver workable regulation which meets the needs of industry as well as consumers.

14. Refining specific proposals: Refining the AIFMD proposals should also focus on the specific obligations it creates. Refining the Directive will remove unintended consequences, unnecessary costs and compliance burdens.

15. For example, the Directive should remove the restriction on investment companies issuing shares (Article 4). The Directive envisages that an AIFM would issue shares and seeks to stop any other entity undertaking this activity. However, investment companies issue shares in their own right, in accordance with company law and under established regulations (eg the Prospectus Directive). Shareholders approve new issues and Directors must take into account their interests before acting. There is no reason to end this approach. Suggesting that external managers should be in charge of this process fails to recognise the nature of the investment company structure and the existing rules which underpin it. Stopping investment company share issues would mean the demise of the sector in a few years as no new funds could be raised to compensate for the normal process of capital leaving the sector. This should not be an acceptable outcome of regulating AIFs and the Directive should be revised accordingly.

16. The Directive also currently requires AIFs to have a liquidity profile in their underlying assets which allows them to offer redemption on demand (Article 12). This may be an appropriate requirement for open-ended funds (which may require asset sales to meet redemption demands). It is not suitable for closed-ended funds (where investors realise their capital by buying and selling shares on a market and there is no link to the liquidity of the underlying portfolio). There are benefits of this closed-ended approach, notably facilitating investment in less liquid assets, such as property, infrastructure or private equity. The AIFMD’s concentration
on open-ended structures illustrates its failure to recognise the diversity of the AIF market and that different types of fund offer different advantages to investors. Again, this provision should be amended.

17. Every aspect of the Directive should be examined and changes made to ensure the regulatory obligations created are appropriate and effective.

**Specific Questions**

18. What economic benefits arise from Alternative Investment Funds? What risks to financial markets arise from Alternative Investment Funds? Will the Directive help reduce these risks?

19. AIFs, such as UK investment trusts, provide capital for investment in European companies, property, and infrastructure. They invest, for example, directly in shares and corporate debt issued by other European companies.

20. AIFs also provide investment opportunities for pension funds and other investors seeking to spread their investment risk. This helps them secure an investment return for consumers (pensioners etc) without concentrating their risk too narrowly. Ultimately this helps provide for the future financial needs of individual citizens across the EU. At the same time, competition between AIFs and other funds bears down on costs and reduce the drag on investment performance. (See annex for discussion on costs in investment companies.)

21. AIFs may create some risks for investment markets. However, these have not been defined for the purposes of the Directive and they may not be solely the preserve of AIFs. For example, recent experience has shown that investment in securitised assets, where investors are uncertain of the risks they incorporate, can create regulatory issues. There may be a case for adjusting the regulatory regime surrounding these instruments to mitigate these risks. The Directive therefore proposes limiting AIF investment in securitised assets to those where the originator retains a 5% interest in the asset. However, if this is the correct approach to reducing risk from this asset class, the Directive is wrong to limit the restriction to AIFs. This is a partial response which, for example, does not cover the proprietary trading activities of banks, despite the fact that these institutions were central to recent problems in financial markets (not AIFs).

22. One difficulty in assessing the effectiveness of the Directive is that the regulatory risks it is supposed to address have not been defined and prioritised. However, as it targets selected market participants rather than behaviour, it is unlikely to be effective in its regulatory ambitions.

23. To what extent is there a need to create a single regulatory regime for Alternative Investment Fund Managers in the European Union? Does the Directive achieve its objectives? Should the objectives of the Directive be modified?

24. The focus of regulatory intervention should be on securing proper regulatory outcomes, not delivering a single piece of legislation. One directive is unlikely to be able to adequately cover all issues and market participants which create regulatory risks. There is no benefit to using one directive to address regulatory issues; instead this creates the potential for regulatory gaps.

25. Rather than focussing on mechanisms (single or otherwise) a better approach would be to define risks and what factors exacerbate them. Specific regulations should then be introduced to target identified problems—regardless of who is involved, be they AIFs or any other market participant. Unfortunately, the Directive has not been based on this approach. It is therefore unlikely to achieve its intended goals.


27. AIFs were not the source of the financial crisis, and this has been recognised by a variety of policymakers. In this context, the adverse effects of the Directive cannot be justified as a necessary response to the financial crisis. Therefore, conventional regulatory processes, and proper cost benefit analysis, should be a priority as policymakers seek to scrutinise and revise the Directive’s proposals.

28. There is no question that the Directive will have a disproportionate impact on investment companies in its current form. Just one outcome, preventing investment companies from issuing shares, will ultimately mean the terminal decline of the sector as funds leaving it cannot be replaced. Regulation must be disproportionate if it curtails the operation of a sector which was not responsible for the financial crisis and for no regulatory benefit.

29. The poor construction of the Directive makes it difficult to assess its overall impact. Each provision needs specific analysis. Nevertheless it is clear that overall the Directive’s impact is negative and disproportionate.
30. Is it appropriate to regulate Investment Fund Managers, rather than the Fund itself? Does the Directive contain appropriate provisions to distinguish between different types of alternative investment? Does the scope of the Directive create a danger of unintended consequences?

31. Many of the Directive’s provisions regulate the AIFM/AIF sector instead of behaviour, which is inherently problematic. However, there are also flaws in introducing proposals which assume that regulation of the manager is the correct approach. For some fund structures this is the right approach. For others, notably the investment company sector, it is not.

32. The AIC is therefore proposing an alternative route to regulating investment companies, based on existing regulatory provisions (see discussion on integrating proposals into the existing regulatory context). This would secure a correct regulatory outcome, without unduly damaging the sector.

33. What is your evaluation of the Commission’s consultation in the preparation of the Directive?

34. Consultation before the Directive was published was poor. The Commission issued general calls for views on issues surrounding hedge funds and private equity. However, it did not undertake the customary consultation which would be expected on specific proposals. This has meant the Directive is poorly targeted and creates significant unintended consequences. It also means that it is unlikely to secure the desired regulatory outcome.

35. From a policymaking perspective it is unfortunate that this lack of early consultation could ultimately extend the timetable for introducing regulation. This would arise as the participants in the debate are occupied with issues which might have more easily be resolved before a declared policy position was published. The process may also have needlessly undermined trust in the policy making process, which is undesirable as confidence is invaluable in encouraging open dialogue and formulating an effective policy outcome. It should be a priority for the future to ensure that future policymaking processes do incorporate proper consultation processes as this will produce better outcomes for all parties concerned.

36. Will the passport system help create a single market in investments funds within the EU? How will the passport system established affect the EU and the UK industry and particularly their position in the global market?

37. The passport system is not relevant for investment companies as many can already “passport” via the Prospectus Directive. Interestingly, the sector has not tended to take advantage of this because of other barriers to developing a single market—notably tax issues.

38. The proposals will also fail to deliver a single market because they deny the passport to funds located outside the EU for a period of three years once the proposals come into force. This will apply even where they have an authorised AIFM. There is no regulatory justification for this provision. It is a serious obstacle to any claim that an effective passport will be created.


40. The Directive will affect funds which are not systemically relevant. For example, VCTs with an external fund manager which breaches the thresholds set by the Directive will be caught by the proposals. This is despite the fact the majority of these VCTs manage only a few tens of millions of pounds/Euros and create no systemic risk.

41. This issue could be resolved by creating an additional “fund” threshold of, say, 100 million Euro. Under this approach the AIFM would be subject to the provisions of the Directive where it breached the current thresholds, except in respect of funds which fall under the “fund level” threshold. This would exclude from the regime funds which have no conceivable systemic impact.
42. Will the provisions strengthening disclosure requirements help to create a more transparent market or do they go too far?

43. Listed investment companies are already subject to substantial public disclosure obligations through the Transparency Directive and Prospectus Directive. The AIC is unconvinced that the Directive’s proposals offer any substantive improvements in transparency for these entities.

44. We are aware of current reviews by the Commission of these two aforementioned Directives. Our understanding is that these reviews have not identified any significant gaps likely to cause consumer detriment. In any event, before imposing additional obligations of funds already covered by these measures, it would be appropriate to await the results of these reviews.

45. What effect will the Directive have upon the position of the City of London and the EU as a whole as a leading location for Investment Fund Managers? Could it cause many hedge funds to relocate outside of the EU? What impact would the Directive have upon professional investors and institutions?

The AIFMD threatens a range of unfortunate outcomes for European capital markets. In particular, insofar as it threatens market entry by non-EU funds it creates the potential for retaliatory action from other jurisdictions. This would be a highly unfortunate outcome which could have unintended consequences—not least a reduction in sources of capital for EU companies. The Directive could also reduce choice for institutional investors and increase costs.

Annex 1

OVERVIEW OF INVESTMENT COMPANY SECTOR

The UK’s investment company industry is comprised of some 519 companies, including UK investment trusts, Venture Capital Trusts, and non-EU domiciled companies (which are overwhelmingly located in Guernsey and Jersey). All have shares which are traded on a public market and are aimed primarily at UK investors. The sector currently manages some Euro 111 billion of assets.

Most investment companies are officially listed on EU regulated markets and are governed by Listing Rules (as set out in the Consolidated Admissions and Reporting Directive, or CARD), the Transparency Directive, Prospectus Directive, Market Abuse Directive (MAD) and, where they are domiciled in the EU, Company Law Directives.

Investment companies are “closed-ended”. European regulation defines a closed-ended fund as a fund where the investors have no right to redemption of their shares out of the assets of the company. Investors in closed-ended funds therefore generally realise their investment by selling through the stock market, which has no effect on the underlying portfolio. In open-ended funds, the manager may need to sell investments in order to meet redemption requests from investors. Closed-ended funds are therefore particularly suitable for unquoted assets (property etc), as the fund manager does not ever have to realise investments to raise money to meet redemptions.

Each investment company is governed by a board of directors, which provides strategic oversight of the company. The directors ensure that the portfolio is invested in line with the investment policy agreed by the shareholders. It monitors the performance of the external fund manager. The day-to-day management of the portfolio is normally subcontracted to a UK regulated fund manager who can be replaced by the board, for example, in the event of persistent poor performance. Since the start of 2004 the contracts of some 40 portfolio managers, or around 10% of the sector, have been terminated and new managers appointed. This exemplifies the role the board plays in adjusting the operation of the company to fulfil their duties to shareholders.

Short of replacing a manager, the board offers value by challenging potential conflicts of interest and testing the manager’s approach to ensure it is focussed on shareholder interests. This helps secure lower costs for investors. AIC research published in 2008 found that investment companies (excluding those with split-share structures or VCTs) saw their charges as a percentage of assets fall for the third year running. The proportion of investment companies with TERs under 1% increased from 25% two years ago, 28% a year ago, to 30% when the survey was published.

September 2009
Letter from the Association of Private Client Investment Managers and Stockbrokers (APCIMS)

In response to the EU Committee’s call for evidence on the Directive on Alternative Investment Fund Managers, proposed by the Commission on 29 April, please find below our views on the Directive.

We are the Association of Private Client Investment Managers and Stockbrokers (APCIMS) and represent firms acting on behalf of investors. Member firms deal primarily in stocks and shares as well as other financial instruments for individuals, trusts and charities and offer a range of services from execution only trading (no advice) through to full portfolio management.

Our member firms operate on more than 500 sites in the UK, Ireland, Isle of Man, Gibraltar and Channel Islands, employing 25,000 regulated staff. Around 460 billion Euros of the country’s wealth is under the management of our members. Our aim is to ensure that the regulatory, tax and other changes across Europe are appropriate and proportionate for the investment community.

Given the lack of evidence on market and regulatory failure or systemic risk, we were surprised to read that the Directive was intended to address problems in the alternative investment fund management industry. It is regrettable that due process was not followed when consulting prior to the publication of the Directive and, as a result, it failed to take into account the impact of such a proposal on markets in the EU and for the UK specifically. UK-based alternative investment fund managers are regulated by the FSA regulations made in conformity with Directives such as MiFID, UCITS, and the CRD. We recognize such regulation does not exist in many other EU jurisdictions. This places the UK hedge fund manager community and the managers of other types of alternative investment funds in specific difficulty.

Whilst we note that all EU regulators must achieve transparent and macro-prudential oversight of AIF’s and that associated risks are mitigated by regulation and supervision; the Directive is damaging to the private client stockbroking and investment management industry for the following reasons:

— APCIMS’ firms have nominee accounts, being authorized and regulated by FSA to hold client money although the majority of firms are not credit institutions. Significant time and resource has been spent on implementing FSA’s client money rules to ensure adequate protections for clients’ money held by firms. The Directive would prohibit this function to clients, and only allow Credit Institutions to hold client money. We strongly believe this proposal to be wholly wrong. This is detrimental to clients and the industry as a whole and transaction costs would increase considerably (from a few cents to 25 Euros) and their business models will be forced to change.

— Access to financial markets would be restricted because only professional investors will be entitled to purchase non-UCITS financial instruments and APCIMS firms’ clients would forfeit the use of a wide range of funds currently in client portfolios. A reduction of financial instruments available to clients will obstruct firms in meeting their regulatory obligations such as a “whole of market” and suitability assessments. Many APCIMS firms’ clients are high net worth, experienced, confident and capable investors and benefit from various protections such as MiFID and the CRD. In fact, UK clients are further protected by the Treating Customers Fairly Principle enshrined in recent FSA supervision and oversight strategies.

— The three year ban on the marketing and sale in the EU of all non-UCITS funds registered outside the EU and the required equivalence tests with regard to tax and regulation is problematic for APCIMS firms who invest in, for example, non-EU based hedge funds (ie the vast majority of them) from 2012. The current global choice of hedge fund manager would be restricted since managers from outside the EU would need to get authorisation by an EU regulator to be eligible to access EU clients. We are also concerned that there could in consequence be a lowering of the returns available on hedge fund investments which might affect the value of personal savings and pensions of UK clients and their families. APCIMS envisages not only loss of business to its member firms but also unnecessary costs in re-engineering their systems to exclude these investment vehicles. Of necessity these costs could be passed on to investors who would have to add them to the probable loss of investment value.

For information, in Appendix 1 we attach an example of the FTSE/APCIMS Indices which is a recognised benchmark for investment portfolio construction. Hedge funds investment, often through funds of funds, account for 7.5% of two of the Indices. Firms with growing high or ultra high net worth clients are likely to have higher levels of investment in these assets.

APCIMS has around 180 members, over 125 are private client investment managers and stockbrokers and the rest are associate members providing related services to our firms.
As currently drafted, we believe the Directive will restrict investors’ choice, provide no obvious increased investor protection and indeed to add to people being exposed to higher risks in some circumstances while also increasing costs. Consequently we believe the proposal needs fundamental changes if it is to contribute to an EU regulatory framework that firms and investors have confidence in.

APPENDIX 1

APCIMS/FTSE PRIVATE INVESTOR INDICES

The Private Investor Indices provided by FTSE and APCIMS are a set of calculations which indicate the returns which investors might expect from their portfolios. The skill in investment management is to design a unique portfolio which will meet an individual investor’s needs, so it is unlikely that your portfolio growth will reflect the movement of the Indices exactly. These are not industry-wide benchmarks, nor do they provide any kind of alternative to the professional investment advice of portfolio managers. However, used properly, they can give a useful perspective on the world of stocks and shares and on the performance of your portfolio.

They can provide:

— A measure to compare the performance of Income, Growth and Balanced funds.
— A basis for reviewing the asset allocation and structure of your portfolio with your fund manager or stockbroker.
— A benchmark for assessing and comparing the performance of discretionary fund managers.

There are three Private Investor Indices, to reflect the differing aims of investors:

— the Growth portfolio is for investors seeking capital growth;
— the Income portfolio is for those seeking a steady income from their investments; and
— the Balanced portfolio is for those seeking a balance of income and capital growth.

Each of these portfolios contains different proportions of UK shares, international shares, bonds and cash to reflect the investment aims. The changes in their values (the movement up or down of the UK shares, international shares, bonds and cash) are represented by the movements of four related indices.

Currently the allocations and their respective indices are:

<table>
<thead>
<tr>
<th>Income portfolio</th>
<th>% Growth portfolio</th>
<th>% Balanced portfolio</th>
<th>% Representative index</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK shares</td>
<td>45.0</td>
<td>47.5</td>
<td>42.5</td>
</tr>
<tr>
<td>International shares</td>
<td>10.0</td>
<td>30.0</td>
<td>22.5</td>
</tr>
<tr>
<td>Bonds</td>
<td>37.5</td>
<td>7.5</td>
<td>20.0</td>
</tr>
<tr>
<td>Cash</td>
<td>5.0</td>
<td>5.0</td>
<td>5.0</td>
</tr>
<tr>
<td>Commercial Property</td>
<td>2.5</td>
<td>2.5</td>
<td>2.5</td>
</tr>
<tr>
<td>Hedge funds</td>
<td>—</td>
<td>7.5</td>
<td>7.5</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

The latest values of the indices can be found on the FTSE website. Indices values are also published every weekend on the Databank page of the Financial Times Money and Business section.

23 August 2009

Memorandum by the Association of Real Estate Funds (AREF)

1. What economic benefits arise from Alternative Investment Funds? What risks to financial markets arise from Alternative Investment Funds? Will the Directive help reduce these risks?

There has been much high-profile comment about the detrimental effect of the proposal on the hedge fund industry. But this to an extent has deflected attention away from another critical aspect of the Directive—its breadth of scope, and the implications for the wider asset management industry. From AREF’s perspective it is important because a wide range of different types of property investment vehicles—retail and institutional—are in scope, including.
The economic benefits of pooled property investment—diversification and increased choice, allowing investors to access prime property sites, are well known and uncontroversial. As regards risk, there has been a lot of public comment on the impact that the hedge fund industry had in the recent financial crisis, but the contentious issues around leverage and short selling in the hedge fund industry are not relevant to the property fund industry.

2. To what extent is there a need to create a single regulatory regime for Alternative Investment Fund Managers in the European Union? Does the Directive achieve its objectives? Should the objectives of the Directive be modified?

AREF welcomes the Commission’s initiative to develop the Single Market by providing a passport to market Alternative investment Funds (AIFs) to professional investors in Europe. But the problem is that the one-size fits all approach is not appropriate given the wide range of funds caught and many of the proposed requirements would be simply unworkable for the property fund industry.


As already stated, the same issues as arise with hedge funds around leverage and short selling issues are not relevant in the property fund sector. In the light of this, the proposals are disproportionate and would have a severe economic impact on the property sector. We attach a submission from AREF to HMT which summarises the key concerns from a regulatory perspective.

4. Is it appropriate to regulate Investment Fund Managers, rather than the Fund itself? Does the Directive contain appropriate provisions to distinguish between different types of alternative investment? Does the scope of the Directive create a danger of unintended consequences?

Regulation of the Manager, not the product, is the right approach. But in reality the Directive does introduce a number of regulations at fund and not manager level—leverage, liquidity and valuation requirements being just some examples.

5. What is your evaluation of the Commission’s consultation in the preparation of the Directive?

The draft AIFMD, as released in late April, was drafted with little formal consultation—other than a very high level document in January 2009. There was no formal consultation on the drafting of the Directive. Overall, the process ran contrary to the Commission’s principles for better regulation. The Commission proposal has clearly been drafted in haste without due impact assessment and needs to be significantly improved to make it workable.

6. Will the passport system help create a single market in investments funds within the EU? How will the passport system established affect the EU and the UK industry and particularly their position in the global market?

We support the principle of a pan-European passport for AIFMs. But the Directive is not consistent with the principles of free trade and open markets with respect to third country funds. It allows such funds access to the passport provided the Commission is satisfied that an equivalent regime is in place there. But a transitional period of three years must be completed before that can be granted. We think this arbitrary constraint on competition is protectionist and should be removed. Additionally, the UK at present has a private placement regime that allows a wide variety of funds to be marketed to professional investors; as the directive stands, this would be prohibited after the three-year transition period. In effect it would then be illegal for an EU citizen to invest in any AIF that does not comply with the directive. While it is of course reasonable for the directive to set down criteria for funds which will receive a pan-European passport, we can see no reason why European legislation should impose similar restrictions on non-passported funds that are operating perfectly well under existing national regimes.

This aspect of the Directive is a key concern for the property fund industry. Many institutional property vehicles are based in the Channel Islands and marketed to professional investors in the UK.

Capital requirements based on assets under management are not, in our view, appropriate for fund managers as the assets are kept separate from the fund managers’ assets and the managers’ insolvency will have no impact on the investors’ assets. But the proposals here are more stringent than they are for UCITS managers—which is wholly inappropriate.

Leverage: It should be made clear that short term draw down facilities are not caught within the definition of leverage. And the proposal for hard caps on leverage should be withdrawn—for more details, see our attached letter.

Valuations: independent valuations of real estate assets are carried out. But the fund’s NAV is valued regularly for pricing purposes and in general this will be done by the manager and not independently. For more details see our attached letter.

Depositaries: there are a number of problems with the proposals here (see our letter to HMT annexed). The key point is that an independent custodian is unnecessary for real estate funds and to make this a requirement would significantly raise the costs of operating such funds.

8. Will the provisions strengthening disclosure requirements help to create a more transparent market or do they go too far?

No comments.

9. What effect will the Directive have upon the position of the City of London and the EU as a whole as a leading location for Investment Fund Managers? Could it cause many hedge funds to relocate outside of the EU? What impact would the Directive have upon professional investors and institutions?

There has been extensive public comment to the effect that adoption of the directive in the current form would be likely to result in a considerable number of investment managers and financial service experts relocating to non EU locations. Clearly were this to happen the loss to the EU economy would be great but proportionately it would be far greater on the UK economy.

And aside from this more general concern, there are a number of knock-on effects from specific provisions in the Directive which were unforeseen. For example, the Directive applies to anyone managing a fund in the EU, even if the fund is domiciled outside the EU.

Whilst the intent is understandable, in practice this broad scope will (without significant further work/clarification) inevitably lead to irreconcilable conflict of laws situations—for example where an EU manager manages a fund domiciled outside the EU but compliance by the manager with the requirements of the Directive would place the fund/manager in breach of the local rules to which the fund is also subject. This may lead to EU managers losing mandates from, for example, US investors.

The proposals will also have a very significant impact on investors, potentially severely limiting choice... As the Directive stands, unsolicited sales are caught within the scope of the Directive—so managers of a non EU AIFs would be prevented from responding to an unsolicited approach from an EU professional investor. So EU investors face a situation where they can use only EU asset managers of EU domiciled funds investing assets under an EU custodian.

10. How does the Directive compare to existing or proposed regulation of Alternative Investment Funds outside of the European Union, particularly that of the United States? How will the Directive affect the position of EU Alternative Investment Funds in the global market?

The US Treasury recently put forward proposals include for the registration of all hedge fund managers whose assets under management exceed a certain threshold and the regular reporting of information relevant to financial stability. But, contrary to AIFMD, the US Administration is taking a broad-based principles based approach to regulation, and one which has been broadly welcomed by the hedge fund industry. And the International Organization of Securities Commissions published a report in June which adopted a principles based approach, and the development of industry good practice standards.
11. What effect will the Directive have on flows of capital and financial innovation?
See our comments under 9 above.

PROPOSAL FOR A DIRECTIVE ON ALTERNATIVE INVESTMENT FUND MANAGERS

The Association of Real Estate Funds (AREF) welcomes the proposal to introduce an “EU passport” allowing Alternative Investment Fund Managers (AIFM) to distribute non-UCITS funds such as real estate funds to professional investors in all Member States. These proposals are a positive step towards the creation of a competitive single market offering European professional and institutional investors a wider choice of real estate funds. However, waiting three years before allowing third country funds access to the passport and restricting access to the existing national private placement regimes denies these investors the widest possible choice.

It is also important to remember that the twin aims of the Directive are to enhance investor protection and reduce systemic risk. All of the provisions in the Directive, as they apply to real estate funds, should be judged against those two aims. For example, in areas where real estate funds pose no systemic risk the relevant provisions of the Directive (if targeted at funds that create such risk) should be disapplied for real estate funds. Such an approach is appropriate since the wording of the Directive itself states: “This proposal [ie the Directive] focuses on those activities that are specific or inherent to the AIFM sector and hence need to be addressed by targeted requirements” (emphasis added).

Finally, by way of initial comment, it is clear that the Directive is politically charged. Real estate as an asset class is linked to the recent market turmoil in as much as the origins of the credit crunch lie in the US residential property market and the complex securitised investments that were linked to that market. It is vital to recognise that those problems had nothing to do with the European real estate investment funds industry and the two should not be tarred with the same brush. Put another way, anger about the global effect of (arguably reckless) lending to residential homeowners, and how such loans came to be repackaged as AAA rated debt, should not influence the debate about enhancing the protection of investors in traditional real estate funds or whether such funds might cause systemic risks.

The Directive has far reaching implications for UK based entities who are involved with the management of real estate funds and we have set these out in the following pages. However, in order to understand fully the impact of the proposals on real estate funds, it is first important to understand the nature of the asset class and the legal structures utilised.

1. BACKGROUND TO REAL ESTATE FUNDS

1.1 The real estate sector provides investment opportunities in a tangible asset class that derives a substantial proportion of its return from rental income. The correlation of real estate performance with other asset classes is low providing valuable diversification throughout the economic cycle. As a tangible asset, real estate (ie buildings) needs to be developed, maintained and serviced. In addition to the widely understood investment management activities of identifying and executing buying and selling opportunities, active management of a real estate portfolio involves property management activities such as managing the population of tenants, organising lettings, (re)negotiating lease terms and rentals, arranging insurance, day to day servicing of a building and periodic refurbishment or redevelopment of premises. Therefore, real estate funds require the services of property managers, asset managers, development managers and managing agents.

1.2 UK real estate funds take a number of legal forms in both open-ended and closed-ended formats. They can be straightforward Unit Trusts Investment Companies or Limited Partnerships investing directly in buildings. They often take the form of English Limited Partnerships (ELP) with investors accessing the ELP via Unit Trust, feeder funds. Notwithstanding the ELP being domiciled in the UK, the feeder funds may be domiciled in any EU or third country. An ELP is operated by a General Partner which is also the legal owner of the real estate assets. Governance of real estate funds can take a number of forms: some follow the UCITS style of a manager and depositary; others are self-governing and operate under the direction of an independent Board of Directors.

1.3 It is common, both in the EU and in third countries, for ownership of a real estate asset to be achieved using a wholly owned special purpose vehicle. This is a matter of established local ownership practice and does not pose systemic risk or issues for investor protection.

5 AREF has 68 member funds representing £26 billion of NAV and includes pooled property vehicles promoted by all of the UK’s leading fund managers. The Association acts as spokesperson for the UK unlisted real estate funds industry on tax and regulatory matters and works towards a conformity and ease of comparison across member funds via the AREF Code of Practice.
2. Definitions
2.1 Article 3(a). It is important that the Directive is amended so that it has a clear definition of an AIF. At the moment, the undefined phrase “collective investment undertakings”, along with recital 5, would catch many vehicles that are not thought of, or regulated as, funds. For instance:

(a) a joint venture vehicle established between two property developers would be caught; and

(b) a listed property company that used subsidiaries to make real estate investments and was managed by a group management company would be caught (and many listed property companies use this structure).

2.2 The directive needs a clear definition of AIF, and sensible exemptions such as those contained in MiFID in relation to services provided intra-group.

2.3 Articles 3(b) and (d) define the “manager of alternative investment funds” as being “any legal or natural person whose regular business is to manage one or several AIF” and “management services” as being “the activities of managing and administering one or more AIF on behalf of one or more investors”. In the context of real estate funds it is unclear which party or parties are intended to be defined as AIFM and the extent to which the services they provide require them to be authorised as an AIFM. It is critically important that the Directive defines “AIFM” and “management services” more clearly.

2.4 Article 18.1(b) refers to the undefined term “portfolio management” in order to limit the delegation of certain functions. It is not clear how this term should be interpreted: on one hand it is defined by MiFID (although this covers financial instruments and not real estate); on the other UCTIS contains an all encompassing definition of “collective portfolio management”. The Directive should include a clear definition of the term “portfolio management”.

2.5 Real estate funds are able to invest in real estate in any jurisdiction and will normally employ a property manager in the location of the asset. In order that effective property management can continue in relation to assets located in non EU countries it is essential that the property management activities described in paragraph 1.1 do not form part of the portfolio management definition.

2.6 Where an investor owns units in a unit trust that is a limited partner of an ELP (ie a feeder fund) it is not clear whether the unit trust or the ELP should be regarded as the AIF or whether both entities are AIF under the proposal.

3. Authorisation
3.1 It is common for the manager of a real estate fund to appoint an investment manager or “property adviser”, whereby the property adviser advises the manager in relation to the fund’s assets and/or has a level of discretion over purchases and sales. In this case a UK property adviser is not required to be authorised under FSMA provided that the assets in question are “bricks and mortar” held directly by the fund. However, it seems very likely that this type of arrangement would in future be caught by the regulatory net, thus requiring substantial numbers of UK based property managers/advisers to become authorised under FSMA. If this is not the intention then urgent clarification to that effect should be given and the necessary carve-outs in the Directive should be sought.

4. Delegation
4.1 Article 18 imposes strict limitations on the ability of AIFM to delegate portfolio management services. In a real estate context this could (without clarification to the contrary) catch property managers, asset managers, development managers, managing agents and the like, and if so the restrictions could have a severe (and we believe unintended) impact.

4.2 Under the proposal, the ability to delegate portfolio and/or risk management functions is very limited in that (inter alia) the delegatee must be “authorised as an AIFM”. This will be unworkable for real estate funds with UK managers since real estate is not an asset class that is regulated under FSMA and so few delegatees will be authorised as AIFM. The directive should not restrict delegation to firms that are themselves authorised as AIFM.

4.3 The Commission needs to recognise that, in a real estate funds context, it is common to see a variety of functions delegated to specialists and that there is no need for those specialists to be regulated when managing bricks and mortar. Put another way, the delegation arrangements that are commonplace in real estate funds do not give rise to any systemic risk, nor should they be seen as dangerous to investors.
4.4 The Commission’s proposal seems to be targeted at fund managers who delegate material functions to non-EU entities and thereby effectively try to limit the ability of EU regulators to supervise and regulate the management activities in question. This is about as far removed from the typical delegation arrangements for a real estate fund as one can get. One would only expect a UK based real estate fund manager to delegate activities outside the EU to the extent of non-EU real estate assets held by the fund in question—but this is because local management of real estate assets is a necessity, because of the nature of the asset.

4.5 Article 18.3 prohibits sub delegation. This would be unworkable for real estate funds given the range of services they employ and the need to obtain those services in the location of the asset.

5. Liquidity Management

5.1 Liquidity is an issue only for investors in open-ended funds. Recital 6 states that “the five year lock-up of investors eliminates liquidity risks” and accordingly, closed-ended funds without an obligation to settle redemptions should be exempt from Article 12 entirely.

5.2 Article 12.3 gives to the Commission the power to impose liquidity requirements for funds offering redemptions more often than half-yearly (UK open-ended real estate funds generally offer monthly or quarterly redemptions and some offer redemptions as frequently as daily). Articles 12.1 and 12.2 require appropriate systems and procedures to be in place to monitor and manage liquidity. The Commission should not impose arbitrary liquidity restrictions and Article 12.3(b) should be deleted.

5.3 We do not yet know the detailed rules the Commission has in mind; however, if minimum liquidity levels are imposed, it will be essential that the liquidity issues for real estate funds are considered separately from hedge funds, private equity funds and other alternative funds.

5.4 For example, many hedge funds and other alternative funds got into difficulty during the credit crunch because they thought they had a reasonably liquid portfolio, which then turned out to be highly illiquid when the global financial markets seized up. In contrast, real estate fund managers were not generally “caught out” in this way since real estate is known to be an illiquid asset class. In the recent past many real estate fund managers brought down redemption gates not because it was actually impossible to sell properties, but because the sale price would have been so low that to proceed with the sale would have been seriously detrimental to the remaining investors.

5.5 If a mandatory liquidity margin is set at too high a level this may deter investors who are investing in order to obtain real estate exposure, not cash exposure. This was a common criticism of the few FSA authorised funds that were established under the SIB (ie pre NURS) regime—that they were required to hold too much cash.

6. Leverage

6.1 Article 2.2(a) provides a welcome exemption for smaller fund managers but greater clarity is required around the meaning of “leverage” in this respect. It seems that the intention is to bring “riskier” funds within scope even if they are small. However:

(a) it is unclear if it is only fund-level leverage that is relevant for this purpose; and

(b) a short-term fund level liquidity/drawdown bridging facility ought to be excluded so that a fund that has such a facility in place (but uses no other leverage) would not thereby fall outside the exemption. The temporary use of leverage to protect a fund against a short-term liquidity problem should not be confused with long-term gearing aimed at enhancing returns.

6.2 Articles 22 to 25 require an appropriate level of transparency, in the form of regular disclosure and reporting, where high levels of leverage are used on a systematic basis. Real estate funds commonly operate with long-term debt funding and it is essential that this is not confused with the leverage generated using complex derivatives strategies as are common in other types of AIF.

6.3 Article 25.3 gives to the Commission the power to impose limits to the level of leverage that can be employed. The appropriate level of disclosure and supervision gives investors the ability to select products with a level of leverage that is suitable for their needs. Hard limits, which imply that all leverage below that limit is “low risk”, should not be imposed by the Commission and Article 25.3 should be deleted.
7. **Changes in the Scope of Authorisation**

7.1 *Article 7* requires an AIFM to notify and seek the approval of the home regulator for any material changes affecting any AIF that it manages; this seems to be unduly onerous. Whilst the principle of keeping the regulator informed is appropriate, the current proposal will lead to anomalous situations arising.

7.2 For example, if a Luxembourg domiciled real estate fund had part of its assets managed by a UK manager and there was to be a change at fund level the consent of both the CSSF (as fund regulator) and the FSA (as regulator of the UK manager) would be required. This seems unnecessarily duplicative.

7.3 A part-solution to this problem would be to disapply the requirement for the approval of the FSA and other local regulators in situations where the fund is itself subject to supervision by an EU regulator who is required to approve the changes.

8. **Valuation**

8.1 *Article 16.1* requires an AIFM to appoint an independent valuator. In the case of real estate independence is well established in respect of real estate assets. However, it is not uncommon for the AIFM, independent of the investment management function, to value the shares and units of an AIF based on the asset values. The valuation function is subject to the independent oversight of depositaries and/or auditors. It is not clear what the Commission will consider independence to mean, but to change this operating model would be costly with no benefit in terms of enhanced investor protection or mitigation of systemic risk.

8.2 *Article 16.1* also requires assets, shares and units to be valued as frequently as the shares or units of the AIF are issued or redeemed. In the case of real estate it is not appropriate to value assets so frequently. In the UK a number of real estate funds are authorised under national UCITS style rules to be marketed to retail investors and provide daily issuance and redemption. However, the UK rules for these funds only require the manager to ensure that the independent valuer values each asset “at least once a month”. The frequency of valuations should be a matter for national law or instruments of incorporation under Article 16.3.

9. **Depository**

9.1 *Article 17* reduces choice in the appointment of a depositary and is likely to increase costs significantly but without really adding anything by way of investor protection. Even in jurisdictions such as Luxembourg where real estate funds have to have a custodian it is accepted that the custodian’s role is very limited because of the nature of the underlying assets.

9.2 It is vital that the Commission differentiates between real estate funds and traditional hedge/securities funds as the issues relating to the safekeeping of their assets are fundamentally different. For example, whilst in a hedge funds context ownership of assets may be opaque due to rehypothecation by prime brokers, these issues simply do not arise in a real estate funds context.

10. **Scope**

10.1 The Directive applies to anyone managing a real estate fund in EU, even if the fund is domiciled outside the EU. Whilst the intent is understandable, in practice this broad scope will (without significant further work/clarification) inevitably lead to irreconcilable conflict of laws situations—for example where an EU manager manages a real estate fund domiciled outside the EU but compliance by the manager with the requirements of the Directive would place the fund/manager in breach of the local rules to which the fund is also subject. An example of a conflict that might arise would be a local requirement to have a local depositary/custodian, which would conflict with the obligations under the Directive to have an EU credit institution as depositary (with limited powers to delegate).

11. **Marketing**

11.1 *Article 3(e)* appears to include an unsolicited approach from a prospective investor in the definition of marketing. This would prevent the manager of a non EU AIF from responding to an unsolicited approach from an EU professional investor. This restricts choice for professional investors domiciled within the EU.

11.2 The Directive applies to any “collective investment undertaking” that is not a UCITS. “Collective investment undertaking” is not defined in the Directive (a significant problem that needs to be rectified) but it seems clear that it is much broader that a “collective investment scheme” as defined in FSMA.

11.3 This has particular implications for all closed-ended investment companies, since they are currently incapable of being collective investment schemes under FSMA, but will fall in future under the Directive. The implications of expanding the regulatory regime in this way have not been thought through. For example, the AIFM Directive restricts promotion of closed-ended real estate funds to professional investors as defined by
MiFID, thereby cutting across the Prospectus Directive regime in a way that is illogical. The provisions of existing Directives should be respected by the AIFM Directive.

11.4 It is also unclear if the Directive is minimum or maximum harmonisation. One area in which this is important is the promotion of real estate funds. As drafted, there is the possibility that the Directive will create a stark “two tier” approach, whereby there will be a small group of real estate funds that are capable of being sold to retail investors (meaning in this case anyone who is not a professional investor under MiFID) but with the vast majority of real estate funds only being able to be sold in the EU to professional investors as defined under MiFID.

11.5 As such, two key issues are:

(a) ensuring that the current UK regime for the promotion of unregulated collective investment schemes is preserved and not abolished—so that, for example, a real estate fund can be sold through an IFA if the IFA has determined the investment is suitable for the investor; and

(b) the Directive, as drafted, positively disadvantages EU fund managers in favour of non-EU managers, since whilst the former could only sell to professional investors as defined under MiFID the latter will be able to continue to use existing private placement rules for a period of three years. So we will have the perverse situation whereby (at least for an interim three year period) it will be easier for a US manager to sell his real estate fund in the EU that it will be for an EU manager.

9 September 2009

Memorandum by Caledonian Investments plc

1. CALEDONIA INVESTMENTS

1.1 Caledonia Investments plc is one of the UK’s largest self-managed investment trusts, listed on the London Stock Exchange since 1960. With a current market capitalisation of around £1 billion, we are placed as a FTSE 250 company and we estimate that we currently have in excess of 11,000 private shareholders on our register, a number which has been increasing steadily in recent years. Our aim is to be a core investment for those seeking a store of increasing value, by investing for the longer term in a range of assets.

1.2 Caledonia’s strategy is to invest in and actively manage significant stakes in companies where we believe there to be good opportunities for building value. We involve ourselves in the businesses in which we invest by working closely and constructively with the managements of our investee companies, often through board representation, as a long term supportive shareholder. Our assets are predominantly allocated in the UK, however we also have substantial investments in Europe, Asia and North America.

1.3 Caledonia is a member of the Association of Investment Companies and fully supports the Association’s earlier submission to this Committee.

2. AIFM DIRECTIVE

2.1 Caledonia very much welcomes the Committee’s inquiry into the AIFM Directive, as we are very concerned that the all encompassing approach proposed in the Directive has been adopted at the expense of proportionality in relation to certain fund structures, in particular closed-ended funds whose shares are traded on a public market, such as ourselves. It is evident that such structures were not considered when the Directive was drafted and therefore the fundamental assumptions underlying the Directive’s regulatory approach are incompatible with the way UK investment trusts operate.

2.2 The consequence of this is that, in its current form, the Directive will require self-managed investment trusts to change fundamentally their business models and will add significant cost and compliance burdens, with no corresponding benefits whatsoever. Ultimately these costs will be suffered by shareholders through lower investment returns.

2.3 Investment trusts have traditionally competed with UCTFs funds through offering investors lower costs, independent governance, a long term approach afforded by the closed-ended structure and access to alternative asset classes. The Directive will make them less competitive and could even threaten their future existence, which ultimately will be detrimental to consumer choice. Furthermore, it is our view that the investment trust sector poses no systemic risk in terms of global financial stability.
3. STRUCTURAL CONCERNS

3.1 The AIFM Directive defines an AIF as any collective investment undertaking which is not regulated as a UCITS and therefore captures all investment trusts, and in particular those which are self-managed.

3.2 The Directive presumes that all AIFs are primarily a legal shell with all the functions undertaken by an external manager. It therefore fails to take any recognition of the fact that investment trusts are public limited companies led by a board of directors, who are elected by shareholders and owe legal duties to them, and that some, like Caledonia, do not use an external manager. By transferring key operational responsibilities such as management of conflicts of interest, business risk and valuation away from the AIF itself to the AIFM, the Directive undermines a board’s ability to direct the activity of the company in the interest of shareholders and potentially conflicts with the duties imposed on directors by UK company law. The authority of a board of directors over the management of the operations of their company is a fundamental issue and should be preserved.

3.3 In addressing the key risks perceived to arise from AIFMs—investor protection, market efficiency and integrity, lack of transparency in building stakes in listed companies—the Directive ignores the fact that other existing EU Directives already regulate the activity of investment trusts in these areas, for example the Transparency Directive, the Prospectus Directive (this already allows investment trusts to market their shares in other EU Member States, which the principal benefit offered to AIFMs by the Directive) and the Market Abuse Directive. In addition, investment trusts as quoted companies have to comply with the FSA’s Listing Rules, prepare accounts under the International Financial Reporting Standards (as adopted by the EU) and obtain annual approval of their investment trust status from HM Revenue and Customs. The additional burdens imposed by the AIFM Directive would be disproportionate in the context of the level of existing regulation with which investment trusts have to comply.

4. SPECIFIC CONCERNS

4.1 AIFs without an authorised AIFM will not be allowed to market their shares in the EU. In our view this will effectively force self-managed investment trust to appoint third party managers thereby fundamentally changing their business models with significant additional cost.

4.2 AIFs must have a redemption policy (incorporated in their constitutional documents) with an appropriate liquidity profile for their investments. This is clearly not appropriate for closed-ended funds, where investors can sell their shares through a regulated market if they wish to realise their investments (as stated above Caledonia’s shares are traded through the London Stock Exchange). If Caledonia was to be required to offer mandatory redemption rights to its shareholders, it would have to restructure itself as an open-ended vehicle and thereby cease to be an investment trust.

4.3 AIFMs must appoint an independent valuer for each AIF to value the AIF’s assets and its shares at least once a year and each time the fund’s shares are issued or redeemed if more frequent. The independent valuation of all assets (including quoted investments) will be costly and of questionable benefit, particularly in relation to unquoted holdings where those who manage the investments are likely to have a closer understanding of their true value. The requirement to value the AIF’s shares in the context of a quoted company is inappropriate as the value of its shares is set by the market.

4.4 AIFMs must ensure that each AIF appoints an external depository which must be a credit institution registered in the EU to:

(i) Receive all subscriptions for shares in the AIF; and

(ii) Safe keep any financial instrument which belong to the AIF and verify that the AIF has ownership of all other assets in which it has invested.

4.5 This requirement will add to cost (currently the majority of Caledonia’s holdings are held directly (either in CREST for quoted investments or in certificated form for unquoted investments)) and may be impractical in relation to non-EU investment markets (or even contravene local securities laws if these require a local depository). The function under (i) is performed for Caledonia by a specialist company registrar, which is not an EU credit institution. The direct liability of the depository to investors will inevitably increase custody and insurance fees and could limit those institutions prepared to take on such risks.

4.6 It is difficult to quantify the cost that would be incurred if Caledonia was to have to restructure itself as an open-ended vehicle, however we estimate that the cost of compliance with the requirements to appoint an independent valuer and depository alone could amount to as much as £1 million per annum, which would increase our management expenses by some 10%.
4.7 AIFMs must ensure that AIF investors receive *investment information* such as strategy and objectives, assets that can be purchased, use of leverage, identity of depository/valuer/auditor before they invest in the AIF. Clearly this is impractical for an entity whose shares are traded on a public market.

4.8 The Directive provides that AIFMs who market shares or units of an AIF domiciled in a third country can only do so if the third country has been subject to an equivalence test and has concluded a relevant agreement with the Member State. Caledonia is concerned that this will reduce its ability to gain access—as an institutional investor—to third country domiciled AIFs.

4.9 We also believe that a requirement in the Directive to maintain *regulatory capital* is inappropriate for a self-managed investment trust such as Caledonia.

**Conclusion**

5. As currently drafted, the Directive will threaten the continued existence of the investment trust sector, which in our view does not pose systemic risk to global financial stability, and will add significant operational cost which will ultimately fall on investors. We therefore welcome the Committee’s interest in this important matter and hope that it will support the Government in its robust opposition to the draft Directive in its current form.

28 October 2009

**Memorandum by the City of London Corporation**

**Introduction**

1. The City of London Corporation aims to promote and reinforce the competitiveness of the UK-based international financial services sector by tackling issues which may impact upon the open, efficient and competitive environment for doing business in the City. The City Corporation welcomes the opportunity to contribute to the Committee’s inquiry, particularly given the strength of the alternative investment fund industry in London.

2. This submission covers the City of London position on the most important and potentially most damaging elements of the European Commission’s proposal for an Alternative Investment Fund Managers’ (AIFM) Directive. The City of London has held various technical meetings with representatives of the Alternative Investment Funds industry and others to identify key issues of concern. This submission represents the views expressed at those meetings and addresses issues on equivalence, delegation and custodians. In addition, there are concerns on the approach the Commission is taking on leverage. The City of London has discussed these matters with the European Commission at meetings held both in London and Brussels.

**External Dimension—Equivalence**

3. Investor choice is the fundamental question arising in relation to the potential treatment of non-EU alternative investment fund managers (AIFMs) and alternative investment funds (AIFs). While the majority of funds are domiciled outside the EU for tax reasons, with the fund management carried out onshore, in many cases legislation in the country in which they are domiciled requires the presence of an administrator within that jurisdiction able to perform some risk management functions. The interface between the EU regulatory approach and the global dimension is therefore critical and, in this respect, more clarity from the Commission on the proposed criteria which will be used for the process of establishing whether regulatory equivalence exists is essential.

4. It is important however that equivalence should not be interpreted as meaning that third countries would have to demonstrate identical regulation and supervision. Certainly the regulatory objectives should be the same, but there should be sufficient flexibility for third parties to determine how those objectives can be met. The need for such an approach is underpinned by the fact that the businesses that are subject of the proposed directive are organised globally, with functions arranged in chains through entities and across jurisdictions. It is unlikely that the US will be able to meet the proposed equivalence standards as provided for in the current text, a situation which if left uncorrected raises the prospect of possible retaliatory measures. The Commission should be pushed on whether it would be able to accept an “appropriateness” test on third countries’ regulatory and supervisory regimes similar to that in MiFID in lieu of the proposed equivalence approach, particularly for the largest non-EU jurisdictions, such as the US. More generally, the application of equivalence rules should be consistent and clear across EU legislation wherever they are applied.
DELEGATION

5. Under the proposals, AIFMs seeking to delegate one or more of their functions to third parties must request prior authorisation from the competent authorities of the home Member State for each delegation. Where the delegation concerns portfolio or risk management, the third party must also be authorised as an AIFM to manage an AIF of the same type. The AIFM remains liable in all cases even though they may have delegated such a range of functions that they in essence cease to be the effective manager. These provisions are more onerous than the equivalent UCITS requirements (for retail products and investors) and would create unnecessary costs on AIFMs which would ultimately be passed on to the investors including institutions such as pension funds on which many ordinary people depend. It is difficult to see a tangible benefit of this enhanced requirement for such investors.

6. Delegation has therefore been identified as the single most important issue to resolve in the current draft Directive. This provision has the potential to impact on hedge funds based anywhere in the EU and not just hedge funds based in the UK. It could have a major impact on investment houses and asset managers managing global, regional and national portfolios. It is important that the focus should be on how the assets are managed, as opposed to the location of the management.

7. Some firms have major concerns with the provisions of the text restricting the delegation of portfolio risk management to other AIFMs only. This is because in the global context, the presence of local experts for portfolio risk management is critical. The lack of clarity in the text on the third country entities qualifying as AIFMs could potentially impact greatly on the range of activities undertaken by London-based asset managers. For example, those managers wishing to take responsibility for these products would be restricted in their ability to delegate to their affiliates elsewhere around the globe who may be better suited to trade and manage the product more efficiently. It would also impact on situations where functions are currently split between jurisdictions (New York and London for example).

8. The effect of current proposals on delegation would result in reduced choice and investor returns from the EU alternative fund management industry. They would also result in reduced potential for risk diversification. Indeed, investors view delegation as an important means of diversifying functions and mitigating risk in a portfolio. At the same time, many of the objectives the Commission is pursuing could be achieved by the extension of MiFID comitology provisions into this area. These procedures would allow firms to take responsibility for their delegated operations.

FUND CUSTODIANS

9. The overriding principle objective of the Directive should be to deliver appropriate investor protection which takes account of the global nature of the business. Access to broader market opportunities can actually enhance investor protection by diversifying portfolios and the risk across products and jurisdictions.

10. The City questions the provision that only EU registered credit institutions should be allowed to act as “custodians” (the institution that holds and provides administration for the fund). Given that investment firms are subject to the same supervision and capital requirements as credit institutions, there should be no grounds upon which to disqualify investment firms from being able to act as a depositary; plus no additional investor protection would be attained. In addition, often in emerging and some G8 markets there is a requirement for securities to be held by a locally incorporated entity. Restricting the role of depositary to EU credit institutions, and further restricting their ability to delegate only to EU credit institutions only, would prevent investors from accessing these markets.

11. The proposal also appears to impose strict liability on the custodian for the return of assets. Underwriting such risk would result in substantial costs that would be passed to the end investor including institutions such as pension funds which indirectly affect the welfare of many individuals. There seems to be a lack of proportionality between the likely costs and any additional protection conferred. It would also be likely that depositaries would withdraw from the market, and those left in operation would be less willing to underwrite risks in the more uncertain emerging markets.

12. An unresolved issue highlighted through events with regard to exposures in the Icelandic and Lehman Brothers crises was the stage at which institutions should reasonably be expected to be aware of problems with assets under their custody and be active in resolving them. There is a fear that adding additional investor protection provisions to fund managers and custodians which already have these in-built protections, will make those funds costlier, and perversely may provide an incentive for investors to use less regulated products.
13. The provisions on the safe-keeping requirements fail to reflect the fact that in modern custody, most intermediaries hold electronic records as opposed to physical assets. Within a portfolio of international securities, this will often mean several layers of intermediaries are required and the custodian will be reliant upon the accuracy of the record-keeping to provide evidence of an investor’s entitlement to a security. The Directive should therefore be amended to frame responsibility so that the custodian is responsible for ensuring at all times that it has control over the assets of the fund.

LEVERAGE, CAPITAL REQUIREMENTS & TRANSPARENCY

14. Major concerns have been expressed regarding the provisions on allowing the Commission to set leverage limits in notional, quantitative terms rather than risk-adjusted terms. Such an approach would make it impossible (and not just uncomfortable) for the industry to manage alternative investment strategies, and in particular, interest rate and foreign exchange strategies from within the EU.

15. There are concerns over the quantitative approach of “notional leverage” because it does not measure risk in portfolios. For portfolios containing exposures to different markets, the overall risk level cannot be judged by a simple calculation and the riskiness of different markets, issuers, countries and instruments need also to be taken into account.

16. Moreover, notional requirements have tended to contribute to pro-cyclical tendencies which conflicts with one of the Commission’s stated objectives to improve financial stability and moderate pro-cyclical effects. There is however an argument that strict caps on leverage could actually increase systemic risk in volatile markets by providing incentives to managers to invest less but in riskier strategies in order to achieve similar levels of investor return. Attention should also be drawn to the range of existing directives that already deal with these issues and to rely on them as much as possible. Furthermore, the proposed approach would appear to conflict with that taken for the UCITS retail scheme which is based on a VaR model and does not restrict leverage for derivatives. Instead of adopting notional requirements, practitioners suggest an alternative more suitable method would be the Basel II approach which takes account of netting and the riskiness of the underlying assets.

17. More generally, systemic risks would be best handled by the reporting of risks on an aggregated basis to regulators. The FSA has done work on pooling together aggregated data on an anonymous basis which has proved valuable in assisting the regulator with its assessments on systemic risk.

18. With regard to private equity, there are concerns on the transparency and disclosure provisions and questions on the scope of the Directive. According to the text, only fund managers managing funds greater than €500 million are within the scope of the Directive provided that the AIF is not leveraged and does not grant investors redemption rights during a five year period. However, while most funds have a life of 10 years, the investments within the fund can be acquired and sold within a shorter period typically between three and seven years. The specific interpretation of the Directive would need to be clear that individual investments, where exit is made in less than five years, do not infringe this exemption.

19. The private equity industry also questions the capital requirements provisions. In practice the requirements would result in private equity funds having to put aside capital equivalent to one quarter of one year’s overheads. This would be a major obstacle to the establishment of new firms, funds and innovation. It would also be prohibitively expensive, not perhaps for global funds, but for mid-market firms. While accepting that capital requirements linked to fixed overheads may be appropriate to a segregated investment manager with a large number of clients, thus providing a buffer to support an orderly wind-down of the fund, this is not the case with private equity funds since they are closed-ended funds meaning that investors cannot break their commitments.

20. Finally, the provisions on transparency which require funds to disclose a business plan to companies in which funds are invested, its other shareholders and employee representatives, have the potential to be a major competitive disadvantage for any private equity fund with European investors. The principal objection concerns the impact on the level playing field because any other purchasers of an EU company—no matter how sensitive or important—will have no such obligation. It would be more equitable to apply the requirements consistently to every kind of private investor, perhaps through a new EU Company Law Directive.

September 2009

10 Value at Risk—a technique used to estimate the probability of portfolio losses based on the statistical analysis of historical price trends and volatilities.
Memorandum by the CBI

The CBI supports proportionate and measured regulation for the Alternative Investment Fund Industry. The current draft EU Directive does not deliver such a framework and will be damaging to the UK and EU economy.

Introduction

The publication of the draft Directive on Alternative Investment Fund Managers (AIFM) on 29 April 2009 represents the culmination of several years of consultations and research undertaken by the Commission on the functioning of the alternative investment fund market. This process included the Own Initiative Reports of MEP’s Lehne and Rasmussen released in 2008, which specifically dealt with the Hedge Fund and Private Equity industries.

The CBI supports a diverse range of corporate ownership structures, including private equity.

This CBI response aims at a measured and appropriate response to the events of the past two years in the global financial markets. Economic recovery must be aided and not stifled by new regulation.

The objectives of EU regulation...

The headline aim of the draft Directive is “to introduce harmonised, comprehensive and effective regulatory framework for AIFM in the EU”. More specifically it seeks to enhance investor protection and develop the single market for AIFM through better monitoring of macro prudential risks, and an improved risk management framework that mitigates micro prudential risks.

The CBI would support an approach that leads to an efficient single market, supports strong investor protection, and allows regulators to monitor systemic risk through unified EU regulation. This Directive does not achieve these aims. The approach is harmonised to the detriment of EU financial services and to the UK in particular. The Directive does not meet the cost/benefit needs of the investor community and would make the EU a less attractive place for AIFM to do business.

The CBI accepts there is a need for enhanced and proportionate regulation...

The CBI supports appropriate regulation in all areas of the financial services sector, and the need to respond to the regulatory failures that led to the financial crisis of the last two years. However the response needs to be tailored to focus on the key risks and issues which culminated in the banking crisis of last Autumn.

The UK private equity sector, in particular, has engaged closely with UK regulators in recent years, and has appreciated the need for greater transparency and disclosure to the market, the regulators and more recently to the general public. Regulatory requirements for other fund managers are also in existence. Future EU regulation should build on this consultative and constructive approach to regulatory changes as this will lead to a more positive and appropriately drafted risk based regulation.

A “one size fits all approach” must be avoided...

The Directive covers a wide range of types of funds beyond simply Private Equity and Hedge Funds. This creates a “one size fits all” approach which is not suitable for the many fund types that it will cover and limits the ability of investment management firms to achieve the best returns for their institutional investors.

The Commission considers that the Directive is sufficiently tailored to the different types of fund managers, but this is not borne out by the evidence. Valuation, key to hedge funds where investments may be traded frequently and in large volumes is far less relevant to private equity where the investments are held for the longer term and no returns are made on interim valuations. Equally for real estate funds, the depositary requirements would result in credit institutions, which have limited specific property skills, undertaking a role for which they are not suitable. Both examples would lead to higher costs, ultimately passed on to the investors.

The importance of the AIFM industry to the EU economy...

As a result of the competitive position of the City of London over the past two decades both the private equity and hedge fund industries within Europe have largely sited themselves in the UK. Currently it is estimated that approximately 80% of all European hedge fund managers and 60% of Private Equity managers are based in the UK.
Whilst managers may be located largely in the UK, investments, particularly private equity, span the EU and therefore the detrimental effects will be felt widely in all EU countries. As one example the private equity industry covers 25,000 businesses across the EU which will come under threat as a result of this directive. This Directive would directly impact on the jobs in these businesses and the many thousands of ancillary jobs that service and rely on the sector. EU economic growth and a decline in unemployment would be impacted and our competitiveness restricted with the rest of the world.

There is a significant level of refinancing that will need to be achieved over the next one to two years, together with large investments in infrastructure, energy security, health and education. Public finances will not be able to fill this demand alone, and the European regulatory framework must support private capital market investment activity.

In order to achieve appropriate regulation, consultation is needed. . .

The draft Directive was prepared with little direct industry consultation. The Commission has, in its staff working document and the associated frequently asked questions, noted that this release is a follow on from a number of studies and consultations stretching back to January 2006. While there has been engagement with the industry in this period, the CBI believes there has not been proper consultation on the drafting of this Directive. This has resulted in a unified view from all sectors of the fund management industry that the draft is misguided.

It follows that the process of appropriate consultation and deliberation with the European Parliament and the Council of Ministers must be allowed to take place unhindered, and without pressure to be achieved by the end of the Swedish presidency.

In line with the G20 Conclusions, a Unilateral Approach to Regulation needs to be Avoided. . .

The G20 meeting held in London in April 2009, as part of the discussion on reforming financial systems for the future, called for greater international cooperation and consistency. The draft AIFM Directive, released less than one month after the G20 summit, does not adhere to this approach. The requirements of the Directive effectively close the borders of the EU to external investment. This would be for a period of three years initially and subsequently for an indefinite period unless equivalent regulations are established in other regions.

The CBI supports appropriate EU action to drive forward the global agenda on financial services regulation reform. However this must not leave the EU isolated. We must work with other international bodies to ensure that appropriate global regulation is implemented.

This Directive would be damaging to the EU economy. . .

Alternative investment fund managers have created a base in the EU and largely in the UK as a result of the favourable conditions of operating here. Nevertheless the business model of private equity and hedge funds remains one of the most mobile of all industries.

This Directive could result in the AIFM sector moving to New York, Zurich or Hong Kong. The whole EU economy would therefore lose as a result of reduced operation of these industries in the EU. The threat to jobs at a time when unemployment is already at its highest for a decade and still rising is considerable.

Adoption of the AIFM Directive in the current form would significantly reduce the attractiveness of the EU as a place to locate and manage Alternative Investment Funds. It could even lead to shrinkage in the volume of fund managers currently operating within the EU. The CBI believes that this would have a direct and indirect (through ancillary services) detrimental impact on the EU economy. At a time when we should be seeking to encourage internal investment in the EU and to grow the EU economy out of recession such regulation would have the opposite effect and potentially result in the recovery taking considerably longer than it otherwise would.

The outcome of the Directive should not lead to protectionism in Europe. . .

The G20 affirmed an aim “not [to] retreat into financial protectionism”. The AIFM Directive appears to result in an approach that would lead to protectionism within the EU. The requirements for a “passport” for non EU funds would be very difficult to attain. It is considered unlikely that many other jurisdictions would adopt similar regulations that would be required to attain the passport. Along with the restriction on non-EU managers and the requirement for an EU depositary, this could result in only EU funds with EU managers being able to invest in the EU. Therefore this would effectively close the EU market from the outside world.
The CBI will lobby to ensure effective and clear drafting is attained. . .

While the CBI has concerns on specific areas, as further noted below, a general concern with the drafting is the lack of clarity and certainty throughout the document.

There are several examples of ambiguous clauses. Without greater certainty and understanding at the outset, it is not possible to identify clearly which aspects of the draft Directive require heightened review and consultation. This is most apparent, but not limited to, the section on leverage. Does leverage within the fund mean only at the fund level, or does it refer to leverage used by the fund within their investments, such as is often the case in private equity portfolio companies?

The draft also currently leaves several areas open to further consultation and Commission action. Again without a clear direction as to the outcome of this additional action, it is not possible to plan for the future. Some AIFM may take actions now based on a worst case scenario even though that scenario may not occur. Therefore despite the potential to lobby effectively to change the Directive, fund managers may already be taking decisions that will weaken the EU economy.

There should be a level playing field for all members of the financial services sector. . .

The draft Directive covers all funds that are not at present harmonised under the UCITS Directive. The requirements of the Directive go further than the current requirements for UCITS regulated entities. This leads to two problems:

— First the Directive is more onerous and detailed than the current UCITS requirements, thereby creating greater protection for institutional investors than currently exists for retail investors. Institutional investors conduct extensive due diligence in their investment practices and are therefore more capable of making a fully informed investment decision which makes the additional protection that they would receive illogical.

— Second the exclusion of banks creates, for the time being, an unlevel playing field that would enable fund managers within banks to enjoy an operating climate denied to traditional private equity houses and stand alone hedge funds.

The Directive would create additional costs to the institutional investor that would not be mitigated by an appropriate and necessary reduction in risk.

There are fundamental flaws with the following areas. . .

— Third country funds
The requirement for equivalence with other jurisdictions and the three year delay for non EU funds to market in the EU creates a potentially protectionist approach that limits choice and is against the conclusions of the G20.

— Excessive disclosure creates an unlevel playing field
The creation of additional disclosures and regulation based solely upon ownership and not the size and nature of an organisation creates a disadvantage that could limit competitiveness and the opportunity for businesses to grow out of recession. When additional investment is needed to help the EU economy grow, regulations should complement this investment and not deter it.

— Delegation and Custodians
Limiting the choice of service provider increases not decreases the risks to institutional investors. What is needed is the right provider based on skill not based on their location. Such an approach that limits the choice will increase the cost and could result in greater systemic risk to the EU.

Detailed Comments on Specific Sections

1. Disclosure to investors—transparency and reporting (Chapter IV)

The CBI supports transparency within business that enables effective analysis of the relative strengths and weaknesses of companies, provided that the transparency is applied consistently. This Directive would require greater disclosure of private equity owned companies than other forms of ownership.

The disclosure section of the Directive is one of the most detailed and one of the most onerous parts of the draft regulations. The requirements would place private equity portfolio companies at a severe disadvantage to comparable companies with different ownership structures. As a result of this, the Directive would have a negative impact on the private equity industry which is a core component of the EU economy.
Annual reports
Annual reports are required to be made available and filed within four months of the year end. Currently, in the UK, non listed companies have nine months from the financial year end to file their accounts and listed companies have six months. This requirement would therefore be more onerous than current requirements of UK listed companies.

Disclosure to investors
Where AIFM manage funds using “high levels of leverage”, they would be required to disclose to investors details on leverage employed in the past quarter and any limits on maximum leverage or guarantees granted under the leverage agreements.

This would be more extensive than current requirements and industry best practice, defined through the Walker code, and would increase the competitive disadvantage of private equity houses and their portfolio companies.

Investments with a controlling influence
Where an AIF is in a position to exercise 30% or more of the voting rights of an investee then the Directive requires further detailed disclosure to the authorities. This section of the Directive seems to be targeted primarily at private equity houses and their portfolio companies. The draft requirements go further than those currently required by the Walker code of conduct and moreover require that disclosure is also made to employee representatives or to employees themselves if no representative body is in place. This would amount to public disclosure and would impact on all portfolio companies not meeting the definition of an SME under EU guidelines (less than €50 million turnover and less than €43 million of net assets).

Requirements include reporting development plans for portfolio companies, expected progress on activities and financial affairs of the company, additional details on employee turnover, terminations and recruitment.

This would result in relatively small companies reporting to a similar standard as a FTSE entity. The additional level of cost would not be proportionate to the benefit derived. The CBI recommends that the investment level required is raised from 30% to a majority shareholding (above 50%). This will ensure that there is sufficient control of the portfolio company to ensure that the required information can be obtained by the AIFM.

The CBI supports the need for good quality informative transparency and disclosure within portfolio company accounts. However we equally support a fair and competitive market for all types of investment and ownership in Europe.

Recommendation—Therefore we recommend that the type of disclosure is consistent with all other forms of ownership. Further to this we acknowledge the greater disclosure demands on larger, multi-nation and conglomerate companies. Therefore we would advocate a changed approach to disclosure that reflects the size and nature of the portfolio companies and does not reflect a one size fits all approach.

2. Cross border marketing of AIF
The CBI supports the Commission’s objective to create a mechanism for cross border marketing and selling of AIF. If enacted suitably, this would result in institutional investors being able to access a wider market and would ensure that a single market truly exists within the EU.

However, we are concerned with the current draft regarding the ability of “third countries” to market funds into the EU. The delay of three years would create an unlevel playing field for non EU fund managers, and despite the ability to continue to market in the UK in that three year period, there is effectively a cessation of that ability in three years time. We remain concerned that there would not be equivalent regulation to the EU AIFM Directive implemented in other jurisdictions and therefore the criteria required to be able to achieve the “passport” would prove almost impossible for funds located in the countries outside of the EU (eg Jersey, Cayman Islands). If this is the case both the investors and the fund managers in the EU would be at a disadvantage to those located elsewhere.

Recommendation—The CBI recommends that the requirements are consistent for all funds, no matter where located, to ensure this does not result in protectionist legislation.
3. Regulating the fund manager

The CBI supports the Commission’s intention to regulate the fund manager and not the fund. We understand that certain interested parties would favour an approach of regulating at the fund level. Fund managers are already regulated in the UK and the industry is receptive to the requirement for this approach to be unified across the EU. We would disagree with any proposal to regulate at the fund level since this would create a level of supervision and interference that is not sought by institutional investors nor is in their best interests.

Creating a unified approach to authorisation and registration of fund managers would aid the flexibility and competitiveness of the industry and is therefore seen as a positive aspect of the directive.

4. De minimis exemption rules

Under current draft proposals all AIFM managing a fund of greater than EUR100 million would be caught by the regulations. The only exception being where the fund was not leveraged and did not grant exemption rights to investors for a five year period after investment. In this scenario the regulations would be applicable if the fund managed more than €500 million.

Private Equity funds are likely to be caught by the higher threshold. Therefore all private equity funds with greater than €500 million in management would be regulated by this Directive.

The CBI understands that the Commission raised the higher threshold from €250 million shortly prior to publication. We support that move but given the number of relatively small fund managers including many UK mid market and some venture capital fund managers that would still be caught by the Directive it would seem that this increase was not sufficient to ensure that the Directive would generate an economic benefit to the EU economy for the cost involved.

Recommendation—The CBI recommends that the de minimus threshold is raised to €1 billion and that regulation is proportionately applied on the basis of size above this level to ensure that a one size fits all approach is not implemented.

5. Capital requirements (“initial and on-going capital”—Article 14)

“All AIFM will be subject to a €125,000 minimal requirement with an additional charge of 0.02% of funds managed above €250 million.” The capital requirement clause appears to be based on the current UCITS requirements. Significantly, however, there is no cap in the AIFM requirement whereas there is in the UCITS requirements.

This does not seem to be logical for two main reasons:

— The application of a higher requirement for institutional investors compared with retail investors does not make sense;

— More importantly, because the separation of the fund manager from the fund makes the application of a capital requirement at this level unnecessary.

AIFMs with funds totalling into the billions, which would be a normal position for many, would result in capital requirements of several million. This is likely to result in additional administration charges on the funds and therefore the investors without a tangible benefit.

The fund and the fund manager are separate entities and there is no clear logic for linking the two in this manner. Any underlying reduction in value of the fund, most notably in a private equity transaction through the impairment of a business that is performing below par, cannot be offset by cash held in a separate entity. Moreover, the fund manager will have numerous investments and assets under management and therefore there would be a conflict of interests between investments should one of these seek to draw down on the capital held. Capital in normal fund managers is required to cover the orderly wind-up of the Firm and not to compensate the fund. By setting capital requirements based upon the size of the fund, an overly high level of capital will be maintained.

Recommendation—The CBI would recommend that there is a clear re-drafting of this section of the Directive. At the very least, a cap should be introduced such as exists in the current UCITS Directive. In addition, we believe that a capital requirement on the fund manager based upon the value of the fund does not provide a tangible benefit to the investors and should be removed.
6. **Leverage** (Obligations regarding AIFM managing specific types of AIF—Chapter V)

The draft Directive covers the issue of leverage in a number of subparagraphs and sections. The first, in the de-minimis exemption section, indicates that only fund managers managing funds greater than €500 million are within the scope of the Directive provided that “[the] AIF are not leveraged and do not grant investors redemption rights during a five year period”.

This poses two issues for private equity managers, in particular. The first of which, is the five year period. While most funds have a life of 10 years the investments within the fund can be acquired and sold within a shorter period often between three and seven years. The specific interpretation of the Directive would need to be clear that individual investments where exit is made in less than five years do not infringe this exemption.

Secondly, it is not clear whether the reference to leverage covers both leverage used at the fund level and also leverage used within investments of AIF. In Chapter V, Article 22, the Directive refers to “AIFM which manage one or more AIF employing high levels of leverage on a systemic basis”. In recent years Private Equity has used high levels of leverage within certain portfolio companies, as have other forms of public and private ownership. To restrict the level of debt within a private equity portfolio company would create an unlevel playing field with these other forms of corporate ownership. The reporting requirements if this test is deemed to be met would be extremely onerous.

**Recommendation**—The CBI recommends that leverage considerations are explicitly removed from the final version of the Directive.

7. **Valuation** (“valuation”—Article 16)

The requirement for an independent valuation of all assets acquired by the AIF on at least an annual basis seems to be unnecessary for most assets within an AIF. Private equity investments are normally portfolio companies incorporated under member state companies legislation, and therefore require an independent audit. The perceived risk to the investor is loss of value in the fund. The requirements of an audit are such that no asset can be held above fair value and therefore the key risk that this article is seeking to address is already mitigated.

The article also refers to further “measures to be adopted by the Commission” in relation to assessment of what is meant by an independent valuator. As noted in the CBI response on leverage, this lack of clarity and definition would potentially result in decisions that cost the UK economy without providing a benefit. In this instance, there would be costs incurred through the additional services of an independent valuator when the services provided by the external audit are considered sufficient.

**Recommendation**—The CBI would recommend that the provision for valuation is in line with UCIT5, in that it should be explicitly stated that the AIFM is assuming ultimate responsibility for the valuation and that it can delegate the valuation function to one or more third parties. Where a valuation is not normally required or is a disproportionate requirement, for example the valuation of a private equity portfolio company, this should be restricted to standard international accounting requirements only.

8. **Depositary Rules** (“Depositary”—Article 17)

The Directive requires that depositaries are appointed to cover all payments made by investors, including ensuring that they are maintained in a segregated account. This is to ensure that the AIFM has ownership of all assets invested in and for the safe keeping of financial instruments. The depositary is required to be a credit institution registered in the EU. Delegation to a third country depositary is possible, but the same level of “equivalence” as with the passport for cross border marketing of funds is required.

The requirement for a separate and independently regulated depositary would change the current practice and increase administration costs with limited tangible benefit to investors. This clause is more restrictive than the comparable UCITS requirement, where a depositary needs only to be regulated in the home country and does not need to be a credit institution.

The CBI believes that current requirements in this area are sufficient, and the evidence supports this view. The costs of credit institutions as depositaries would be onerous on the fund managers and would be passed on to the investors through additional management fees.
In conclusion, this requirement is damaging, contrary to market practice and likely to be expensive, the end impact being on investors and therefore in the industry. The level of proposed liability of depositaries is not dissimilar to insurance against the loss of the asset. The current business model of the depositaries does not support the potential exposure. Depositaries are unlikely to accept liability for sub-custodians who are outside of their network because of risk inherent to that jurisdiction. The insurance cost would be extremely expensive, if indeed it were available at all and ultimately it would be the investors who would bear this cost.

Recommendation—The CBI recommends a formal consultation with AIFM to ascertain which model of delegation, if any is required and that this is implemented dependent on the type of AIFM and not on all AIFM in the same manner.

9. Delegation

Authorisation from the home member state is required for all management functions delegated to third parties. By requiring the third party to be authorised as an AIFM under the Directive, it is considered unlikely that many third parties outside the EU will be able to achieve this authorisation. The ability of fund managers to manage their global funds cost effectively will be restricted and current economies of scale would potentially be lost.

As with the draft requirements for depositaries, this is more onerous than the equivalent MiFID requirements and would create unnecessary costs on AIFMs which ultimately would be passed on to the investors. Equally as with depositaries it is difficult to see a tangible benefit to the investors for this enhanced requirement.

Recommendation—The CBI believes that the MiFID requirements, which have proved to be effective, are more than sufficient for the AIFM sector.

August 2009

Memorandum by The Council of Bars and Law Societies of Europe (CCBE)

The Council of Bars and Law Societies of Europe (CCBE), which represents more than 700,000 European lawyers through its member bars and law societies of the European Union and European Economic Area, has been following very closely current initiatives of the European Commission in tackling the recent financial crisis.

The CCBE welcomes these efforts, but we are concerned that some of the initiatives do not take account of lawyers’ position within the administration of justice, and the rules of professional secrecy and legal professional privilege to which lawyers across Europe are subject.

Professional secrecy and legal professional privilege, as they are called—they describe rights of clients to enable them to consult a lawyer with guaranteed confidentiality—are known in both the civil and common law systems, and indeed in every democratic system run under the rule of law around the world.

The recently proposed Directive on Alternative Investment Fund Managers, which vests public authorities with extensive powers, seems to ignore the confidentiality of the client-lawyer relationship and illustrates very well the CCBE’s concerns.

Article 41 of the proposed Directive would make it impossible for clients involved in alternative investment funds to consult a lawyer in full confidence.

The CCBE would like to emphasise that this is not about defending the interests of lawyers but rather about safeguarding the administration of justice and the rule of law. The right to consult a lawyer in order to ask advice should always be provided on the basis that the client is assured that what is said to the lawyer, and the advice of the lawyer whether in writing or orally, remain confidential. This is part of fundamental freedoms and rights.
The CCBE therefore supports the following amendment to recital 22 of the proposed Directive:

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<th>Commission proposal</th>
<th>CCBE proposed amendment</th>
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<tr>
<td>Recital (22)</td>
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<td>It is necessary to clarify the powers and duties of competent authorities responsible for implementing this Directive, and to strengthen the mechanisms needed to ensure the necessary level of cross-border supervisory cooperation.</td>
<td>It is necessary to clarify the powers and duties of competent authorities responsible for implementing this Directive, and to strengthen the mechanisms needed to ensure the necessary level of cross-border supervisory cooperation. Competent authorities will need to observe national rules on professional secrecy and legal professional privilege.</td>
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**Justification**

Professional secrecy/legal professional privilege of lawyers is a generally recognised principle in all Member States (1). Everyone has the right to consult a lawyer in order to ask advice which is provided on the basis of strict confidentiality. The obligation of a lawyer to professional secrecy serves the interest of judicial administration. The European Court of Justice in the AM&S case (2) and the Wouters case (3) expressed the importance of professional secrecy/legal professional privilege for the maintenance of the rule of law. A competent authority with the powers specified in Article 20 would seriously undermine professional secrecy/legal professional privilege.


(3) See footnote 1 above.

*September 2009*

**Letter from Coupland Cardiff Asset Management**

Thank you for the opportunity to submit comments to the Committee’s inquiry into the European Commission’s proposal for a Directive on Alternative Investment Fund Managers (COM (2009) 217) adopted on 29 April 2009.

By way of background Coupland Cardiff Asset Management LLP was established in 2005 and at its peak managed $1.3 billion. As at 31/7/09 we manage $300 million across both alternative and UCITS III structures. Our comments are with specific reference to the hedge fund industry.

Please find below our responses to the specific questions raised by the Commission’s draft Directive:

1. **What economic benefits arise from Alternative Investment Funds? What risks to financial markets arise from Alternative Investment Funds? Will the Directive help to reduce these risks?**

   1.1 The UK hedge fund industry employs an estimated 40,000 contributing an estimated £3 billion per annum to the UK Treasury.

   1.2 The Directive will make it difficult for non-EU funds to access the EU market thus reducing capital inflow into Europe which in turn result in job losses in all sectors.

   1.3 By reducing access to non-EU funds, EU investors will face a loss of choice and increased costs thus reducing the net investment inflow to companies.
1.4 “Share prices can go down as well as up”. It is primarily the alternative asset industry which use short selling & hedging techniques which have a positive impact on our economy:

- Short selling encourages companies to be efficient and transparent.
- Provides liquidity in a bear market and has been shown to reduce volatility.
- Provides extra income to the lenders—pension, mutual and insurance funds.
- Enables a diversity of investment opportunities for investors.

1.5 Numerous studies have demonstrated that the alternative asset industry had little impact on the recent financial crisis. It is widely acknowledged that the hedge fund industry entered the crisis with little to no leverage, as opposed to more traditional financial institutions which had in excess of 30x leverage. It has been argued that the alternative asset industry acts as a barometer or early warning system for the wider financial sector/economy and, had their guidance been followed, the crisis last year may have been significantly less. We would argue that the risk to the financial markets would increase should the alternative investment industry cease to exist.

2. To what extent is there a need to create a single regulatory regime for Alternative Investment Fund Managers in the EU?

2.1 While there is a strong argument, and one we support, for common minimum operating standards, we believe these should be agreed at a global level with detailed expert consultation. The Directive dismisses the G20 process, ignores the work carried out by FSB and IOSCO. The Directive is protectionist, bureaucratic and breaches the principle of subsidiarity. Regulatory oversight works more efficiently at a local level.

3. What risks arise from Alternative Investment Funds? Is the Directive proportionate give the role of AIF in the crisis? Will the Directive introduce over-stringent regulations or does it not go far enough?

3.1 Excessive leverage is the often the main risk historically associated specifically to AIFs. Over the years Prime Brokers have continued to employ more rigorous and robust margin lending regimes, thus effectively limiting access to excessive leverage. The standard risks of investment apply to all funds, alternative or otherwise; there is no such thing as a risk-free investment. We would note to the Committee the Directives definition of “high levels of leverage on a systemic basis” as anything where “combined leverage exceeds the value of equity capital of the AIF in two out of the past four quarters”. This is more regimented than the UCITS III leverage which permits up to 10% cash leverage on a temporary basis (which for various reasons could be for a long and sustained period) and permits simple additional leverage up to 100% of NAV. This would suggest that the Commission wishes to enforce restrictions on AIF’s marketed to Professional investors that are greater than those applied to UCITS III funds marketed to retail investors.

3.2 The Directive suggests that the problems of last year were exacerbated due to the illiquidity of AIF investments. Given the low leverage employed at that time, and the reluctance of the prime brokers to extend leverage, the illiquidity faced by the AIF would have been similar to that of mutual, pensions and insurance funds. Unlike such structures however, most AIF typically have redemption gates and at minimum monthly redemption notice periods to ensure a) that the manager has plenty of time to liquidate assets to meet redemptions and b) to ensure that the whole fund cannot be forced into a fire sale thus negatively impacting both the NAV and the equity markets. A strong argument can be made that daily liquidity and little redemption notice (similar to most UCITS III funds) however does enforce fire sale conditions as the UCITS III manager has no such flexibility on when he must liquidate underlying assets. It should be noted that all redemption terms are very transparent in the placement memorandums of AIFs and no retail clients are permitted to invest in them. Professional clients are deemed to understand the implications of longer redemption notice periods. The Directive effectively deems all investors to be a retail client and is therefore in contravention of Markets in Financial Instruments Directive (“MiFID”) which defines three types of investor: retail, professional and eligible counterparty.

We would like to make note to the Committee that we operate exclusively in Asian markets; markets typically thought to be illiquid. By following our own internal concentration and liquidity risk guidelines we were able to meet all investor redemptions and did not need to raise a gate. By having sufficient redemption notice, the managers were able to efficiently time the transactions required to meet redemptions whilst retaining a balanced portfolio. This ability to meet redemptions was not due to enforced regulations on either our management company or our funds, but due to the expertise of the portfolio manager.
3.3 The Directive allows for exemptions to be made for any fund with a lock-up period of greater than five years. If the Commission genuinely fears a liquidity crisis all this exemption will do is to force a genuine crisis for AIFs once every five years.

3.4 Given the limited role AIFs played in the crisis (ref para 1.5), and that AIFs are generally agreed not to be a systemic risk to the financial system, this Directive can only be seen as disproportionate and unnecessary.

4. Is it appropriate to regulate Investment Fund Managers rather than the Fund itself? Does the scope of the Directive create a danger of unintended consequences?

4.1 The most effective way to regulate the Investment Industry via Fund Manager. This method of regulation has proven very successful by the FSA; it ensures that fundamental principles of operations, compliance and integrity must be applied to all assets managed out of the UK irrelevant of fund structure or domicile. No country should have legal jurisdiction over a company domiciled elsewhere. This sets a dangerous precedent for all industries and sectors which if set, would inevitably lead to increased regulatory & legal costs everywhere and ultimately to job losses.

4.2 It has been directed at professional investors but ends up imposing requirements in excess of those which already exist in the UCITS, ie retail, regime. There is also both conflict and overlap with MiFID. Implementation of this Directive for the AIF should logically result in greater regulation and compliance oversight for the UCITS industry. This will further add to the already large costs of compliance which are ultimately born by savers, investors and pensioners.

4.3 The Directive suggests that any manager running less than €100 million be exempted. We would ask the Committee to note that fixed running costs (IT, Rent/Rates, insurances) are very high and that many AIFMs must manage at least this amount in order to breakeven and recover start up costs. While there are managers who operate below this threshold, such managers will typically not last the duration. Therefore the Directive, while stating it will catch only 30% of managers, we believe it will hit close to 100% of all long term viable managers & employers.

4.4 The ultimate and very real danger will be the closure of the AIF industry in Europe with all its unintended consequences—loss of investor choice, loss of capital inflow and investment, loss of jobs, increased costs for pension funds and thus an increase in the pension deficit across all countries within Europe.

4.5 Although the Directive argues that it is only regulating the manager, in reality many obligations imposed will directly impact the fund, eg appointment of an EU depositary, dictating leverage levels; it is in effect regulating the funds.

5. What is your evaluation of the Commissions consultation on the preparation of the Directive?

5.1 The Directive has been poorly drafted and is ill thought out. Given the obvious inconsistencies and presumably the unintended consequences; it has been clearly drafted without expert consultation and too quickly. Rushed and inappropriate regulation made in protectionist isolation also reflects poorly on the EU and could lead to wider global trade problems.

6. Will the passport system help create a single market in investment funds within the EU?

6.1 Until there is tax harmonisation and simplification across the EU, the ability to passport funds into other EU jurisdiction will remain little more than a concept. It is often the tax reporting requirements of some EU countries that deter the marketing of AIFs rather than the regulatory requirements.

6.2 We also note that the transition period is three years and will only be applied where a third country has signed an agreement with each Member State where the fund is to be marketed; thus requiring third party countries to re-write their own laws.

6.3 In theory, UCITS IV will permit asset managers to merge any mirror funds they have across the European Union in order to relaunch them under the cheaper master-feeder structure and use passporting. In reality however, in some countries, mergers, like redemptions, trigger capital gains tax liabilities and revenues that local governments may be reluctant to give up. Thus the practical implementation of passporting is and will remain unknown for some time yet; passporting is therefore a convenient concept with no guarantee as to how, and indeed if, it will work in reality.
7. Is the threshold for defining “systemically relevant” Alternative Investment Funds appropriate? Should the Directive include provisions on capital requirement? Does the Directive contain appropriate rules on leverage? Is the requirement for independent valuation agents and depositaries for AIFs adequate?

7.1 We refer point 4.3.

7.2 Re the holding of capital requirements, we would argue that the greater of €125,000 or 0.02% are both arbitrary numbers. Whilst we have no objection to the principle of increased capital requirements, we would prefer to see sensible and meaningful calculations based on running costs and any other applicable factors. We would suggest that the Commission review the ICAAP provisions already in place in the UK for the logical application of capital requirements.

7.3 Independent valuations are already an accepted practice in the AIF industry and are recommended by the Hedge Fund Standards Board (HFSB), a voluntary code of conduct for the industry; for UK based AIFMs it is virtually impossible to market a fund unless it has an independent Administrator producing regular NAVs. We have no objection to such a provision in the Directive.

7.4 Similarly, very few AIFM hold client assets, investors demanding that independent depositaries/ custodians/prime brokers be used; again this practice is recommended by HFSB and we have no objection to this. We do however strongly disagree that all AIFs should have an EU depositary.

7.5 The Directive dictates that EU managers will be required to have a depositary and that the depositary must be an EU credit institution; that any custody functions can only be delegated to another EU credit institution. Given that the majority of emerging markets and some G8 countries, eg Japan, require locally incorporated custodians, this means that any AIFs investing outside of the EU will be unable to continue operations from within the EU. As we invest exclusively in Asia, this Directive will mean that we have no choice but to relocate outside of the EU should we wish to continue to operate; this would result in considerable financial cost to the company and the loss of jobs in the UK.

7.6 In addition, the Directive requires that assets will always be available to investors even where custody is delegated and the sub-custodian defaults. Imposing such an obligation on depositaries will result in a significant capital cost increase, which will ultimately be passed on to investors. In some cases, investing in some emerging markets will be impractical as depositaries will be unwilling to accept the associated risks. This leads to loss of investor choice and can only be seen as protectionist towards the EU markets.

7.7. As a note of personal experience, the few EU depositary institutions with whom we have dealt with have provided an inferior product to some of the non EU service providers. We believe that the Board of Directors of an AIF and the AIFM are much better suited to evaluating the appropriateness of custodial/prime brokerage services and determining who that provider should be. We would ask the Committee to recognise that a primer broker provides services which a traditional depositary is unable to provide and that by imposing such restrictions, efficiencies would decrease and costs increase. The increase in costs would be again ultimately borne by the investor, ie the pension, mutual, insurance fund. This imposition is purely protectionist with no overall benefit to the investor. We refer to para 2.1.

8. Will the provisions strengthening disclosure requirements help to create a more transparent market or do they go to far?

8.1 All of our funds are subject to annual audits in accordance with International Accounting Standards and given that our funds are also listed on the ISE are subject to IFRS7 provisions. The requirements specified in Articles 20 or 21 of the Directive are either already covered by the Placement Memorandums, International Accounting Standards, the provisions dictated by the Financial Standards Authority, or the trade reporting requirements dictated under MiFID. We have no objection in principle to these requirements but would question the purpose of the Directive if it is to simply duplicate regulatory requirements already in place and universally accepted.

9. What effect will the Directive have upon the City of London and the EU as a whole as a leading location for Investment Fund Managers. Could it cause many hedge funds to relocate outside of the EU? What impact would the Directive have upon professional investors and institutions?

9.1 Should the Directive be passed in any form similar to the current proposal, the EU will see a reluctant exodus not only of hedge fund managers but also of their service providers; much of the Fund Administration and Custody business will be lost from Ireland and Luxembourg. Brokerage firms accruing trading and sales commission will see revenue fall thus resulting in lower tax revenues to the EU and the loss of jobs. IT service companies, cleaners, furniture/IT sales into the EU will fall resulting in loss of VAT revenue and jobs. This
Directive will immediately lead to a significant increase in costs for AIFs and AIFMs for the promise of an ill-defined and possibly unworkable passport programme three years down the line. The Directive as is currently stands unfortunately encourages AIFMs to relocate outside of the EU. In our situation, we will have no choice but to relocate or close our business altogether.

9.2 Professional investors are just that—professional. We would argue that their detailed understanding of investment opportunities and associated risks are greater than that of the Commission. Such investors depend upon efficient markets and choice in asset allocation. The Directive will restrict choice and will ultimately result in greater costs to the investor. The imposed requirements designed to benefit professional investors are in some cases more onerous than those that already exist in the UCITS regime to protect retail investors. It would appear that the Directive has paid little attention to the demands of professional and institutional investors. This Directive will result in fewer investment opportunities for professional and institutional investors and will thus ultimately encourage them, where possible, to either relocate part or the whole of their business outside the EU.

10. How does the Directive compare to existing or proposed regulation of the AIF outside of the EU, particularly that of the US?

10.1 The United States appear to be genuinely concentrating their efforts in ensuring wider initial regulation of AIFMs and the collection of data, similar to the process as operated by the FSA. Although we have some reservations with the US proposal, we would recommend this as a far more sensible approach. We strongly approve of the robust principles and supervision employed by the FSA. We believe that the extra regulations proposed by the Directive are unnecessarily burdensome but would provide no real value over and above that already associated with an FSA regulated manager. We would recommend the Commission to review and implement the FSA standards across the EU.

11. What effect will the Directive have on flows of capital and financial innovation?

11.1 The Directive will make it very difficult for non EU funds to access the EU market, which in turn will reduce capital inflows and investment. Even after the recent declines, hedge funds account for an estimated $300 billion of assets managed from Europe, a significant sum that if only 25% was re-directed would have a serious effect on EU companies potentially prolonging a harsh recession experienced by all Member States.

In summary, we would like to reiterate to the Committee that we strongly advocate sensible and applicable regulation of all players in the financial markets. We thoroughly support the efforts of the FSA in recent years to improve standards through the introduction of ever higher principles and business standards combined with the regular collation of meaningful information.

Whilst we acknowledge the seemingly noble aims of the Commission, we are concerned that this misguided Directive will have far reaching negative consequences well beyond what appears to be an attack on the UK alternative asset industry and the UK Treasury. Simply, it is protectionist in nature and could result in retaliatory measures and tariffs from countries outside the EU. It will without doubt lead to significant job losses within the EU; it will lead to job losses in our company and the reduction in tax revenue to the UK purse. We urge the Committee to drive forward necessary consultation and review of this poorly thought out, ill drafted proposed legislation.

1 September 2009

Memorandum by CVC Capital Partners

A submission with respect to Private Equity as a constituent part of the Alternative Investment Funds sector. Submitted by CVC Capital Partners:—a Private Equity Group with a significant presence in London and other European jurisdictions. Classification:—Third Country AIFM/AIF.

BACKGROUND

Private Equity invests capital on behalf of professional investors, mainly pension funds, in business and infrastructure projects for the long term benefit of both. PE does not “trade” shares and manages Funds for these investors over a period of 10 or more years. Typically there is no leverage at the Fund level. As such, PE offers no systemic risk to the financial system and has a well established contractual framework which governs the arrangements with the professional investors. PE does not market or manage funds to retail or less sophisticated investors.
1.1 The most relevant economic benefit to the European Community is the capital resource allocated to Private Equity that is available to support long term investment in European business and Infrastructure. Capital deployed by PE firms allows new businesses to be formed, the support of small and medium sized businesses for growth, conglomerates to restructure, public (government)/private partnerships to be formed and investment in infrastructural projects. This is especially relevant now due to the capital constraints that the banking sector and governments are under currently and for the near term foreseeable future.

1.2 Risks to the Financial Markets by Private Equity that arise from this activity are minimal as accepted by the AIFM Directive itself and is a view shared by the FSB, IOSCO, FSA, de Larosiere and Turner which all concluded that Private Equity Funds “did not contribute to increase macro-prudential risks”, ie there is no systemic risk created by PE.

1.3 The proposed Directive will not reduce any systemic risk to the Financial Markets as there is none in the first place. The “risks” for the investor that exist within PE are essentially investment performance risk; none of the proposals either in the Directive nor in any directive can mitigate or regulate that risk. It is for the knowledgeable professional investor to assume that risk and mitigate it by careful diligence and negotiating with the PE manager, of his choice, the terms of the contract between them.

If the aim of the Directive is to protect the Investor community to this sector it should be noted that, to our knowledge and belief, the professional investor community were neither part of the limited consultation process nor welcome the Directive’s proposals that (a) may restrict their choice of where they can invest their capital or (b) are purportedly aimed at their protection.

2.1 In our opinion a single stringent regulatory regime for AIFM, so long as their customer base are professional investors, is not required. AIF are not homogeneous and present different risk profiles. Regulation is for the protection of investors and the financial markets. The latter is not at risk by PE’s activity and the former are non retail investors and therefore capable of making knowledgeable decisions with respect to risk and returns. The basis of the relationship between PE manager and investor is contractual that has been developed between the two for over 20 years. Regulatory oversight should be proportional, relevant and focused on benefitting (not damaging) the stakeholders involved in this sector.

2.2 Therefore the Directive does not achieve its objectives as its objectives are flawed, to the contrary it is so poorly drafted that it creates a new category of risks and inefficiencies. The most damaging of which from a macro perspective are those that conflict with Article 56 of the Treaty with regard to free flows of capital:

— Risk to free flow of capital as EU institutions may be constrained as to which funds they can invest in.
— Risk of reducing available capital flows into the EU at a time when governments require assistance to deal with structural problems of infrastructure, competitive industry and related pension issues. All the significant contributors to this capital that flows into the EU may be negatively impacted by this Directive. The major contributors are US, Middle East and Asian institutions aside from European institutions. Global allocations of capital to Private Equity are approximately 52% US, 8% other, 40% European and it has been estimated that approximately 0.8 trillion euro have been invested in Europe over the last decade by global (Third country) PE groups.
— Protectionist nature of the Directive may cause retaliatory protectionist legislation from sources of capital from the USA, Asia and elsewhere.
— Creates an uncompetitive environment within private capital as Funds or other forms of private capital not caught by this legislation can still invest and own European businesses free of any regulatory constraints (eg: Sovereign Wealth Funds).

Consequently the Directive’s objectives and its drafting (through lack of proper consultation) need to be modified.

3.1 With respect to Private Equity Funds the primary risks, from an investor perspective are:

— Investment Performance Risks—eg poor fund performance leading to loss of invested capital.
— Fiduciary breach by manager leading to say loss of invested capital.
— Breach of contract by manager and or investor.

The latter two will have contractual remedies in law and are not a matter for regulatory supervision; the former is a commercial risk.

3.2 The Directive is not a proportionate response given the role of any AIF let alone PE to the financial crisis. It is interesting to note that the banks (which are heavily regulated) had a significant role in the creation of financial crisis (with hindsight).
3.3 The Directive, as drafted, will introduce over-stringent regulation on a sector that arguably does not require stringent regulation. The abnormal haste and poor consultation process have produced a draft that is disproportionate in nature.

The weight of this Directive will fall relatively more heavily on the UK which has the majority of the European AIF managers based in London. The relatively small AIFM business in many EU countries will lead them to be indifferent to this legislation or may even see it as advantageous to wrest business away from the UK. (Eg Luxembourg sees it as an opportunity with respect to the custodian/valuation/audit requirements).

4.1 It is more appropriate to regulate those that operate the fund than the fund itself as it is common for the funds themselves to be constituted outside of the EU. The funds are often in the form of limited closed ended partnership vehicles, the partners of which are from many countries.

4.2 The proposed Directive does not contain appropriate provisions to distinguish between the different types of Alternative Investments. Private Equity and similar (Real Estate) have a long term illiquid risk return criteria, which arguably is different to Hedge Funds which could be regarded as having shorter term and more liquid risk return criteria.

4.3 The Directive creates a danger of unintended consequences.

— Risk to capital flows and protectionist action as mentioned above.
— Increased compliance burden and associated costs will diminish returns to the investors as these costs will be borne by the funds and their investors ultimately.
— An uneven competitive landscape is created as PE firms within this burdensome Directive are at a disadvantage to their rivals (including non PE firms, Banks, Sovereign Wealth groups, wealthy individuals and private companies).
— Deliberate migration of firms from the EU (London) to outside the EU with no offering to EU investors.

5. It is our understanding that there was a relatively short and incomplete consultation period when compared to other significant proposed legislation.

REGULATORY ASPECTS

6. No knowledgeable comment

7.1 The Directive’s proposed capital requirement is counter-constructive and shows the poor understanding of the way the PE sector functions.

Capital Requirements are being imposed for the protection of the investor. In the PE sector the funds are closed ended, the invested assets belong to the Fund and not the manager, and there are contractual protections for the removal of the manager in the event of breach of contract. Closed Ended Funds cannot be wound up quickly nor without mutual consent of investor and manager, similarly neither can funds be withdrawn.

The greatest protection for an investor is to maximise the alignment of interests between manager and investor. This is achieved by the manager investing as much as possible into the fund alongside the investor on the same terms, thereby maximising the incentive to invest and manage the fund successfully. The proposed capital requirements will reduce the amount of capital available for this.

It should also be noted that excessive capital requirements would hinder start ups of new smaller firms which ultimately give wider choice to the investor community of who they decide to allocate capital to. These new entries lead to a more open market and long term competition within the PE sector.

7.2 Leverage is not relevant to the PE sector as PE funds themselves rarely leverage at the Fund level itself.

7.3 The proposals with respect to independent valuation and depositories are another example, in our opinion, of a wholly misguided understanding of the sector with respect to PE.

PE funds are closed ended with no ability to freely trade a position in it during its life. Any sale or transfer of interest must be approved by the manager and is at a price negotiated between purchaser and vendor. The underlying assets are unquoted investments in small to medium sized companies and therefore there is no “ready market” to easily reference the value of these investments.

Compensation and returns are ultimately calculated on the cash on cash profit generated by the funds and not on any interim valuations unlike some other Fund Management sectors.
The PE managers themselves are best suited to preparing the interim valuations, to agreed standards, as they are most knowledgeable about the underlying portfolio of companies and how they are performing. Performance and hence value are not purely confined to reported earnings but have to take into account management issues, outlook, banking covenants etc. An outside valuer, (a) would be too far removed b) would interpose a third party between manager and investor creating a possible misalignment of information flows and (c) would be unwilling to create a liability to himself with respect to the investors in the funds.

Similarly a Depository (an EU based depository) just exacerbates the problems. The PE Funds holdings are often multi-jurisdictional as an EU Fund is not constrained to investing in EU companies. As mentioned above the Funds are invested in unlisted private companies. The shares or other instruments of ownership are either registered in the Funds’ names or to the manager who holds then with respect to the Funds (effectively a segregated account). The annual audit process under International, UK or US accounting standards (and any developed country) will require proof of ownership by the Fund of the underlying assets. All funds are required to produce audited accounts. Lodging with a depository privately held share certificates, or extracts from a share register or similar (depending on the jurisdiction) does not give significantly greater protection to an investor. We are unaware of any deliberate fraud whereby a PE manager of a fund has recorded an investment in its own name, sold the investment and successfully absconded with the proceeds.

8. The provisions with respect to disclosure must be considered separately. Firstly disclosure of a Fund’s performance to the Regulator would allow the collation of more statistics on the AIFM sector for the further analysis of systemic risk or not over a period of time.

Disclosure of marketing materials: There is already legislation in each of the EU countries with respect to marketing of private placements in collective investment funds which operates very effectively. This proposed Directive seems to add an additional and somewhat conflicting burden. We would suggest that the same documents that are required under the private placement legislation be those that are required by the regulator in order to initiate the regulatory and passport approval process. That way the laws match and the respective regulator has the same formal fund documentation as an investor.

Disclosure related to Portfolio companies; the proposal is extremely discriminatory to a company that is held by a Fund falling under this Directive when compared to a company held privately in any other manner. Any legislation that creates such a manifestly uneven obligations and potential competitive disadvantages between similar companies is poor legislation. If the portfolio companies are disadvantaged then that may impact the value of the company and hence the performance of the fund.

In our view the disclosure requirements do little to create a more transparent market and go too far in creating a disadvantage for Funds and their portfolio companies regulated under this Directive.

**IMPACT**

9.1 The Directive as drafted may lead to AIFM deciding to relocate outside the EU (ergo London) and logically they would not offer their Funds to EU based investors to avoid the burdensome cost of compliance and the competitive disadvantages this Directive generates.

9.2 Consequently EU Institutional Investors (Pension Funds, Insurance Companies) will have reduced access to Alternative Investment Managers thereby constricting their right to free choice, increasing risks associated with a more concentrated portfolio, and (in our view) increasing the likelihood of suffering reduced returns for their pension pools.

10.1 It is too early to say but draft legislation from the US/SEC appears to be a much lighter touch more akin to the requirement to register with the SEC and some associated financial and ownership reporting with respect to the manager. The US would become a more attractive location to be regulated in under a comparative scenario.

10.2 We conclude that EU Alternative Investment Funds will be at a significant disadvantage competitively and from a return perspective than their peers outside of this Directive. We also conclude that EU professional investors who currently invest in AIF globally will be negatively impacted.

11. Please see answers to 1 and 2.

In summary

— External sources and flows of Capital into the EU may be materially diminished having a real impact on investment in business and infrastructure and hence Europe’s growth and ability to compete.

— Internal Capital within the EU for investment in AIF’s of choice will also be constricted.

— An uncompetitive playing field is created as many other sources of private capital external to the EU and this proposed regulation can still acquire EU businesses.
These outcomes are contradictory to the G20 statements and Article 56 on the free flow of capital and counter intuitive against the backdrop of avoiding protectionist policies with respect to capital and trade.

8 September 2009

Memorandum by Dechert LLP

Questions 2 and 6

To what extent is there a need to create a single regulatory regime for Alternative Investment Fund Managers in the European Union?

There is already a (recently implemented) pan-EU regulatory regime covering alternative investment fund managers (AIFM) in Europe in the form of the Markets in Financial Instruments Directive (2004/39/EC).

Whilst we appreciate the drivers behind further regulation in the financial services industry following recent events, we do not consider that a case has been made to single out AIFMs for special regulatory attention. It is widely acknowledged that the alternative investment fund (AIF) industry was not the cause of the recent financial crisis. Further, many of the risks that are perceived to be associated with AIFs as regards their activities are simply not applicable to many AIFs, or are also found in other quarters of the investing community that undertake those activities and which are ignored by the Directive.

Financial services regulation generally seeks to regulate behaviour or outcomes that are thought to be problematic. If certain behaviour—be it directional shorting, “excessive” leverage or opacity—is thought to present, for example, a systemic risk (an argument which is far from conclusively made out by the Directive’s explanatory notes), there seems to us to be no logical basis to single out only one specific group of market participants that could engage in such behaviour—ie AIFMs—for regulation.

To the extent that further regulation in the sector is found to be necessary (following proper consideration and consultation), as a general matter we would agree that it makes sense to have common standards across the EU as far as possible.

Does the Directive achieve its objectives? Should the objectives of the Directive be modified?

The Directive appears to go well beyond financial regulatory objectives, muddling these with a political agenda. We comment on certain objectives—as we understand them from the Impact Assessment to the Directive (SEC (2009) 576) and the text of the draft Directive—below.

— Risk monitoring and management

We do not see how the Directive’s objectives of monitoring and/or managing macro and micro prudential risks in financial markets can be achieved by requirements that apply in respect of AIFMs and AIFs but which do not apply to other large sections of the investing community such as banks, insurance companies and occupational pension funds—which nevertheless engage in exactly the same types of activity, often to a greater degree.

— Consumer protection?

The Directive states at point 29 of the preamble that its objective is to ensure a high level of consumer and investor protection by laying down a common framework for the authorisation and supervision of AIFMs. We are surprised at the focus on consumers: AIFs are neither intended for, nor generally available to, “consumers” as the word is generally used in the industry: ie, retail customers.

Consumers do ultimately benefit from AIFMs indirectly (for example, through investment of their pension funds or other investment products). Crucially, however, in such cases there is an interposed professional manager, who is best placed to take a view on the risks involved and will often only invest in AIFs following sophisticated legal and operational due diligence processes.

In our view the Directive as currently drafted will restrict not only the choice of investment opportunities available to such professional managers, but also competition within the industry (see, for example, our comments to the following question). These are not outcomes usually associated with a pro-consumer agenda. Further, to the extent that these outcomes diminish AIF returns, they will ultimately be felt by consumers via their individual pension plans and savings products. Accordingly we consider that the Directive as it stands fails consumers rather than protects them.
— Accountability of AIFM, etc

We understand them from the Impact Assessment to the Directive that one of the Directive’s objectives is the greater public accountability of AIFMs investing in and managing companies. Again, it is not clear why AIFMs should be singled out. Why, for example, should investors who join together to make private investments be required to disclose onerous levels of information to regulators, shareholders, etc—when investors acting alone, or other types of investors, are not?

Will the passport system help create a single market in investments funds within the EU? How will the passport system established affect the EU and the UK industry and particularly their position in the global market?

In principle, a passport system would help to create a single market. Its potential to open up capital markets and to simplify what can be a significant and costly compliance burden, dealing with the existing patchwork of regulatory approaches is, in theory, to be welcomed.

The alternative fund industry, however, is a global industry. Provided there is “equivalent” regulation in other non-EU states it ought to be possible for managers in such states to access the EU market and vice-versa. Unfortunately, as the Directive currently stands it is not clear that any third country, including the United States, would meet the proposed standards for equivalence (please refer to the comparison appended hereto).

Ultimately, the passport system will help neither the interests of the UK nor EU market if it effectively serves to deprive the market of access to third country managers and funds. Mutual market access should be negotiated at an EU level based on a minimum best practice acceptable to both the EU and elsewhere.

Question 3

What risks arise from Alternative Investment Funds? Is the Directive proportionate given the role of AIF in the financial crisis? Will the Directive introduce over-stringent regulations or does it not go far enough?

The lack of causation between AIFs and the recent financial crisis is well documented by the major reports (see, for example The High-Level Group on Financial Supervision in the EU Report (chairied by Jacques de Larosiére) etc) and we will not dwell on this. Similarly, a number of industry representatives and trade bodies have highlighted some of the costs likely to arise from the Directive, which go to proportionality (or lack thereof).

We believe it is important to distinguish the perceived risks associated with AIFs and the real risks. In our view AIFs pose little systemic risk when compared with other industry players, specifically banks. For example, evidence points to the fact that in overall terms neither hedge funds’ nor private equity funds’ levels of leverage have been excessive:

— Dan Waters, FSA Asset Manager Sector Leader, said in a speech to the International Fund Forum on 24 June 2009, “Some four years ago we set up a specialist supervision team to focus explicitly on hedge fund managers, and began gathering comprehensive data from the prime brokerage community that lends to them, giving us a good grip on their levels of leverage—which in recent years—including the run up to the crisis—have very typically been modest, especially in comparison to banks.”

— Insofar as private equity is concerned, the World Economic Forum on the Global Economic Impact of Private Equity found, in 2008, that private equity-backed companies had a default rate of 1.2% per year, compared to an average default rate of 1.6% for US corporate bond issuers.

The policy contained in the Directive does not appear to acknowledge that the real roots of the financial crisis lay in the ready availability of debt across the board. The use of leverage by certain AIFs was a small part of the overall picture. It would seem more logical for the focus of the regulatory attention to be the debt markets or banking institutions rather than investment structures that are primarily equity-driven.

Turning to micro rather than macro risks: in our view, those best placed to assess such risks are the investment professionals. At the underlying AIFM level, in most cases managers’ personal fortunes are tied to their investment performance. Further, as noted earlier, AIF investors such as pension funds often have highly developed portfolio risk and due diligence functions that carefully scrutinise AIFs both pre-investment and on an ongoing basis. The AIF industry on both sides of the Atlantic has been developing best practice standards for quite some time, with close involvement from such investors. The Directive goes considerably further than such standards. This suggests that investors themselves do not see the net benefit in such additional restrictions and indeed this is borne out by much of the feedback on the Directive from investor representatives to date.
QUESTION 4

Is it appropriate to regulate Investment Fund Managers, rather than the Fund itself?

We believe that, in general, it is appropriate that the Directive should seek to regulate the manager rather than the funds. After all, as noted above in our response to Question 2, there is already an effective system of manager regulation in place.

The Directive is, however, overly influenced by continental European fund structures, whereby the manager frequently has a greater degree of control over the fund than is the case with certain other structures common in the marketplace. With a corporate fund, for example, strategic management and control (including, for example, the appointment of key service providers) rests with the board of directors, not the management company. Likewise, a limited partnership fund acts through its general partner.

Accordingly, to make sense and to be workable in practice, regulation of AIFMs should be confined to matters that the AIFMs can actually control in the context of the fund structure.

Does the Directive contain appropriate provisions to distinguish between different types of alternative investment?

Although the Directive distinguishes between different sorts of funds to some degree, ultimately it applies concepts that appear to be motivated by systemic risk concerns indiscriminately to all kinds of AIFs. For example:

- the concept of a depositary in the context of a private equity fund is a wholly unnecessary concept that will serve only to add an additional layer of fees, limit structuring opportunities and ultimately lead to competitive disadvantage for EU AIFs; and
- leverage limits may be aimed primarily at hedge funds, but could equally apply to other fund types, such as private equity funds, property funds or commodity funds.

It seems to us that better focused regulation that is more sensitive to the particular needs of managers of different types of investment strategies pursued by AIFs would better achieve the objectives.

Does the scope of the Directive create a danger of unintended consequences?

There has been wider commentary on potentially significant unintended consequences for the industry (which extends far beyond AIFMs themselves) and the consequential impact on the wider UK economy, which we will not rehearse here.

Here are some specific points:

- The Directive excludes non-EU managers who are nonetheless properly regulated in and by another jurisdiction (for example Australia, Hong Kong and the United States) from providing management services to AIFs. We do not believe that this restriction is in the interests of EU investors or the operation of an EU export market for the provision of fund vehicles.
- In particular, the Directive will most likely exclude EU investors from participating in anything except but EU AIFs as the “equivalency” test for the approval of marketing of other regimes is not likely to be met in practice. It will hamper the ability of EU investors to access third country management talent, and will also effectively prevent EU AIFs from pursuing certain strategies that will not be compatible with the practical effect of the Directive, such as emerging market funds.
- AIFs provide valuable capital which can be deployed in all manner of situations: venture capital, private equity, real estate development, etc. The Directive will restrict the flow of this capital, in turn affecting jobs, local economies, etc. This consequence is exacerbated by the current dearth of capital available from other quarters.

See our other responses for detail on some other unintended consequences. For example, see responses to questions 4 and 7.

QUESTION 7

Does the Directive contain appropriate rules on leverage?

We believe that the rules on leverage in the proposed Directive are commercially unworkable. If one fund in a group of funds managed by the same AIFM uses leverage up to a certain point, the terms of the Directive may prevent any other fund managed by that AIFM from using leverage. However, in general, funds managed by the same AIFM are not affiliated and so the use of a high level of leverage by one will not affect the others.
AIFMs may have different objectives for different funds and the rules on leverage in the Directive could actually harm an AIFM’s ability to manage separate funds.

Private equity funds are generally leveraged on an investment-by-investment basis so that, absent any bridging loan, the failure of one investment fund due to excessive levels of leverage will not even present a failure risk to the fund overall, let alone the market.

See also our comments at question 3 above.

Is the requirement for independent valuation agents and depositaries for Alternative Investment Funds adequate?

See question 4 for our comments on the inappropriateness of depositaries for private equity funds (which apply equally to certain types of real estate funds and others whose assets are not held in custody in the same way that securities are). The same might be said of valuation agents for closed-ended private funds that are not traded. The Directive also fails to strike an appropriate balance between the advantages of independent valuation (where appropriate) and the fact that the manager may actually be best placed to value assets in many circumstances—meaning that the Directive could result in less accurate valuations than would otherwise be the case.

The Directive effectively states that no custodian (depositary) outside the European Union is suitable to act as custodian for funds. It is worth noting that the UCITS Directive does not impose similar geographic restrictions on the use of sub-custodians for UCITS funds, reflecting the needs of the market: and this is in a retail context. The Directive also creates a situation where the depositary could be subject to semi-strict liability for the potential frauds of other parties and other matters. It is also worth noting that a lot of valuable asset servicing expertise, in the form of fund administrators and other parties, does not reside in institutions who would be eligible to become “depositaries”.

These requirements, especially the high standard of liability and the requirement that depositaries be EU-authorised credit institutions, will in all likelihood reduce the number of institutions willing or able to carry out this service (potentially leading to concentration risk and increasing the impact of institutional failure) and will also lead to a significant increase in the costs that AIFs will have to bear. Moreover, the level of liability to which depositaries would be subject would no doubt force a change in the service level arrangements under which the depositary is willing to operate, thereby potentially limiting the ability of some AIFs to engage in transactions in some countries or engage in transactions with certain counterparties. Again, the end effects of these restrictions will be felt by those who ultimately invest in AIFs—primarily EU individual investors.

For example, limitations on sub-depositaries would make it difficult or even impossible for an EU-domiciled AIFM to manage an AIF with a global or emerging markets strategy and for any AIF with such an objective to be established in the EU, since sub-depositaries around the world are typically used by AIFs not investing solely in the EU and are often required in order to operate such a strategy. Why should EU investors be deprived of the chance to participate in such strategies?

Question 8

Will the provisions strengthening disclosure requirements help to create a more transparent market or do they go too far?

As the Directive only applies to EU based AIFs, the disclosure requirements regarding controlling influence in companies will not ultimately achieve a more transparent market across the board, as non-EU based AIFMs and other industry players that are not categorised as AIFMs will not need to adhere to the same rules. This will create an uneven playing field for EU AIFs against all other market participants.

In addition, there are dangers in disclosing too much. For example, disclosure of information relating to strategy, development and any other “forward-looking” information may be abused by third parties or serve to fetter management discretion in reacting to future developments. Given that some of the proposed disclosure requirements in relation to private companies go beyond that which is required in relation to listed companies, the case for requiring such disclosure needs to be better made.
QUESTION 10

How does the Directive compare to existing or proposed regulation of Alternative Investment Funds outside of the European Union, particular that of the United States? How will the Directive affect the position of EU Alternative Investment Funds in the global market?

Please see the table attached as Appendix which compares requirements under the Directive to current and proposed US requirements.

**APPENDIX**

<table>
<thead>
<tr>
<th>Category</th>
<th>Requirement under Proposed Directive</th>
<th>Corresponding Current or Proposed US Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Authorisation/Registration</td>
<td></td>
<td></td>
</tr>
<tr>
<td>required for EU-based manager required to:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Manage EU-based funds?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Manage non-EU based funds?</td>
<td>Yes</td>
<td>Maybe</td>
</tr>
<tr>
<td>Market EU-based funds in EU?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Market non-EU based funds in EU?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Market EU-based funds in US?</td>
<td>No</td>
<td>Maybe</td>
</tr>
<tr>
<td>Market non-EU based funds in US?</td>
<td>No</td>
<td>Maybe</td>
</tr>
</tbody>
</table>

*Current: Yes if fund is US-based and the fund is one of 15 or more US-based clients the EU-based manager has had during the preceding 12 months or the EU-based manager holds itself out as an investment adviser in the United States.

*Proposed: Yes if (i) fund is US-based and the fund is one of 15 or more US-based clients the EU-based manager has had during the preceding 12 months or (ii) fund (directly or in combination with other similar funds managed by the EU-based manager) has assets under management of at least $25 million attributable to US investors, or the EU-based manager holds itself out as an investment adviser in the United States.*
### Alternative Investment Fund Manager Directive: Evidence

<table>
<thead>
<tr>
<th>Category</th>
<th>Requirement under Proposed Directive</th>
<th>Corresponding Current or Proposed US Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Authorisation/Registration required for US-based manager required to:</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| Manage EU-based funds? | Yes, but not permitted | Maybe.  
*Current*: Yes if fund is one of 15 or more clients the US-based manager has had during the preceding 12 months or the US-based manager holds itself out as an investment adviser in the United States  
*Proposed*: Yes if the US-based manager has AUM of $30 million or more |
| Manage non-EU based funds? | No |  |
| Market EU-based funds in EU? | Yes, but not permitted for 3 years after adoption | No |
| Market non-EU based funds in EU? | Yes, but not permitted for 3 years after adoption | No |
| Market EU-based funds in US? | No |  |
| Market non-EU based funds in US? | No | Maybe  
*Current*: No requirement for registration as an investment adviser but registration as a broker dealer may be required depending on the facts and circumstances  
*Proposed*: No requirement for registration as an investment adviser but registration as a broker dealer may be required depending on the facts and circumstances |
| Are there de minimis exemptions to requirements for authorisation? | Yes, for managers with AUM less than €100 million | Yes  
*Current*: Yes, for managers with fewer than 15 clients during the preceding 12 months and who do not hold themselves out in the United States as investment advisers  
*Proposed*: Yes, for US managers with AUM less than $30 million |
<p>| May a manager opt into authorisation to manage funds? | Yes | Yes |
| Permitted to delegate to other managers in the EU? | Yes | Yes |</p>
<table>
<thead>
<tr>
<th>Category</th>
<th>Requirement under Proposed Directive</th>
<th>Corresponding Current or Proposed US Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Permitted to delegate to other managers in the US?</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Does the manager need to seek further authorisation prior to managing or marketing new funds?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Is the manager required to identify and disclose conflicts of interests?</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Is the manager required to separate risk management and portfolio management functions?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Is the manager required to adopt risk management procedures and review them annually?</td>
<td>Yes</td>
<td>Yes if required to be registered (see above)</td>
</tr>
<tr>
<td>Is the manager obligated to ensure that the fund implements a redemption policy appropriate to the liquidity profile of fund investments?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Is the manager required to adopt liquidity management procedures?</td>
<td>Yes</td>
<td>Yes if required to be registered (see above)</td>
</tr>
<tr>
<td>Is the manager required to maintain own funds capital?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Is the manager obligated to ensure an independent valuator has been appointed in respect of the fund?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>May a third country valuactor be appointed?</td>
<td>Yes, subject to limitations</td>
<td>Yes</td>
</tr>
<tr>
<td>May a third country administrator be appointed?</td>
<td>Yes, subject to limitations</td>
<td>Yes</td>
</tr>
<tr>
<td>Limitations regarding depositaries</td>
<td>Yes, must be an EU credit institution</td>
<td>Yes, must be either: (i) a US bank or FDIC insured savings association; (ii) a US registered broker-dealer holding client assets in customer accounts; (iii) a US registered futures commission merchant holding client assets in customer accounts, but only with respect to clients’ funds and security futures, or other securities incidental to transactions for the purchase or sale of a commodity for future delivery and options thereon; or (iv) a non-US financial institution that customarily holds financial assets for its customers, provided that the non-US financial institution keeps the advisory clients’ assets in customer accounts segregated from its proprietary assets</td>
</tr>
</tbody>
</table>
MEMORANDUM BY FIDELITY INTERNATIONAL

1. Fidelity International

Fidelity International (“FIL”) is a global investment business managing £109.3 billion of assets as at 30.06.09, £28 billion of them in the UK. Fidelity is a long-only manager, we do not manage hedge or private equity funds, none-the-less this Directive will significantly impact our business, as described below.

2. Overview

The Proposal defines alternative investment funds (AIFs) as all non-UCITS collective investment vehicles. This Proposal is an attempt to create a Single Market Regime for all investment funds which are not UCITS. As such, the new regime attempts to create a single playing field for all non-UCITS funds including hedge funds, private equity funds, listed investment trusts and real estate funds.

In addition the Proposal provides for a passporting regime for EU domiciled non-UCITS funds. No cross-border EU regime exists currently for such funds, including real estate funds, so this will facilitate cross-border marketing and reduce compliance and legal costs which are ultimately borne by investors.

In embracing all non-UCITS funds the proposal fails to reflect the complex interplay in non-UCITS collective investments between the liquidity and ease of valuation of the underlying assets and the characteristics of the fund. Thus an open-ended property fund, where the underlying assets are illiquid would need high levels of liquidity, whereas an investment trust, where liquidity is provided in the secondary market, needs no liquidity requirement mandated.

3. Overall Impact

Although the proposal is couched in terms of investor protection, the key effect is to restrict access by EU professional investors to the global portfolio management industry in anything other than UCITS-compliant asset classes. It will also drive up the costs of investment, thus reducing returns. This will have damaging effects on pension funds, insurance companies etc. Although these institutions are themselves excluded from the Directive, they often choose to invest through funds for reasons of economic efficiency. This proposal will damage the EU economy unnecessarily.

4. Issues from the Point of View of Fidelity International

FIL’s main business is in the management of UCITS which are distributed across Europe. FIL does not manage hedge or private equity funds.
There are concerns relating to:

— UK investment trusts
— the treatment of depositaries

The Directive creates opportunities for passportable real-estate funds.

5. UK Investment Trusts

These funds are caught and would be defined as Alternative Investment Funds (AIF). They are closed-ended investment companies listed on a major stock exchange. They are the oldest known collective investment vehicles and have been in existence for over 100 years.

The Directive does not recognise that investment trusts are companies controlled by their boards which have oversight of the fund and hire the fund manager. Nor that they are subject to the Prospectus and Transparency Directives and Listing rules. As such they effectively enjoy passporting rights across the EU.

If the Directive was enacted in its current form it would have the following, mainly deleterious, effects on investment trusts.

Depositary

The funds would require a depositary which would be responsible for safe custody of the assets, would need to be an EEA authorised credit institution, could, in effect, not delegate outside the EEA, and would be directly responsible for the receipt and payment of subscriptions and redemptions.

In addition the depositary would have a duty of strict liability to the fund.

This is all foreign and unnecessary for investment trusts, the assets are owned by the company and are subject to safekeeping regulations. The proposal would merely add to cost and restrict choice.

Delegation

Services, including portfolio management could only be delegated to an AIFM authorised in the EEA. Fidelity believes assets are thus best managed close to the markets concerned. Delegation of fund management to non-EEA portfolio managers would not be possible.

Valuations

These would need to be carried out by independent valuers. This is currently a responsibility of the board.

Liquidity management

Liquidity systems and redemption policies would need to be put in place. This is quite irrelevant when the secondary market is the source of liquidity.

Issue of shares

The Directive proposes that such issues must be made by the manager: in the case of investment trusts this would prevent any new issues of shares, shares are issued by the company.

The way forward

Ideally investment trusts should be completely excluded from the scope of this Proposal. Because of the way the Directive has been drafted, and the political imperatives, there is no certainty of investment trusts being carved out completely from the Directive.

The proposal is to amend the Prospectus and Transparency Directives to achieve the aims of the AIFM where relevant and necessary, but to avoid the clearly irrelevant ideas such as liquidity management and the use of depositaries. In addition we will argue for delegation of portfolio management outside the EEA to be acceptable.

The alternative, as noted below, is to argue that funds created under national regimes and not seeking a passport under this Directive should be exempt.
6. Real Estate Funds

The Directive opens up the attractive possibility of the creation of passportable real estate funds. Real estate funds bring with them a number of technical challenges related to the illiquidity of the underlying assets, valuation methodology and marketing disclosures. We do not think the Directive as currently written successfully addresses these issues.

Within the real estate funds arena, as with other alternative asset classes, there exists a number of fund models for undertaking very similar investment strategies. The fact that there is no standard model is of course partly derived from the fact that real estate does not fall under UCITS regulations. These models have developed in each of the domestic markets to meet the needs of the respective client bases.

In Germany the real estate open-ended vehicle primarily targets retail investors who require daily redemption options, stabilised independent valuations and a moderate gearing policy. In order to meet these requirements, the industry and the product have evolved such that a high cash weighting is maintained to meet redemptions and a “smoothed, sustainable valuation” methodology is applied.

Some open ended property funds for retail customers in the UK, also employ daily redemptions, although unlike the German model, valuations tend to be done on a mark to market basis and cash levels are often lower.

Different approaches have been taken depending on the type of investor. For example, real estate funds for institutional clients often employ longer redemption periods (typically quarterly) that better reflect the illiquidity of the asset class, thereby facilitating lower cash levels being maintained. The prevailing valuation methodology outside Germany is one of regular, independent, mark-to-market reflecting the current price that would be paid between a willing seller and a willing buyer. This methodology is consistent with the broader accounting principle of reflecting current values, a concept supported and actively promoted by the EU.

Fidelity believes the EU directive should not legislate in such a manner as to remove or limit the choice of investors or approaches. We believe a legislative framework should be installed which allows these different approaches to co-exist but regulated appropriately and with appropriate clear marketing messages for investors. For instance, the interplay between the type of investor, the redemption profile and liquidity must be reflected in the regulatory structure. In offering daily redemption, a minimum level of liquid assets must be held by the fund.

A consistent EU wide valuation methodology must apply for all assets in order for the purposes of calculating regulatory requirements such as compliance with the gearing policy and level of regulatory capital. The issue of valuation methodology is critical for the Commission to address, not in order to engage in a technical real estate debate, but because the experience of—and risk for—the client is significantly different depending on which methodology is employed. It does not seem tenable, given accounting practices, regulatory principles such as treating customers fairly, or practical mechanisms such as employing gearing limits relative to a “value”, to introduce differentiated EU-wide regulation without addressing such an important aspect.

One point which has been overlooked to some extent is the clarity of marketing language, or lack of. We would encourage marketing language be made clearer and the level of disclosure more consistent thereby allowing investors to more accurately determine the relative merits and risks of a potential investment for themselves.

In adopting this stance, a range of different strategies and structures can be created which meet the requirements of heterogeneous investors and fit within the umbrella of the directive without having to impose unnecessary and onerous limitations on areas such as gearing, levels of liquidity and delegation.

7. Depositaries

The provisions requiring an independent depositary to be appointed who is a licensed credit institution are very restrictive; most EU depositaries are not credit institutions.

Nor do we believe that the obligations of depositaries should be greater than they currently are for UCITS. The UCITS model has worked with maximum investor protection for millions of EU citizens. Recent problems have not been failures of the regime but of performance by particular firms. Tightening the rules does not improve performance.

Where depositaries are used the standard of liability needs to be clarified as that of reasonable care, otherwise depositaries are likely to exit their role or substantially increase their costs to the detriment of investors.

Depositaries are unsuitable for real estate funds where it is legal counsel/notary who ensures and verifies title. These provisions need to be amended accordingly.
8. **Capital Requirements**

These provisions require capital of at least €125,000. Where the value of the portfolio exceeds €250 million, additional capital requirements are required of 0.02% of the amount by which the portfolio exceeds €250 million. There is no cap on capital. These provisions need to be capped to avoid being disproportionate. The capital requirements should follow the provisions in the UCITS Directive.

9. **Local Funds**

We see no reason why funds which comply with local fund and distribution requirements (UK NURSS, German Spezialfunds,) should not be allowed to remain so long as no EU passporting rights are sought.

10. **General Remarks**

We have not sought to answer all the Committee’s questions in detail but we would comment that the lack of formal consultation by the Commission was an unfortunate failure of process that should not be repeated. Had they consulted appropriately many of the problems identified could have been ironed out at an early pre-legislative stage, whereas now there is a time-constrained rush to complete the legislative process.

*9 September 2009*

**Memorandum by the Hedge Fund Standards Board**

**Introduction**

The Hedge Fund Standards Board (HFSB) was set up to act as custodian of the Best Practice Standards published by the Hedge Fund Working Group in 2008 and to promote conformity to the Standards. It is also responsible for ensuring that they are updated and refined as appropriate. Over 50 managers from the UK and abroad—totalling approximately USD 200BN in assets under management, have already committed to the process of the HFSB, and more are expected to sign up to the Standards over coming months. The HFSB expects its Hedge Fund Standards to be widely adopted and an increasing number of investors to use the Standards in their due diligence. This market based regime was developed in close cooperation with the FSA, and is designed to provide a framework of discipline for the Hedge Fund industry which is more effective than traditional prescriptive regulation, while being fully integrated into the UK’s regulatory regime for Hedge Funds.

The HFSB is pleased to have the opportunity to respond to the House of Lords European Union Committee Call for Evidence on the Directive on Alternative Investment Fund Managers (AIFM).

**Consultation Responses**

1. **What economic benefits arise from Alternative Investment Funds? What risks to financial markets arise from Alternative Investment Funds? Will the Directive help reduce these risks?**

Hedge Funds provide many benefits to investors and the economy as a whole. They are almost irrelevant in quantitative terms, representing only 1 to 2% of the total financial system, but their qualitative impact is very important. They are driven by investor demand and they only exist and develop if they provide investors with superior returns. But in doing so they also contribute to more complete financial markets, provide opportunities for risk management and, in general, contribute to financial innovation which is of benefit to the whole economy.

To investors, they provide additional choice of investment opportunities along the risk return spectrum, helping investors to optimise their portfolios. Hedge Funds in particular seek to provide return opportunities in economic environments in which traditional investments such as stocks and bonds offer limited returns. Today, most investment in Hedge Funds is done by Institutional Investors—in particular, pension funds, insurance companies and endowments. These sophisticated investors have complex asset management requirements, want and appreciate a broad spectrum of choices and allocate more and more to Hedge Funds because this is the best way of adapting their portfolios to their investment preferences.

The economic benefits of Hedge Funds are related to financial market efficiency and innovation, as well as more comprehensive risk management.
In the financial markets:

— Hedge Funds contribute significantly to market liquidity, thereby *reducing spreads* (= the transaction cost to all market participants).

— The activity of Hedge Funds lead to more efficient price discovery: Hedge Funds often invest heavily in information acquisition (research) to spot valuation anomalies early on and trade accordingly. Thereby, markets incorporate new information more quickly. This results in more robust prices. In this context, short sellers can be seen as “market detectives” who spot excessive valuations early on and provide a corrective force, thereby preventing misallocation of capital in the economy.

— Some hedge funds engage in short selling, and this activity can help *dampen price bubbles*, by smoothing out excessive peaks in market prices and accelerating price corrections, while at the same time buying at times when prices are falling (ie, to cover the short position). This also reduces price volatility in markets, thereby ultimately reducing the cost to companies of raising capital in the markets.

— More generally, Hedge Funds are extremely innovative, by constantly developing new strategies and products, bringing them to investors and testing their viability in the marketplace. Whenever new products or strategies are successful, they are often adopted by others and disseminated throughout the financial system, with substantial benefits for all concerned. Hedge Funds can be considered the leading edge of the markets, the laboratory where innovation is tested, and the source of competitive advantage for the financial sector. The long term competitive survival of the financial industry cannot be based on routine processes executed on a large scale; it has to be reaffirmed by constant adaptation to a market which is frequently changing and demanding new solutions. This is, perhaps, the most important reason why Hedge Funds are of crucial value to the development and prosperity of the financial industry, in Britain and in Europe.

The economic benefits of Hedge Funds are especially related to risk management. By providing risk taking opportunities for investors Hedge Funds create more complete markets, where all contingencies can be appropriately price and traded. Investors have access to higher return opportunities, by accepting these risks within their larger portfolios. And firms and even policy makers benefit by finding investors prepared to take these risks, defining a price for them and managing them in a process that creates no systemic consequences. Since risk taking and risk management is such a vital part of a developed, innovative and sophisticated economy, it is of crucial value that systems exist to handle risk in a controlled fashion, by finding those who are prepared to invest and face the potential losses, while preserving overall systemic stability. As we have painfully learned over the last two years, it is much better that risks be taken by knowledgeable and sophisticated investors, operating through Hedge Funds, than by large scale banks, investing money that belongs to unsuspecting depositors.


While there is significant benefit in creating a harmonised European market place for alternative investment management, the approach taken in Directive is questionable:

— The Directive seeks to cover a very wide and diverse spectrum of asset management activities in significant detail. The expert feedback to the draft Directive has highlighted that many aspects are not workable. A one size fits all approach might not be appropriate at the level of detail the Directive is currently targeting.

— The Directive is protectionist, preventing European investors from investing abroad. In particular, funds managed in the US—which form the bulk of the industry—will not be allowed to sell to European investors. Investors have voiced strong concerns about this type of “investor protection”. The development of European financial markets will never be healthy and competitive, if the market is not open and firms are protected from competition from abroad.

— The Directive proposes centralising a lot of powers in Brussels, ignoring the subsidiarity principle, a key pillar of European policy making. Local regulators should be empowered in areas where they are better capable of setting out detailed requirements in dealing with their industries. Clearly, this has to be in line with the higher level requirements as set at the European Union level.

The objectives of the Directive seem to be appropriate, but the chosen response is not proportionate. It is questionable if the Directive achieves its objectives in an efficient and effective manner in its current form.

In the area of hedge fund activity, concerns have been voiced in relation to systemic issues, investor protection, and market integrity.

The HFSB does not see evidence of the systemic nature of hedge funds. In addition, there is widespread agreement that the activity of hedge funds has not been the cause of the financial crisis. However, the HFSB agrees that systemic risk regulators should have confidential access to relevant information from all types of financial market participants (including alternative investment fund managers) allowing them to assess the potential build up of systemic risks.

In relation to investor protection issues, it is important to note that Hedge Funds are usually not sold to retail investors, which require a higher level of protection than institutional and other sophisticated investors. However, sophisticated investors have not asked for more protection (and are now concerned about the implications of the Directive). Indeed, in some areas, the requirements of the Directive go beyond what is currently required in the UCITS regime, which is meant to cater for retail investors. This is for example the case in the area of depository liabilities. This and other examples demonstrate that the Directive is not proportionate.

There is a serious concern that the Directive creates over regulation, leading to misallocation of regulatory resources, thereby preventing the supervisor from focussing on more relevant issues. One example to highlight this is the need for globally integrated alternative investment fund managers to seek authorisation for delegation of fund management activities. Also, changes to investment strategy and policy for individual AIFs will need to be notified to authorities with approval/rejection/restrictions to be granted within a month. It is very doubtful that regulators are in a position to assess the viability of investment strategies. The overarching concern is that the Directive creates significant bureaucracy, with no obvious benefit.

Issues in relation to market integrity should not be dealt with in a manager directive, but rather in the appropriate market abuse legislation—which is already in place—thereby applicable to all market participants, not just alternative investment fund managers.

4. Is it appropriate to regulate Investment Fund Managers, rather than the Fund itself? Does the Directive contain appropriate provisions to distinguish between different types of alternative investment? Does the scope of the Directive create a danger of unintended consequences?

The HFSB believes it is appropriate to regulate the fund manager, rather than the fund itself as long as the fund is sold to sophisticated investors only, who have not asked for more investor protection (via product/fund regulation).

The Directive does not differentiate sufficiently between types of alternative investments. Even within the hedge fund sector, there is great diversity of activities, and some requirements might in the future limit certain hedge fund strategies or even make them impossible to pursue. This relates in particular to the leverage limits that the Directive seeks to impose on the industry.

There is significant scope for unintended consequences. The leverage limits suggested in the Directive could have a pro-cyclical effect, forcing managers to unwind positions in times of increased market volatility or distress, thereby causing forced selling in already tumbling markets. This is exactly the opposite of what is actually desirable in times of distress.

5. What is your evaluation of the Commission’s consultation in the preparation of the Directive?

While the Commission consulted publicly on Hedge Funds in February 2009 prior to issuing its Draft Directive, it is unclear whether and how the consultation feedback has fed into the process to develop the Directive. On the Directive itself, no consultation has taken place.

The HFSB believes that the European Commission should have consulted in a much more proactive manner on the regulatory objectives and the actual draft.

REGULATORY ASPECTS

6. Will the passport system help create a single market in investments funds within the EU? How will the passport system established affect the EU and the UK industry and particularly their position in the global market?

A European passport will be a major step forward in the development of Europe's financial markets. It will contribute to a much larger and efficient internal market, will enable the most competitive fund managers to expand and will create conditions more comparable to those in the US.


From a systemic risk perspective, it is very unlikely that small firms that fall under the Directive have any stand alone relevance at all. However, in a systemic risk context, it makes much more sense to allow regulators to collect the data they deem relevant. In most instances, they might focus on the largest funds, but there might also be instances where a regulator wishes to collect data from all managers, irrespective of size.

A capital requirement for the manager is already imposed via other pieces of legislation, notably Mifid. A capital requirement for the actual fund is not needed. This is where investors and creditors determine the appropriate and desired level of “leverage”, which is a function of the riskiness of the fund strategy as well as the risk appetite of investors and creditors.

While HFSB is promoting independence in the valuation process via its Standards, we acknowledge that there can be instances where independent valuation might not be suitable or even possible. This is why HFSB does not prescribe one single way of doing things, but rather provides leeway under the condition that managers explain and disclose their approach to investors. It is then investors who can decide for themselves, whether they like the approach or not. This is superior to prescriptive and rigid rules. HFSB agrees that there needs to be independent custody of assets.

8. Will the provisions strengthening disclosure requirements help to create a more transparent market or do they go too far?

HFSB is in general in favour of disclosure to investors. Therefore, we welcome meaningful requirements to enhance transparency to investors.

IMPACT

9. What effect will the Directive have upon the position of the City of London and the EU as a whole as a leading location for Investment Fund Managers? Could it cause many hedge funds to relocate outside of the EU? What impact would the Directive have upon professional investors and institutions?

The Directive will weaken Europe and the City of London as a leading location for investment management. The protectionist element might reduce foreign competition, resulting in the European investment management industries losing their current competitive edge. Protectionist measures could also lead to retaliation by trade partners, either in the area of asset management, or elsewhere. Also, the Directive makes it much more difficult to manage a globally integrated asset management company from Europe, given the bureaucratic requirements the Directive will establish in the area of delegation of functions.

European professional investors, and in particular European pensioners will suffer, given the reduction in choice of investment opportunities and the incremental cost the Directive will cause, which will ultimately be borne by investors in the form of reduced returns.

10. How does the Directive compare to existing or proposed regulation of Alternative Investment Funds outside of the European Union, particularly that of the United States? How will the Directive affect the position of EU Alternative Investment Funds in the global market?

The regulatory framework in the US is currently in the making, starting with the requirement that Hedge Funds be registered with the Securities and Exchange Commission and with some oversight powers for the SEC. But it is very unlikely that the US will impose similarly damaging requirements on its own alternative investment management industries.

This will indeed weaken the position of European and in particular UK alternative investment fund managers. In the past, being a UK-based, FSA-regulated manager has been a quality mark, given the sophistication and appropriateness of the FSA regulatory regime, in particular in relation to hedge funds.
11. **What effect will the Directive have on flows of capital and financial innovation?**

Capital flows will be restricted given the investment restrictions imposed on EU investors to invest with non-EU managers. The depository requirements and the restrictions on the delegation of functions will certainly reduce flows to emerging markets.

Financial innovation will be slowed down, in particular where the Directive interferes with investment strategies or imposes restrictions (leverage limits, approval of investment strategies).

Ultimately, all this will be detrimental to efficient global capital allocation and global economic growth.

*September 2009*

**Memorandum by the HSBC Group**

HSBC welcomes the opportunity to comment on the draft Alternative Investment Management Funds Directive and does so as a major participant in the global alternative funds market. HSBC Group participates in three main roles covering all aspects of the alternative investment industry value chain:

1. Global investment manager with investment funds manufactured in several different cities around the world including Hong Kong, New York, London and a number of other European jurisdictions. Current AuM USD$391b.

2. Major private bank and investment advisor to 11 HSBC fund of funds. The manager of these funds is based in Guernsey and the funds are Guernsey unit trusts. These funds have USD$2.6b AuM.

3. One of the top global administrators and custodians to third party alternative investment fund management companies with assets under administration of USD$2,703b in 10,800 funds.

With assets of US$2,421b, and a market capitalisation of US$141b at 30 June 2009, HSBC is one of the world’s largest banking and financial services organisations.

1. **What economic benefits arise from Alternative Investment Funds? What risks to financial markets arise from Alternative Investment Funds? Will the Directive help reduce these risks?**

1.1 **General Economic Benefits**

The positive effects of the emerging alternative fund sector on the economy are well documented and include better corporate governance through activist managers, greater liquidity in markets, higher performance returns and the free flow of capital across Europe for both small and large corporations. The industry has spurred job creation, financial growth as well as innovation in financial products.

1.2 **Economic Benefits to Institutional Investors**

Alternative Investment Funds (AIFs) provide economic benefits to institutional investors such as pension funds, as recently noted by the Alternative Investment Management Association (AIMA). The economic benefits derive from a combination of good returns, lower correlation to traditional asset classes such as bonds and equities, and low volatility. Consequently, institutional investors have been steadily increasing their allocations to alternatives. Due to an ageing population pension funds will continue to require strong growth and reliable returns in order to meet future pensioner demands. It has been estimated that the Directive as proposed could cost the European pension industry EUR 25 billion (£21.3 billion) per year through increased charges and lower investment returns.

1.3 **No Significant Risk to Financial markets**

The perceived but as yet unsupported negative side of alternative funds rest around the herd instinct driving down prices in a bear market, naked short selling, lack of transparency to investors and to regulators as well as tax evasion. We do not believe AIFs pose significant risk to financial markets, as it has been widely recognised that AIFs were not the primary cause of the global economic crisis. Indeed, following the on-set of the financial crisis hedge funds have been forced to close, themselves victims of the crisis. Their closure had minimal impact markets.

1.4 **Directive Unlikely to Prevent/Reduce Risk**

Whilst the planned separation of depositary, valuation and management functions under the proposed Directive may reduce fraud and mis-pricing risk, the Directive is unlikely to prevent market risk. In every downturn in the economic cycle, large corporations default with equity holders carrying the risk. Fund investors carry similar equity-type risks but have the benefit of professional management to help reduce the
risk. Both corporations and funds default largely through taking wrong calls around the turn of the economic cycle. Regulation would be unable to pinpoint this particular risk and it is doubtful it would prevent it at all. We also do not believe that the Directive will help reduce risk to the financial markets. Specifically addressing risks posed by hedge funds, given their international dimension, a purely European response would not be as effective as an internationally agreed response, which would also ensure a level playing field globally. In preference to the Directive, regulators should consider endorsing or codifying one global hedge fund standard or code of practice.

2. To what extent is there a need to create a single regulatory regime for Alternative Investment Fund Managers in the European Union? Does the Directive achieve its objectives? Should the objectives of the Directive be modified?

2.1 Single Regulatory Regime for all Non-UCITS Funds not correct approach

Although we support the need for a single regulatory regime and harmonisation, we do not believe however that creation of a single regulatory regime for Alternative Investment Fund Managers (AIFMs) in the EU, applicable to all non-UCITS funds is a good approach. The Directive covers too many differing funds to be effective; non-UCITS retail schemes (NURS), which are already locally regulated, closed-ended investment companies which are traded on a regulated market, as well as hedge funds, private equity and real estate funds. We are of the view that the current methods of regulating these funds remains appropriate, however, regulatory resources should be more systemically focused.

2.2 Focus should be on Systematic Risk

As currently proposed, we do not believe that the Directive achieves its objectives as it will apply to AIFM with AuM of EUR 100 million and above, irrespective of the number of AIF which they manage and whether they are systemically important or not. The Directive should only apply to those institutions, whether hedge funds or not, which pose systemic risk to the financial system. Regulators could then more effectively target their limited resources.

2.3 Consistency with MiFID and UCITS Directives

The Directive should also be consistent with the Markets in Financial Instruments Directive (MiFID) and the UCITS Directive.


3.1 Risks vary Dependent on AIFM Strategies

AIFs pose the same risks as any other financial traded environments—liquidity, position, counterparty, default, operational etc. The larger AIFs become and more meaningful to the economy, the larger the risk to the economy in the event of default (systemic). The greater the use of derivatives and shorting techniques the more risk controls have to be in place, and more sophisticated risk controls at that.

3.2 Sufficient checks and balances already in existence

In our view, there are sufficient checks and balances in the existing regulatory framework (particularly in UK) to manage trading and position risks posed by AIF’s.

The AIFM Directive is not proportionate in our view for the following reasons:

— Blanket capital requirements not aligned to the risks posed by AIFs.
— Arbitrary restrictions on leverage.
— Protectionist measures which restrict the sale of third country funds into Europe.
— Unworkable restrictions on the free operation of global fund managers based in Europe to place mandates with managers in the US and Asia.
— Unacceptable responsibilities and liabilities on the depository function which are tantamount to a full guarantee for all investors, both retail and institutional.
— Lack of status for the role of Prime Broker.
— Requirement for a European Credit Institution is restrictive.
3.3 One Global hedge Fund or Code of Practice
In preference to the Directive, regulators should consider working with the industry and endorsing or codifying one global hedge fund standard or code of practice. The hedge fund industry, through its association AIMA (Alternative Investment Managers Association) has already commenced a number of initiatives to create global standards and a code of practice which have not had time to be fully implemented.

4. Is it appropriate to regulate Investment Fund Managers, rather than the Fund itself? Does the Directive contain appropriate provisions to distinguish between different types of alternative investment? Does the scope of the Directive create a danger of unintended consequences?

4.1 Directive need not apply to the funds themselves
As AIFMs in the UK, whether managers of long-only funds or hedge funds, are already required to be regulated, the Directive need not apply to the funds themselves, no matter where they are domiciled. It is also acknowledged that the Directive sought to exclude the marketing of non-EU funds established in jurisdictions such as the British Virgin Islands and the Cayman Islands, (where the majority of hedge funds are domiciled) to EU investors, principally due to tax reasons. However, as the Organisation for Economic Cooperation and Development (OECD) has recently announced that both jurisdictions have joined the global “white list” of countries which use internationally recognised tax standards, then the reasons for excluding funds from these jurisdictions diminishes.

4.2 It is unnecessary for the Directive to apply to such a wide universe of funds
The Directive does not contain appropriate provisions to distinguish between different types of AIF and consequently, there are unintended consequences from it having being drafted too widely covering all non-UCITS funds. We believe that it is unnecessary for the Directive to apply to such a wide universe of funds, as the Directive currently covers retail funds which are already nationally regulated, such as non-UCITS retail schemes (NURS) in the UK, as well as closed-ended investment companies which are traded on a regulated market. The Directive as proposed will also cover private equity, which is at odds with the Commission’s own press release which stated that it does not consider that private equity poses a systemic risk to the financial system. The Directive also does not allow national authorities to authorise other types of fund for professional investors within their own territory, so that the private placement regime which is currently available in a number of European countries would be prohibited after the three-year transition period.

4.3 It is our view that the imposition of strict controls over private equity and other innovative funds at European level will have the unintended consequence of restricting the flow of capital across Europe, one of the aims of the Lisbon Agenda.

5. What is your evaluation of the Commission’s consultation in the preparation of the Directive?

5.1 Prior self regulation work has been ignored
There appears to have been no consultation with the industry either at association level or at business level, which can be evidenced by the criticism levelled at the AIFM Directive from the industry. Prior to introduction of the AIFM draft, there has been a lot of work undertaken by the industry through IOSCO, Alternative Investment Managers Association (AIMA) and the Hedge Fund Standards Board to review regulation, self regulation and the introduction of a code of conduct. Not enough time has been allowed for these types of initiatives to work.

We are of the view that if there had been sufficient consultation concerning the draft Directive, as well as a comprehensive cost benefit analysis, then the areas which have been identified as unworkable and non-cost effective would have been amended very early on. For example, the concept of prime brokerage is not addressed in the Directive, whilst a “valuator” which is not a known concept is included.

6. Will the passport system help create a single market in investments funds within the EU? How will the passport system established affect the EU and the UK industry and particularly their position in the global market?

6.1 Passport System as proposed will not help to create single market
We do not believe that the passport system as proposed will create a single market in investment funds within the EU. This is because an EU ADFM which manages non-EU based funds (which applies to the majority of UK hedge funds), will not be permitted to market to EU professional investors in other Member States under
the passport provisions of the Directive for a period of three years from the date of adoption of the Directive. Third country funds are placed at a competitive disadvantage during the three year period, which is detrimental to the UK hedge fund industry.

6.2 Passporting requirements protectionist and too costly

The proposed passporting requirements have been viewed by a number of commentators as being protectionist as the Directive will make it too costly and difficult for non-EU funds to access the EU market. This could invite retaliation from other global markets, such as the US. Institutions such as pension funds should have access to the full range of global funds, not just EU funds.


7.1 Threshold for defining “systemically relevant” funds set too low

We believe that the threshold for defining “systemically relevant” AIFs has been set too low. An AIFM with AuM of EUR 100 million, irrespective of the number of AIF which they manage, is not large enough to pose a systemic risk to the financial system.

7.2 Capital Adequacy Directive already establishes uniform capital requirements

It is not necessary for the Directive to include capital requirement provisions as the Capital Adequacy Directive (CAD) already establishes uniform capital requirements for both banking firms and non-bank securities firms. The CAD has also established a comprehensive and risk-sensitive framework, designed to ensure continuing financial stability. Prime brokers, who provide credit facilities to hedge funds, are already subject to this directive. The Directive should also include a maximum cap on the amount of capital required, in line with the UCITS Directive.

7.3 Directive does not contain appropriate rules for leverage

We do not believe that the Directive contains appropriate rules concerning leverage as “high levels of leverage” is defined much too widely and has been set at too low a figure. In addition, in the event that markets were to again fall dramatically, hedge funds which are close to their leverage cap would be forced to sell assets. This would worsen such scenarios as seen recently when hedge funds were forced to sell into a falling market following high investor redemptions. Levels of leverage are a feature of the market and differ from fund type to fund type. Leverage can be both desirable to reduce risk and undesirable because it increases risk. Arbitrary levels of regulatory leverage will not work. In our view, markets are best placed to determine what levels of leverage a fund can employ based on standard lending criteria. In an efficient market, funds that employ too much leverage creating a high risk strategy will soon have their limits and ratings cut by the market.

7.4 Independent Depositaries

7.4.1 We welcome the proposed requirement for independent depositaries, and are of the view this would:

— Promote functional independence.
— Assist in management of any conflicts of interest.
— Enable a more fully experienced and resourced oversight role to be performed.
— Provide alignment with the existing UCITS regime.

7.4.2 However, we have serious concerns over the proposed AIFM liability standards to be imposed on Depositaries. In devising these standards and in the ongoing assessment of liability, there is a need for recognition of the necessary variation in safekeeping models for differing asset types and geographic regions eg:

— Assets directly held by the Depositary, and fully under their control.
— Assets that cannot be held by the Depositary for geographic or other reasons, which are held through a Sub-custodian selected and supervised by the Depositary.
— Assets that cannot be held by the Depositary that are held through counterparties selected and appointed directly by the Fund Manager.
Where assets cannot be held directly by the Depositary, the role of Depositary can only realistically be an oversight function.

7.4.3 Alignment with the existing UCITS framework in this regard would be our preference, where liability is imposed “as a result of the depositaries unjustifiable failure to perform its obligations or its improper performance of them”. Further investor protection could be provided by ensuring that disclosure is made in the fund’s prospectus of risks associated with assets being held with the Depositary’s sub-custodians/other delegates.

7.4.4 The strict liability currently proposed for depositaries will have the effect of imposing guarantee or insurance policy pricing which will be passed back to investors making it much more expensive for investors. The number of custodian banks will reduce rapidly with possible concentration risk consequences. The Directive also requires all depositaries to be EU Credit Institutions—as most hedge fund prime brokers are not—and can only act under delegation, this is likely to put further strain on hedge fund industry infrastructure.

7.5 Independent Valuations—“What is Independent?”

As fund administrators, we adhere to the concept of independent valuations. The majority of top tier fund administration groups, including ourselves, already have robust independent pricing models, using multiple price sources in place capable of meeting this requirement. However, there are also potential pitfalls for banks with regard to the question of “what is independent?”. Many of the larger banks operate both internally independent administration, and fund management units. We are of the view that providing there are sufficient “chinese walls” and independence between the fund manager and the valuation agent then complete independence should not be a necessity—this situation already arises with the relationship between the Bank’s own fund managers and fund administration clients.

8. Will the provisions strengthening disclosure requirements help to create a more transparent market or do they go too far?

8.1 Whilst we agree with any move to create a more transparent market, the provisions as currently drafted go too far. One such provision being the disclosure of an investor’s preferential terms, which we believe an investor will not wish to be disclosed. The amount of disclosure required is likely to add cost to the investor for information gathering and disclosure. It is doubtful the disclosure requirements will prevent the types of build up of risks envisaged by the Directive.

9. What effect will the Directive have upon the position of the City of London and the EU as a whole as a leading location for Investment Fund Managers? Could it cause many hedge funds to relocate outside of the EU? What impact would the Directive have upon professional investors and institutions?

9.1 Proposed Directive would have drastic effect on the City of London

We welcome the FSA’s recent commissioning of a cost benefit analysis of the proposed Directive on the UK. The proposed Directive would have a drastic effect on the position of the City of London as the leading EU location for AIFs. As the vast majority of AIFs are domiciled outside the EU these funds would not be permitted to be marketed to EU investors until three years from the date of adoption of the Directive, which would put these funds at a competitive disadvantage in the interim. If the AIFs were to re-register in the EU the costs would be borne by current investors, which would also lead to higher compliance costs and reduced returns.

9.2 It has been estimated that if the Directive is implemented in its current form it could lead to approximately 10,000 to 20,000 job losses in the UK with consequent loss of tax revenue. It is believed that a number of smaller firms may consider locating to less restrictive regimes such as US, Hong Kong or Switzerland.

9.3 The Directive would greatly limit professional investor and institutional choice which runs counter to its supposed intentions. We estimate this could lead to a loss to the European pension industry of EUR 25 billion (£21.3 billion) per year.
10. How does the Directive compare to existing or proposed regulation of Alternative Investment Funds outside of the European Union, particularly that of the United States? How will the Directive affect the position of EU Alternative Investment Funds in the global market?

10.1 Directive would make EU less competitive

As currently proposed, the Directive would make the EU less competitive than other jurisdictions and would lead to less choice for professional and institutional investors. Regarding global regulation, the US is not currently the model regulatory system as the majority of US AIFM fall within an SEC exemption, which means that they are not currently required to be authorised by the SEC. Proposed new regulation will require hedge fund managers in the US to register with the SEC and provide the regulator with information on the funds they manage, however, registration requirements are thought to be relatively “light touch” when compared with the AIFM Directive.

10.2 Best approach is that proposed by G20 Summit

The best response is that proposed by the G20 summit, which called for a more coordinated international approach. National regulators should work more closely together on standardisation, transparency and information sharing. We consider that the FSA currently sets the standard for how this can be done well and effectively. Consequently, parallel initiatives should be implemented by other key jurisdictions such as the US.

11. What effect will the Directive have on flows of capital and financial innovation?

11.1 We believe that the Directive would lead to capital flowing out of the EU due to the increased costs and lower returns. The Directive which is overly prescriptive would stifle financial innovation and would lead to AIFM re-locating outside of the EU, as currently proposed by a number of UK AIFM.

8 September 2009

Memorandum by the Initiative for Policy Dialogue, Columbia University

In order to assist the Committee in his Inquiry into the European Commission’s proposal for a Directive on Alternative Investment Fund Managers, we have decided to focus on five questions posed in the consultation paper (Question No. 3, 4, 5, 7, 9).


3.1 The unfolding of the global financial crisis certainly requires a reassessment of the systemic risk created by hedge funds, focusing not exclusively on the direct risk to their counterparties but also on the “indirect” risk that they pose to the whole markets. Since the collapse of the US hedge fund Long-Term Capital Management in 1998, the regulatory debate has focused on how to reduce the systemic risk deriving from the collapse of a single hedge fund that could imperil the safety of banks exposed through their counterparty exposure (eg prime brokerage activity, provision of leverage, trading counterparty exposures). While in the context of the current crisis an unprecedented number of funds have ceased their activities, this time hedge funds’ failures have been only a relatively limited source of stress for the banking system.

3.2 Nonetheless, hedge funds have represented an important source of systemic risk through different channels. During the panic in the markets triggered by the collapse of Lehman Brothers, hedge funds’ activity has been a channel of transmission of this panic, heightening the severity of the deleveraging process and the volatility in the markets. As the Turner Review has acknowledged: “hedge fund activity in aggregate can have an important procyclical systemic impact. The simultaneous attempt by many hedge funds to deleverage and meet investor redemptions may well have played an important role over the last six months in depressing securities prices in a self-fulfilling cycle” (p.72).

3.3 The recognition of the broader range of systemic risk generated by hedge funds calls for a change in the approach to their regulation that prevailed before the crisis. Since the collapse of LTCM, the “direct systemic risk” created by the hedge funds to the banking system has been tackled not by directly regulating the funds, but rather by regulating the bank counterparties, so-called “indirect regulation”. While this approach has contributed to strengthen counterparty discipline and to tighten the credit standards with respect to hedge funds, at the same time several official reports and academic studies have highlighted important limitations (eg use multiple prime-brokers, conflict of interests, competition between banks, etc…). More significantly, the crisis has demonstrated that “indirect regulation” has been a “first line of defense” to protect banks from the potential “direct systemic risk” created by the collapse of a hedge fund, but it has been unable to protect the
financial system from the indirect risks created by the procyclicality of HF activities in a falling market. These issues are far better tackled through more direct forms of regulation.

3.4 Moreover, the crisis has also showed the inadequacy of another regulatory mechanisms that has gained popularity in recent years in the UK and at the international level: self-regulation. Industry-driven codes of best practices could mitigate the investor protection concerns created by hedge funds, but they are insufficient to address the concerns related to the systemic risk created by their activities. The crisis has discredited the claims that the demands from investors are strong enough to guarantee sufficient disclosure of information on a voluntary basis, and it has highlighted instead the need for regulators to require mandatory disclosure. The limitations of self-regulatory codes of best practices have also been highlighted by the International Organization of Securities Commission, which has argued in March 2009 that “none of the industry codes have the force of law or of self-regulation. They are simply recommendations to voluntarily adopt a set of standards. It is noteworthy that a November 2008 survey of over one hundred UK hedge funds found that while over 60% supported the HFWG initiative in terms of establishing standards for industry, less than 10% are prepared to sign up to these standards”.

3.5 The limitations of the regulatory approach that prevailed before the crisis lead us to praise the decision by the European Commission to directly regulate hedge funds. This move is consistent with the statement released by the G20 leaders in London, as well as with parallel initiatives in the US. Both sets of initiatives stress the importance of comprehensive regulation and the need for all the systemically important financial entities to be regulated. As the G20 Working Group 1 has argued: “All systemically important financial institutions, markets and instruments should be subject to an appropriate degree of regulation and oversight, consistently applied and proportionate to their local and global systemic importance. Consideration has to be given to the potential systemic risk of a cluster of financial institutions which are not systemically important on their own”. This statement reflects the need for regulation to be comprehensive in order to avoid regulatory arbitrage, that is, in order to avoid that regulation has the effect of moving risk to unregulated institutions and instruments.

Comprehensive regulation of all the systemically important institutions is also justified by the need to integrate a purely micro-prudential approach to the regulation of financial markets with a macro-prudential approach. While microprudential regulation focus on the stability of individual institutions and seek to keep them behaving prudently, macro-prudential regulation focus on the stability of the financial system as a whole (for a clear analytical distinction, see Geneva Report 2009). The Turner Review has stated that a key lesson of the crisis for financial regulators is that authorities do not need to focus exclusively on the supervision of individual institution but rather on the whole system. This principle must inform also the approach of financial authorities to the regulation of hedge funds. According to the Turner Review regulators and central banks “need to gather much more extensive information on hedge fund activities … and need to consider the implications of this information for overall macro-prudential risks” (Turner Review p.73)

3.6 At the same time, we do not believe that the directive introduces over-stringent regulation compared to the kind of systemic risks posed by hedge funds and highlighted by the crisis. On the contrary, we argue in the rest of this paper that the directive does not go far enough in several important aspects.

4. Is it appropriate to regulate Investment Fund Managers, rather than the Fund itself? Does the Directive contain appropriate provisions to distinguish between different types of alternative investment? Does the scope of the Directive create a danger of unintended consequences?

4.1 Regulating managers, on the model already adopted by the FSA, is certainly a prerequisite to tame the risks alternative investment funds pose, since the funds are legal entities that exist only through fund managers. The decision to cover the managers of funds and not the funds themselves is also the most politically-feasible approach, since most managers are already located onshore. However, the decision not to regulate the funds limits the range of regulatory instruments that can be deployed.

4.2 Firstly, regulating fund managers limit the capacity of regulators to reduce the risks created by the collapse of hedge funds through the imposition of adequate capital requirements. The directive impose capital requirements exclusively upon the managers. While this solution is sound in the case of smaller funds whose collapse would not pose significant risk and would therefore not require a bailout, this is not true in the case of those funds whose size and leverage make them of systemical importance. The plan advanced in the US by the Treasury Secretary Tim Geithner suggests that the larger funds should be covered by adequate capital requirements.
4.3 Second, regulating managers does not allow appropriate taxation of the funds, which in most cases are located offshore for tax purposes. Therefore, as a group of expert of the Foundation for European Progressive Studies (FEPS) has recently suggested, in order to effectively regulate capital and liquidity requirements of funds, as well as their taxation, the directive should cover both funds and fund managers.

5. **What is your evaluation of the Commission’s consultation in the preparation of the Directive?**

5.1 Several critics of the Commission’s consultation have pointed out that this has been excessively short, and the directive was rushed in response to the financial crisis. These criticisms are over-stated. The number of responses to the consultation has been high, and 104 among from interest groups, national regulatory agencies, and independent commentators had the opportunity to send their contributions to the consultation.

5.2 While the consultation has been shorter than the consultation that preceded the Markets in Financial Instruments Directive (MIFID), its length is comparable to other consultations in the same period, such as the directive on the regulation of credit rating agencies. Moreover it is important to recognize that excessively long consultations do not necessarily enhance the quality of the legislation, since they increase the risk that the legislation will be “captured” by interest groups that have vested interests in minimizing the regulatory burden. It is indeed particularly important for policymakers to solicit in the consultation the views from institutional investors, pension funds, and independent experts, which are more likely to be primarily concerned with the stability of the financial markets. We very much welcome the effort by the House of Lords to give an opportunity to these actors to be heard in the legislative process.

7. **Is the threshold for defining “systemically relevant” Alternative Investment Funds appropriate? Should the Directive include provisions on capital requirement? Does the Directive contain appropriate rules on leverage? Is the requirement for independent valuation agents and depositaries for Alternative Investment Funds adequate?**

7.1 Threshold for defining “systemically relevant” funds. The directive set the threshold of 100 million euro (or 500 million euro when the funds are not leveraged and have no redemption rights exercisable during a period of five years). We do not regard this threshold as too low. For instance, the Hedge Fund Transparency Act presented in the US Congress by Senator Grassley and Levin at the beginning of 2009 sets a much lower threshold for mandatory registration with the SEC (50 million dollar).

7.2 We acknowledge that defining a sensible threshold is not a straightforward task. An excessively low threshold could be particularly burdensome for venture capital funds, which provide capital to early-stage companies, and thus perform a particularly useful function for the real economy. On the other hand, thresholds higher than the one set by the directive would simply give hedge fund managers the incentives to divide their portfolios into smaller funds in order to avoid being subject to the requirements set by the directive.

7.3 Moreover, the very introduction of “de minimis exemption” is problematic since it runs against the principle affirmed by the G20, according to which no financial institution should escape appropriate regulation and supervision. As the crisis has revealed, it is not the size of a single hedge fund to determine it creates systemic risk, as hundreds of small funds taking similar positions and adopting similar investment strategies could have a particularly destabilizing impact on the financial markets. As suggested by the Foundation for European Progressive Studies (FEPS), a sensible approach would be that of denying any kind of blanket exception, in order to bring every fund under the regulatory and supervisory umbrella. Then specific exemptions on the requirements imposed by the directive could then be imposed to smaller funds, following the principle that the greater the systemic risk posed by a fund, the more demanding the requirements imposed.

7.4 Leverage. The severity of the global financial crisis is clearly related to the excessive level of leverage in the financial markets. As the Financial Stability Forum has acknowledged leverage, together with size and interconnectedness with the rest of the system is one of the main sources of systemic risk in the financial system. The significant use of leverage that characterizes certain categories of hedge funds has represented a source of systemic risk by increasing the vulnerability of these funds to market shocks, by increasing the severity of the deleveraging process, and consequently, by amplifying the impact of hedge funds’ activities on the broader financial markets. Consistently with the decision by the Basel Committee to introduce a leverage ratio for the banking industry, also alternative investment funds should by subject to a limit in the amount of leverage.

7.5 The Directive takes a step in the right direction by assigning to the Commission the right to “set leverage limits where required to ensure the stability and integrity of the financial system” and grant national regulators “additional emergency powers to restrict the use of leverage in respect of individual managers and funds in exceptional circumstances”. While an argument commonly made is that leverage is better controlled through the prime brokers than through regulation, the crisis has shown how banks have been unable or unwilling to limit the build up of significant levels of leverage that have worsened the panic in the markets during the
deleveraging process. Part of this problem could be explained by the fact that providing leverage and primebrokerage services are extremely important and profitable activities for banks. We think therefore that it is important that the Commission sets the total level that hedge funds can have through a precise rule consistent across member states (rather than through discretionary principles) in order to avoid any kind of regulatory arbitrage. As the FEPS has suggested, the limits on leverage should be based on the type of activity, the risk profile of the fund and the maturity of their funding. Moreover, the rule defining the limits on leverage should take into account the leverage that remains embedded in derivatives. The Financial Services Authority, in collaboration with other national securities regulators, should further analyze this issue in order to assist the Commission in the definition of a maximum level of leverage for hedge funds.

7.6 Capital and Liquidity Requirements. The directive states that each alternative investment fund managers is required to hold and retain own funds of at least 125,000 euro, plus setting additional capital requirements that shall be equal to 0.02 per cent of the amount by which the value of the portfolios of the AIFM exceeds 250 million euro. Since these capital requirements are on the fund’s manager, they are more appropriate to protect the investors from unexpected operational problems rather than to prevent excessive risk-taking. Effective capital requirements for prudential reason cannot be introduced unless the range of the directive is expanded to cover also the funds instead of exclusively the managers. It would therefore be appropriate to go beyond the minimum capital requirements on the managers defined by the directive to impose capital requirements on the underlying fund proportional to their risk profile. It would be somewhat more complex, but possibly desirable, to increase margin (capital) requirements when HF positions become very large in a particular market, or grow very quickly. This would introduce an element of countercyclicality in this regulation.

7.7 Moreover, the crisis has shown the vulnerability of hedge funds to wave of redemption calls from investors and tightened credit conditions. It would therefore also be desirable to have some forms of liquidity requirements to reduce the vulnerability of hedge funds to maturity mismatches.

7.8 The need for capital and liquidity rules has also been acknowledged by the FSA in the Turner Review. This document argues that “regulators need the power to apply appropriate prudential regulation (e.g., capital and liquidity rules) to hedge funds or any other category of investment intermediary, (or to otherwise restrict their impact on the regulated community) if at any time they judge that the activities have become bank-like in nature or systemic in importance” (p.73).

9. What effect will the Directive have upon the position of the City of London and the EU as a whole as a leading location for Investment Fund Managers? Could it cause many hedge funds to relocate outside of the EU? What impact would the Directive have upon professional investors and institutions?

9.1 Despite the public outcry for costs that the AIMF directive could impose upon the City of London this argument risks to be shortsighted. Sound and comprehensive regulation is not just extremely valuable for the economy as a whole (given the very high cost of crises), but it is also essential for the long-term stability and survival of individual financial institutions. Regulation has often been perceived as opposed to the interests of the financial institutions, as well as undermining the attractiveness and competitive position of the City of London. In contrast with this perception, the current crisis—that has wiped out so many financial institutions and threatened the survival of so many others—shows that effective and appropriate regulation of all relevant financial institutions, would also be in the long-term interest of the industry. We thus agree with the Turner Review and its assessment that an effective and comprehensive regulation represents an important asset rather a burden for the stability and attractiveness of the City of London.

9.2 It is important to recognize how the current financial crisis has radically altered the landscape for the hedge fund industry, causing the demise of an unprecedented number of funds and a rush of redemption calls from investors. In this historical moment, more efficient and comprehensive regulatory initiatives, capable of restoring confidence and improving the reputation of the hedge fund industry, will represent an asset rather than a burden for both the HF industry and the overall financial markets where they are based. If Europe pioneers comprehensive and effective transparency and regulation, including of hedge funds, this regulation will make European markets stronger and more competitive to attract investors, and British hedge funds will be the first to reap these advantages.

9.3 We are aware of the fact that these considerations are more compelling in the medium- and long-term than they are in the short-term. We are hopeful that legislators will have the vision to accept the minor costs that the legislation could impose on hedge funds in the short-term, but the severity of the crisis must remind policymakers of the urgency of these changes and their value for safeguarding financial stability and avoiding future crises.

September 2009
Memorandum by the Investment Management Association (IMA)

1. What economic benefits arise from Alternative Investment Funds? What risks to financial markets arise from Alternative Investment Funds? Will the Directive help reduce these risks?

We take the question to be primarily directed at hedge funds. But it is important to note that the Directive as drafted has much broader scope. The term “Alternative Investment Funds” in this context covers a very wide range of different types of fund, many of which are very long established and are considered mainstream. These include:

- Investment Trusts
- Private Equity Funds
- Property Funds
- Non-UCITS retail funds (NURS) including many unit trusts and OEICs
- Institutional Funds, including pension funds

The fundamental economic function of the investment management industry is to act as an efficient conduit for capital from those who wish to invest to those who need investment. The industry is a UK success story, accounting for over a third of the EU industry, and with a very wide range of domestic and overseas clients. The UK industry managed some £3 trillion at the end of 2008, of which perhaps £700–800 billion could conceivably be within the draft Directive’s scope.

The majority of these funds do not give rise to risks to financial markets as they do not involve high degrees of leverage.

Hedge funds are distinguished by their use of a wider range of investment techniques than more “mainstream” funds, including short-selling and leverage. In practice, however, they use a wide variety of strategies, and there is no single investment feature which identifies a fund as a “hedge fund”.

While concern about hedge fund leverage may be one reason that lies behind the Directive, other financial institutions, including some banks and securities firms, are larger, and generally more leveraged, than hedge funds. Hedge fund leverage was not a factor in the current crisis. Indeed it is clear that most hedge funds were employing fairly low levels of leverage, particularly when compared to the double digit levels seen in certain banks. A recent report from McKinsey demonstrates that the implied leverage ratio (total leverage and assets under management divided by assets under management) of hedge funds globally reached 3.5 in 2006–07, falling back to 2.0 in the first quarter of 2009.12

We set out our views on the economic impact of Hedge Funds in the attached Annex.

2. To what extent is there a need to create a single regulatory regime for Alternative Investment Fund Managers in the European Union? Does the Directive achieve its objectives? Should the objectives of the Directive be modified?

The “passport” to market Alternative Investment Funds (AIFs) to professional investors in Europe, which the Directive will introduce, is to be welcomed. IMA has long been calling for firms to be able to distribute hedge funds, property funds, and other non-harmonised funds cross-border to institutional investors; the proposed Directive incorporates this.

However, the Directive applies to a wide range of fund types, some of which are not designed to be marketed outside the United Kingdom. Yet, so wide is the scope of the Directive, that these funds will be required to comply with the Directive or they will not be able to be marketed in the UK.

Only a very narrow class of Alternative Investment Funds would therefore benefit from the passport. The overwhelming majority of the products described in response to Question 1 do not do so, and so could not benefit from the passport in their present form.

The two key objectives of the proposed Directive are to enhance investor protection and to reduce systemic risk. These are in themselves uncontroversial. But the Directive’s very wide scope and its one-size-fits-all approach undermines them. Many of the funds described above are already subject to regulation and pose no systemic risk. It is difficult to see, therefore, why they should be covered.

3. **What risks arise from Alternative Investment Funds? Is the Directive proportionate given the role of AIF in the financial crisis?** Will the Directive introduce over-stringent regulations or does it not go far enough?

Many of the funds covered by the Directive are for professional investors, yet many of the proposals are stricter than those required for retail funds (which operate in the UCITS market). The proposals are disproportionate in that many of the risks arising from the range of more conventional asset types and vehicles covered by the Directive are little different to those funds operating in the UCITS market. For example, the provisions on capital requirements, valuation rules, delegation and depositaries are more stringent than the corresponding UCITS requirements.

The Investment Management Association believes there is no evidence that any Alternative Investment Funds played a significant role in the development of the current financial crisis. It is a crisis of banking, not of hedge funds (as argued in response to Question 1 and the Annex.)

4. **Is it appropriate to regulate Investment Fund Managers, rather than the Fund itself?** Does the Directive contain appropriate provisions to distinguish between different types of alternative investment? Does the scope of the Directive create a danger of unintended consequences?

Taking the approach of regulating the manager, and not the fund, would be the right one. Regulation of the fund—given the wide variety of products, each with different characteristics—would seriously hinder innovation and product development.

However, the Directive does not simply regulate the fund manager. It also introduces a number of regulations at the fund, not the manager level. These include leverage, liquidity and valuation requirements. As drafted, it adopts a one-size-fits-all approach and does not distinguish between different types of fund. There are a number of unintended consequences which are simply unworkable.

Commercial real estate is one sector where the detailed requirements—such as those on delegation, liquidity, leverage, and custody—are unworkable, and wholly unnecessary.

Investment Trust Companies are an investment vehicle dating back to 1868—ironically over a century before the UCITS directives on which the AIFM Directive is at least in part modelled. Despite having stood the test of time, it is impossible to see how they can fit within the framework of the Directive. They have no depositary because the responsibility for oversight rests with the board of the company. They are not regulated entities because they are incorporated under UK company law, but are subject to the Transparency and Prospectus Directives. And the portfolio manager is hired and fired by the board, a concept which the directive simply does not recognise.

The effect of the Directive as drafted would be to exclude any fund which does not comply with these provisions from operating within the EU, including within the UK domestic market. We cannot believe that this was an intended consequence.

5. **What is your evaluation of the Commission’s consultation in the preparation of the Directive?**

The draft Directive was released in late April with no formal consultation—other than a very high level document in January 2009. The principles of better regulation were ignored.

The Commission proposal has clearly been drafted in haste without due impact assessment and needs to be significantly improved to make it workable. Many of the provisions are far too stringent and the implications of the wide scope have not been thought through. Additionally, there is considerable lack of clarity on fundamental issues such as the definition of a collective investment undertaking and the AIFM definition.

6. **Will the passport system help create a single market in investments funds within the EU?** How will the passport system established affect the EU and the UK industry and particularly their position in the global market?

We support the principle of a pan-European passport for Alternative Investment Fund Managers.

But when it comes to third country funds, the Directive is not consistent with the principles of free trade and open markets. It allows such funds access to the passport only if the Commission is satisfied that an equivalent regime is in place in their domicile. But a transitional period of three years must be completed before that can be granted. For this period, third country funds will be placed at a competitive disadvantage to EU-domiciled funds as regards the ability to market around Europe. We think this arbitrary constraint on competition is protectionist in its effect and should be removed. We believe that Europe only benefits from open markets.
In addition, the UK at present has a private placement regime that allows a wide variety of funds to be marketed to professional investors. As the Directive stands, this would be prohibited after the three-year transition period. In effect it would then be illegal for an EU citizen to invest in any Alternative Investment Fund that does not comply with the Directive.

While it is of course reasonable for the Directive to set down criteria for funds which will receive a pan-European passport, we can see no reason why European legislation should impose similar restrictions on non-passported funds that are operating perfectly well under existing national regimes. As currently drafted it would no longer be possible for certain UK regulated funds to continue to be marketed in the UK.


Systemically relevant funds

We have no strong views on the thresholds specified in the draft Directive, but are much more concerned about its scope. It aims to cover systemically important alternative investment funds whereas in its current form it would cover also many types of national retail fund regimes that do not pose any systemic risks. The management of these funds should be excluded from the application of the Directive however they ought to have the ability to opt into the regime should they want to benefit from the European passporting rights.

Capital requirements

Investment management is not a business that requires large amounts of capital, needing only what is prudently necessary to keep the business running. This is because investors’ assets are held separately from those of the manager, not on his balance sheet. It is quite different from, say, banking or life insurance in this respect.

Capital requirements for Alternative Investment Fund Managers should be no higher than those for UCITS managers. The UCITS Directive limits the capital requirement on the manager to not more than £10 million, whereas the AIFM does not contain an upper limit. At the very least there needs to be a similar cap for AIFM. There must also be certainty that there will not be double capital requirements on a manager based on the assets under management of the UCITS and AIFs it manages.

Leverage

There are several problems here:

- First, greater clarity is required around the meaning of “leverage”. For instance, it is unclear if it is only fund-level leverage that is relevant for this purpose.
- Short-term fund level liquidity/drawdown bridging facilities ought to be excluded so that a fund that has such a facility in place (but uses no other leverage) would not thereby fall outside the exemption.
- Hard limits, which imply that all leverage below that limit is “low risk”, should not be imposed by the Commission as proposed in Article 25.3.

Independent valuations

It is reasonable to require valuations to be independent of the portfolio management function. Real estate funds in the UK are required to appoint independent surveyors to value the assets, in addition to the fund auditor. It is not uncommon for the AIFM, independent of the investment management function, to value the shares and units of an AIF based on the asset values. The valuation function is subject to the independent oversight of depositaries and/or auditors.

It is not clear what the Commission will consider independence to mean, but to change this operating model would be costly with no benefit in terms of enhanced investor protection or mitigation of systemic risk.

Depositaries

There are a number of problems with the proposals here and we set out the main ones:

- It is inappropriate to have a requirement for a depositary applied to all types of non-UCITS funds which form a very diverse range of investment vehicles. Even if there does need to be a vehicle performing certain “depositary” duties, the category of entities permitted to do this should be widely drawn and take in all of the types of entity that currently act as prime broker to AIFs that are sold in...
the EU market. The proposed restriction to EU credit institutions is too narrow. The proposal should recognise the role of the prime broker and its special features (it is not a sub-custodian) and consider what it needs to do to provide its services and identify the precise problems which the AIFM proposal seeks to address.

— The proposed liability standard in the AIFM proposal represents a radical departure from the current UCITS standard. Again we highlight a few key issues only:

— Firstly, it appears that the current proposal is a strict liability regime which is something approaching an insurance policy for investors in the event of any loss. This aspect of the proposal would lead to providers exiting the custody/prime brokerage market and would have negative impacts for investors, including but not limited to, increased costs and decreased investment choice. Any such proposal should involve a review of the resulting potential for systemic risk as it will result in further concentration in an already concentrated custody market.

— Secondly, any modification of the existing regime (in particular the proposed removal of the existing reference to national law) needs much more thought and consideration and needs to understand and take into account the complexities and subtleties involved otherwise material legal uncertainty will potentially result, which will be detrimental to investors.

— It is our view that any clarification of depositary liability regime requires a common understanding of the depositaries’ functions.

The starting point for any consideration of change is an evaluation of the existing regime. We therefore support the work which CESR was asked to undertake in this regard. Its findings should be published before any changes are considered.

We also welcome the proposal from the Swedish Presidency that consideration of Art 17 of the AIFMD proposal should be put on hold for the moment and revisited once the on-going consultation on UCITS depositaries is completed.

If, nevertheless, the Commission wishes to proceed, the AIFM depositary liability proposal should be modified to adopt the same liability standard as in the current UCITS Directive subject to the comments above on the appropriateness of having a depositary in the first place.

8. **Will the provisions strengthening disclosure requirements help to create a more transparent market or do they go too far?**

The provisions on annual reports and disclosure to investors are acceptable. But the requirement in Article 20(1)(i) to identify the investor where he receives preferential treatment is unreasonable and unnecessary. Describing the nature of the preferential treatment is sufficient. Also the requirements on reporting of trades to the competent authorities in Article 21 are excessive and amount to product regulation by the back door.

9. **What effect will the Directive have upon the position of the City of London and the EU as a whole as a leading location for Investment Fund Managers? Could it cause many hedge funds to relocate outside of the EU? What impact would the Directive have upon professional investors and institutions?**

If the Directive were adopted as currently drafted, all asset management business in the EU would have to conform to the requirement of either the UCITS or the AIFM Directives. This would impose major costs and dislocation on many firms, both in the UK and in other EU member states. Almost certainly some firms would consider whether it was any longer worth their while to operate in the European market. (Suggestions that hedge fund managers would relocate to, for example, Switzerland to escape the Directive’s impact are however wide of the mark. If a fund could not be sold out of London, it would not be possible to sell it out of Switzerland into the European market either. The only purpose of relocating would be withdraw entirely from the European market.)

Global asset managers will need to consider whether they wish to continue to service their US, Asian or Middle East clients from Europe and the UK in the future. The burdensome requirements introduced by the Directive, for example, the restrictions on the ability to delegate functions outside the EU may make them decide to move their businesses out of the EU.

European pension funds and other institutional investors would be major losers. They would see a significant reduction in the range of investment strategies and managers available to them. Many pension funds are significant investors in hedge funds and other alternative instruments because they see them as a means of reducing risk and helping assets to match their liabilities. The restrictions and compliance costs imposed by the draft Directive are likely to increase costs for investors.
EU managers would almost certainly lose mandates from, for example, US investors. The economic impact here could be significant. As of 31 May 2009, some 12% of the $10 trillion of the assets of US mutual funds and nearly 70% of the $400 billion US market in exchange-traded funds were run by investment advisers with a European parent.13

10. How does the Directive compare to existing or proposed regulation of Alternative Investment Funds outside the European Union, particularly that of the United States? How will the Directive affect the position of EU Alternative Investment Funds in the global market?

The US Treasury recently put forward proposals for the registration of all hedge fund managers whose assets under management exceed a certain threshold and the regular reporting of information relevant to financial stability. But, contrary to the AIFMD, the US Administration is taking a principles-based approach to regulation which has been broadly welcomed by the hedge fund industry. And the International Organisation of Securities Commissions published a report in June this year which adopted a principles-based approach and the development of industry good practice standards.

11. What effect will the Directive have on flows of capital and financial innovation?

It could cause some global asset managers to reconsider whether or not to continue with an EU or UK base. It will restrict the range of investment options available to pension funds and investors and could add further costs.

See also Annex—Hedge Funds—Economic Impact

Annex

HOUSE OF LORDS, EUROPEAN UNION COMMITTEE
Sub-Committee A (Economic and Financial Affairs and International Trade)
Directive on Alternative Investment Fund Managers—Call for Evidence
Annex to the submission from the Investment Management Association (IMA)

Hedge Funds—Economic Impact

1. Hedge funds are, in our view, not best seen as an asset class, but as a collection of strategies which involve investment in a wide range of securities and instruments, using a wide range of investment techniques, coupled with a prime brokerage arrangement. Hedge funds are commonly associated particularly with leverage and short positions in the market. In reality, the extent of the use of both varies considerably between funds: for example, some hedge strategies are entirely long only.

2. Hedge funds may be leveraged to any level in theory. Clearly excessive leverage can have systemically significant potential impacts and this was one of the central lessons from the failure of Long Term Capital Management (LTCM) in 1998. LTCM was over 25 times leveraged in the summer of 1998, with suggestions that the ratio had reached over 100 at one point. Interestingly, however, the President’s Working Group on Financial Markets noted in its report on LTCM that: “[T]his issue is not limited to hedge funds. Other financial institutions, including some banks and securities firms, are larger, and generally more leveraged, than hedge funds.”14

3. In the current crisis, however, it is clear that most hedge funds were employing fairly low levels of leverage, particularly when compared to the double digit levels seen in certain banks. A recent report from McKinsey demonstrates that the implied leverage ratio (total leverage and assets under management divided by assets under management) of hedge funds globally reached 3.5 in 2006–07, falling back to 2.0 in the first quarter of 2009.15

4. This magnitude of leverage is compatible with the European Commission’s own estimates, but the Commission argues that even at this level of leverage, there were macro-prudential risks resulting from procyclicality. Clearly, forced selling in stressed market conditions can have a sharp impact on prices. However, it is very difficult to demonstrate with any precision how hedge fund liquidation as opposed to other forms of investor behaviour (particularly amid the tidal wave of fear in the wake of the Lehman collapse) affected the

13 Investment Company Institute’s letter to the European Commission, 27 July 2009
markets. It is probable that for this reason, the Commission’ Regulatory Impact Assessment only goes as far as to suggest that the unwinding of leverage funds “may” have undermined financial stability.16

5. At the same time, hedge funds have also been accused of pro-cyclical in terms of taking short positions in equity markets as they fell sharply through the summer and autumn of 2008. These concerns spurred a wave of semi-coordinated regulatory activity aimed at limiting and/or making more transparent short selling by all market participants.

6. However, as an authoritative academic study has shown, there is “no strong evidence that the imposition of restrictions on short selling in the UK or elsewhere changed the behaviour of stock returns.”17 Indeed, during the period from when the ban was introduced in mid-September to the middle of January 2009, when it was lifted, the FTSE 350 financial sector index had averaged a loss of 0.44% a day. In the three months prior to the introduction to the ban, this figure was 0.20%. Volatility also substantially increased.

7. An independent study commissioned by the London Stock Exchange also pointed to a significant impact on market quality resulting from the 2008 short-selling restrictions, concluding that: “stocks restricted from short-selling exhibited a statistically significant deterioration in liquidity, which is not explainable by market-wide changes such as increased volatility.”18

8. While there may be times when disorderly markets necessitate some form of regulatory constraint on trading activity, or at the very least, close monitoring at the aggregate level, the economic reality is that short selling should in normal circumstances be a driver of efficient markets, not of pro-cyclical activity. In fact, some funds will have taken short positions on financial institutions in the run up to the financial crisis based precisely on their concern about the pro-cyclical nature of the policy environment and market behaviour that was driving the growth of an ultimately unsustainable global credit bubble.

9. In conclusion, the LTCM case demonstrated how hedge funds can represent a perceived systemic threat at a time of broader turbulence in the financial markets. To that extent, close monitoring and potential intervention to limit excess leverage may be justified. The lesson from LTCM may well have been learnt for hedge funds. It is far less clear that the recent financial crisis has shown either that hedge funds are carrying unsustainable and dangerous levels of leverage or that short selling activity by them or other market participants has substantially exacerbated the crisis. Certainly, compared to the problems in the banking system, it is difficult to see how hedge funds can collectively be accused of contributing significantly to the market crisis of the past 12–18 months.

10. With respect to monitoring, market disclosure is not necessary to resolve the potential problems, and could exacerbate some of the problems, when they do arise. Public disclosure of short positions could seriously harm:

- Investment managers, by exposing their proprietary positions to others.
- Other investors who may attempt to mimic the disclosed investment strategy or use the information for their own benefit without cost and without understanding the implications.
- The market, by reducing efficient price discovery, increasing volatility and spreads.

11. Disclosure to the regulator should meet the problems identified with minimum disruption and cost to the functioning of the market, but should only be necessary during periods of market instability. The blanket imposition of disclosure on short positions in all companies would damage the market, on which the prosperity of the country relies.

12. The Turner Review noted, with respect to short selling restrictions, the importance of a regulator “adopting a philosophical approach which overtly balances the benefits of increased liquidity in markets with the danger that in specific markets at particular times, financial stability concerns may be more important”. We consider that our recommended approach, of applying disclosure only to sectors as and when they are at risk, chimes in with Lord Turner’s recommendation that the regulator should only apply “special measures if needed”. All the evidence indicates that most of the time special measures are not needed: they only become necessary (and therefore justifiable) at times of instability.

13. We would also note that our recommended approach on disclosure is in line with our international peers in Australia (the IFSA) and the USA (the IAA and the ICI), and recent proposals from the Italian regulator, CONSOB.

September 2009

17 Ian Marsh and Norman Niemer, The Impact of Short Sales Restrictions (Analysis commissioned by ISLA, AIMA and LIBA, 2008).
Memorandum by Dr Syed Kamall, MEP

This Submission

This submission is the personal evidence of Syed Kamall MEP, the Shadow Rapporteur on the Alternative Investment Fund Managers Directive (AIFMD). It does not seek to describe the Directive in detail but to contextualise the background and the potential impacts of the Directive.

Summary

The principal point made in this submission is that this is an unnecessary Directive which will only serve to limit the growth of the financial services industry in London and across Europe. Furthermore, the draft directive was drafted in a hurry and there has been no thorough economic impact assessment. Although this Directive now looks inevitable, the Council of the European Union and the European Parliament may be able to amend the Directive significantly in order to limit its regulatory scope.

Political Background

There has always been a degree of antipathy on the Continent of Europe towards the way in which the Anglo-Saxon economies buy and sell large numbers of shares in companies and the consequent frequency in the change of control of companies. Takeovers by private equity vehicles, because they often result in restructuring of companies are sometimes portrayed as undermining the European concept of “social solidarity”, even though such takeovers may save jobs and even create new ones, especially where the company that was taken over had been performing badly.

It has emerged in the media this summer that as far back as April 2007, before the credit crunch was widely understood or predicted by most economists, the German Government favoured coordinated action to regulate hedge funds.19 Germany was enjoying a current account surplus and there were significant money flows out of the country so it had an interest in ensuring that German money was not flowing into risky financial instruments. At the time they regarded the unregulated hedge funds as risk-takers; it subsequently turned out that the regulated commercial banks were far higher leveraged and invested in generally much riskier derivative instruments (often mortgage-backed).

In 2007, socialist Members of the European Parliament, former Danish Prime Minister Poul Nyrup Rasmussen and Ieke Van den Burg from the Netherlands published a report reproving hedge funds. Hedge Funds and Private Equity: A Critical Analysis.20 The following year the same MEPs pushed for regulation in an own-initiative report21. Although own-initiative reports from the European Parliament are not legally binding, they are often foreshadow draft Directives such as the one we now have before us.

For its part, the European Commission resisted regulating hedge funds for two years. But politicians in the European Parliament have seized on the credit crunch as reason to look again at regulating hedge funds and private equity. This is despite there being scant evidence that either forms of alternative investment were the cause of the credit crunch. (The commercial banks were far more highly geared than most investment funds and it was their failure to run themselves properly and the regulatory authorities’ failure to oversee their risks that resulted in them running into trouble.)

It has proved convenient for elected politicians to play to their electorates by trying to blame the credit crunch on a few “greedy” individuals investing in hedge funds. The blame should in fact lie with the politicians, regulators and bankers who were complicit in allowing credit to be overextended to people who could not afford the homes they were buying, and who allowed bankers to buy securities the underlying value of which they knew very little. To its credit, the European Commission has stated in the preamble to the Directive that “AIFM were not the cause of the crisis”22.

805 of Europe’s hedge funds managers and 60% of Europe’s private equity managers are located in London. Both the German and French governments, during their Presidencies of the EU from January–July 2007 and July–December 2008 respectively, encouraged the Commission to work up a draft Directive. The new Swedish Presidency has been more conciliatory in tone, and there may be significant amendments made to the text of the Directive before it is passed into law.

Now the draft Directive will pass to the Council and the European Parliament for consideration under the co-decision procedure. The Commission has indicated that it hopes the Directive can be adopted by the end of the current year with implementation by Member States required by the end of 2011.

20 http://www.pes.org/downloads/Hedge_Funds.pdf
SCOPE OF THE DIRECTIVE

The Directive on Alternative Investment Fund Managers covers a number of “alternative” investment funds such as hedge funds, private equity, commodity funds, real estate and venture capital funds.

Hedge funds and private equity are very different investment vehicles. That they are clumped together under this draft regulation is odd. Private equity investments tend to be longer term investments in which the investor takes ownership of all or part of a company with a plan to sell this share at a profit (usually) within a few years. Hedge funds, on the other hand, invest in a range of instruments on behalf of people and organisations such as high net worth individuals, insurance companies and pension funds.

The risks in these types of investments are much the same as those of any other type of investment. In investment there is always a risk of failure, this is intrinsically how markets function. Hedge funds may be risky in that often they are managed by individuals and deal with large sums of money. Most hedge fund managers earn their profit through management fees which are, in most cases, a percentage of the total value of the fund. Therefore, hedge fund managers have an incentive to act prudently in their investments as failure will result in a loss for them as well as the investor.

Although performance fees may create the incentive for managers to take unnecessary risks with investors’ assets, high-water marks are often used to discourage this sort of volatile trading. People who invest in such funds should (and in most cases do) act prudently when investing and are often looking to “riskier” investments as potentially producing higher returns for their overall investment portfolio.

IMPACTS OF THE DIRECTIVE

Capital adequacy—The draft Directive’s rules on capital requirements are intended as an insurance that funds can meet investor claims. For AIFMs with significant funds under management, the 0.02% capital add-on will place severe pressure on their capital resources. It represents a significant jump from current rules in the UK where AIFs require enough capital to meet basic payrolls, this frees up capital for more investment. The new requirements are unnecessary for many funds that use lockup periods to limit investor withdrawals and this jump in requirements can also cause barrier to entry to markets for new managers and therefore may hinder competition. Many Member States of the EU do not currently have capital requirements at all; so the UK is already ahead of many other Member States in this respect and our capital requirements have proven sufficient for us in the past.

Leverage—The draft Directive intends to impose limits on the amount of leverage that managers of alternative investments can employ. I do not believe that the investment strategies of fund managers should be restricted in this way or that government should be the judge of risk. Investors know the risks and should pay the consequences and lose their money if these funds do poorly. (Taxpayer bailouts for failed ventures should not be an option.)

Disclosure—Managers should not be made to make information about borrowing and leveraging public. This would discourage competition in the industry. It may be prudent to see that alternative investment fund managers disclose information on their assets and risk to relevant authorities in their Member States, and that this information is not disclosed to the market. Potential investors should research information on risk before investing.

Custody—The draft Directive, if implemented in its current form, would make it very difficult for investment managers to invest in funds that are not domiciled inside the EU. This would apply to the majority of hedge funds and other investment funds managed in the UK, as the portfolios themselves are often located in other countries.

We could well face a scenario where hedge funds do not relocate their portfolios into European credit institutions. My conversations have revealed that fund managers could instead relocate to Switzerland, Shanghai, Delaware or Dubai. Far from increasing tax revenue in EU member states, this Directive could reduce it by pushing fund managers out of the EU altogether.

Unemployment would follow and exodus of the hedge fund industry from London. The City has already incurred many job losses. The lost jobs in the hedge fund industry would not return.

It is crucial to remember that investors and fund managers are not the only beneficiaries of AIFs. Pensioners in Europe could also be affected. Many private pensions invest with hedge funds. One study shows that this Directive could cost the European private pension industry €25 million and limit options for pensioners. Some European Member States’ pension industries rely very heavily on AIFs, the Dutch pension industry for example would be extremely jeopardised under the current regulatory framework.

It is also important that such funds retain the ability to takeover and turn around failing companies in order to save jobs and local communities.

It is also vital that a thorough investigation into other beneficiaries and groups that depend on AIFs, such as homeowners, charities, and consumers, is prepared before implementation of the Directive is completed.

**Conclusion**

We need to be sure that this legislation will not drive investment out of Europe. It would be wise to study the legislation being considered in other countries, such as the more measured approach of the Obama administration. The Financial Services Authority has announced that it will publish a cost analysis of the EU Directive later this year. The City is only just waking up to the implications of the Directive but I expect the clamour for it to be amended to grow in the coming months.

8 September 2009

**Letter from Lovells LLP**

Lovells LLP is an international law firm headquartered in London with 361 partners and 3,220 employees worldwide. We have a significant investment funds practice, which is focussed on alternative investment funds, advising managers and promoters, as well as investors.

We have been involved with the submissions made by the City of London Law Society and the Association of Real Estate Funds to the Treasury, the FSA and the Swedish Ministry of Finance on the Proposal for a Directive on Alternative Investment Fund Managers (the Directive).

We set out below responses to some of the questions set out in your Call for Evidence on the Directive.

1. Significant economic benefits arise from alternative investment funds (AIFs) in London, including employment opportunities (with the AIFMs and their EU based service providers) and associated tax revenues. Lovells is only one of many law firms active in this area, but our turnover that is directly attributable to alternative investment funds runs to millions of pounds every year (and has been increasing year on year for the last six or more years).

2. Whilst we welcome the passport provisions (other than the way in which they apply to non-EU AIFs / AIFMs, see 6 below), we believe that there is no need to create a single regulatory regime for alternative fund managers in the EU as their business models and legal structures are very different. Therefore, using a “one-size fits all” approach and attempting to regulate all types of alternative funds in the same manner should be avoided.

One of the main problems with the Directive is that it is not really clear what its real objectives are. It is clearly a reaction to the recent global economic crisis, but now most people seem to accept that alternative funds did not cause the crisis. The Directive purports to be a response to funds that allegedly pose a systemic risk, but yet it is drafted in such a way as to apply to every type of alternative fund, even ones that clearly pose no systemic risk at all. The relevant parts of the Directive which are targeted at funds which create systemic risk should be disapplied for funds that do not pose such risks.

3. —

4. Regulating AIFMs rather than AIFs is in our view the correct approach. That said, we note that the Directive introduces product regulation “through the backdoor”, for example the Commission’s and regulators’ right to impose limits on leverage would apply at the level of the AIFs rather than to AIFMs.

The Directive does not distinguish between fund types and this is one of its major failings This problem is illustrated by the fact that all the “talk” is about hedge funds and private equity funds, but yet real estate funds (to give just one example) will also be caught and materially adversely affected. Also, structures for funds differ widely (for example there are significant differences between a fund in corporate form which is “self-managed” by its board of directors and a fund in non-corporate form with an external manager)—none of these (sometimes subtle, but critical) differences are addressed in the Directive at all.

5. We think the consultation process in relation to the Directive has been insufficient and inadequate and share the concerns expressed by Lord Myners and the industry in this regard. For example, the Directive’s impact on the sectors other than hedge funds and private equity funds seems to have been ignored.

6. We welcome the passport system other than the protectionist way in which this applies to non-EU AIFs and AIFMs. Our view is that it should be possible for non-EU AIFMs and AIFs to benefit from the passport provisions immediately rather than after a three year period (article 33.8) as that would lead to a significant restriction in choice for institutional investors in the EU and mean that EU AIFMs potentially would be at a competitive disadvantage compared to non-EU AIFMs.
7. —

8. We think that the disclosure provisions in the Directive go too far and we do not think the benefits of such close monitoring (and there is indeed a real risk of information overflow that regulators will not be able to cope with) would exceed the cost involved in monitoring these risks (for example leverage or crowded trades behaviour). Leverage should instead be monitored at the side of the lender rather than the borrowers, to assess systemic risk.

Another aspect of the Directive is the disclosure requirements for private equity funds. These requirements are onerous and mean that the private equity funds within the scope of the Directive would have to disclose confidential information about the business plans of their portfolio companies which would place these private equity funds at a significant competitive disadvantage. Again, these disclosure obligations do not appear to remedy any systemic risks but be politically motivated.

9. As originally proposed, there is a real risk that the Directive could leave to an illogical and unnatural “carving-up” of the world in terms of alternative funds in a number of ways. For example, a manager who did not really need to access European investors might well decide to domicile the management company outside the EU so as to avoid all the regulation flowing from the Directive (hence all the warnings of managers moving to Switzerland)—this is because one could argue that the only reason for being in the EU and complying with the Directive is that it would otherwise be difficult/impossible to sell your funds to European investors. Secondly, and linked to this, the Directive would have a large (negative) impact on the ability of European investors to invest in funds domiciled/managed outside the EU—restricting access for sophisticated investors is unnecessary and potentially will adversely affect returns for European investors.

10. The Directive’s current approach will result in what our clients are calling “Fortress Europe”—if this happens it seems highly likely that other countries (eg US, Australia) will retaliate and prevent European funds being sold in those jurisdictions. This would not seem to be in the interests of sophisticated/professional investors, who (surely by definition) should be able to access the best products for their needs.

11. —

12. Other points we would like to draw to your attention are the following:

12.1 The Directive must include a clear definition of an Alternative Investment Fund. This is currently not defined and currently would include many presumably unintended vehicles, including for example joint ventures and intra-group arrangements. Also, the exclusions from the “collective investment undertaking” definition appear arbitrary and would not create a level playing field as between banks, insurers and fund managers.

12.2 Certain provisions of the Directive refer to an AIF being “leveraged” and this needs to be clearly defined (ideally so that it is only the leverage at the level of the fund that is relevant and so that it refers to long term gearing, rather than short term liquidity facilities).

12.3 The delegation provisions are very restrictive and should be removed (in particular the requirement that an AIFM can only delegate portfolio and risk management to an AIFM). Very often a local investment manager is appointed for example in relation to emerging market funds or, indeed, a global fund. This will be required because of local expertise. However, this would not be possible under these delegation rules, which appears illogical. The ban on sub-delegation is also impractical—for example it might currently preclude arrangements for the security of a building at night, or collecting rent from tenants in the case of a real estate fund, both of which are necessary and harmless activities.

9 September 2009

Letter from Managed Funds Association

Managed Funds Association (“MFA”)$24 welcomes the opportunity to provide comments in response to the House Of Lords, EU Sub-Committee A’s call for evidence (the “Call for Evidence”) regarding the European Commission’s proposal for a Directive on Alternative Fund Managers (the “Directive”). MFA supports efforts to develop an effective and efficient regulatory system and the goals of reducing systemic risk, promoting investor protection and protecting the stability of the financial system. Nonetheless, MFA respectfully believes that the Directive, if passed as written, would interfere with efficient market practices

$24 MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.
1. **What economic benefits arise from Alternative Investment Funds? What risks to financial markets arise from Alternative Investment Funds? Will the Directive help reduce these risks?**

AIFs, such as hedge funds, are among the most sophisticated institutional investors and play an important role in the world’s financial system. They provide liquidity and price discovery to capital markets, capital to companies to allow them to grow or improve their businesses, and sophisticated risk management to investors such as pension funds, to allow those pensions to meet their future obligations to plan beneficiaries. AIFs engage in a variety of investment strategies across many different asset classes. The growth and diversification of AIFs have strengthened global capital markets and provided their investors with the means to diversify their investments, thereby reducing overall portfolio investment risk. As investors, AIFs help dampen market volatility by providing liquidity and pricing efficiency across many markets. Each of these functions is critical to the orderly operation of our capital markets and our financial system as a whole.

AIFs were not the root cause of the problems in the world’s financial markets. In fact, AIFs overall were, and remain, substantially less leveraged than banks and brokers, performed significantly better than the overall market and have not required, or sought, government assistance despite the fact that our industry, and our investors, have suffered mightily as a result of the instability in the world’s financial systems and the broader economic downturn. The losses suffered by AIFs and their investors did not pose a threat to capital markets or the financial system.

Although AIFs are important to capital markets and the financial system, the relative size and scope of the AIF industry in the context of the wider financial system helps explain why these funds did not pose systemic risks despite their losses. With an estimated $1.5 trillion under management, the hedge fund industry is significantly smaller than the US mutual fund industry, with an estimated $9.4 trillion in assets under management, or the US banking industry, with an estimated $13.8 trillion in assets. According to a report released by the Financial Research Corp., the combined assets under management of the three largest mutual fund families are at $1.9 trillion, which exceeds the total assets of the hedge fund industry. Moreover, because many AIFs use little or no leverage, their losses did not pose the same systemic risk concerns that losses at more highly leveraged institutions, such as brokers and investment banks, did. A report by PerTrac Financial Solutions released in December 2008 found that 26.9% of hedge fund managers reported using no leverage. Similarly, a March 2009 report by Lord Adair Turner, Chairman of the UK Financial Services Authority, found that the leverage of hedge funds was, on average, two or three-to-one, significantly below the average leverage of banks.

Though AIFs did not cause the problems in global financial markets, we believe that the public and private sectors (including AIFs) share the responsibility of restoring stability to markets, strengthening financial institutions, and ultimately, restoring investor confidence. AIFs remain a significant source of private capital and can continue to play an important role in restoring liquidity and stability to capital markets.

As stated above, MFA supports efforts to develop an effective and efficient regulatory system and the goals of reducing systemic risk, promoting investor protection and protecting the stability of the financial system. We believe that this objective can be met without prescribing overly burdensome regulation that acts as a barrier to entry for global market participants and unnecessarily limits cross-border flows of capital. We are concerned that a number of provisions in the Directive, such as limits on which entities can serve as depositaries for AIFs and the restrictions on non-EU AIFM managing or marketing AIFs within the EU, would unduly interfere with efficient market practices and would adversely affect the ability of AIFMs to provide vital services to investors and limit the available choices and the potential benefits to EU investors who seek to invest in AIFs. We discuss these and other problematic provisions of the Directive in response to the questions below.

2. **To what extent is there a need to create a single regulatory regime for Alternative Investment Fund Managers in the European Union? Does the Directive achieve its objectives? Should the objectives of the Directive be modified?**

In determining whether a single regulatory regime is the best approach for regulation of AIFMs, we believe that policy makers should consider two important policy goals. First, given the global nature of the AIF industry, it is critical for policy makers and regulators to eliminate, when possible, unnecessary duplication and inconsistency in regulation, and to avoid creating inappropriate barriers to participation within their

As stated in response to question 1, AIFs were not the root cause of the problems in the world’s financial markets. Moreover, lending by banks and brokers to AIFs is collateralized, and so any AIF failures which have occurred appear to have been managed reasonably well with minimal losses to those regulated institutions, if any. The same cannot be said for failures by banks and brokerage firms which have harmed the businesses and operations of many AIFs this year, the most notable example of which is the bankruptcy of Lehman Brothers Holdings Inc. Indeed, AIFs, which invest in and rely on these institutions as counterparties for their investment activities, are suffering along with other market participants as a result of the difficulties these institutions are facing. In light of the fact that AIFs were not a source of systemic risk or the cause of counterparty failures, we believe that certain of the provisions in the Directive, as discussed in more detail below, are overly restrictive and not proportionate to the risks posed by AIFs.

4. Is it appropriate to regulate Investment Fund Managers, rather than the Fund itself? Does the Directive contain appropriate provisions to distinguish between different types of alternative investment? Does the scope of the Directive create a danger of unintended consequences?

We believe that authorisation of AIFM is an intelligent approach to regulation of the AIF industry. MFA supports the authorisation of currently unregistered investment advisers to all private pools of capital, subject to a limited exemption for the smallest investment advisers with a de minimis amount of assets under management. We also support the concept that the substantive requirements applicable to authorised AIFMs to certain types of AIFs should differ depending on the types of AIFs to which the AIFMs provides management services. We would encourage EU officials to consider carefully the differences among the types of AIFs to tailor the requirements applicable to AIFMs managing different types of AIFs to avoid adopting regulations that will have a disproportionate, adverse impact on certain portions of the industry.

5. What is your evaluation of the Commission’s consultation in the preparation of the Directive?

As policy makers and regulators engage in legislative or rulemaking initiatives, they should engage in discussions with and seek comments from market participants. This public-private dialogue helps lead to more effective regulation and avoid unintended consequences, market uncertainty and increased market volatility. While the Commission undertook a consultation process in the preparation of the Directive, we strongly encourage the Commission and other policy makers in the EU to continue to engage in further consultation and dialogue with market participants, including AIFM and pension and other investors in AIFs. We also strongly encourage the Commission to undertake an impact assessment, including seeking input from affected market participants, to ensure that policy makers have a full understanding of the consequences of implementing the Directive.

6. Will the passport system help create a single market in investments funds within the EU? How will the passport system establish affect the EU and the UK industry and particularly their position in the global market?

Because there are currently different private placement requirements applicable in different Member States, the benefit of the authorisation process and passporting is perceived to be a simplified and efficient process that eliminates legal and compliance uncertainty. MFA welcomes the simplification and rationalisation of the current private placement regime. However, we believe that access to the passporting regime should not be delayed for non-EU AIFM. It is not clear how the three year delay improves the functioning of the EU market or is in the interests of EU AIFMs or investors.

Authorisation and passporting under the Directive would open marketing opportunities in certain jurisdictions where AIFMs are currently prohibited by national law from initiating offers of shares or units of AIFs to investors in those countries and investors in such countries may only invest in AIFs through a process of reverse enquiry (ie, the initiative comes from the investor rather than the AIF or the AIFM). However,
authorisation and passporting under the Directive would restrict marketing in other countries (such as the United Kingdom) where current national laws permit marketing to a universe of potential investors that is broader than the universe of professional investors.


Systemic Relevance. MFA and its members acknowledge that at a minimum the AIF industry as a whole is of systemic relevance and, therefore, should be considered within a systemic risk regulatory framework. As policy makers and regulators seek to determine whether any individual AIF is of systemic relevance, however, it is important that consideration be given to the relatively small size of AIFs compared to other financial institutions, the relatively low levels of leverage used by AIFs, and the narrower focus of AIFs. As institutional investors, AIFs do not provide payment and settlement services to the public nor are AIFs licensed to open bank accounts or brokerage accounts for the public. For these reasons, and others, AIF losses have not caused systemic risk during this global crisis.

There are a number of factors that policy makers around the globe are considering as they seek to determine which entities should be considered to be of systemic relevance. Those factors include the amount of assets under management of an entity, the concentration of its activities, and an entity’s interconnectivity to other market participants. While no single factor should be determinative of the systemic relevance of a market participant, we believe that the Directive’s thresholds of assets under management and use of leverage are very low for purposes of determining whether an AIF or AIFM is systemically relevant. As a result, we believe that many funds and managers that do not pose systemic risks concerns will be unnecessarily subject to restrictive systemic risk regulation.

Capital Requirements. The initial capital requirement set out in the Directive may be a barrier to entry for new AIFM. In addition, this formula for capital adequacy uses a “one size fits all” approach that does not consider whether the actual obligations of the AIFM are increasing as assets under management increase. Moreover, unlike the capital requirements for banks, which mandate capital requirements on the basis of a formula that scores the risks to which the bank is subject, the capital requirements to be imposed on AIFMs would not be geared to the AIFMs’ risks or expense obligations. The capital requirement also fails to take into account that many of the risks associated with the management of an AIF are borne by contract by the AIF and not the AIFM. For example, there is counterparty risk associated with the management of an AIF, but the obligations to the counterparty are typically owed by the AIF out of the assets of the AIF rather than by the AIFM.

Leverage. The Explanatory Memorandum that prefaces the text of the Directive posits that “[t]he abrupt unwinding of large, leveraged positions in response to tightening credit conditions and investor redemption requests has had a procyclical impact on declining markets and may have impaired market liquidity.” Studies have shown the hedge fund industry was not highly leveraged leading into the recent market crisis, particularly compared with other financial institutions like banks and broker-dealers. As noted above, in fact, the Turner Report found that the leverage of hedge funds has been, on average, two or three-to-one. Contrary to the misconception about AIFs’ use of leverage, these funds often seek to invest in ways that reduce the potential volatility of the market cycle. This misconception about the amount of leverage used by AIFs and the potential systemic risk concerns regarding the use of leverage appears to carry over to the text of the Directive.

Because the Directive sets the threshold for what constitutes a high level of leverage on a systematic basis at the level of one times capital (a level which we believe is neither systemically high nor raises any systemic concerns), we believe that the authority granted to set leverage restrictions is overly broad. We also strongly disagree with the notion that leverage of 1 times capital (a 2-to-1 leverage ratio) is systematically high, or raises systemic risk concerns.

The stated objective of the Directive to which this requirement relates is the “proper monitoring of macro-prudential risks” and the related operational objective is phrased as “enhance transparency of AIFM activity, including the systematic use of leverage, to enable the effective monitoring of systemic risks.” Any strict limitation on the maximum amount of leverage an AIFM may employ seems to exceed the stated objective of transparency.

We do not believe that there should be regulatory restrictions on the use of leverage outside of the context of more general systemic risk regulation affecting all the relevant market participants, including banks. The potential risks posed by the use of leverage are not specific to AIFM. As a result, systemic risk regulation


28 Article 22 of the Proposed Directive.
regarding leverage should not be focused on AIFMs and AIFs, but should be considered across market participants. In this same vein, setting leverage restrictions specific to AIFMs is also inconsistent with one of the stated purposes of the Directive, as explained in the European Commission’s frequently asked questions regarding the Directive, which states:

This proposal focuses on those activities that are specific or inherent to the AIFM sector and hence need to be addressed by targeted requirements. A number of the concerns that are commonly expressed about the activities of AIFM are linked to behaviors (eg, short-selling, and remuneration) which are not unique to this category of financial market participants. To be fully effective and coherent, these concerns must therefore be addressed by comprehensive measures which apply to all market participants who engage in the relevant activities.29

Valuation. We do not believe that there should be a requirement for an AIFM to hire a third party valuation service provider. We believe that, particularly with respect to harder-to-value instruments, the personnel of the AIFM, and especially the portfolio manager, are likely to be in the best position to determine the fair value of those instruments. We support the implementation of robust internal policies and procedures regarding valuation and the maintenance of appropriate independence between the valuation and portfolio management functions, to the extent practicable. We believe that the total separation of the portfolio manager and other investment management personnel from the valuation process, however, would be ill-advised and would ignore the expertise and market sophistication of the portfolio managers and other investment management personnel.

A requirement for an independent valuator also may give investors a false sense of assurance that about the valuations placed on securities. A valuator may not be as well placed as an expert portfolio manager to know when a price received from a pricing service or counterparty does not reflect a fair price for the security. Without access to that expertise, portfolio securities may be significantly under-or over-valued, potentially disadvantaging some investors and providing a windfall to others.

EU AIFs generally will engage an independent third party administrator to calculate the net asset value of the AIF and its shares or units in accordance with policies adopted by the governing body of the EU AIF and disclosed in the AIF’s offering documents. A requirement to engage a valuator would increase costs for these AIFs without any apparent gain in independence from the AIFM. Moreover, because the valuator must be separate from the administrator and the AIFM and must act without input from the AIFM in determining values, it is not clear that there are entities able, willing and qualified to carry out this function at present in any event.

Finally, the Directive speaks of AIFMs appointing “a valuator”. It is not clear that an AIFM could engage more than one valuator with respect to a single AIF, which may be necessary or desirable depending on the types of assets held by the AIF.

Depositories. We believe that the requirement that depositaries be EU authorised credit institutions inappropriately restricts the universe of available custodians. Indeed, restricting the number of custodians in this manner may increase systemic risk, as it would increase counterparty risk in the industry by limiting the number of available counterparties and increase the likelihood that a significant event at one credit institution will have a significant effect on the industry.

We are also concerned about the requirement to use an EU authorised depositary, particularly for non-EU AIFs. Certain types of AIFM (eg, AIFM for hedge funds) frequently maintain custody of the assets of their AIF with their prime broker, either directly or through sub-custodians in different countries in which assets are held. We do not believe that the Directive should limit the ability of the industry to continue using this custody model, which is integral to the operation of the hedge fund model.

The requirements applicable to depositaries under the Directive, especially the high standard of liability that depositaries would be subject to, will likely reduce the number of institutions willing to carry out this service and will lead to a significant increase in the costs that an AIF will have to bear; costs that will fall directly on investors through an increase in the AIF’s total expense ratio. Moreover, the level of liability to which depositaries would be subject would no doubt force a change in the service level arrangements under which the depositary is willing to operate, thereby potentially limiting the ability of some AIFs to engage in transactions in some countries or engage in transactions with certain counterparties.

Under the Directive, depositaries have a fairly limited ability to delegate to other qualified depositaries and their liability to investors and the AIFM would not be affected by any delegation. We are concerned that these limitations on sub-depositaries would make it difficult or even impossible for an EU-domiciled AIFM to

manage an AIF with a global or emerging markets strategy and for any AIF with such an objective to be domiciled in the EU, since sub-depositaries around the world are typically used by AIFs not investing solely in the EU and are often required in order to operate a global or emerging markets strategy. We note that the UCITS Directive does not impose similar geographic restrictions on the use of sub custodians for UCITS funds, reflecting the needs of the market.

Finally, the Directive speaks of AIFMs appointing “a depositary”. It is not clear that an AIFM could engage more than one depositary with respect to a single AIF which may be necessary or desirable depending on the types of assets held by the AIF.

8. Will the provisions strengthening disclosure requirements help to create a more transparent market or do they go too far?

Regulatory Reporting Requirements. The Directive imposes a number of regulatory reporting requirements for AIFM. We generally support requirements on market participants to provide information to regulators that regulators may determine is necessary or advisable to help them assess, on both a current and a forward-looking basis, potential risks to the financial system. However, because much of this information will be sensitive, proprietary information about AIFs, it is critical that the information be kept confidential, both by regulators receiving the information, and any other regulatory body with which the information is shared. We would urge EU officials to address these confidentiality concerns in any final directive.

Disclosure of Side Letters. The Directive requires that if an investor obtains preferential treatment or the right to obtain it, the identity of that investor and a description of the preferential treatment must be disclosed to other investors prior to their investment. Neither of these requirements includes any concept of materiality, however. As a result, the Directive would require that even non-material terms of side letters be disclosed.

Many side letters contain non-material terms required by investors who have their own specific requirements for investments in AIF but which are not relevant to other investors. Side letters are a useful tool for providing investment flexibility for investors with special requirements, allowing the investment to be tailored so that the investor may invest. Without this flexibility, some investors would face a very limited universe of AIF investment choices.

We understand that AIF’s should disclose to investors that it (or the AIFM on its behalf) has the authority to enter into side letters and that the terms of side letters that are material to other investors in an AIF should be periodically disclosed to those investors. We disagree, however, with the approach of requiring the disclosure of non-material side letter terms. We also believe that the identity of investors in funds should not be required to be disclosed to other investors, as the identity of an investor that receives preferential treatment is not necessary to enable other investors to assess the impact of any side letter on their investment and may run contrary to applicable data protection or privacy laws. Disclosure by an AIF that it (or the AIFM on its behalf) is authorized to enter into side letters and periodic disclosure of material terms in side letters should be sufficient to enable other investors to assess the potential impact of side letters on their investment.

Disclosure of Control Positions. The Directive requires an AIFM to make certain disclosures when one or more of its AIFs acquire a 30% or more of the voting rights in a listed or unlisted company. The AIFM would be required to disclose its development plan, the policy for preventing and managing conflicts of interest, and any other regulatory body with which the information is shared. We would urge EU officials to address these confidentiality concerns in any final directive.

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9. What effect will the Directive have upon the position of the City of London and the EU as a whole as a leading location for Investment Fund Managers? Could it cause many hedge funds to relocate outside of the EU? What impact would the Directive have upon professional investors and institutions?

The Directive prohibits any AIFM which is neither authorised under the Directive nor authorised in accordance with the national law of a Member State from providing management services to any AIF domiciled in the EU. Since the Directive does not permit a non-EU AIFM to seek authorisation under the Directive, the Directive effectively prohibits a non-EU AIFM from providing management services to an AIF domiciled in the EU.
domiciled in the EU. We do not believe that this restriction is in the interests of investors or promoting the competitiveness of EU AIFs in the global marketplace.

In addition to these restrictions on which AIFM can manage an EU AIF, the Directive permits only a very limited power of delegation from EU-AIFM to non-EU AIFM. If the Directive is adopted as proposed, it will cause significant operational difficulties for many AIFMs, including those based in London, especially those AIFMs that have portfolio management and risk management operations in multiple jurisdictions around the world.

The Directive’s limitations on the delegation of portfolio management and risk management functions also provide an excess level of regulation over the limits of the UCITS Directive and the MiFID Directive, both of which allow an investment manager to delegate portfolio management functions to investment managers in non-EU jurisdictions as long as the arrangement meets the relevant conditions.

The Directive also places significant restrictions on the ability of a non-EU AIFM to market non-EU AIFs to EU investors by requiring the country where the AIFM is domiciled to meet significant legislative and regulatory standards. It is not clear that any non-EU country would meet these requirements and, as a result, the Directive would effectively preclude a non-EU AIFM from marketing to European investors.

The management and marketing restrictions imposed on AIFM will likely have significant adverse consequences for EU AIFs and EU investors. Because of the global nature of the AIF industry, many AIFM would be unable to meet the requirements of the Directive, and therefore be unable to manage EU AIFs or market non-EU AIFs to EU investors. As a result, EU AIFs and EU investors would be limited in their choices of AIFM, which will adversely affect the benefits these investors receive from investing in AIF.

10. How does the Directive compare to existing or proposed regulation of Alternative Investment Funds outside of the European Union, particularly that of the United States? How will the Directive affect the position of EU Alternative Investment Funds in the global market?

Mandatory registration of advisers to AIFs and robust systemic risk regulation are key components of the US Administration’s proposed regulatory reform framework, consistent with the principles set out in the G-20’s post-London declaration and the International Organization of Securities Commissions final report on hedge fund regulation. As noted in response to question 4 above, MFA supports the authorisation of currently unregistered investment advisers to all private pools of capital, subject to a limited exemption for the smallest investment advisers with a de minimis amount of assets under management. MFA is also supportive of a robust systemic risk regulatory framework for those entities that are systemically relevant. We believe that a number of the provisions of the Directive, however, go far beyond the principles established by these international organizations and that many of those aspects of the Directive are inconsistent with a globally harmonized approach to the regulation of AIFs and AIFMs.

See Article 5 of the Proposed Directive, which requires an AIFM to apply for authorisation in the Member State where the AIFM has its registered office and to have its head office in the Member State where it has its registered office. See also Article 18(1) of the Proposed Directive, which permits delegations of portfolio management and/or risk management only to third parties authorised as an AIFM to manage an AIF of the same type. These provisions together prohibit a non-EU AIFM from managing an EU AIF directly or by delegation from an EU AIFM.

Article 21 of the UCITS Directive provides that the management or investment company must employ a risk management process which enables it to monitor and measure at any time the risk of the positions and their contribution to the overall risk profile of the portfolio. Portfolio management may be delegated to a third party under the UCITS Directive. However management companies will retain full responsibility for the effectiveness and appropriateness of the risk management process involved in the management of the fund’s portfolio, and should take all necessary steps to ensure that the delegate is able to carry out the delegated activities reliably and effectively and in compliance with applicable laws and regulatory requirements. The management or investment company will still need to be able to supervise the delegated activities and should establish procedures the periodic assessment of the delegate’s activities insofar as they impact on the portfolio management. Article 5g of the UCITS Directive does not exclude delegation to companies organised outside of the EU.

Directive 2004/39/EC of the European Parliament and of the European Council of 21 April 2004 (the “MiFID Directive”). Under the MiFID Directive, portfolio management functions are permitted to be outsourced to service providers located in third countries provided certain conditions are met. These include: (i) responsibility for performance must remain with the delegate’s management; (ii) a service level agreement must be in place between the parties; and (iii) the delegate must have competence and diligence when entering into, managing or terminating any arrangement for the outsourcing to a service provider of critical or important operational functions or of any investment services or activities. Additional requirements are levied on third country service providers where portfolio management is provided to retail clients.


As discussed above in response to question 9, the Directive places significant restrictions on the ability of an EU-AIFM to delegate important functions to entities outside of the EU. These restrictions will limit the ability of EU AIFM to operate on a global basis. As the AIF industry continues to become increasingly globalized, it will be difficult for EU-based AIFM to compete in the global marketplace. Moreover, because the Directive precludes non-EU AIFM from managing EU AIF, investors in these funds will be severely limited in their choices when selecting AIFM. By significantly restricting the universe of AIFM that can be selected by EU AIF and the investors in EU AIFs, EU AIFs and their investors will be adversely affected in their ability to compete in the global marketplace.

11. What effect will the Directive have on flows of capital and financial innovation?

See response to question 10.

CONCLUSION

MFA welcomes the opportunity to provide comments in response to the Call for Evidence regarding the Directive. MFA supports efforts to ensure effective and efficient regulatory system and the goals of reducing systemic risk, promoting investor protection and protecting the stability of the financial system. We are committed to being constructive participants in the regulatory reform discussions and working with policy makers to reestablish a sound financial system and restore stable and orderly markets. In that regard, MFA respectfully believes that the Directive if passed as written would interfere with efficient market practices without justification and would have unintended consequences that would adversely affect the ability of AIFMs to provide vital services to investors and limit the available choices and the potential benefits to EU investors who seek to invest in AIFs.

9 September 2009

Letter from Maples and Calder

By way of introduction, Maples and Calder is an international law firm specialising in advising major international financial institutions in relation to the formation of alternative investment funds (including hedge funds and private equity funds) in the Cayman Islands, Ireland and British Virgin Islands. We estimate that we have established, over the years, more alternative investment funds than any other professional firm in the world. We have over 200 lawyers based in the Cayman Islands, Dublin, London, Hong Kong and Dubai, the majority of whom practice in the area of alternative investment funds. We are a member of the Alternative Investment Management Association (“AIMA”) and the Managed Funds Association (“MFA”).

We are aware that various committees of the European Union (“EU”) Commission and the EU Parliament are currently reviewing the draft of an EU Directive dealing with the proposed regulation of Alternative Investment Fund Managers based in the EU. We are also aware that the current draft EU Directive includes various provisions that would impose limitations upon the marketing of non-EU domiciled alternative investment funds to investors based in EU member states and the ability of EU or non-EU based alternative investment funds to appoint investment managers and service providers based outside the EU (particularly in the United States of America (“US”)).

Over the last 20 years or so, the Cayman Islands has become the preferred domicile for approximately 70% of the world’s hedge funds. Currently there are in the region of 9500 hedge funds registered with the Cayman Islands Monetary Authority (“CIMA”) under the Mutual Funds Law. There are also significant numbers of private equity and other closed ended alternative investment fund registered in the Cayman Islands. Consequently, many of our clients, who are investment managers based in the EU or the US or investors based in the EU and who manage or invest in Cayman Islands alternative investment funds, will be affected by the potential impact of the EU Directive as currently drafted. In particular we are aware that many institutional investors have expressed concerns that the EU Directive would severely limit their ability to invest in the vast majority of alternative investment funds which are either based outside the EU or employ service providers or investment managers based outside the EU.

As the leading Cayman Islands law firm, we are writing to you to offer to provide you with background information on the regulation of alternative investment funds based in the Cayman Islands which may assist you in your discussions and research so that the EU Directive might accurately reflect the role and regulation of alternative investment funds formed outside the EU. We would also respectfully submit that the alternative investment funds and service-providers based in the Cayman Islands are already subject to regulation and that institutional and sophisticated investors should not be unnecessarily prevented from investing in Cayman Islands alternative investment funds.
The vast majority of these Cayman Islands alternative investment funds are currently marketed under private placement rules to institutional and sophisticated investors (such as pension funds, insurance companies and charitable endowments) based around the world, including in the EU. The ability of the Cayman Islands to develop to this position as a market leader in alternative investment funds is based on the confidence that alternative investment fund managers, institutional investors and counterparties (such as financiers and prime brokers) have in the Cayman Islands legal and regulatory regime. Consequently as a leading centre for the alternative investment funds industry, the Cayman Islands financial services industry is aware of its responsibility to regulate alternative investment funds appropriately. To this end, the Cayman Islands already regulates hedge funds under the Mutual Funds Law, investment managers under the Securities Investment Business Law and banks and trust companies (including custodians) under the Banks and Trust Companies Law. The Cayman Islands legal system is based on English law principles and the final court of appeal is the Privy Council in London. Whilst many hedge funds have suffered from the recent drop in market prices and values, it is worthy of note that the numbers of hedge funds which have actually been the subject of serious litigation or criminal frauds is a very tiny percentage of the overall number.

The role and importance to the international financial community of international financial centres such as the Cayman Islands is often misunderstood and misstated. It is our submission that the Cayman Islands currently provides the international alternative investment funds management industry and institutional investors with a stable, well-regulated and neutral jurisdiction through which to facilitate international and cross border business for the benefit of the global economy. In addition to the huge number of reviews that have been conducted by legal and professional advisers on behalf of the investors who invest in Cayman Islands alternative investment funds, the Cayman Islands financial services regime has also been subjected to significant reviews over the last few years by international bodies such as the International Organisation of Securities Commissions ("IOSCO") (which has admitted CIMA, the main regulator of financial services in the Cayman Islands, as a member of IOSCO), the International Monetary Fund, the Financial Action Task Force and the United Kingdom Government.

As you no doubt are aware, many reports on the recent global financial crisis (including the Turner Report commissioned by the UK's Financial Services Authority, the UK financial services regulator, and the Larosière Report commissioned by the President of the EU Commission) have acknowledged that alternative investment funds established in offshore financial centres were not the origin of such crisis, which arose from trading and lending activities of banks onshore in major financial centres such as London and New York. However, we are aware that the G20 nations have mandated a review and regulation of hedge funds in order to assist with the need to monitor trading activities of large financial institutions which may constitute a systemic risk to the global financial system. Consequently, the Cayman Islands financial services industry stands ready to engage in a constructive dialogue and discussions with regulatory authorities in other countries to assist with a review of the existing level of regulation and, where appropriate, develop improvements to its regulatory regime to assist with the global oversight of the world's financial system.

This is consistent with the approach taken to other international initiatives over the past few years where the Cayman Islands has responded positively and swiftly to requests for assistance from international bodies and foreign governments in connection with the fight against crime and money laundering by implementing strict anti-money laundering and client verification legislation. Furthermore in connection with the exchange of information on tax matters, the Cayman Islands has entered into a number of OECD Model tax information exchange agreements with the US and several EU member states and is currently in negotiations with a view to entering into further tax information exchange agreements with other EU member states. In 2004 the Cayman Islands adopted the EU Savings Directive under which Cayman Islands banks automatically share information about bank accounts of EU residents with EU member states.

In the Appendices to this letter we summarise why international business is conducted in the Cayman Islands (Appendix 1) and in particular why hedge funds are often domiciled in the Cayman Islands (Appendix 2). We will also explain the ways in which the Cayman Islands Government has introduced measures to combat money laundering and to facilitate the exchange of information to assist foreign governments and tax authorities (Appendix 3 and Appendix 4). Finally we outline the laws dealing with the regulation of financial services in the Cayman Islands (Appendix 5).

Cayman Islands alternative investment funds act as an effective channel for global international investment and provide much needed liquidity, investment opportunities and access to capital markets for businesses and investors in both the major developed economies and emerging market countries. For example, Cayman Islands investment funds are currently being formed to participate in the US administration's TALF and PPPIP programs. We would hope that any new regulations on alternative investment funds are developed in a way which will not impede the formation of such alternative investment funds which can provide liquidity and capital to assist in the global economic recovery.
APPENDIX 1

INTERNATIONAL BUSINESS IN THE CAYMAN ISLANDS

1. REASONS FOR ESTABLISHING A BUSINESS IN THE CAYMAN ISLANDS

1.1 The financial services industry in the EU reflects the growth of globalisation and is international and cross border by nature. Once a financial institution has decided to establish an office in the EU, its next challenge is often how to create business structures or investment fund vehicles which can accommodate investors and business partners from all over the world within the complex parameters of existing tax and securities laws that apply to the investors, the management team and the business or investment activities, all of which could be located in multiple jurisdictions. In this regard even though the financial institution arranging the international transaction or the investment fund manager is based in the EU, the international business partners will not all be based in the EU. Consequently, the EU may not be the natural location for the incorporation of a company established to own or conduct the international business venture or to act as the investment fund. In many cases, the business parties or investors will be looking for a neutral jurisdiction, like the Cayman Islands, which does not give any one party “home field” advantage and does not disadvantage one or more of the parties. In fact, international investors will have their own reasonable legitimate business reasons (including legal, political, tax or regulatory) for preferring not to use an EU incorporated company for an international business venture.

1.2 The Cayman Islands is the domicile of choice for the establishment of companies for many different types of international businesses and has been particularly successful in attracting investment fund formation from US and EU based investment fund managers. In this regard, the Cayman Islands does not compete as a financial centre with the EU. Instead, the use of Cayman Islands vehicles established by EU based businesses simply help these EU businesses service an international client base or to carry out international cross border transactions. Whilst certain services can be provided to the Cayman Islands vehicles by Cayman Islands based service providers, in many cases EU based businesses provide these services to the Cayman Islands companies and thus generate fees and revenues for these services in the EU. In this way economic activity surrounding the Cayman Islands vehicle helps sustain or create jobs and taxable revenues in the EU.

1.3 When reviewing the reasons why Cayman Islands vehicles are established by international businesses, it is important to note that the primary reason for forming Cayman Islands vehicles is to carry out legitimate international business activities. The fact that there are no direct corporate or income taxes levied in the Cayman Islands and that accordingly transactions can be structured on a “tax-neutral” basis, unfortunately often leads to a misconception that investors in offshore companies are only doing so to evade tax and not for legitimate business reasons which are tax compliant. A financial institution’s or an investment fund manager’s decision to establish an international joint venture company or an investment fund in the Cayman Islands will likely be based on a detailed review of all business factors, including where the investors or shareholders are based, where the business venture or investment activity will take place, the nature of all tax, regulatory, litigation and bankruptcy laws and political risk in all relevant countries which could impact the proposed business plan and transaction cash flows. This detailed review will be conducted with the advice of experienced legal counsel and advisors in all relevant jurisdictions to ensure that the use of a Cayman Islands vehicle for the proposed business venture will meet the business objectives of all the parties and will be in compliance with the laws and regulations (including tax and regulatory requirements) in those other relevant jurisdictions.

1.4 Certainly, the creation of an investment fund or joint venture company in the Cayman Islands will require the parties to understand the tax implications of the transactions involved. The Cayman Islands government does not levy corporation, income or capital gains tax and so the business parties do not suffer an additional layer of tax in the Cayman Islands. However, that does not mean that the business parties or investors are free from tax liabilities in their home jurisdictions. An EU investor in a Cayman Island company will be taxable in the EU on its dividends or capital gains on its investment in accordance with the EU tax laws. In addition the Cayman Islands fund may be subject to withholding taxes (eg the US withhold on certain dividend sourced income) in the country in which its investments are located. In addition, many EU and US tax laws already provide for significant and detailed anti-tax avoidance provisions designed to prevent the abusive use of offshore companies. The Cayman Islands government has repeatedly condemned tax evasion and has already introduced transparency and cooperation measures by signing several Tax Information Exchange Agreements (including with the US in 2001 under which it regularly shares tax information with the US authorities) and adopting the EU Savings Directive in 2004. As noted in Appendix 4, the Cayman Islands have also recently introduced a unilateral tax information assistance regime for several OECD countries which has been cited by

41 For more details on the various existing tax information assistance mechanisms in the Cayman Islands see http://www.tia.gov.ky/html/agreement.htm
the OECD as “setting a good example”\textsuperscript{42}. Furthermore, as the recent US Government Accountability Office report states, the Cayman Islands has been publically acknowledged by US Federal agencies for its timely cooperation with information requests\textsuperscript{43}.

1.5 With regard to tax matters, as mentioned previously many services provided by EU based businesses to Cayman Islands companies or investment funds result in taxable revenues being earned and taxes being paid in the EU. However many EU member state’s tax laws are also specifically drafted to enable EU based investment advisors to service foreign based investment funds without the risk that the foreign investment fund itself (or indirectly the foreign investors) will be deemed to be taxable in the EU member state. Without the ability for the EU based funds industry to manage foreign based funds in this way, it is accepted that the EU investment fund management industry would not have flourished in certain EU member states and the EU would not be able to attract much foreign sourced investment capital. For the same reason, the US currently has similar rules that enable US based fund managers to manage foreign based investment funds on a similar basis\textsuperscript{44}.

1.6 In most cases, a Cayman Islands company is simply the channel through which global capital moves between jurisdictions. For example, Cayman Islands companies are established for many international business purposes, including helping Boeing or Airbus to sell aircraft with export credit backed support, US or EU multinationals to access global markets competitively, EU or US based banks supported by government agencies to make secured loans to Cayman Islands joint venture companies to finance power projects in developing countries and US or EU based hedge fund managers to attract international investors. Through investment funds and companies the Cayman Islands already acts as a crucial channel for inward investment into major economies including the EU and the US: according to US Treasury figures\textsuperscript{45}, Cayman Islands investment funds are one of the largest holders of US debt, sovereign and private. Cayman Islands investment funds are already being formed to play a role in the economic recovery by enabling international institutional investors to channel private capital into the leading economies, for example to buy “distressed” assets, which will bring much-needed liquidity to the markets from private capital sources\textsuperscript{46}. So, rather than being “part of the problem”, the Cayman Islands is a key player in the international financial community, providing solutions to the present economic difficulties.

1.7 Approximately 9,500 open-ended investment funds (including hedge funds) are domiciled in the Cayman Islands. Whilst many hedge funds have suffered from the recent drop in market prices and values, it is worthy of note that the actual numbers of hedge funds which have been the subject of serious litigation or criminal frauds is a very tiny percentage of the overall number.

2. Examples of the Types of Business Conducted in the Cayman Islands

2.1 The Cayman Islands financial services industry has grown significantly over the last 30 years directly as a result of the corresponding growth in worldwide financial markets and in particular the alternative investment fund industry. The development of the global alternative investment fund industry is well-documented in many books and journals and this submission is only intended to provide a very brief overview of this topic. The Cayman Islands has been successful in attracting the following types of financial business:

(a) investment funds—principally hedge funds and private equity funds marketed to institutional investors. The Cayman Islands are widely recognised as the leading jurisdiction for hedge fund formation.

(b) capital markets transactions—such as securitisations, capital raising corporate finance subsidiaries and note issuing programmes;

(c) structured investment products—note repackagings, credit linked transactions such as credit derivatives and credit linked notes and structured and derivative products;

(d) insurance companies and related products, such as captive insurance companies, catastrophe bonds and other alternative risk transfer products;

(e) commercial aircraft and ship finance;

(f) joint venture companies and corporate subsidiaries for international businesses; and

(g) international commercial banking.

\textsuperscript{42} Jeffrey Owens, Director of the OECD’s Centre for Tax Policy and Administration, see http://www.oecd.org/document/9/0,3343,en_2649_33767_42482898_1_1_3_37427.00.html

\textsuperscript{43} United States Government Accountability Office, Report to the Chairman and Ranking Member, Committee on Finance, US Senate, “Cayman Islands: Business and Tax Advantages Attract US Persons and Enforcement Challenges Exists” GAO-08-778, p 5


\textsuperscript{45} http://fms.treas.gov/bulletin/index.html

\textsuperscript{46} http://www.newyorkfed.org/markets/talf_faq.html
2.2 Many of these transactions are arranged and managed by well-known fund managers, investment banks and companies based around the world and in which sophisticated institutional and high net worth investors (including pension funds, insurance companies, university endowment funds and sovereign funds) invest in order to diversify their investment portfolios through a variety of “alternative investment strategies”. Consequently, only a small percentage of Cayman Islands investment funds (probably less than 1%) are marketed to retail investors and substantially all capital markets debt issuance is through the global clearing systems such as DTC and Euroclear/Clearstream and is held by institutional investors. There is a growing trend for big institutional investors, such as pension funds, insurance companies, university endowment funds and sovereign funds, to allocate larger proportions of their investment portfolios to alternative investment funds, many of them established in the Cayman Islands. It is well-documented that almost all the major developed countries have ageing populations and in the medium term it is anticipated that both private and state-run pension plans will struggle to finance their pension fund obligations based on traditional investment strategies. Consequently hedge funds, private equity funds and other investment funds based in offshore financial centres with global investment strategies may play an increasingly important role in generating enhanced returns for pension funds investors.

2.3 The alternative investment fund business, capital markets and commerce generally are becoming increasingly global. Many large multinational companies have separate and diverse businesses in many different jurisdictions. Most major investment banks and many of the bigger investment fund managers now have global investor client bases and investment management teams in more than one of the main financial centres, including New York, London, Tokyo and Hong Kong. These investment banks, investment fund managers and multi-national companies must compete globally for capital, investors and customers to build their businesses. To provide some examples:

(a) a fund manager based in London or New York with expertise in investing in European or US equities might seek investors from outside the UK or US, including Europe, the Middle East or Japan, who are looking to invest in European or US equities. The same US or UK based fund manager may also have expertise through branches in other countries to offer investment funds which specialise in investing in investments in countries outside the UK or the US (eg emerging markets);

(b) a multinational corporation may wish to enter into a joint venture with investors from many different jurisdictions to build a power generation plant or other infrastructure project in a developing country;

(c) an entrepreneur in a developing country may wish to start a business with a view to eventually raising capital by way of a public share offering in the UK or the US;

(d) a commercial airline will need the ability to raise significant capital sums from international lending syndicates to finance its aircraft fleet;

(e) a financial institution based in one jurisdiction may wish to issue notes or bonds to investors in different jurisdictions through the international capital markets, allowing it to access new sources of capital whilst at the same time providing international investors with new investment opportunities with diversified risk profiles;

(f) a business may wish to insure against natural disaster risk by way of issuing bonds into the international capital markets; and

(g) an international bank may maintain a branch or subsidiary in the Cayman Islands to provide multi currency accounts for corporate customers in order to facilitate trade financing or to provide sweep facilities and an internal treasury function to the group.

2.4 The global financial system needs, and will continue to need, legal entities which are formed (whether in the Cayman Islands or elsewhere) to facilitate such international transactions. In many cases, investment managers, investment banks and multinational companies will, on advice of their onshore legal counsel, use companies based in the Cayman Islands and other international financial centres to build their investment fund structures, capital markets transactions or other business ventures. The international business community thus benefits by being able to form such legal entities swiftly and efficiently in a stable jurisdiction and on a tax-neutral basis. This can be of particular benefit to developing countries in Africa and other regions, where facilitating inward private investment is critical to their economic development.

2.5 In relation to banking, the Cayman Islands is one of the leading international financial centres that provides legitimate commercial advantages to onshore banks. All banks carrying on business in or from the Cayman Islands are licensed and regulated by the Cayman Islands Monetary Authority (“CIMA”). Branches and subsidiaries of international banking groups are regulated by CIMA on a consolidated basis with the onshore regulator in accordance with Basel Core Principles. Private banks are required to establish a full physical presence (ie staff and resources) with CIMA as the primary regulator. As a general policy, CIMA will not issue licences to a private bank unless they are a subsidiary or an affiliate of a major international banking
group. For those entities where CIMA is the primary regulator, risk management policies and procedures will be implemented in accordance with Cayman Islands law. Entities which are principally regulated by the home supervisor will be required to adhere to home jurisdiction requirements. Both home and host supervisor will have access to relevant information retained by Cayman Islands branches or subsidiaries. The model of consolidated supervision and the risk procedures and ratios adopted by CIMA have been reviewed and approved by the IMF.\(^\text{47}\)

3. THE REASONS WHY THE CAYMAN ISLANDS ATTRACTS HIGH QUALITY INTERNATIONAL BUSINESS

3.1 Some of the reasons why the international business community use companies based in the Cayman Islands include the following:

(a) Political Stability. The Cayman Islands are politically and economically stable. Unemployment is low and the standard of living one of the highest in the Caribbean. The favourable economic situation of the Cayman Islands is key factor in its political stability. This stability is also reflected in Moody’s country ceiling rating of “Aaa”.

(b) Cayman Islands Legal Infrastructure. The laws of the Cayman Islands are substantially based upon English common law and a number of “key” English statutes, although Cayman Islands statutes have been adapted to assist the international business community. This gives Cayman Islands law and its legal system a common origin with those of many of the jurisdictions of its users, with the added attraction of supplementary legislation which specifically contemplates the types of structures and vehicles which its users require. It also means that the business entities (such as Cayman Islands companies, limited partnerships and unit trusts) and the types of securities which Cayman Islands entities offer are well recognised and accepted around the world, and particularly by fund managers and investors in New York, London, Tokyo and Hong Kong. Bankruptcy-remote vehicles established in the Cayman Islands are also recognised worldwide; indeed the major rating agencies have published specific criteria for Cayman Islands companies, given that the Cayman Islands have become one of the main offshore jurisdictions for debt issuance vehicles.\(^\text{48}\) The final court of appeal is the Privy Council in London. All the major audit firms have offices in the Cayman Islands and there are several major Cayman Islands law firms to give legal advice to support the financial services industry.

(c) Quality of Service Providers. The quality of the service-providers (attorneys, auditors, mutual fund administrators, trust companies, company managers, etc.) in the Cayman Islands is very high. The majority of the Islands’ professionals are recruited from the top law and accountancy firms and financial institutions in London and other major financial centres. In response to client demand, the Cayman Islands have therefore developed an expertise and level of service in the financial services industry which meets the standards set by major onshore financial centres.

(d) Investor requirements. By using a Cayman Islands company to make an investment into foreign jurisdictions, investors are able to better realise their investment by either selling their shares or in an initial public offering (IPO) of shares in the Cayman Islands company. The Cayman Islands legal infrastructure, with which most international investors are familiar, makes it easier to effect such sale or IPO. If the investment were directly into a company in the foreign jurisdiction, the investors would need to understand what rules applied to such investment and a flotation could be more complex and expensive in ensuring that the listing and relevant securities registration rules and local rules are complied with on the IPO; the “catchment” area for investors would also be narrower. As many Cayman Islands entities have been listed on major stock exchanges such as London, New York and Hong Kong, investors can have confidence that a flotation should, from a legal standpoint, be possible in due course.

(e) Lender requirements. In some cases, an investment fund or a multinational company will need to borrow significant sums of money to leverage its investment activities or finance its business activities. For example, a multinational business might need to borrow to finance a business based in a developing or an emerging market country. Many lending institutions would prefer to organise the lending and related security interest arrangements offshore through a Cayman Islands company rather than in a developing or emerging market country. Such lenders take comfort in having this important element of these transactions facilitated through corporate vehicles based in the Cayman Islands since the Cayman Islands offers (a) a legal regime which recognises security interests, netting, set-off, inter-creditor and subordination rights (eg created under English or New York law).


\(^{48}\) www.dealogic.com
commonly utilised in international cross-border financings and does not have a corporate rehabilitation regime (ie there is no administration or Chapter 11 equivalents in our Companies Law) which can affect creditor rights, (b) a creditor friendly system where lenders can easily enforce security interests, (c) a legal system which has been scrutinised and approved by all major credit rating agencies, and (d) corporate and partnership entities created under essentially common law legal principles with which lenders are familiar. These transactions can be extremely complex; indeed some would be difficult and in some cases impossible to structure directly under the legal regimes of the relevant developing or emerging markets. It is for this reason that governmental and quasi-governmental agencies such as the Overseas Private Investment Corporation, a US governmental agency, and the International Finance Corporation, a division of the World Bank, will support lending to investment fund or finance structures using Cayman Islands vehicles; and in the context of aircraft finance deals, the export credit agencies, including the ECGD do likewise.°

(f) Exchange Control and Cash Flow Neutrality. A Cayman Islands company is not subject to Cayman Islands foreign exchange controls and there are no significant restrictions on the payment of interest or dividends, the repayment of capital or the ability to repurchase shares or redeem or repurchase debt. This is important because some cross-border transactions would be rendered uneconomic if cash flows are interrupted by foreign exchange controls or such payment restrictions.

(g) Tax Neutrality. Cayman Islands companies provide a tax-neutral platform so that investors from multiple jurisdictions are not subject effectively to double taxation by virtue of the investment fund or offshore company adding extra layers of foreign taxation at different levels of the structure in addition to the investors’ home country tax. This neutrality is important because it provides a level playing field for all investors; in other words it avoids creating a vehicle in a jurisdiction that may provide more benefits to some investors than others. The fact that there are no direct corporate or income taxes levied in the Cayman Islands and that accordingly transactions can be structured on a “tax-neutral” basis, unfortunately often leads to a misconception that investors in offshore companies are free from all forms of taxation. This is not the case at all. Investors based in onshore jurisdictions are likely to be taxed on dividend and other income received from the offshore company and on any capital gains realised on the sale or redemption of shares in the offshore company. Many onshore jurisdictions have also introduced anti-avoidance tax rules that tax income and gains which are rolled up in the offshore vehicle as if they had been distributed. Additionally, the offshore company may itself be subject to withholding taxes imposed in respect of income or gains on its investments by tax authorities in the onshore jurisdictions in which the offshore company’s businesses or investments are located and such withholding taxes are frequently not creditable against taxes paid by the investor in the offshore vehicle in respect of the same income or gains. Furthermore, a Cayman Islands company may have a branch or a place of business in an onshore jurisdiction or be centrally managed and controlled in an onshore jurisdiction and be subject to the taxing regime in that onshore jurisdiction.

(h) Legal Neutrality. This is often important. A Cayman Islands company provides a level playing field for all investors; in other words it does not provide more benefits to some investors than others based on, for example, their nationality. This favours the pooling of international investment.

(i) Jurisdictional Litigation Risk, Tax and Regulatory Mitigation. International investors and businesses are often concerned that a direct investment in investments based in jurisdictions outside their home territory might expose them to jurisdictional litigation risk or make them subject to additional complex tax or regulatory requirements in multiple jurisdictions. Investments through offshore companies can therefore be a valuable risk management tool for international businesses. To highlight some examples:

(1) Some non-US investors prefer to invest in US investments through an offshore fund and not directly in the US because of the perceived increased litigation risk of being deemed to be present in the US by virtue of their passive investment activities. International investors are well aware of the highly litigious business environment in the US and the often vexatious litigation commenced by US class action lawyers. Many investors are concerned about the risk of being subject to a jury trial in the US and the unpredictable damages claims which might ensue. This concern was highlighted by a McKinsey report prepared for the Mayor of the City of New York in 2007 as a reason why the New York financial service industry was losing business to other major international financial centres, such as London. On a similar theme we have seen more offshore companies being formed by non-US businesses and listing on the AIM stock exchange.

° See www.opic.gov, www.ifc.org and www.ecgd.gov.uk for a list of projects or transactions in which Cayman Islands entities feature

in London rather than the NASDAQ as a result of the increased regulatory risk and costs involved with compliance with recent US regulations, such as the Sarbanes-Oxley Act.

(2) In some cases US investors in fund limited partnerships prefer to see the partnership hold non-US investments through offshore holding companies to reduce the risk that their limited liability status might be jeopardised by an investment by the fund in other jurisdictions.

(3) In order to encourage passive inward foreign investment into some jurisdictions, we understand that the onshore tax codes in some countries may seek to create certain safe harbours for foreign investors or foreign investment funds whose activities are restricted to passive investing with an onshore based fund manager in the onshore jurisdiction. These foreign investors or foreign investment funds may be deemed not to be engaged in a trade or business in the onshore jurisdiction for tax purposes solely by virtue of their passive investment activities and therefore are not generally subject to tax in that jurisdiction generally on their other worldwide business revenues, save perhaps for a withholding tax on certain dividend payments on some investments. However, foreign investors or foreign investment funds may still prefer to invest in investments managed by an onshore fund manager through an offshore fund to reduce the risk that the foreign investors could unnecessarily be held to be engaged in a trade or business within the onshore jurisdiction and inadvertently become subject to onshore tax on their foreign-based assets because their investments are managed by an onshore-based fund manager. In this way the use of offshore investment funds helps onshore fund managers compete globally for international investors.

APPENDIX 2

CAYMAN ISLANDS HEDGE FUNDS

1. INTRODUCTION

1.1 The hedge fund industry is an international industry. Hedge fund investment managers based in the EU compete against hedge fund managers based in other locations such as Manhattan, Hong Kong, Singapore and Geneva. Typically, hedge fund investors are not retail investors but institutional investors such as sovereign wealth funds, pension plans, insurance companies, university endowments and family offices of high net worth investors. The minimum investment required to invest in a hedge fund is usually above US$100,000 and often above US$1,000,000. In most cases, a European individual retail investor can only indirectly be exposed to an investment in hedge funds or other alternative investment funds through a fund of funds established as a UCITS fund in places like Ireland or Luxembourg.

1.2 Once an investment advisor has decided to establish an office in the EU, the next business challenge is how and where to establish the investment fund company it will manage which will enable it to attract investors from around the world.

1.3 Let us assume that an investment advisor based in the EU wants to start a new global long/short hedge fund which will focus on investing in debt or equity securities issued by companies based in the EU, the US and emerging market countries. The investment advisor will often start a hedge fund with a small number of seed investors. In this example, we will assume that the investment advisor is in discussions with a number of international investors including a Middle Eastern sovereign wealth fund, US pension funds, UK pension funds, a Cayman Islands fund of funds and Japanese financial institutions.

1.4 The first question is where the investment advisor will establish the hedge fund vehicle into which the investors will invest and which will undertake the investment activities. The investment advisor must consider the location of the investors, the countries in which it will invest, the effect of any tax or exchange controls on cash flows through the hedge fund, the confidence, familiarity and preference of the investors and trading counterparties in the selected jurisdiction, the regulatory position and the quality of the local service providers.

1.5 The Cayman Islands has become the preferred domicile for approximately 70% of the world's hedge funds. In our example, the investment advisor has decided to establish the new hedge fund (a “Master Fund”) in the Cayman Islands with various feeder funds (the “Feeder Funds”), including a Delaware feeder fund, as represented by the diagram in Example 1 below.

1.6 This example is indicative only of general principles and a fully worked example would require specialist advice from counsel in all relevant jurisdictions.
2. Why the Cayman Islands?

2.1 The international investors will want to invest in a tax neutral investment fund. None of the non-EU investors will usually want to invest in a hedge fund based in the EU or the US, since otherwise the hedge fund might unnecessarily be subject to EU or US corporation tax. Foreign investors will not want to be subject to EU or US tax on a global strategy fund where the only touch point with the EU or the US may be the location of the investment advisor. The Cayman Islands hedge fund may be specifically exempted from EU corporation tax if the hedge fund’s central management and control is outside the EU. US tax exempt investors (such as pension funds and college endowments) will often prefer to invest in a Cayman Islands company to qualify for relief against unrelated business taxable income as permitted under the US tax code.

2.2 There are no additional taxes or exchange controls imposed on the hedge fund in the Cayman Islands.

2.3 The hedge fund is regulated by the Cayman Islands Monetary Authority and investors are comfortable with the Cayman Islands regulatory regime, which is based on a requirement for adequate disclosure. In addition, investors recognise that the investment advisor will be regulated by an EU based regulator, such as the UK Financial Services Authority. The prime broker and custodian are also likely to be regulated in the EU. If a fund administrator in the Cayman Islands is selected, that administrator will be regulated by the Cayman Islands Monetary Authority. If an overseas administrator is selected, that administrator will usually be regulated in that overseas jurisdiction.

2.4 Currently, the shares in a Cayman Islands investment fund can be sold to EU and UK investors under the permitted sophisticated investor private placement rules in the relevant securities laws. Each jurisdiction in which the company offers its shares will also typically have its own offering restrictions.

2.5 International investors are familiar with Cayman Islands hedge funds and comfortable with the legal system and their rights as shareholders in the Cayman Islands. The Cayman Islands Companies Law expressly provides for the easy redemption of shares.

2.6 All major prime brokers and counterparties are comfortable with conducting business (including extending credit and margin) to Cayman Islands companies.

2.7 The hedge fund, although domiciled in the Cayman Islands, will still be required to comply with the laws on market manipulation, insider dealing, late trading and short selling in the jurisdictions in which it trades.

2.8 For more detail and information on hedge funds please see: Hedge Funds: Law and Regulation (Cullen/Parry) Sweet & Maxwell; Hedge Funds (Gabbert) Lexis/Nexis; International Financial Services London—Hedge Funds Report April 2009 and; Alternative Investment Management Association—www.aima.com

3. Anti Money Laundering Due Diligence

3.1 The company formation agent who incorporates the hedge fund is required under the Money Laundering Regulations (described in more detail in Appendix 3) to “identify the client”. This means in this instance identifying (a) the initiator of the transaction, normally the investment manager or sponsor that approached the company formation agent and (b) the directors and shareholder(s) of the hedge fund in accordance with the requirements of the Money Laundering Regulations and the related guidance notes.

3.2 As most hedge funds in the Cayman Islands are regulated under the Mutual Funds Law (2009 Revision), the hedge fund itself is required to conduct “KYC checks” on the investors into the hedge fund. This is often delegated to the administrator of the hedge fund if the administrator is located in the Cayman Islands or a jurisdiction which is deemed to have laws and regulations equivalent to the Money Laundering Regulations.

4. Cash Flows and Tax

4.1 The investors will subscribe for shares in the relevant Feeder Fund and each Feeder Fund will in turn subscribe for shares in the Master Fund. It is common for a hedge fund to have a Delaware based feeder fund for US taxable investors, a Cayman Islands unit trust for Japanese investors and a Cayman Islands corporate feeder for other non-US investors and US-tax exempt investors. The Feeder Funds will make the necessary tax and regulatory filings in the US, Japan and other relevant jurisdictions on advice from counsel in those jurisdictions.

4.2 The Cayman Islands Master Fund will invest the share subscription proceeds in the global investments. It will not be subject to additional tax in the Cayman Islands but it may be subject to withholding taxes in other jurisdictions on amounts it receives on its investments.

4.3 The Cayman Islands Master Fund will be advised by the EU based investment advisor and will pay advisory fees for these services. These will be taxable receipts in the EU and helps create jobs for an EU based business.
4.4 The Cayman Islands Master Fund may trade through an EU based prime broker and use an EU based custodian and will pay fees and commissions for these services. These will be taxable receipts in the EU and help create jobs for these EU based businesses.

4.5 The investors will not be subject to capital gains or income tax in the Cayman Islands. Investors will however be subject to income and capital gains taxes on receipt of dividends or proceeds of share redemptions in their home jurisdiction. The investors may also be subject to anti-tax avoidance rules in their home jurisdictions to prevent abuse.

4.6 The countries in which the hedge fund invests benefit from increased liquidity created by the hedge fund’s investment activities.

4.7 Please note that we only practise Cayman Islands law and do not purport to hold ourselves out to be experts in tax or securities laws of any other jurisdiction. Tax and securities law is by its nature, very complex and the above analysis is a general overview only. Each fund will have different circumstances and will require detailed advice from counsel qualified in the relevant jurisdictions.

Example of a Typical Hedge Fund Structure

- US taxable investors
  - Shares
  - Delaware LLC Feeder Fund
- Non-US institutional investors and US tax exempt investors
  - Shares
  - Cayman Islands Feeder Fund
- Japanese investors
  - Units
  - Cayman Islands unit trust

Investment Management Agreement
- Investment Manager (EU)
  - Global Long/Short Fund (Cayman Islands Master Hedge Fund)
- Fund Administrator (Cayman Islands or other Approved Jurisdiction)

Print Broker Agreement
- EU Prime Broker (US Investments)

Custody Agreement
- EU Custodian (Non-US Investments)
APPENDIX 3

CAYMAN ISLANDS ANTI-MONEY LAUNDERING REGIME

1. So-called “all crimes” anti-money laundering legislation was introduced in the Cayman Islands in 1996. Prior to this, in common with many other countries such as the UK, the Cayman Islands had money laundering provisions which criminalised dealings with the proceeds of drug trafficking. The Proceeds of Criminal Conduct Law (“PCCL”), was passed in 1996 and has been regularly amended and revised to meet international standards. The Cayman Islands was the first Caribbean jurisdiction to introduce such legislation and the PCCL has been used as a legislative model for other regional jurisdictions. The PCCL essentially provides for the criminalisation of all forms of money laundering, a mandatory reporting obligation, a tipping off offence, the empowerment of the police and courts to search, freeze and confiscate the proceeds of crime and the ability of the courts and relevant authorities to assist in the enforcement of foreign confiscation judgments. The PCCL was recently repealed and replaced by the Proceeds of Crime Law, 2008, which extended the powers and provisions of the PCCL, to include sections similar to the UK Proceeds of Crime Act 2002 and Serious Organised Crime and Police Act 2005.

2. The Terrorism Law was introduced in 2003 and provides for terrorism and terrorist financing offences. The Terrorism Law includes a mandatory reporting obligation and tipping off offence. Since October 2001, the Cayman Islands have also applied the Terrorism (United Nations Measures) (Overseas Territories) Order, which provides for similar offences.

3. The Money Laundering Regulations (the “Regulations”) were introduced in 2000 and essentially codified the basic procedural requirements which the financial service industry had been applying voluntarily for some time. The Regulations require that financial service providers conducting relevant financial business maintain the following procedures when entering a business relationship or carrying out a one-off transaction:
   (a) client identification and verification;
   (b) record keeping;
   (c) internal controls and communication for ongoing monitoring of relationships;
   (d) suspicious activity reporting and appointment of a Money Laundering Reporting Officer;
   (e) appointment of a Compliance Officer; and
   (f) training and awareness.

4. Client identification and verification procedures will normally include obtaining information on the controllers and principal beneficial owners of client entities. In 2001, the Regulations were amended so that the requirement to maintain client identification and verification procedures would apply to all relationships established prior to the introduction of the Regulations (ie perform due diligence on all relationships pre-2000). Financial service providers were given until September 2003 to obtain such information. To date, the Cayman Islands are the only jurisdiction to have completed the retrospective due diligence exercise across all industries.

5. The Regulations apply to all licensed banks, trust companies, corporate service providers and company managers, insurance companies, and insurance brokers, agents and managers, mutual fund administrators and regulated mutual funds, as well as those entities registered and licensed to conduct securities investment business, amongst others.

6. In contrast, the US has yet to apply the USA Patriot Act Rules to entities beyond certain banks, brokers-dealers, and commodity pool operators, and the key company incorporation states of Delaware, Nevada and Wyoming do not enforce similar standards. Wyoming supposedly domiciles over 400,000 companies and Delaware domiciles over 500,000 corporations. The Cayman Islands domiciles just over 60,000. The UK (and other EU member states) has only recently extended its Money Laundering Regulations to trust companies following the implementation of the third EU Money Laundering Directive in 2007.

7. Unlike other jurisdictions (including certain states in the US and members of the European Union, including the UK), the Cayman Islands do not permit companies to issue bearer shares, unless they are deposited with a recognised custodian.

8. The Guidance Notes on the Prevention and Detection of Money Laundering in the Cayman Islands (the “Guidance Notes”) were first issued in 2001 and provide practical guidance as to the application of the Regulations. The Guidance Notes superseded the Anti-Money Laundering Code of Practice which had been in use from 2000. The Guidance Notes are not law but apply to the same entities subject to the Regulations and are to be considered when determining a financial service provider’s compliance with the Regulations. They therefore carry evidentiary weight and must be followed by financial service providers. The Guidance Notes,
which run to more than 150 pages, set out detailed guidance, of both general and sector-specific application, for financial service providers who must verify client identity, maintain adequate records, maintain suspicious activity reporting procedures, provide anti-money laundering training and so forth.

9. The Cayman Islands have been a member of the Caribbean Financial Action Task Force (“CFATF”) since its inception in 1992. The CFATF is a 30-nation member organisation, recognised by the FATF as an associate member, which is commissioned to undertake peer evaluations on behalf of the FATF and fellow agencies. The United States is a CFATF supporting nation, along with the UK, Canada, France, Mexico, Spain and The Netherlands.

10. The Cayman Islands anti-money laundering and combating of terrorist financing regime recently underwent an assessment by the CFATF in June 2007. The CFATF evaluation team included a representative from US Treasury FinCEN and the Canadian RCMP. The assessment report was issued in December and indicated that the Cayman Islands were compliant or largely compliant with 38 out of the 49 FATF AML and CFT Recommendations. The Recommendations represent the international standards for AML/CFT.

11. The results of this assessment follow the excellent rating provided by the IMF on evaluating the Cayman Islands using the same AML/CFT methodology in 2003. The IMF reported that the Cayman Islands had an intense awareness of anti-money-laundering and combating of financing of terrorism in the business community.

12. Based on the FATF evaluations undertaken to date since 2004 on over 85 FATF member and non-member (onshore and offshore) jurisdictions, the Cayman Islands currently rank sixth equal for overall compliant and largely compliant Recommendations. This means that the Cayman Islands achieved better results than most other countries including the United Kingdom, Switzerland, Spain, Italy and Ireland.

APPENDIX 4

CAYMAN ISLANDS INTERNATIONAL COOPERATION AND INFORMATION EXCHANGE

1. The Cayman Islands has invoked numerous statutory measures to cooperate with and assist foreign governments, authorities and courts with the provision of information held in the Cayman Islands. Such laws override any statutory or common law duties of confidentiality.

2. Mutual legal assistance for criminal matters has been covered under the Criminal Justice (International Cooperation) Law from 1997 and, with particular regard to US criminal matters, under the Narcotics Drugs (Evidence (United States of America) Law from 1984 and the Mutual Legal Assistance (United States of America) Law (“MLAT”) from 1986. It is understood that the MLAT mechanism with the US has been rarely used since 1986 (ie approximately 230 requests). Extradition between the Cayman Islands and US is provided for by the United States of America Extradition Order 1976 and Amendment Order of 1986.

3. The Misuse of Drugs Law and Proceeds of Crime Law, 2008 also contain provisions for the sharing of information with authorities in relevant circumstances. As of 2008, of 23 requests made to the Cayman Islands from US authorities since 2003 in relation to money laundering and predicate offences, 22 have been granted.

4. The Cayman Islands are also a party to the Hague Convention 1970 on the taking of evidence abroad and can share information with other Hague Convention signatories.

5. As a regulatory matter, CIMA is empowered under the Monetary Authority Law (2008 Revision) to entertain requests for information from any recognised overseas regulatory authority exercising equivalent functions. As such, CIMA do not consider requests from fiscal authorities in relation to tax matters (see below under 6). If certain criteria are met, CIMA will direct a local financial service provider or connected person to disclose information they hold which is responsive to the overseas regulatory authority’s request. Separately, CIMA has entered into Undertakings and Memoranda of Understanding with the multiple regulatory authorities and agencies, including the SEC and the FSA.

6. In relation to disclosure for tax matters, the Cayman Islands made an advance commitment to the OECD in terms of adhering to their principles on exchange of tax information and transparency. In 2001, the Cayman Islands signed a Tax Information Exchange Agreement with the United States. This provided for the provision of information in relation to criminal tax matters from the 2004 tax year and civil matters from the 2006 tax year and does not require a dual criminality test (ie that the matter constitutes a criminal offence in both the US and the Cayman Islands). Since then, the Cayman Islands have introduced the Tax Information Authority Law, 2005, which established the Tax Information Authority as the competent authority in the Cayman Islands for dealing with foreign tax information requests and tax reporting and schedules the Tax Information Exchange Agreement with the United States. The US Tax Information Exchange Agreement conforms to the
model developed by the OECD Global Forum on Taxation, and is a form of an agreement which both the G-8 and G-20 countries have endorsed as reflecting “high standards of transparency and exchange of information for tax purposes”.

7. In 2005, the Cayman Islands implemented with the Member States of the European Union exchange of information measures consistent with the EU Savings Directive and has introduced the Reporting of Savings Income Information (European Union) Law, 2007 (and related Regulations). The Tax Information Authority is empowered to deal with disclosures under both laws and is the local liaison with the relevant foreign competent authority. A total of 11,616 reports were made for the period 1 January 2005 through 31 December 2007.

8. The Cayman Islands decided not to introduce the transitional withholding tax option, favoured by Switzerland, Belgium, Luxembourg and Austria, as it was perceived not to be supportive of higher standards of transparency and could promulgate tax evasion. The Law and Regulations imposed obligations on “paying agents” within the Cayman Islands (which may include banks and fund administrators) who make or hold payments of “savings income” for individuals who are tax residents of EU Member States. The obligations require that “paying agents” provide information via the Tax Information Authority to the respective EU tax authorities on the amount of payments of “savings income” together with details of the recipient EU tax resident individuals.

9. The Tax information Authority Law was amended in 2008 to provide for a parallel mechanism for cooperation in tax matters that can be used in addition to bilateral agreements. The mechanism would allow the Cayman Islands to enter unilateral arrangements for the sharing of tax information with certain jurisdiction and was designed specifically to reflect OECD technical standards for transparency and provision of information. This legislation has been recognised by the OECD as innovative and acknowledged as offering the possibility of speeding up the process of allowing for the exchange of tax information internationally.

10. As at 31 July 2009, the Cayman Islands has entered a total of 11 bilateral agreements and has 12 unilateral arrangements in place for tax information exchange with up to 17 of the 30 OECD member states, including the US, UK, Germany and Ireland.

11. The OECD issued a progress report on 2 April 2009 with respect to 82 financial centres around the world towards implementation of an internationally agreed standard on exchange of information for tax purposes. Cayman was placed on the OECD’s “grey” list of jurisdictions that have committed to the internationally agreed tax standard, but not yet substantially implemented it. The 11 jurisdictions with which Cayman has entered into a bilateral tax information exchange agreement were recognised but Cayman was not credited for the additional 12 jurisdictions to which it has extended the unilateral exchange mechanism described above. However a footnote to the list acknowledged the additional 12 jurisdictions and stated that this legislation is being reviewed by the OECD. It is hoped that this will lead to Cayman being removed from the “grey” list at the earliest opportunity and added to the “white list”. The countries with which Cayman has bilateral tax information exchange agreements are: United States, Denmark, Finland, Greenland, Iceland, Norway, The Faroe Islands, The United Kingdom, Sweden, Ireland, The Netherlands.

12. The Cayman Islands Government and CIMA have had ongoing dialogue with foreign national and international agencies such as the SEC and International Organization of Securities Commissions (“IOSCO”) to ensure that the Cayman Islands is viewed as cooperative and responsive in relation to requests for information on regulatory and criminal matters. This assistance was recently publicly recognised by the US Department of Justice in relation to an agreement reached with the Cayman Islands regarding a particular MLAT request and consequent prosecution in the US.

APPENDIX 5

REGULATION OF FINANCIAL SERVICES IN THE CAYMAN ISLANDS

1. CAYMAN ISLANDS REGULATOR

1.1 The Cayman Islands Monetary Authority (“CIMA”) is the financial services regulator, responsible for prudential and anti-money laundering regulation of hedge funds, investment managers, fund administrators and custodians as licensees and registrants under the Mutual Funds Law, the Securities Investment Business Law and the Banks and Trust Companies Law.
1.2 CIMA is a full member of the International Organisation Securities Commission ("IOSCO"), the Offshore Group of Banking Supervisors ("OGBS"), the Offshore Group of Insurance Supervisors ("OGIS") and the Offshore Group of Collective Investment Scheme Supervisors, as well as a member of the OECD’s Level Playing Field sub-committee.

1.3 CIMA adopts and applies the Basle Core principles (for banking), IAIS principles (for insurance), IOSCO principles (for securities and investment) and OECD principles for corporate governance.

1.4 In a review conducted in 2003, the International Monetary Fund ("IMF") recognised that an “extensive program of legislative, rule and guideline development has introduced an increasingly effective system of regulation, both formalising earlier practices, and introducing enhanced procedures.” (source: CIMA website).

1.5 As a regulatory matter, CIMA is empowered under the Monetary Authority Law (2008 Revision) to entertain requests for information from any recognised overseas regulatory authority exercising equivalent functions. Separately, CIMA has entered into Undertakings and Memoranda of Understanding with the multiple foreign regulatory authorities and agencies, including the US Securities Exchange Commission and the UK’s Financial Services Association.

2. Investment Funds

2.1 As part of the overall good governance of the financial industry, the Mutual Funds Law regulating mutual funds and mutual fund administrators, came into force in July 1993 and was most recently amended in August 2008. Responsibility for the regulation of mutual funds and mutual fund administrators rests with CIMA. Hedge funds and mutual fund administrators are required to be registered or licensed before commencing business.

2.2 The aim of the Mutual Funds Law is to protect investors and the Cayman Islands against undesirable promoters and managers of mutual funds by ensuring that only those with the appropriate experience and standing are permitted to establish and manage mutual funds in the Cayman Islands.

2.3 Whilst the content of investment objectives, rates of return or other commercial matters (such as the appointment of local custodians or managers) are not expressly subject to proscriptive rules, the position of the Cayman Islands law is that, provided proper disclosure is made and persons of appropriate experience and reputation are responsible for the mutual fund, investors should be free to make their own determination as to whether to invest.

2.4 There are three available forms of regulation of mutual funds under the Mutual Funds Law:

(a) The Licensed Mutual Fund

The first route is to apply to CIMA for a licence for the mutual fund that may be issued in the discretion of CIMA. It is necessary to file with CIMA an offering document together with the prescribed statutory form (Form MF3). If CIMA considers that each promoter is of sound reputation, the administration of the mutual fund will be undertaken by persons who have sufficient expertise and who are fit and proper to be directors (or, as the case may be, managers or officers in their respective positions), and that the business of the fund will be carried out in a proper way, then the licence will be granted. This route will be appropriate for mutual funds which are promoted by well-known and reputable institutions and which do not propose to appoint any Cayman Islands mutual fund administrator.

(b) The Administered Mutual Fund

The second route is for the mutual fund to designate its principal office in the Cayman Islands at the office of a licensed mutual fund administrator. In this case, an offering document together with the prescribed statutory form must be filed with CIMA. The administrator and the fund must also complete and file a prescribed statutory form. There is no requirement for the mutual fund itself to obtain a licence. Instead, the mutual fund administrator is required to be satisfied that each promoter is of sound reputation, the administration of the mutual fund will be undertaken by persons who have sufficient expertise to administer the mutual fund and are of sound reputation and that the business of the mutual fund and the offer of equity interests will be carried out in a proper way. The administrator must report to CIMA if it has reason to believe that a fund for which it provides the principal office is acting in breach of the Law or may be insolvent or is otherwise acting in a manner prejudicial to its creditors or investors (see the section below headed CIMA’s Powers’).
The Section 4(3) Mutual Fund

There exists a further category of regulated mutual fund pursuant to section 4(3) of the Law and which is of application either:

(i) where the minimum investment per investor is at least US$100,000; or

(ii) where the equity interests are listed on a recognised stock exchange.

For a section 4(3) fund, there is no requirement for licensing or the provision of a principal office by a mutual fund administrator in the Cayman Islands; rather the section 4(3) mutual fund simply registers with CIMA by filing an offering document together with the prescribed statutory form (Form MF1).

2.5 Every regulated mutual fund must issue an offering document (unless exempted by CIMA), which must describe the equity interests in all material respects and contain such other information as is necessary to enable a prospective investor to make an informed decision (whether or not to invest). In addition, the pre-existing statutory obligations with regard to misrepresentation and the general common law duties with regard to proper disclosure of all material matters continue in effect. There is an obligation to file an amended offering document in the event of material changes where there is a continuing offering. CIMA has issued guidelines regarding the form and content of offering documents for certain types of licensed hedge funds.

2.6 Every regulated fund must file, with its initial application, a written consent from each of the administrator and the auditor to its appointment.

2.7 All regulated mutual funds must (unless specifically exempted) appoint auditors (approved by CIMA) and file audited accounts within six months of the financial year-end.

2.8 CIMA has implemented its electronic reporting system for all funds registered with CIMA in the Cayman Islands. CIMA has released on its website the electronic Fund Annual Return (“FAR”) form and has opened the internet portal through which funds’ local auditors must submit the required returns. Related guidance notes have also been released. The FAR form and portal can be accessed at www.cimoney.com.ky/ereporting. The FAR form must be submitted annually through the fund’s auditor, although the operators of the fund remain responsible for the accuracy of the contents of the FAR form. All directors and investment managers of registered hedge funds should therefore put in place procedures to ensure compliance with these new requirements.

2.9 The fund must also inform CIMA if it has changed its registered office or its principal office or (in the case of a unit trust) if there has been a change in the trust company acting as its trustee.

2.10 The fund must also comply with any special conditions which CIMA has imposed in respect of its licensing as a mutual fund.

2.11 CIMA has wide-ranging enforcement powers under the Mutual Funds Law. If CIMA is satisfied, in respect of a regulated mutual fund, that: (a) the fund is unable or likely to become unable to meet its obligations as they fall due; (b) the fund is carrying on (or attempting to carry on) business or winding up in a manner that is likely to be prejudicial to investors or creditors; (c) the fund (if a licensed mutual fund) is carrying on business in breach of a condition of its licence; (d) the direction and management of the fund has not been conducted in a fit or proper manner; or (e) a person holding a position as a director, manager or officer of the fund is not a fit and proper person to hold the respective position, then CIMA has wide powers, eg to notify investors if circumstances permit, to appoint persons to assume control of the affairs of a regulated mutual fund, to require additional audited accounts to be provided, to reorganise the affairs of or dissolve a mutual fund or generally to take such other action as is considered necessary to protect the interests of investors or creditors including the cancellation of a fund’s licence or registration. The exercise of all such powers is subject to appeal.

2.12 An auditor is under a statutory obligation, when auditing the accounts of a regulated mutual fund or a mutual fund administrator, to notify CIMA if it obtains information or suspects that the fund or the administrator: (a) is or is likely to become unable to meet its obligations as they fall due; (b) is carrying on or attempting to carry on business or is winding up its business voluntarily in a manner that is prejudicial to its investors or creditors (or, in the case of a mutual fund administrator, in a manner which is prejudicial to investors in any fund administered by it or to its creditors or the creditors of such a fund); (c) is carrying on
or attempting to carry on business without keeping any or sufficient accounting records to allow its accounts to be properly audited; (d) is carrying on or attempting to carry on business in a fraudulent or criminal manner; or (e) is carrying on or attempting to carry on business otherwise than in compliance with the Law, certain other Cayman Islands laws and regulations (including as to anti-money laundering) or a condition of its licence (if a licensed mutual fund).

2.13 Any mutual fund administrator or auditor who (in good faith) advises CIMA that it has grounds for exercising its authority (as set out above) has the benefit of statutory protection from liability.

3. **Investment Managers, Investment Advisors, Brokers and Dealers**

3.1 The Securities Investment Business Law (2004 Revision) (the “SIB Law”) sets out a framework for CIMA to regulate securities investment business in the Cayman Islands. Any person conducting securities investment business must be licensed by CIMA, unless that person is exempt from holding a licence.

3.2 A person who carries on securities investment business and who is exempt from obtaining a licence may still be subject to registration under the SIB Law (which means that they are required to make an annual filing with CIMA). The SIB Law also creates certain offences.

3.3 Securities investment business is defined as being engaged in the course of business in any one or more of the activities set out in Schedule 2 of the SIB Law. The activities set out in Schedule 2 include:

- (a) dealing in securities as an agent;
- (b) dealing in securities as principal, but only where the person dealing holds himself out as dealing in securities at prices determined generally and continuously, or holds himself out as engaging in the business of underwriting securities or regularly solicits members of the public to induce them to buy or sell or subscribe for securities and the dealing results from that solicitation;
- (c) making arrangements in relation to securities with a view to another person dealing in securities or a person who participates in the arrangements dealing in securities;
- (d) managing securities belonging to another person on a discretionary basis; and
- (e) advising in relation to securities but only if the advice is given to someone in their capacity as investor or potential investor and the advice is on the merits of that person buying, selling, subscribing for or underwriting a particular security or exercising any right conferred by a security to buy, sell, subscribe for or underwrite a security.

3.4 An applicant for a licence must satisfy CIMA that: (a) it will be able to comply with the SIB Law (and any regulations made under the SIBL Law); (b) it will be able to comply with the Money Laundering Regulations (2009 Revision); (c) it will not be against the public interest, including, but not limited to the need to protect investors, for the application to be approved; (d) the applicant has personnel with the necessary skills, knowledge and experience and the facilities, books and records that CIMA considers appropriate; and (e) the applicant’s senior officers and managers are fit and proper persons.

3.5 Once CIMA has licensed the investment manager, a licensor’s obligations include the following:

- (a) the licensee shall separately account for the funds and property of each client and for the licensor’s own funds and property;
- (b) to notify CIMA of any change in its principal office or of the name of any body corporate or individuals acting as its agents in the Cayman Islands;
- (c) not to appoint a director or similar senior officer, or a general partner, as the case may be, unless CIMA’s written approval to the appointment has been obtained or CIMA has exempted the administrator from this obligation;
- (d) to have at least 2 directors;
- (e) subject to certain exceptions, no shares may be issued or transferred unless CIMA has either given its approval to the issue or transfer or waived the obligation to obtain that approval; and
- (f) to have its accounts audited annually by an auditor approved by CIMA and to send its audited accounts to CIMA within six months of the end of the relevant financial year together with a certificate of compliance with the provisions of the SIB Law and any regulations made under the SIB Law or the Monetary Authority Law (2004 Revision), signed by the licensee or if a company, a director of the licensee.
3.6 The investment manager is also required to comply with any special conditions attaching to its licence. CIMA may also make regulations in respect of licensees which:

(a) specify standards for the form and content of any advertising or promotion of securities or of securities investment business;

(b) require a licensee to make full and proper disclosure to clients of the capacity in which he is acting in relation to a particular securities investment business transaction and whether the transaction is being effected for his own account or that of any person other than the client;

(c) specify standards for dealings with clients and clients’ assets, including the holding upon trust of clients’ assets by the licensee;

(d) establish financial requirements and specify standards for financial conduct and record keeping and reporting;

(e) specify disclosure requirements in respect of the amount, value or arrangements for the payment or provision, of commissions or other inducements;

(f) specify arrangements for the settlement of disputes; and

(g) specify the nature and extent of any insurance arrangements required of the licensee.

3.7 A licensee shall not, without the prior written approval of the Authority, open outside the Cayman Islands a subsidiary, branch, agency or representative office or change its name.

3.8 CIMA has wide-ranging enforcement powers under the SIB Law. If CIMA knows or has reasonable grounds to believe that a licensee (a) is or appears likely to become unable to meet its obligations as they fall due; (b) is carrying on business fraudulently or otherwise in a manner detrimental to the public interest, to the interest of its clients or to the interest of its creditors; (c) has contravened any provision of this Law, or of any regulations made hereunder, or of the Money Laundering Regulations (2009 Revision); (d) has failed to comply with a condition of its licence; (e) has not conducted the direction and management of its business in a fit and proper manner, or has senior officers, managers or persons who have acquired ownership or control who are not fit and proper persons; or (f) has failed to comply with any lawful direction from the CIMA, then in such cases CIMA may (i) revoke the licence; (ii) impose conditions or further conditions upon the licence or amend or revoke any such conditions; (iii) apply to the court for any order which is necessary to protect the interests of clients or creditors of the licensee, including an injunction or restitution or disgorgement order; (iv) publish in the Gazette and in any official publications of CIMA, a breach by any person of the SIBL Law, of any regulations made thereunder or of any lawful direction issued by CIMA; (v) at the expense of the licensee, require the licensee to obtain an auditor’s report on the licensee’s anti-money laundering systems and procedures for compliance with the Money Laundering Regulations (2009 Revision); (vi) require the substitution of any director or officer of the licensee whenever appointed, or the divestment of ownership or control acquired under section 8 of the SIB Law; (vi) at the expense of the licensee, appoint a person to advise the licensee on the proper conduct of its affairs and to report to CIMA thereon; (viii) at the expense of the licensee, appoint a person who shall be known as the CIMA’s appointed controller, to assume control of the licensee’s affairs who shall, subject to necessary modifications, have all the powers of a person appointed as a receiver or manager of a business appointed under section 18 of the Bankruptcy Law (as revised); (ix) in the case of a reasonable belief that the licensee has materially contravened the Money Laundering Regulations (2009 Revision), report the same to the Attorney-General; or (x) require such action to be taken by the licensee as CIMA reasonably believes necessary for the purposes of dealing with the circumstances referred to in the aforementioned paragraphs.

3.9 Furthermore if an auditor of a licensee in the course of carrying out an audit or producing a report under the SIB Law becomes aware of or has reasonable grounds to believe that the licensee (a) is or is likely to become unable to meet its obligations as they fall due; (b) is carrying on business in breach of the SIB Law or any regulations made hereunder; (c) is carrying on or attempting to carry on business in a manner that is prejudicial to its clients or is winding up its business voluntarily in a manner that is prejudicial to its clients or creditors; or (d) is carrying on or attempting to carry on business without maintaining any or sufficient accounting records or record keeping systems to enable the auditor to carry out an audit or produce a report under the SIB Law, the auditor shall immediately give CIMA and the licensee written notice of his knowledge or belief giving reasons therefor, and an auditor who contravenes this provision is liable to removal by CIMA from its list of approved auditors.

3.10 CIMA may apply to the court for a licensee, former licensee or company that is or has been in contravention of section 5(1) to be wound up by the Court, notwithstanding any winding up of the company voluntarily.
4. **Mutual Fund Administrators**

4.1 Prior to the introduction of the Mutual Funds Law in 1993, service providers to mutual funds were normally licensed under either the Banks and Trust Companies Law or the Companies Management Law.

4.2 The Mutual Funds Law introduced two types of new licence, the mutual fund administrator’s licence and the restricted mutual fund administrator’s licence, one of which is required if the licensee proposes to undertake mutual fund administration. This is defined as the management, including control of all or substantially all of the assets of a mutual fund, or the administration of a mutual fund, the provision of a principal office to that fund or the provision of a trustee or, a director of that fund (depending on whether it is a company or a unit trust). Excluded from mutual fund administration are, inter alia, the activities of the general partner of a partnership mutual fund and the provision of a registered office at which statutory and legal records are kept or company secretarial work is undertaken.

4.3 CIMA will only grant a license to a fund administrator if the licensee meets the statutory test that it (a) has available sufficient expertise to administer regulated mutual funds, (b) is of sound reputation and (c) will administer regulated mutual funds in a proper manner. A mutual fund administrator requires a net worth of US$480,000; a restricted mutual fund administrator has no net worth requirement. The mutual fund administrator must itself have a principal office in the Cayman Islands with two individuals or a body corporate as its agent resident or incorporated in the Cayman Islands and may act for unlimited number of mutual funds.

4.4 A restricted mutual fund administrator may act in relation to such number of related licensed mutual funds as may be approved by CIMA (CIMA’s current policy is to permit a maximum of 10 funds) but is required only to have a registered office in the Cayman Islands. This category permits the promoter who incorporates a fund manager in the Cayman Islands to manage a related family of funds. Subject to CIMA’s approval, unrelated funds may be managed. The main difference, apart from net worth requirements and fees, is that, under current policy, a restricted mutual fund administrator will not be permitted to provide a principal office to the mutual fund so that every mutual fund for which a restricted mutual fund administrator provides mutual fund administration must, if not a section 4(3) mutual fund or exempted from registration under section 4(4) of the Law, be separately

4.5 Once CIMA has licensed the mutual fund administrator, its obligations are as follows:

(a) to notify CIMA of any change in its principal office or of the name of any body corporate or individuals acting as its agents in the Cayman Islands;

(b) not to appoint a director or similar senior officer, or a general partner, as the case may be, unless CIMA’s written approval to the appointment has been obtained or CIMA has exempted the administrator from this obligation;

(c) to have at least two directors;

(d) no shares may be issued or transferred unless CIMA has either given its approval to the issue or transfer or waived the obligation to obtain that approval; and

(e) to have its accounts audited annually by an approved auditor approved by CIMA and to send its audited accounts to CIMA within six months of the end of the relevant financial year.

4.6 The administrator is also required to comply with any special conditions attaching to its licence.

4.7 CIMA has the enforcement powers described in paragraph 2.12 above with regard to a licensed mutual fund administrator which does not discharge properly its private sector regulation or otherwise acts in breach of the Law, including revocation of the mutual fund administrator’s licence where it is placed in winding up (liquidation). Auditors have similar duties to report any issues to CIMA in the manner described in paragraph 2.13 above.

5. **Banking and Custody**

5.1 The Cayman Islands is recognised as one of the top 10 international financial centres in the world, with over 40 of the top 50 banks holding banking licences. As at June 2009, there were 270 licensed banks, with approximately two thirds being international bank branches. Banks and trust companies (including those that conduct custody business) which conduct business in the Cayman Islands must be licensed under the Banks and Trust Companies Law (2009 Revision) (the “BTC Law”). Branches and subsidiaries are regulated by CIMA on the basis of consolidated supervision in connection with the onshore home regulator.

5.2 Private banks number less than 20 and are required to establish a physical presence in the Cayman Islands, with a greater minimum net worth and capital adequacy ratio, (source: CIMA website).
5.3 For all banking licensees CIMA typically adopts more stringent capital adequacy requirements than proposed under the Basle Core principles.

5.4 Reasons to establish a banking presence in the Cayman Islands include the provision of multi currency accounts (without exchange restrictions) with access to international markets, depositary sweep facilities and internal treasury functions, on a tax neutral basis, all of which are performed with full transparency to and subject to the regulation of the onshore banking regulator.

5.5 Applications for licences under the BTC Law are made to, and reviewed in detail by, the CIMA. The Cayman Islands have for many years insisted that no disreputable or unsound banking or trust company business be conducted in or from the Islands. It is now also the policy that bank licences will only be granted where the applicants can demonstrate an established track record in the banking or finance industry and that the branch or new entity is or will be a member of a group with acceptable home-based supervisory regulation on a consolidated basis.

5.6 Trust licences will only be issued where those involved in the direction or management of the relevant entity have the necessary experience in trust and fiduciary business.

5.7 It should be noted that CIMA will not generally consider any application for a bank licence unless the applicant is part of an established banking group or has an established bank within its group of companies, has an established track record of at least five years and a capital base of at least US$50 million.

5.8 CIMA has the enforcement powers described in paragraph 2.12 above with regard to a licensed bank or trust company which does not discharge properly its private sector regulation or otherwise acts in breach of the Law, including revocation of the licence where it is placed in winding up (liquidation). Auditors have similar duties to report any issues to CIMA in the manner described in paragraph 2.13 above.

7 August 2009

Memorandum by Open Europe

Summary
Open Europe’s findings and recommendations are based on two separate surveys of the alternative investment industry carried out during August 2009. One of the surveys covered members of the Alternative Investment Management Association (AIMA), representing hedge fund managers from all over the world, which received 121 responses from managers representing $342 billion Assets under Management (AUM) (61% of the total size of the industry in the EU). The second survey covered members of the British Private Equity and Venture Capital Association (BVCA), which received 41 responses from private equity managers primarily based in the UK, representing funds under management of over $204 billion (66% of the total size of the industry in the UK).

AIFMs provide investment and create growth, jobs and more efficient markets across Europe. We estimate that the private equity sector and the hedge fund industry contributed around €9 billion (£7.9 billion) in tax revenues to the EU economy in 2008, enough to fund the EU’s overseas aid budget for 12 years. The £5.3 billion tax income in the UK alone is enough to pay for over 200,000 nurses or 165,000 teachers.

The idea behind supervising AIFMs is sensible. Indeed, most major EU markets, including the UK, already have requirements for compulsory authorisation and supervision of AIFMs and certain aspects of the Directive, such as the passporting provision, should be welcomed. However, our research has shown that unless a range of amendments take place, the AIFM Directive will impose substantial costs across the board, without offering sufficient benefits for the industry, investors or the wider economy.

In a worst case scenario, thousands of jobs and millions of pounds in tax revenues could be at stake. Because of the many restrictions in the Directive, AIFMs may decide to stop marketing their funds to EU investors. In this scenario, there would be little incentive for fund managers to remain in the EU at all. Restraining the AIF sector could also lead to less investment in European firms and make Europe a less attractive place for investors and talent from around the world, thereby reducing the EU’s overall competitiveness.

The Directive will mean that the choice for investors will be radically reduced—up to 80% in some cases. In our survey, several private equity managers also said that their ability to deliver returns for investors could be reduced by between 1 and 2%, and in some cases by as much as 5–10%, if the Directive comes into force in its current form, which would result in a loss of billions of pounds for the European pension industry. The cost to the industry will also be substantial. We estimate that the Directive will cost the private equity and hedge fund industries in the EU between €1.3 billion and €1.9 billion in the first year, with the annual recurring costs estimated at between €689 million and €985 million.
Our report identifies numerous problems with the draft Directive, including protectionism, its excessive scope, the prescriptive organisational rules and the amount of leeway provided for the European Commission to add to the Directive after it has been agreed.

We propose four steps to create a radically improved Directive, which are: better separation between different types of funds; freeing up investor choice by dropping the Directive’s protectionist elements; bringing the organisational requirements in line with existing EU law; and scrapping the restrictions on specific investment policies.

1. **What economic benefits arise from Alternative Investment Funds? What risks to financial markets arise from Alternative Investment Funds? Will the Directive help reduce these risks?**

1.1 There are numerous benefits of Alternative Investment Funds on the UK and wider European economies, most particularly job creation, economic growth and more efficient markets. We note that €51 billion was invested by private equity firms in European companies and that European pensioners, savers, charities and universities benefit from the AIF industry through increased returns and diversified investments.\(^{52}\) The basic private equity business model focuses on improving underperforming businesses and create value from them, which has significant economic benefits when successful. The global private equity industry has over $1 trillion in uninvested capital, and can thus be a much-needed source of capital for firms struggling to attract investment in the current economic climate.\(^{53}\)

The EU Commission itself acknowledges the benefits of AIFs, with the Commission’s partial impact assessment on the AIFM Directive noting, “As active participants in European financial markets, AIFM activities make a significant contribution to market liquidity and efficiency”. The European Central Bank has stated that hedge funds increase “the completeness of financial markets. This should ultimately also result in greater social welfare”.\(^{54}\)

Controversial practices, such as short selling, also have economic advantages, as is noted by the Swedish Central Bank (The Riksbank), which says “The benefits of short selling clearly outweigh the drawbacks” as “price formation will be more efficient”.\(^{55}\)

The tax income from AIFMs is also significant. Open Europe calculates that the private equity management sector and the hedge fund management industry contributed around €9 billion (£7.9 billion) in tax revenues to the EU economy in 2008, enough to fund the EU’s overseas aid budget for 12 years or France’s income from the Common Agricultural Policy.\(^{56}\) The £5.3 billion tax income in the UK alone is enough to pay for over 200,000 nurses or 165,000 teachers.

Additionally, we estimate that 40,000 people are directly employed in the management hedge funds and private equity in the EU, 18,000 of whom are employed in the UK.\(^{57}\) The alternative investment fund industry supports more than 30,000 extra jobs in the UK among advice and service providers and we estimate that around 724,000 people were employed by private equity backed firms in 2008.\(^{58}\)

1.2 There are clearly some risks associated with AIFMs, particularly in cases where funds are highly-leveraged or linked with large financial institutions. The AIF sector has also seen some shocking examples of market abuse in the last decade, and there needs to be a supervisory and regulatory structure in place to deter, detect and punish such behaviour.

1.3 We believe that there are positive aspects of the Directive that will help to reduce the risks that arise from AIFs and AIFMs. Our report notes that many of the principles behind the Directive are consistent with good market practice and draw on the themes established by the Hedge Fund Standards Board, IOSCO, and the Walker Report, for instance. We believe that the basic transparency and disclosure requirements in the Directive should be broadly welcomed. These could help to improve the industry’s reputation, create a better understanding of it, and prevent market abuse. It will also benefit both investors and managers by weeding out unscrupulous managers. Similarly, the requirements for compulsory supervision and authorisation already exist in most member states (for good reason), including the UK, and should be welcomed.

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\(^{52}\) See Open Europe, “The EU’s AIFM Directive”, 2009, pg. 9
\(^{53}\) Ibid.
\(^{54}\) Ibid.
\(^{55}\) Ibid.
\(^{56}\) Ibid., pg. 11
\(^{57}\) Ibid.
\(^{58}\) Ibid., pg. 12
However, it must be acknowledged that there are times when it is not possible for managers to provide the kind of data that the Directive requires, such as the obligation to provide a description of “all” the assets a manager may invest in, given that a manager may take hundreds of positions each day.

With regard to better supervision it is also unclear exactly what information managers are required to provide and for what purpose. The Directive is a ‘catch-all’ response that is not sufficiently targeted, which may therefore unnecessarily create additional costs to the industry and investors.

2. To what extent is there a need to create a single regulatory regime for Alternative Investment Fund Managers in the European Union? Does the Directive achieve its objectives? Should the objectives of the Directive be modified?

2.1 As has been widely acknowledged, the financial crisis neither began in nor was caused by the alternative investment industry, so in many ways the proposed draft Directive is a disproportionate response to the crisis, not least given the scope and prescriptive nature of the proposal. However, there are areas where the industry needs to improve and, given the cross-border nature of the industry and its significant effects on other financial actors, it seems appropriate for there to be supervision and a set of common standards at a supra-national level. But there is also a strong argument for addressing the issue primarily on the global level rather than on the EU level. At the moment, it appears as if the draft proposal undercuts rather than strengthens global initiatives for better regulation and market practice. It would have been better to establish global principles first—for example on custody—and then decide common EU rules on basis of the agreed global standards.

After all, this is an inherently global industry, and a unilateral EU response will not be effective.

2.2 We believe that the AIFM Directive falls far short of achieving its objectives, not least because it’s not entirely clear what the objectives are. For example, the Directive effectively excludes managers outside the EU from access to the European market, significantly reducing consumer choice and thus harms investors rather than protecting them, as is the Directive’s aim. Investors could be harmed further through increased compliance costs and reduced returns, should the Directive come into force.

Furthermore, the thresholds to be included in Directive’s proposals of €100 million for hedge funds and €500 million for private equity firms are far too low; even the European Commission’s own partial Impact Assessment admits that the benefits of such low thresholds do not outweigh the costs. The threshold levels in the Directive mean that many funds are included by the Directive despite being too small to have any effect on financial stability, thus the Directive exceeds its objective in this regard with the result of creating an unnecessary financial and administrative burden on AIFMs.

The Directive’s definition of what constitutes an Alternative Investment Fund also prevents it from achieving its objective of creating a “level playing field”. That funds managed by banks, insurers and sovereign wealth funds are excluded from the Directive whilst other Alternative Investment Funds with whom they compete are included creates an unlevel playing field—in direct contradiction with the Directive’s goal.

The goal of creating a “level playing field” is further undermined by the introduction of specific requirements for private equity firms. An obligation for them to comply with the Transparency Directive, for example, puts private equity firms at a disadvantage when compared with other buyers with whom they compete, such as family firms, wealthy individuals and sovereign wealth funds, as these are not subject to the same requirements.

The Directive’s definition of “high leverage” as the combined annual leverage of the AIF which exceeds its equity capital means that most, if not all, funds will be considered as running high levels of leverage. This again means that the Directive fails to focus only on “systemically important” funds and again exceeds its goal of reducing systemic risk.

In some cases, the draft Directive may in some cases even increase risks and the scope for market abuse. For instance, the obligation on managers to appoint an “independent” agent to assess what the assets in the manager’s fund are worth (see below); or the requirement for all funds marketed in Europe to deposit their cash and assets with an EU-based bank (depository). Quite aside from the massive cost this will impose on the industry, the requirement may in fact increase the risks associated with depositing assets, due to the concentration of deposits, lack of choice and disregard for best market practice.

And critically, if one of the objectives of the draft Directive is to try to get AIFs domiciled offshore to relocate to an EU domicile, the proposal appears counterproductive. Only 23% of hedge fund managers responding to our survey said the Directive would make them more likely to move to an EU domicile, whilst 27% said...
they would be less likely to move their funds onshore. A clear majority of managers also said that it would be difficult for them to deliver their investment strategies through a UCITS-structure, and so bring their funds onshore. Therefore, the draft Directive appears to provide a boost for the offshore management model, rather than an end to it. This means that the proposal represents a missed opportunity. Policymakers should instead consider a genuine review of the taxation, regulation and governance of the alternative investment industry, and so provide a real incentive for funds to move onshore.

2.3 We feel that the creation of a single regulatory regime in the EU should not extend to entrenching protectionism within the industry and severely limiting access to European markets by offshore (ie all non-EU) Alternative Investment Managers; thus this underlying protectionist objective—explicit or not—should be changed. The Directive also needs to be much clearer on what it is trying to achieve, in terms of preventing systemic risk and increase investor protection.

3. **What risks arise from Alternative Investment Funds? Is the Directive proportionate given the role of AIF in the financial crisis? Will the Directive introduce over-stringent regulations or does it not go far enough?**

3.1 See above.

3.2 As has already been mentioned, it is widely acknowledged, including by the de Larosiere Report, the Turner Review, the G20 and the European Commission itself, that the alternative investment industry did not cause the financial crisis.Whilst we accept that there are areas where better regulation of the industry is needed, the Directive is a hugely disproportionate response to this, generating extra burden for Alternative Investment Funds, their investors and regulators, without offering sufficient benefits in return.

3.3 The Directive creates over-stringent regulations and threatens to radically increase the compliance cost for the industry. Our survey show that, on average, private equity and hedge fund managers expect their compliance cost to increase by one-third if the draft Directive comes into force.

Our report estimates that compliance costs will cost the private equity and hedge fund industries in the EU between €1.3 billion and €1.9 billion (£1.2 billion and £1.6 billion) in the first year, in addition to annual recurring costs of between €689 million and €984 million (£597 million and £853 million). The draft Directive could also have a negative impact on the economy as a whole and lead to losses of tax revenues and jobs. As our report details, much of the extra burden placed on AIFMs stems from provisions that are irrelevant or even counterproductive, and, as has already been mentioned, many of the regulations ultimately contradict the main aims of the Directive.

4. **Is it appropriate to regulate Investment Fund Managers, rather than the Fund itself? Does the Directive contain appropriate provisions to distinguish between different types of alternative investment? Does the scope of the Directive create a danger of unintended consequences?**

4.1 We think it is appropriate to regulate managers rather than the funds themselves as this provides the regulator with oversight of all the funds under the control of the manager, both inside and outside of the EU, and thus allows the regulator to take a broader perspective on the industry.

4.2 We consider the Directive’s definition of an AIF to prevent the distinction between different types of alternative investment and that this is one of the directive’s major problems. Because of the very broad definition, the Directive includes not only private equity and hedge funds, but also funds of hedge funds, real estate funds, listed closed-end funds, infrastructure funds, commodity funds, long-only funds and non-UCITS retail funds, for instance. This is problematic, as many of the these funds differ fundamentally from one another, and many of the Directive’s provisions seem to have been written with hedge funds in mind, and are irrelevant for other types of AIFs.

4.3 We believe that this overly broad scope could create numerous unintended consequences, which could harm the industry and the economy as a whole. In addition to the fact that the definition means that many of the Directive’s requirements do not make sense for large parts of the alternative investment industry, the inclusion of smaller funds in the Directive presents a significant threat to the industry’s smaller players, with knock-on effects for the industry and economy, such as less investment in European firms. The broad scope also creates risks for market distortion, as noted above.

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65 Ibid., pg. 13
66 Ibid., pg. 19
67 Ibid., pg. 22
68 Ibid.
5. What is your evaluation of the Commission’s consultation in the preparation of the Directive?

5.1 We agree with Lord Myners in his description of the European Commission’s lack of consultation on the Directive as “lamentable” and would point to the fact that consultation lasted only six weeks, including the Christmas holidays, contravening the Commission’s guidelines stating that consultation should be open for “at least eight weeks”. We feel that the timetable for the Directive in general has been unusually aggressive and note the apt comparison made by Pierre Bollon of the French Asset Management Association (AFG): “While the European Commission took more than five years to adopt the Ucits IV Directive, and took the time to consult various state and industry actors, [the AIFM Directive] was put together and published with haste in only five weeks.” This is peculiar, as neither the de Larosiere Report, nor the Turner Review, proposed urgent action in this area.

5.2 In addition to the aggressive timetabling of the Directive, the Commission’s consultation related only to hedge funds, ignoring the numerous other AIFs encompassed by the Directive, despite the Commission’s stated commitment to “consulting as widely as possible on major policy initiatives.”

6. Will the passport system help create a single market in investments funds within the EU? How will the passport system established affect the EU and the UK industry and particularly their position in the global market?

6.1 The “passport” system in itself should help create a single market in AIFs across the EU and we welcome this proposal and its potential to enhance the Single Market.

6.2 The ability to trade in AIFs across the EU that the “passport” brings should result in significant benefits to both managers and investors, through increasing investor choice and opening new markets for managers.

We are concerned, however, about the baggage with which the “passport” provision comes with at the moment, and fear that it may cause significant harm to the UK and EU industries. Combined with the restrictions put on non-EU managers and funds, the provision means the effective exclusion of non-EU AIFMs from the EU, which would significantly reduce investors’ choice and could trigger protectionist countermeasures from other countries, such as the United States. The exclusion of such firms would have a harmful effect on the EU and UK’s positions in the global market, as it would make the UK/EU a less attractive place for managers, investors and talent from around the world.

Furthermore we believe that firms falling below the Directive’s thresholds should be able to opt in to the passport provision without being subject to the Directive’s other regulations, owing to the disproportionate effect that such regulations would have on smaller firms.

In addition, managers that are allowed to market their funds to investors under the Prospectus and MiFID Directives should be allowed to do so also in future, irrespective of the AIFM Directive. Likewise, so-called “reverse solicitation”, similar to that laid down in the UCITS Directive, should be allowed, ie when a fund is approached by a professional investor—and not the other way around—the AIF/AIFM should not be subject to the AIFM Directive’s marketing requirements.


7.1 As was discussed in 2.2 we believe that the thresholds for inclusion in the Directive are far too low and the European Commission’s own partial Impact Assessment has said that the benefits of such low thresholds do not outweigh the costs. The threshold include firms with no systemic importance, thus giving them a significant financial and administrative burden for no clear purpose and the threshold for private equity firms breaches the subsidiarity principle as firms managing less than €1 billion usually invest in local or regional, or heavily specialised, firms.

7.2 As several legal analyses have pointed out, it is rather odd that the capital requirement is based on AUM, rather than expenditure. The FSA, for instance, requires fund managers in the UK to hold capital at all times, equivalent to at least 25% of their annual expenditure. This is to ensure that the manager company can continue its operations even when its income (generated through fees) is suddenly reduced, while the regulator...
can step in to appoint another manager and/or gradually wind down the fund. This is probably a more sensible solution than the one proposed by the AIFM Directive.

7.3 As was also mentioned in 2.2 the Directive’s rules on leverage are excessive. The current definition means that most, if not all, funds will be considered as running high levels of leverage, rather than only those considered to be systemically important.\(^78\)

In addition, the use of leverage does not necessarily bring about higher investment risks as AIFs can also finance relatively low-risk investments through leverage. Furthermore, the risk primarily arises at the level of the lending banks, which are already regulated by the Capital Requirements Directive.\(^79\) Also, pre-set leverage limits may in fact make the markets more unstable. As the Swedish Government has noted:

“Ex ante leverage caps can give rise to procyclical effects which could exacerbate any instability on the markets. This is due to the fact that in a market downturn, a number of AIF might simultaneously breach their caps (the leverage ratio would automatically go up) which could trigger a mass de-leveraging, potentially deepening the downturn and affecting market stability.”\(^80\)

7.4 Our report found that there are many aspects of the Directive’s valuation requirements that are concerning. Whilst the principle of independent valuation is similar to what is currently recommended as best practice by bodies such as the Hedge Fund Standards Board, the Directive goes too far.

Whilst valuation does take place within the industry at the moment (either in-house or through an outsourcing arrangement) it is considered part of the fund manager’s remit. The Directive introduces the requirement for a legally independent valuator (the meaning of which is currently unclear), which would prevent the manager being involved in the valuation process at all, which represents a significant change to current market practice.\(^81\) We also note that this change could impose significant additional costs on both AIFMs and administrators, as most managers would be required to change valuators. It would be better if the draft Directive considers valuation as a function of the AIFM rather than a completely separate entity.

There are currently no standards set in the EU for valuation—under the draft Directive, these will be set by the European Commission in the future. This raises the concern that there is the potential for the EU to effectively restrict valuation to EU-based valuators only, which could prove problematic as it is unclear whether there is enough expertise in the EU for the type of regulation required by the draft rules. A restriction to solely EU-based valuators could, therefore, reduce the current standards of valuation, rather than strengthening them.\(^82\)

In addition the valuation requirement is not relevant to the private equity industry, as was pointed out by virtually every single private equity manager responding to our comprehensive survey. This is because the value of the company a private equity firm has invested in is essentially irrelevant until the shares in this company are sold, at which point the value of the company is certain.\(^83\)

The requirement in the Directive for an EU-based credit institution to act as a custodian for AIFs’ assets would completely undercut the current business model, in which AIFMs make use of prime brokers. Curiously, the draft Directive does not even mention prime brokers. It is thought that there are only four prime brokers that currently have credit institution status in the EU. This means that in most cases the manager must appoint an EU-based custodian, which must then appoint a prime broker to do the actual safe-keeping. While this is a clumsy arrangement in itself, it is made worse by the fact that the Directive is also making custodians liable for any failure of the prime broker/sub-custodian.

This requirement goes far beyond existing EU law and it is hard to see how it will work in practice. In its report on the proposed Directive, the Swedish EU Presidency noted, “Given the global character of the activities of many market players, the current draft does not seem workable” on this point.

8. Will the provisions strengthening disclosure requirements help to create a more transparent market or do they go too far?

Whilst we believe that the principle of disclosure is positive and should be welcomed, we also think that the Directive’s requirements for extra disclosure for private equity firms go too far. These requirements oblige private equity managers to give significant amounts of information to shareholders, on for example development and employment matters, which is peculiar as the company’s Board of Directors, rather than its shareholders, are usually responsible for this type of information.\(^84\) There have even been some concerns in

\(^{78}\) Ibid., pg. 17
\(^{79}\) Ibid., pg. 27
\(^{80}\) Ibid.
\(^{81}\) Ibid., pg. 24
\(^{82}\) Ibid.
\(^{83}\) Ibid.
\(^{84}\) Ibid., pg. 28
the industry that this aspect of the Directive may be in conflict with the company law of most member states. In addition, as noted above, this extra disclosure requirement threatens to distort competition, as other “private” buyers are not subject to the same requirements.

9. What effect will the Directive have upon the position of the City of London and the EU as a whole as a leading location for Investment Fund Managers? Could it cause many hedge funds to relocate outside of the EU? What impact would the Directive have upon professional investors and institutions?

9.1 Our report conducted the most comprehensive impact assessment to date of the Directive and we concluded that the draft Directive could have a significantly negative impact on both the City of London and the wider EU economy, through reduction in investment, capital flows, job creation, etc.

The protectionist element of the Directive, which would effectively restrict the European market in AIFs to EU-based managers, would harm the UK and EU economies as fewer managers are able to do business within the EU.

9.2 The significant extra restrictions alongside the restructuring and compliance cost placed upon AIFMs could encourage managers to stop marketing their funds to EU investors altogether, in which case they have little incentive to remain in the EU at all. In that case, they could move to less regulated economies, notably Switzerland and the United States.

9.3 Our survey showed that only 2% of AIFMs’ clients have thus far viewed the Directive favourable, despite the Directive’s supposed goal being investor protection. We believe that this is not surprising as the Directive significantly limits investor choice and possibility to get value for their money.

Investor choice will be significantly reduced as investors will no longer have a free choice from the best performing funds and fund managers as, under the Directive, they will be restricted to managers and funds established in the EU. As our report illustrates, only around 20–25% of hedge fund managers are based in the EU. Thus, unless a series of international deals on taxation, regulation and information are agreed between EU and non-EU countries—as required by the draft Directive—investors could suffer a 75–80% loss of choice. We consider it to be unlikely that such agreements will be reached, hence the loss of choice for investors could be massive.

The same applies for funds, as EU-based investors could be restricted to choose from the less than 16% of funds currently managed by EU-based managers. Whilst it is unlikely that the loss of choice would be quite this extensive for funds, since some taxation agreements are likely to be reached, we believe that this still gives an indication of the potential restrictions put on investors and the change to manager-investor relations that would follow.

Professional investors and institutions would also have their returns affected as the Directive could hamper managers ability to deliver returns. Indeed several private equity managers said in our survey that their ability to deliver returns for investors could be reduced by between 1 and 2%, with some giving estimates as high as 5–10%. The amount of money invested in AIFs is such that even if only the lower-end estimates prove correct, European investors still stand to lose billions of pounds, with AIMA calculating that the loss of choice and reduction in returns could cost the European pension industry as much as €25 billion. In addition, much of the compliance cost to the industry could be passed on to investors.

In the end, these various costs will hurt individual savers and pensioners.

10. How does the Directive compare to existing or proposed regulation of Alternative Investment Funds outside of the European Union, particularly that of the United States? How will the Directive affect the position of EU Alternative Investment Funds in the global market?

10.1 —

10.2 The additional regulatory burden that would be placed upon EU AIFMs would significantly weaken their position within the global market, particularly given the absence of such stringent legislation in comparable economies.

85 Ibid.
86 Ibid.
87 Ibid., pg. 17
88 Ibid., pg. 18
89 Ibid.
11. **What effect will the Directive have on flows of capital and financial innovation?**

One of the main strengths of the Alternative Investment Fund industry, particularly in the current economic climate, is that it provides a supply of capital to firms that may otherwise struggle to attract investment, and our report cites numerous examples of where AIFs have provided significant capital to firms, creating jobs and economic growth. We believe that restraining AIFMs could result in less start-up capital for entrepreneurs and less money in the EU economy to spur innovation and growth. Furthermore, the exclusion of non-EU based AIFMs from the EU market represents a considerable barrier to international capital flows.

**September 2009**

**Memorandum by Poul Nyrup Rasmussen, President, Party of the European Socialists**

1. **What is your overall view on the current proposal on alternative investment fund managers (AIFM)? Would the proposal help prevent a future crisis?**

There is an almost unprecedented financial crisis. Alternative funds are part of the financial system. As a matter of principle, they urgently need to be regulated. The regulatory scheme must be watertight—there must be no “crack in the dam”.

The crisis is undeniably linked to an excessive and uncontrolled use of leverage—and hedge funds and private equity are to a large extent co-responsible for this situation. But even long before the actual financial crisis we identified in an in-depth study, ”Hedge Funds and Private Equity: A Critical Analysis”, a number of problems related to the behaviour of hedge-funds and private equity i.e. the high level of leverage, herd effects and procyclicality, extremely high fees and tax evasion.

(1) Hedge funds are characterised by the very same factors that make banks systemic—they use leverage, very high in many cases. They also have serious asset-liability mismatches. In de Larosière report, they were described as being part of a “parallel banking” system. History tells us that unregulated banking always ends up in huge collapses. The most high profile example of the problems relating to hedge funds, before the current crisis, was the collapse of LCTM at the end of the 1990s. It had a ratio of $200 in debts for each dollar of own capital. Its failure threatened to unleash a wave of fire selling of LCTM assets and led liquidity on many markets to almost totally disappear. In the end, a meltdown of the global financial system was avoided at the last moment by the Federal Reserve pressing major banks to bail out LCTM.

(2) This time, the financial crisis began with the collapse of two Bear Stearns affiliated hedge funds, the Bear Stearns High-Grade Structured Credit Fund and the Bear Stearns High-Grade Structured Credit Enhanced Leveraged Fund, in March 2007. The U.S. Treasury Department and the Board of Governors of the Federal Reserve intervened to rescue Bear Stearns in the spring of 2008, which revealed that hedge funds were de facto considered systemically significant. The lack of regulation of hedge funds meant that regulators did not have the minimum information required to monitor and manage systemic risk. Another example is the Carlyle Capital Corporation, a hedge fund specialized in mortgage-based assets which was leveraged up to 32 times, and which defaulted on about US$ 17 billion of debt.

(3) Academic research has brought to light a number of features of hedge funds: their returns are largely based on hidden risks and high vulnerability to infrequent risk (as evidenced, for instance, by the skewness or the excess of kurtosis of their risk profile), they use high levels of classic as well as embedded leverage, they divert a high level of the investments in extremely high fees, they have played a major role in the dissemination of risky products directly linked to the crisis (for instance, almost half of Collateralized Debt Obligations were purchased by hedge funds).

The ECB has also identified hedge funds as source of risk. They consider that the failure of a large individual or a group of hedge funds could lead to far-reaching repercussions for exposed banks and financial markets, the serious mismanagement of exposures to hedge funds at an individual bank or banks might lead to a
systemic crisis via contagion effects, and that instability could be initiated through the impact of hedge fund activities on financial markets. As early as 2006, the ECB had identified further risks:

- The returns of different hedge fund strategies have become more correlated over time. Likewise, correlations between individual hedge funds classified in the same strategy have increased.
- Hedge funds are investing in increasingly illiquid positions. This asset illiquidity exposes them to the risk of sudden redemptions from investors leading to a forced sell-off of illiquid assets.
- Finally, in certain market conditions (poor fund returns, increasing risk aversion, increasing interest rates), high investor redemptions are to be expected. Still as far back as 2006, the ECB noted that “important risks may be developing—although they are extremely difficult to quantify—related to credit risk transfer markets in which hedge funds have become increasingly present.”

(4) So, we know, from experience, that hedge funds can potentially cause or trigger a financial crisis, even though they were not the root cause of this latest financial crisis. That’s why regulating hedge funds, not only by supervising them (which implies requiring them to register) but also by preventing excessive leverage and any other practices which can have a destabilising effect on the markets, would contribute to prevent a future crisis. In that respect, the current proposal will help prevent a future crisis.

(5) With respect to private equity, it is common knowledge that private equity’s returns are based on leverage. When the level of debt is high, companies that have been the subject of an LBO will be more fragile in crisis time. Private equity also has a pro-cyclical effect in crisis time.

As far back as 2006, the ECB noted “in the euro area, rapid re-leveraging in some parts of the corporate sector—partly induced by a surge in leveraged buyout activity facilitated by private equity funds” (. . .) “will require close monitoring in the period ahead.”

A 2009 Ernst & Young report indicated that more than half of the profits generated by private equity firms in recent years result from debt accumulation. The higher the amount of debt used to buy a company, the better the return in a successful investment. Only a fifth of the profits came from strategic and operational improvements.

Higher debt burdens on targeted companies reduce their chances of survival. Standard & Poors reports on “weakest link” companies (those with a B minus or lower rating, and nearest to default) feature private equity involvement. A July 2009 report indicated that of the 293 “weakest link” companies more than half have or have had private equity holdings. Of the further 140 companies that actually defaulted, private equity firms were involved in at least 79 of them.

(6) There is some evidence that PE—controlled companies create less jobs (or destroy more jobs)96 than other companies. In addition, a substantial portion of these companies use their cash-flow to reimburse the debt taken on by the acquisition vehicle to buy them. In a number of cases, this leads to a diversion of resources away from useful investment and growth. From a macro-economic standpoint, PE results in a higher level of debt throughout the economy (the total LBO debt is estimated around USD 1,000 billion)97 and the corresponding risk has been well identified for a long time.98 In addition, through the use of CDOs, the debt linked to leveraged buy-outs has been disseminated in the economy.

It is thus critical to control the level of leverage used by private equity.

(7) However, for the current proposal to be more effective in preventing the crisis, we need to address its some loopholes and look at some other practices:

1. The proposal covers only EU-based fund managers (not the funds themselves, and not managers based elsewhere).
2. The registration proposed is a formality with no real requirements.
3. It sets a threshold of €100 million for hedge funds and €500 million for private equity, which will herald a golden age for fund managers and “consultants” to collude in circumventing the threshold.
4. The capital requirements are miniscule (calculated as 0.02%).
5. Transparency is inadequate in terms of information to be provided and frequency of reporting.
6. There is no real disclosure of portfolio companies.
7. Nothing on market disruption by non-EU funds.

97 “Get Ready for the Private Equity Shakeout—Will this be the next shock to the economy?”, Boston Consulting Group, December 2008.
98 See for instance the FSA Discussion Paper, 06/6, “Private equity: a discussion of risk and regulatory engagement”, where the risk was clearly identified.
8. No regulation of naked short-selling.
9. No specific protection of institutional investors.

2. To what extent will the Directive improve the detection of systemic risk caused by alternative investment funds and help reduce this systemic risk?

(1) Registration systems, together with the necessary micro and macro supervision framework, are essential to evaluate the total amount of leverage in the economy.

On the other side of the Atlantic, people are very much aware of this. In the US, President Obama is moving fast to regulate. On 17 June, Obama announced a real, comprehensive, wide-ranging plan for regulatory reform of the financial markets, including the registration of advisers of hedge funds and other private pools of capital with the SEC.

Obama also stated, and I quote, that he “urges national authorities to implement by the end of 2009 the G-20 commitment to require hedge funds or their managers to register and disclose appropriate information necessary to assess the systemic risk they pose individually or collectively”.

The European Directive uses an “all encompassing” approach, which means that all collective investment vehicles are addressed to the extent they are not regulated under the UCITS directives. This will prohibit any attempt of regulatory arbitrage within the EU. Closed-end and open-ended funds are addressed. This is an important step towards the registration and supervision of all financial players.

The Directive is useful to the extent it provides regulators with more information. In its opinion released in October, the ECB has stated: “The proposed provisions on reporting to the competent authorities should, in principle, contribute significantly to enhancing financial stability monitoring”. Information is a key component in the prevention of crises.

In the existing, pre-Directive system, there is much reliance on self-discipline and micro-prudential investor control. However, this system is not efficient—both the investors and the funds may act diligently and reasonably, and yet the system may fail. This is the well-known “paradox of aggregation”. Anybody who has ever been a spectator at a crowded football or rugby game has witnessed the difference between microeconomics and macroeconomics: from a micro perspective, it is rational for each individual to stand up to get a better view; but from a macro perspective, each individual acting rationally will produce the irrational outcome of everybody standing up, but nobody having a better view.

(2) Although registration is a necessary step to identify systemic risk, it is not sufficient to reduce it. The Directive must provide for the necessary tools to curb the risk created by alternative investment:

— The tools to limit the risk must be broad enough to capture all types of risks. They must include limits on leverage, controls on liquidity mismatches and capitalization rules.
— The Directive itself must set limits. Details of the proposed regulation may be left to level 2 legislation, provided the Directive itself is clear enough. The limits should include absolute “bottom line” limits as well as limits set at the European level (for instance by ESMA) on the basis of the economic situation.
— The regulation must also provide for a principle of counter-cyclicality.
— The Directive must also address destabilizing practices such as naked short selling.

So, the Directive will improve the detection of systemic risk caused by alternative investment funds and help reduce this systemic risk, provided that it is implemented as part of a package of measures providing the necessary supervisory and regulatory tools.

3. The AIFM proposal covers a wide range of funds already subject to different local and EU regulations and with very different characteristics. A previous witness suggested that without significant revision, the Directive will lead to less choice and greater costs for investors with the EU, without achieving the stated objective of the Directive. Can you comment on these concerns?

The alleged potential impact of the Directive on the industry should be viewed against the significantly negative effects the industry has had on the real economy. While private equity funds have been engaged in ladening companies with excessive debt, hedge funds have played a role in exacerbating the financial and economic crisis, with the consequences we all know. Investors have made huge losses. Thus, slightly higher regulatory compliance costs would actually prevent far greater losses in future for investors but also for the wider economy.
I therefore wish to submit the following points for your consideration:

— “More costs” means “more immediate costs”. However, what really matters are total costs, after taking into account all costs induced by the failure of some funds or their excessive risk taking.

— Your previous witness mentioned the cost “for investors”. I submit to your attention that this is not the most important factor for determining the value of financial regulation. The most important factor is the overall cost to the economy, of the regulatory scheme. In this context, the Directive would lead to lower total costs.

On this question, I would also like to make two further comments:

The first comment regards costs for investors. These costs were never particularly low. With management fees of 2% (uncapped) and hurdle rates typically set at 20%, the cost of the service was in fact quite high. A study has even shown that, once these costs had been paid, the average result of funds were not as good as the SP 500 (Gottschalg).

In addition, the cost to society is high. Carried interest is not taxed as income in several countries, but as long term capital gains, at a reduced rate. Private equity also uses leverage very extensively. As interests are tax deductible, these highly leverage structures bring little to the taxpayer. Funds and fund managers are heavily tax subsidized. Alternative investment is costly to investors and to society.

Costs should also be viewed in the context of corresponding benefits. What have investors and the wider economy gained in exchange for high fees and tax subsidies under the current system? Effective regulation will ensure more transparent costs and sustainable returns.

And finally, we should take into consideration the fact that the draft European Directive will give alternative investment funds access to the entire single market—the biggest economy in the world. It grants the industry a uniform private placement regime, which will make it easier to do business. As a result, it is likely that investors will end up with more choice rather than less.

4. We have heard concerns from other witnesses that the Directive as drafted appears to aim to offer a retail level investment protection, whereas alternative investments are overwhelming utilised by professional investors and so do not require this level of protection. Do you agree with this view?

The Directive does not go very far in the direction of “retail level protection”.

First, the crisis has shown that so-called “professional investors” were very often far from understanding the extent of risk they were taking and the mechanisms pursuant to which these risks might unfold.

When alternative investments concerned mostly high net worth individuals for limited total amounts, no detailed regulation was needed. Now, we are talking about products that:

— Will receive funding from retail sources through funds of funds, or from institutions that are entrusted with public money, such as pension funds, retail banks or insurances. According to a recent FSA study, more than 80% of investors in hedge funds are institutional investors—for instance pension funds—and not high net worth individuals. Through pension funds or municipality funds, the risks are spread indirectly to final investors who may be retirees or local tax-payers.

— Will become much more accessible to all investors—including, in practice, retail investors—through the passport mechanism.

In this new context, more detailed regulation is needed. To the extent necessary, the UCIT directive will need to be revised for harmonization purposes.

5. Do you agree with the decision made by the Commission to regulate the managers of AIFs rather than the products themselves? Other evidence we have received argues that the Directive regulates more than just the managers by including measures designed to regulate the fund itself. Can you comment on the argument that this a case of a product regulation by the back door?

One major loophole I want to close in the directive is that it covers only EU-based fund managers not the funds themselves. I think both fund managers and funds need to be covered, in particular as offshore funds are most often used for tax and regulatory arbitrage reasons.

I note that, with the notable exception of the US and the UK, almost all countries regulate funds as well as managers. This includes Australia, Brazil, Canada, France, Germany, Hong Kong, Ireland, Italy, Japan, Jersey, Luxembourg, Mexico, the Netherlands, Portugal, Spain and Switzerland.
The right territorial criterion to use when determining which fund manager or fund should be registered is not only the location of the entity (as it may easily be relocated offshore) but the location of the final investors—EU regulation should provide protection to EU investors irrespective of the location of the fund or the fund manager.

6. **What is your assessment of the proposed provisions on leverage?** How can leverage limits be used to reduce systemic risk? Do you agree with the view that the Commission should not seek to impose leverage limits for hedge funds as a leverage ratio is not necessarily a good indicator of the risk represented by the fund? Do you believe that higher capital requirements on prime brokers may result in effective indirect supervision of hedge funds’ leverage?

What is your assessment of the proposed provisions on leverage?

If you look at the specific provisions for hedge funds, the proposed control of leverage is a good step forward, although some improvements could strengthen the effectiveness of the directive considerably:

1. Indeed, under this Directive, an AIFM employing leverage on a systematic basis above a defined threshold will be required to disclose to the competent authorities the aggregate leverage, the form of leverage (cash borrowing, securities borrowing, leverage embedded in derivatives), and the main sources of leverage (lending institutions such as prime brokers, banks etc) to the home authority of the AIFM. Information on the level of leverage must be disclosed on a quarterly basis to investors. However, the frequency of disclosure is left to implementing measures and the relevant information should be disclosed to supervisors on a periodic basis which is sufficient to provide a close monitoring.

2. The proposal includes the introduction of limits to leveraging by the Commission and recognises emergency powers for authorities of the home Member States to restrict the use of leverage in respect of individual managers and funds, “if the stability and integrity of financial markets so requires”. The condition should be “if the stability or integrity of financial markets so require”.

**How can leverage limits be used to reduce systemic risk?** Do you agree with the view that the Commission should not seek to impose leverage limits for hedge funds as a leverage ratio is not necessarily a good indicator of the risk represented by the fund?

1. All hedge funds are not the same and regulators need to take into account their size and/or leverage and/or asset-liability mismatch and/or inter-connectedness. This assessment has to be updated regularly over time, by the monitoring process allowed by the registration of hedge funds. Once this is done, there is a need to have more stringent supervisory and regulatory requirements for systemic funds including but not limited to (1) minimum capital adequacy ratios, (2) minimum liquidity requirements and (3) other appropriate prudential norms such as restrictions on leverage.

2. Ex ante limits on leverage should be more clearly specified and there should be rules regulating the division of risks and providing for capital adequacy requirement. Ex ante limits to leverage are left to implementing measures and rules on division of risk should be added. Specific limits should depend on the type of activity, the risk profile of the fund and the maturity of their funding. Margin capital requirements could also be required when positions become large in a particular market or grow quickly. This means that meaningful capital adequacy requirements must be introduced. These limits should be set up ex ante and take into account the stability or integrity of financial markets and the general situation of the economy.

Therefore, the Commission, while seeking to impose leverage limits for systemically relevant hedge funds, would consider not only their leverage ratios, but also other relevant items (type of activity, the risk profile of the fund and the maturity of their funding).

**Do you believe that higher capital requirements on prime brokers may result in effective indirect supervision of hedge funds’ leverage?**

1. It is indeed essential to address the issue of prime brokers, because they are key partners of funds. Considering the risk they incur, additional capital requirements should be imposed under upgraded Basel 2 rules. These requirements should be based on the type of fund and could be increased if the level of disclosure does not comply with applicable rules.

2. Another issue that needs to be addressed is the creation of a Global Credit Register. The European Central Bank and now the High-Level Group on Financial Supervision chaired by Jacques De Larosière have proposed the setting up of a global credit register. There have been additional proposals for the creation of a global directory of all trading positions to help identify systemic risk arising from credit and counterparty exposures and from herding and contagion in the financial markets. This register should be set up and all information that is collected should be filed with it.
7. What is your assessment of the proposed provisions on passporting of non-EU products?

In its evidence to the Committee, AFG (The Association Française de la gestion financière) argues that the passport system will help to develop a truly single market in investments funds within the EU as long it is limited to EU funds and managers. If the AIF passport was to be extended to non-EU funds and managers it will imply that, in the case of collapsing of a non-EU AIF, the European investor would have to go before a non-European court to try to recover its money, creating legal and potentially political risks. Conversely, we have received much evidence criticising the 3rd country marketing provisions as protectionist. Could you comment on these two different points of view?

I am favourable to a passport provided that an appropriate set of rules is applicable. Competition will increase and investors will have a broader choice. Besides, the creation of a single regulatory at EU level will reduce regulatory arbitrages and decrease legal uncertainty, and thus will directly enhance investor protection.

However, it does not make sense to impose strict requirements to EU managers and then to open the door to the marketing of products that are not appropriately regulated. Passporting should be for EU managers marketing EU funds.

Under the Directive, third countries would have a very large access to the EU under conditions that would be difficult to enforce. Indeed, from 2014 (or three years after the directive will become law in Europe), AIFs domiciled in a “third country” may be marketed in the EU, provided that such third country has entered into an agreement based on the OECD Model Tax Convention (Art 26) and AIFMs established in a third country may market AIFs in the EU if the following conditions are met: signature of an OECD Model Tax Convention, equivalence of rules regarding prudential supervision and on-going supervision, reciprocity, signature of a cooperation agreement. This is not about protectionism; this is about effectiveness of the directive.

8. The European Central Bank (ECB) has warned the EU against adopting a unilateral hedge fund regulation. The ECB has also urged the European Commission to “pursue dialogue with its international partners, in particular the United States, to ensure the organisation of a coherent framework at global level”. Can you comment on the ECB’s view?

In its opinion of 16 October 2009, the ECB was right to underline the need for a strong political commitment, at international level. I am also in favour of more international cooperation and harmonization. But the best way to do nothing is to wait for everybody to agree. In addition, the EU will be stronger in its discussions with the US if it already has a set of rules.

We should also be clear on the issue of international regulatory arbitrage:

The proposed AIFM directive has brought droves of City lobbyists to Brussels. They are saying that we will drive the industry away from London, and away from Europe, to other jurisdictions.

The fact is European legislation will bring us one step closer to an international regulatory floor—organised through the G20 process—which will limit regulatory arbitrage.

The vast majority of hedge fund and private equity vehicles are incorporated in offshore jurisdictions, with the Cayman Islands being the most popular. It is likely that billions of dollars of taxes have been avoided and evaded on income earned through offshore hedge fund and private equity investments. The work being done in the EU and G20 on tax havens will also bring funds onshore.

The European Union is not the only jurisdiction moving to regulate. As I have said, G20 leaders have committed to extend regulation across their jurisdictions. This is already taking place. In the US, President Obama is moving fast to regulate. Both the US as well as the EU have made some progress towards this. While entities such as SIVs will be covered by new restrictions on off balance sheet exposures, the legislations proposed both in the US as well as in the EU are broad enough in scope to cover most private pools of capital including hedge funds, private equity firms, family offices, venture capital funds, etc.

9. Can you provide an opinion on the US approach to regulating hedge funds as compared to what is being proposed in the EU?

It is difficult to assess in detail the US approach as several legislative proposals are on the table and the outcome is not completely clear yet.

I note however that the minimum threshold proposed in the US is $30 million of assets under management, which is much smaller than in the proposed directive.
While in headline terms the US and the EU proposals apply only to “US and EU fund managers respectively”, the scope of the US proposal is clearly much broader. It uses a very stringent requirement which means that most foreign based fund managers with even a minimal US client base (more than $25 million assets attributable to US clients or 15 or more US clients) will be covered by the registration requirements which is clearly superior to the EU suggestion of covering only fund managers who are actually based in the EU. However neither of the proposals make any reference to the market footprint of non-domiciled managers who could pose systemic risk through their activities in the local markets even without having local offices or clients.

10. In his evidence to our Committee, John Chapman suggested imposing a tax upon buying and selling by hedge funds to “level the playing field between hedge fund and other investors”. Could you comment on this suggestion?

(1) I support the idea of reducing the tax subsidy benefiting alternative investments. This potentially includes taxes on financial transactions, limits to deductibility on interest payments linked to acquisition debt or taxing carried interest as income.

(2) To the extent the proposal made by John Chapman would apply to “buying and selling by hedge funds”, the basis of such taxation would be the frequency of transactions. Market turnover as a percentage of GDP had reached record highs before the crisis. This taxation could be a way to incentivize market operators to return to more reasonable levels.

I December 2009

Letter from the Polish Financial Supervision Authority (KNF)

I would like to thank you for the invitation to participate in the call for evidence of Sub-Committee A of the European Union Committee, which KNF—the Polish Financial Supervision Authority has received from the House of Lords. In response, we would like to submit a concise statement of written evidence to the inquiry into the proposal for a Directive on Alternative Investment Fund Managers (COM(2009)217), adopted on 29 April this year.

In general, KNF welcomes the initiative of the European Commission and considers this as an important step towards a more harmonised and efficient EU financial market. The main aim is to address the question of systemic risk that may be associated with alternative investments and provide regulations designed to safeguard the EU against that risk, which is fully justifiable.

While KNF fully acknowledges the existence of systemic risks associated with the alternative investments sector and supports initiatives aiming at limiting those risks, we have indicated some concerns over several aspects of the proposal in its current shape, as presented on 29 April.

KNF is of the opinion that the considerable complexity of the problem requires broader public consultation and more thorough impact assessment both at the European and national level. The alternative investment sector is broad and diverse; its current legal status differs substantially across Europe. The proposal, in its current wording, does not allow for any clear assessment of the impact of the future directive on European financial market as a whole, and on each particular national market. In addition, the impact assessment does not estimate the probable cost of the regulation to the industry and in consequence seems to underestimate the danger of a potential withdrawal of the affected alternative industry from the EU.

Moreover, the proposal, by regulating the broad scope of entities of the so-called alternative investments sector, does not precisely address a huge diversity of entities that make up that sector. Instead, it rather applies the all-encompassing approach, which may be appropriate for some parts of the sector but at the same time, affects other to a degree higher than necessary. The proposal does not make it sufficiently clear what entities are to be included under its scope. While it may be understood that it avoids implementing substantial amount of exemptions and applies universal approach, the result is that some of the entities which, in our opinion do not pose significant systemic risk in Poland and need not to be additionally regulated, are to be included under the regime of the directive. This relates especially to closed-ended funds which are regulated in Poland in a manner similar to UCITS regime, and to private equity/venture capital sector which is not perceived as posing any significant systemic risk. As a consequence, KNF believes that the scope of the future directive on AIFM needs to be refined and some justified and well designed exemptions shall be introduced.

Finally, particular parts of the text of the proposal need to be clarified and some terms used in the proposal additionally unified with their meaning accepted in other EU directives that regulate financial market. This, in our opinion, results from the necessity of a general coherence among EU directives that regulate financial market. The future directive on the AIFM needs to be adjusted to the already existing directives such as MIFID, UCITS and Prospectus Directive in order to avoid introducing a double layer of EU regulation of alternative investments in Europe.
In order to fully review the proposed regulation, KNF awaits the results of the works of the financial services working group of the EU Council. As the remarks and suggestions tabled by the national delegations shall be transferred into the new version of the proposal, KNF awaits publication of the compromise text of the proposal by the Presidency, as this will allow us to analyze the draft and mould our position. We would also welcome a more thorough impact assessment from the European Commission.

KNF is of the opinion that any new regulations not flexible enough for justified needs of the European financial market, and regulations that limit the competitiveness of the European entities, shall not be supported. Nevertheless, we hope that the final shape of the proposal will include effective mechanisms for supervisory cooperation between home and host supervisors, and that the future directive will substantially increase stability and competitiveness of the European financial market.

9 September 2009

Letter from the Property Industry Alliance (PIA)

This letter has been produced by the Property Industry Alliance, which seeks to achieve a more co-ordinated and effective approach from leading properties bodies on policy, research and best practice issues. The Alliance brings together the BCSC, the British Council for Offices, the British Property Federation, the Investment Property Forum and the Royal Institution of Chartered Surveyors.

The Property Industry Alliance is pleased that the Commission has taken forward proposals to permit the cross-border marketing of property funds to professional investors using an EU passport. The Property Industry Alliance has reviewed the submission which the Association of Real Estate Funds has made to HM Treasury about the Directive and endorses that submission. The Property Industry Alliance, however, has identified a number of serious concerns about the Directive which apply across the UK property industry and this letter sets out those concerns.

Timing

We are not aware of any evidence of property fund managers having played a significant role in the global economic crisis, yet they are being treated in the same way as hedge/private equity fund managers.

The Directive contains a large number of detailed proposals that will affect the way that property funds are both managed and marketed. The Directive is currently being introduced with limited consultation and on a fast-track timetable. That this is the case is, according to the Impact Assessment, largely due to the current global financial crisis. Indeed, there are regular references in the Impact Assessment and in the Directive to actions undertaken by hedge funds and private equity funds. However, the Directive also catches property fund managers. We are not aware of any evidence of property fund managers having played a significant role in the global economic crisis, yet they are being treated in the same way as hedge/private equity fund managers.

In our view, there needs to be further detailed discussion on the impact of the Directive on the real estate market place, and if this leads to the splitting of the Directive into aspects that must (in the view of the Commission) be brought in rapidly to regulate hedge funds and private equity funds, this should result in a further Directive being introduced in a more considered way that applies to other types of fund manager.

Scope of Regulation

It is important that the Directive is amended so that it has a clear definition of an Alternative Investment Fund which is restricted to entities which pose a systemic risk to the financial system.

As drafted, the Directive captures firms based within the EU that manage any “collective investment undertaking” (Alternative Investment Funds or “AIFs”) if the funds under management exceed €100,000,000.

It is important that the Directive is amended so that it has a clear definition of an AIF which is restricted to entities which pose a systemic risk to the financial system. Currently, the undefined expression “collective investment undertakings”, along with recital 5, would catch many vehicles that are not thought of, or regulated as, funds, including listed property companies, REITS and joint venture vehicles established between two property developers or investors. We would point out that many listed property companies have subsidiaries which invest in or develop real estate assets which are managed by a group management company (and which would be subject to regulation under the Directive).

Furthermore, the exclusions from the definition of “collective investment undertaking” appear somewhat uneven, ranging from funds managed by life and general insurers to sovereign wealth funds and banks. This has the potential to create a playing field which is far from level amongst different industry players.
Also, as drafted, the Directive requires the regulation of all AlFs, irrespective of the application of any exemptions. The Directive and the Impact Assessment make regular cross-references to MiFID. MiFID contains a number of exemptions that apply to firms carrying on what would otherwise be a business that required authorisation. For example, MiFID article 2, paragraph (b) exempts from the scope of regulation “persons who provide investment services exclusively for their parent undertakings, for their subsidiaries or for other subsidiaries of their parent undertakings”. In our view, a similar exemption should be inserted into the Directive. It is not unusual for property investment structures to be set up where management is undertaken on an intra-group basis, and there is no need for such a manager to be subject to regulation where this is the case.

**Capital**

*It is important to ensure that a sensible balance is struck between the need for better regulation through capital adequacy and other requirements, and the costs which that regulation may impose on investors.*

Managers within the scope of the Directive are required, by article 14, to have own funds of at least €125,000. Where the amount under management exceeds €250,000,000, an additional capital amount of 0.02% of the amount by which the value exceeds €250,000,000 must also be kept. We can see no rationale for the second element of this proposal. The fund vehicle will legally be separate from the manager. The capital required by a fund manager to act as the manager of funds is not in fact linked to the value of the funds under management. From the point of view of a regulator, the concern should be that, if a manager has insufficient funds, the regulator can “step in” and appoint another manager, or wind down the fund. It would make much more sense to link the capital required to be a manager with the on-going costs of management, rather than to the value of the funds under management. This might lead to a requirement that the manager kept at least one month’s expenses as a minimum level of capital if, in fact, that sum exceeded €125,000.

**Depositories**

*We do not consider that an AIFM should be required to appoint a credit institution as depository.*

Article 17 requires an AIFM to ensure that a depository is appointed to receive payments. The depository must be a credit institution. We do not consider that an AIFM should be required to appoint a credit institution as depository. It would make much more sense if the party responsible for receiving payments made by investors, and the safekeeping of investor’s assets, was required to use a credit institution or custodian to help it carry out these tasks, rather than to be a credit institution itself. An AIFM may appoint a third party (in the UK, often called an “Operator”) to carry out certain investor facing administrative functions, and it would be unfortunate if only credit institutions could be appointed to this role—indeed, that would not reflect the current practice. We suggest that article 17 to be amended to make it clear that a party providing administrative functions on behalf of the manager, such as an Operator, must place payments received from investors in a credit institution, and ensure that financial instruments are kept safe at an authorised custodian, but not that the Operator itself needs to carry on, or be regulated to provide, these functions.

**Marketing to Professional Investors**

*We welcome a pan-European passport for marketing real estate funds to professional Investors.*

We are pleased that the Commission has put forward a proposal that will enable the pan-European marketing of real estate funds to professional investors. However, we do not agree with the logic behind the three year delay for funds domiciled outside the EU contained in article 33, paragraph 8 and we have general concerns about the introduction of a more restrictive marketing regime for funds domiciled outside the EU.

**Definition of Marketing**

*We do not consider that an AIF should be subject to the marketing regime set out in the Directive where the AIF receives an unsolicited approach from a potential Investor.*

One important aspect of the passport provided to managers is the definition of marketing. The current definition is “any general offering or placements of units or shares in an AIF to or with investors domiciled in the Community, regardless of at whose initiative the offer or placement takes place”. We cannot see why property funds that are not targeted at investors in a particular jurisdiction should be subject to the Directive’s marketing requirements. MiFID, for example, takes a very different approach and recognises the existence of execution-only business and “reverse solicitation”. If, without having a fund marketed to them, an investor approaches an AIF to invest in a fund, we do not think that the AIF should be caught by the marketing regime
set out in the Directive. This is the approach adopted by MiFID, which we believe is preferable. We cannot understand why the reverse solicitation model is permitted for funds that can be marketed to retail investors under MiFID, but not for funds that are being marketed to professional investors under the Directive.

Leverage

*If the Commission considers that lending as a whole is an issue on a macro-economic basis, it should be tackled at the point of the lender, rather than on a micro-economic level in relation to specific borrowers.*

The Directive contains measures that require specific disclosure to investors of the total amount of leverage employed on a quarterly basis, and gives the Commission the right to set limits to the amount of leverage that can be employed. We think that these measures are unnecessary in relation to property investment fund vehicles. Firstly, it would typically be the case that the fund would disclose to investors where leverage was to be used, and the maximum amount. Investors do not want to receive quarterly updates on a matter to which they have already agreed, and it is an unnecessary burden on the AIFM to have to make this notification. Secondly, we do not think it is practicable to set limits on the amount of leverage that can be employed. The amount of leverage should take into account the willingness of lenders to lend, and the attitude of investors to leveraging their investment. We are concerned that this “one size fits all” approach would be uncompetitive internationally and, in practice, do nothing to improve the stability of the financial system. If lending as a whole is considered to be an issue on a macro-economic basis, it should be tackled at the point of the lender, rather than on a micro-economic level in relation to specific borrowers.

Valuation

*The Directive should not seek to undermine well established real estate valuation standards, procedures and methodologies.*

We welcome the proposal that each AIFM must ensure that each alternative investment fund which it manages appoints an independent valuer to value its real estate assets.

We would emphasise that, in a real estate context, the Directive should not seek to undermine the well established real estate valuation standards, procedures and methodologies in the member states of the European Union such as those contained in the RICS Red Book which are recognised by financial institutions across Europe and around the globe.

3 July 2009

Memorandum by Simmons & Simmons

As the leading law firm in the UK advising hedge funds and hedge fund managers and a sponsoring member of the Alternative Investment Management Association (AIMA), we are pleased to set out below our responses to the questions raised by the Committee as set out in its Call for Evidence.

   1.1 We have no comment on this question.

   2.1 We have no comment on this question.

   3.1 Given the objectives of the Directive (see paragraph 9.2 below), and that the de Larosière Report, the Turner Report and the Commission itself have acknowledged that AIF were not the cause, but if anything victims, of the financial crisis, it could be said that the Directive is not proportionate and that the obligations proposed to be imposed on AIFM are indeed over-stringent.
4. Is it appropriate to regulate Investment Fund Managers, rather than the Fund itself? Does the Directive contain appropriate provisions to distinguish between different types of alternative investment? Does the scope of the Directive create a danger of unintended consequences?

4.1 As section 5 of the Commission’s Impact Assessment (page 33) itself recognises, “In many cases, the [AIF] is purely a legal shell for the pooling of assets and even then, the assets of the fund are usually not held by the AIF but by a custodian or depositary, depending on the business model. The AIF has no economic life of its own…. Rules on the fund itself would not therefore respond to any real regulatory need”. We fully concur with this conclusion.

4.2 It is generally common ground that the “one size fits all” approach of the Directive is not appropriate and that, in particular, it needs to recognise the distinctions between the different types of AIF. Indeed section 3.3 of the Commission’s Impact Assessment itself recognises that “a significant number of different legal entities or structures are used to create and operate AIF” and refers in the footnote to a study conducted in nine member states that found more than 60 different legal vehicles used for non-UCITS funds.

5. What is your evaluation of the Commission’s consultation in the preparation of the Directive?

5.1 In our view the Commission did not consult in the preparation of the Directive. As it effectively recognises itself in section 2 of the Impact Assessment (page 10) thereof, such consultation as was carried out related to the cross-border marketing of AIF. It did not relate to any of the other provisions of the Directive.

6. Will the passport system help create a single market in investments funds within the EU? How will the passport system established affect the EU and the UK industry and particularly their position in the global market?

6.1 The Directive provides that EU AIFM authorised under the Directive will be granted a passport to market the AIF which they manage throughout the EU to professional investors (defined to mean investors within the meaning of Annex II of the MiFID Directive). The passport is subject to a requirement that each EU member state in which an AIFM wishes to market a non-EU AIF has entered into an agreement with the country in which the non-EU AIF is domiciled to share information on tax matters which complies fully with the standards laid down in the OECD Model Tax Convention and which ensures an effective exchange of information in tax matters. It should be noted that if an EU member states wishes to restrict the marketing of non-EU AIF domiciled in a particular country, it may do so by not entering into an agreement to share information in tax matters with that country.

6.2 The passport to market non-EU AIF will, however, only become available three years after the date on which the legislation of the EU member states implementing the Directive is required to enter into force (the transposition date). Until then EU member states may allow or continue to allow (as the case may be) EU AIFM to market non-EU AIF to professional investors under the existing national private placement rules currently in force in those member states. It is not clear, however, whether where those national private placement rules currently permit non-EU funds to be marketed to investors who are not professional investors as defined for the purposes of the Directive, marketing to such non-professional investors will be permitted. It must also be noted that during this three year period non-EU AIF will be at a competitive marketing disadvantage when compared to EU AIF, particularly in countries such as France and Italy which do not currently allow non-EU AIF to be marketed even on a private placement basis.

6.3 The Directive also provides that an EU member state may authorise a non-EU AIFM to market an AIF of which it is the manager (whether it is an EU AIF or a non-EU AIF) to professional investors throughout the EU provided that five conditions are satisfied. These conditions include a determination having been taken by the Commission (rather than the relevant EU member state) that the legislation of the non-EU country in which the non-EU AIFM (not the AIF itself) is established in relation to prudential regulation and ongoing supervision is equivalent to the provisions of the Directive and is effectively enforced and that AIFM established in the EU are granted comparable effective market access to professional investors in that non-EU country. It seems very unlikely, if not impossible, that all of the conditions will be able to be satisfied.

6.4 The ability of an EU member state to authorise non-EU AIFM to market EU and non-EU AIF to professional investors in the EU will also only apply with effect from three years after the transposition date. While EU AIFM will be permitted to market non-EU AIF in the EU during this three year period under the existing private placement rules currently in force in the EU member states as described above, it is not clear whether non-EU AIFM will also be permitted to do so.

6.5 Critical to a consideration of these provisions is the definition of marketing. The Directive defines this to mean any general offering or placement of shares or interests in an AIF to or with investors domiciled in the EU, regardless of at whose initiative the offer or placement takes place. It has been suggested that the definition was not intended to extend to responding to unsolicited approaches from investors, but the Commission has
subsequently made it clear that it fully intended to capture both active marketing (by an AIFM) and passive marketing (at the initiative of the potential investor) in order to avoid circumvention of the Directive’s marketing restrictions. Accordingly, if a non-EU AIFM receives an unsolicited approach from an EU investor, any response to that approach is likely to constitute marketing by the AIFM.

6.6 The conditions which must be satisfied in order for a non-EU AIFM to be authorised to market the AIF which it manages to professional investors in the EU in effect introduce a form of protectionism which will not benefit EU investors. The likely inability of a non-EU AIFM to satisfy the conditions will result in EU investors being substantially restricted in the choice of AIF in which they may invest. As well as reducing choice, a likely consequence is that many EU investors will have difficulty meeting their investment objectives. Moreover, if the EU effectively locks out AIF managed by non-EU AIFM in this way, non-EU countries may in turn reciprocate and lock-out AIF managed by EU AIFM from their own markets. This cannot be in the interest of EU investors. It would also contradict the terms of the Communique issued by the G20 in April 2009 in which it was agreed that protectionist measures would not be engaged in by the G20 countries.


7.1 The Directive does not employ the concept of leverage which is “systemically relevant” as did IOSCO, the G20 and the Turner Report, but rather its provisions relate to AIFM which manage one or more AIF “employing high levels of leverage on a systemic basis”. Under the Directive the latter test will be deemed to be met by any AIF which employs leverage exceeding the “value of [its] equity capital” and it appears from the FAQs issued by the Commission that “equity capital” means “net assets”. As a result almost all hedge funds will be deemed to have met the test since in the FAQs the Commission recognised that the average level of leverage employed by hedge funds was one times net assets.

7.2 The Directive obliges the Commission, in order to ensure the stability and integrity of the financial system, to adopt measures setting limits to the level of leverage which AIFM can employ in relation to AIF, taking into account the type of AIF, their strategies and their sources of leverage. This provision has been criticised for a number of reasons, including the difficulty, if not impossibility, of defining leverage and setting appropriate limits thereon as well as the undesirability of potentially creating an unlevel playing field vis-à-vis other financial market participants. It is thought likely that if this obligation is retained, it may cause certain AIFM to have to cease marketing certain AIF in the EU or to move outside the EU with the result that they will be unable to market their AIF in the EU, thereby restricting the choice of AIF available to investors in the EU. Further, one EU member state has suggested that, if leverage limits are imposed, investors and counterparties could be induced to reduce their normal due diligence procedures and to relax their risk management standards, which would not be in the interests of investors generally.

7.3 For each AIF that it manages (whether it is an EU AIF or a non-EU AIF) an AIFM is required to ensure that a depositary is appointed to fulfil certain tasks. The depositary is required to be an EU credit institution and since the right of the depositary to delegate is expressed as a right to delegate to “other depositaries”, it appears that sub-custodians must also be EU credit institutions.

7.4 The obligation to appoint an EU credit institution as depositary is stricter than the requirement under the UCITS Directive, which merely requires the depositary of a UCITS fund to be an institution which is subject to prudential regulation and ongoing supervision. Also, the UCITS Directive authorises the EU member states to determine which categories of institutions shall be eligible to be depositaries. Currently, many of the largest depositaries/custodians operating in the EU are not EU credit institutions and not all EU credit institutions act as depositaries of UCITS. This requirement will unnecessarily and significantly restrict an AIF’s choice of depositary and will effectively concentrate counterparty risk in the hands of a small number of EU credit institutions, which in view of the problems which certain EU credit institutions have faced during the current financial crisis is not in the interests of investors.

7.5 In addition, requiring an AIF to appoint an EU credit institution as depositary will conflict with the laws in certain domiciles in which AIF are established or incorporated and which themselves require a local depositary or custodian to be appointed. Further, the majority of prime brokers on whose services hedge funds are reliant are neither EU credit institutions nor have an EU credit institution in their group. It is also becoming increasingly common for hedge funds to appoint more than one (and sometimes multiple) prime brokers with a view to reducing counterparty risk. Requiring that only one depositary be appointed and that it be an EU credit institution will make it impossible for multiple prime brokers to be appointed and will lead to a concentration of risk.
7.6 Given that it is standard market practice in the custody world for depositaries/custodians to appoint sub-
custodians (which may be subsidiaries or other affiliates of the depositary/custodian or third party sub-
custodians) of securities in the countries in which the issuers of those securities are incorporated, that in certain
jurisdictions title to securities or other assets must be held by a local sub-custodian and that no EU credit
institution operates through a branch network outside the EU, the provision of the Directive requiring sub-
custodians to be EU credit institutions will be unworkable.

7.7 The Directive imposes what is in effect strict liability on the depositary for its own failures and for those
of any sub-custodians which it appoints. This is disproportionate and contradicts not only current market
practice in relation to AIF but also in relation to custody generally. Depositaries are not currently
compensated for the risk of strict liability and thus are likely to charge substantially more for assuming this
risk (which additional cost will be borne by investors) and/or not act for certain AIF and/or not for AIF
pursuing certain strategies (for example, emerging market investment strategies). This is likely to be the case
whether or not the requirement that sub-custodians be EU credit institutions is removed since even if it were,
more doubt whether depositaries would be prepared to accept strict liability for sub-custodians in, or which hold securities issued by issuers in, emerging market countries. This will limit the ability of AIF
to invest in emerging markets, which is not in the interests of investors nor consistent with the EU’s obligations
to aid developing countries.

7.8 Where a prime broker is not itself an EU credit institution and thus cannot act as depositary, it will be
necessary for the depositary of an AIF which is a hedge fund to appoint prime broker(s) as global sub-
custodian(s) and in such case the depositary will have to accept liability not only for each prime broker but
also for each prime broker’s sub-custodian network. This is again likely to increase the fees which depositaries
charge to AIF and which will be borne by investors. Further, since the demise of Lehman, many prime brokers
have been developing modifications to the custody element of their prime brokerage offering, whereby assets
in excess of the prime broker’s margin requirement would be transferred to, and held by, a separate custodian
so as to mitigate the potential for any loss that might be suffered in the event of the prime broker’s insolvent.
The appointment of any such separate custodian will further complicate the issues and is likely to increase the
costs borne by investors.

7.9 The provisions of the Directive relating to depositaries, sub-custodians and prime brokers, and
depositaries’ liability therefor, will reduce the choice of depositaries and prime brokers (and, accordingly,
reduce competition), increase counterparty risk, limit the ability of AIF to invest in emerging markets and
cause some depositaries to refuse to act for AIF pursing certain strategies or investing in certain markets as
well as to increase their fees.

7.10 The Directive requires an AIFM to ensure that each AIF which it manages appoints an independent
valuation agent to calculate the value of the AIF’s assets and of its shares. Current market practice is for this
function to be performed by a third party administrator which, however, sometimes relies on the AIFM to
value certain hard-to-value assets the pricing of which the administrator then verifies. If administrators are to
be required to assume responsibility for valuing all of the assets of AIF; and assuming that they are prepared
to accept this responsibility, it is likely that they will wish to be compensated for the additional responsibility
and these additional costs will be borne by investors.

7.11 In addition, as mentioned above, the definition of management services includes the activity of
administering AIF and as a result, it may be necessary for the AIFM to appoint the third party administrator
of an AIF (by way of delegation), whilst the independent valuation agent is appointed by the AIFM itself. This
could lead to existing arrangements with third party administrators having to be restructured, the costs of
which would be borne by investors.

7.12 The Directive permits an AIF to appoint an independent valuation agent established in a non-EU
country, subject to certain conditions compliance with which is to be determined by the EU Commission.
However, the Directive provides that these provisions will only come into force three years after the
transposition date and it is unclear whether AIF which have currently appointed non-EU valuation agents
will have to replace those valuation agents with EU valuation agents during that three year period, thus resulting in
existing arrangements having to be, at least temporarily, restructured at the cost of investors.

7.13 It has recently been suggested by at least one EU member state that the Directive should be amended to
provide for AIFM to be responsible for the valuation of an AIF’s assets and of its shares following the UCITS
model. An AIFM would not be prevented from delegating this function to an independent valuation agent
but the AIFM would retain liability vis-a-vis the AIF and its investors for the performance by the valuation
agent of its functions. This would not be in the interests of investors, since most AIFM are likely to be less
well-capitalised than independent valuation agents and in the event of a failure by a valuation agent to perform
its obligations, investors would have no direct claim against the valuation agent. This suggestion also runs
contrary to the recommendations of IOSCO, AIMA and the Hedge Funds Standards Board. Further, it introduces a conflict of interest, which is not in the interest of investors, in that an AIFM’s fees are calculated by reference to the value of the assets of the AIF which it manages.

8. Will the provisions strengthening disclosure requirements help to create a more transparent market or do they go too far?

8.1 We have no comment on this question.

9. What effect will the Directive have upon the position of the City of London and the EU as a whole as a leading location for Investment Fund Managers? Could it cause many hedge funds to relocate outside the EU? What impact would the Directive have upon professional investors and institutions?

9.1 EU AIFM will be faced principally with the choice of complying with the provisions of the Directive and thus being able to avail themselves of the passport to market the AIF which they manage throughout the EU or moving their business outside the EU, so as to become non-EU AIFM, and thus probably in practice being unable to market the AIF which they manage in the EU as described in paragraphs 6.3–6.6 above.

9.2 The objectives of the Directive are to reduce the risks which the activities of AIFM potentially cause to investors, creditors and trading counterparties of AIF and to the stability and integrity of financial markets. The provisions of the Directive go considerably further than this, however, and impose requirements designed to benefit professional investors which are more onerous than those imposed by the UCITS Directive to protect retail investors. It seems certain that the Directive in its current form will restrict the ability of EU investors to select the AIFM and AIF of their choice (see in this regard paragraphs 6.1-6.6 above). In addition, the provisions of the Directive relating to depositaries, sub-custodians and prime brokers, and depositaries’ liability therefor, will reduce the choice of depositaries and prime brokers (and, accordingly, reduce competition), increase counterparty risk, limit the ability of AIF to invest in emerging markets and cause some depositaries to refuse to act for AIF pursuing certain strategies or investing in certain markets as well as to increase their fees.

10. How does the Directive compare to existing or proposed regulation of Alternative Investment Funds outside of the European Union, particularly that of the United States? How will the Directive affect the position of EU Alternative Investment Funds in the global market?

10.1 The “equivalent” proposed legislation in the United States is the Private Fund Investment Advisers Registration Act of 2009. The proposed legislation would require most previously unregistered investment advisers (the term used in the US to describe investment managers), including advisers to private funds with US investors (including hedge funds and funds of hedge funds) to register with the SEC and would also require all registered investment advisers to comply with new reporting and record keeping requirements and provide information about private funds which they manage, including assets under management, use of leverage, counterparty credit risk exposures, trading and investment positions and trading practices. Under this proposed legislation, US investment advisers with more than US$30 million in assets under management and non-US investment advisers that do not satisfy the requirements of the “foreign private adviser” exemption would be required to register under the US Investment Advisers Act of 1940 (the “Advisers Act”) . The legislation would also give the SEC the authority to require registered advisers to provide reports, records and other private fund information to investors, prospective investors, counterparties and creditors. Once registered, all previously unregistered investment advisers would have to comply with the provisions of the Advisers Act, including but not limited to requirements with respect to disclosure, custody of client assets, compliance procedures, receipt of performance-based compensation, and maintenance of books and records.

10.2 The proposed legislation contains no provisions of a similar nature or effect to those in the Directive.

11. What effect will the Directive have on flows of capital and financial innovation?

11.1 We have no comment on this question.

We attach for the benefit of the Committee copies of the notes we have previously prepared on the Directive containing respectively a detailed analysis of its provisions and a description of the key issues for US (and other non-EU AIFM) managers of, and for investors in, hedge funds and funds of hedge funds.
COMMISSION PROPOSAL FOR A DIRECTIVE ON ALTERNATIVE INVESTMENT FUND MANAGERS

On 30 April 2009 the European Commission published the final text of a proposal for an EU Directive on Alternative Investment Fund Managers (“AIFM”). We initially commented on the draft Directive (“Directive”) in a note which we made available on 1 May 2009 and have now prepared a more detailed analysis of the Directive which is intended to supplement and expand upon that earlier note. This analysis draws not only on the Directive itself, but also on the separate impact assessment which accompanied the Directive proposal (“Impact Assessment”) as well as on the explanatory memorandum which forms part of the proposal (“Explanatory Memorandum”) and on the preamble to the Directive which under EU law may be used in interpreting the Directive (“Preamble”). The analysis concentrates on the significant issues raised by the Directive for AIFM which are managers of hedge funds, but will also be relevant for AIFM which manage other types of alternative investment fund (“AIF”), including funds of hedge funds.

The Impact Assessment recognises that the Directive may have negative effects on EU AIFM but suggests that its net impact on the competitiveness of the EU AIFM industry may be relatively limited. This seems to ignore the fact that many provisions of the Directive may require significant changes to the structure and operation of existing AIFM and AIF, much of the cost of which is likely to be borne by investors. In addition, many of the provisions of the Directive seem to reflect the protectionist instincts of certain of the EU member states articulated under the guise of necessary regulations and investor protection measures.

1. Which AIFM are covered?

1.1 The Directive will apply to any AIFM established in an EU member state which provides management services to one or more AIF, whether the AIF is domiciled inside or outside the EU, whether the AIF is open-ended or closed-ended and whatever the legal structure of the AIF.

1.2 The Directive will not apply to AIFM which either directly or indirectly through a company with which the AIFM is linked by common management control or by a substantive direct or indirect holding, manage portfolios of AIF whose cumulative assets under management, including any assets acquired through the use of leverage, in total do not exceed €100 million. There was initially some uncertainty as to whether the reference to assets under management was to net or gross assets but it appears from the Impact Assessment that it is to net assets. The threshold is increased to €500 million where the portfolios of the AIF are not leveraged and where investors have no redemption rights for at least five years following the date of constitution of each AIF. It is clear that the higher threshold is aimed at private equity funds. Other types of funds which are open-ended, even if their portfolios are not leveraged, and which impose a five year lock-up, are unlikely to be able to take advantage of this higher threshold except during the five year period following their constitution.

1.3 According to the Commission, the €100 million threshold was chosen so as to exclude AIFM for which the requirements would be disproportionate and that as a result approximately 30% of EU domiciled hedge fund managers, managing 90% of EU domiciled hedge funds, will be covered by the Directive. This is misleading as the majority of hedge funds are not EU domiciled and based on figures provided to the Alternative Investment Management Association (“AIMA”) by a well-known industry source, the Directive will in fact cover approximately 87% of all assets under management by EU hedge fund managers in EU and non-EU domiciled hedge funds. This threshold was reduced from €250 million immediately before the Directive was published and it is interesting to note that the Impact Assessment states not only that the initial €250 million threshold was selected for reasons of proportionality but also that lowering the threshold to €100 million would double the share of AIFM covered while increasing the net assets covered by around 20% only. The Impact Assessment also states that the additional benefits resulting from reducing the threshold to €100 million would not outweigh the additional costs in the form of administrative burdens on the smaller AIFM which would be caught. As AIMA has suggested, it would be more appropriate if the thresholds were increased to at least €500 million and €1 billion respectively.

1.4 Many AIF are structured as master-feeder funds and it would be inimical if when calculating whether the threshold has been reached, an AIFM were required to aggregate the assets under management in the feeder fund(s) as well as in the master fund, but the Directive is not entirely clear on this point. The reference (see 1.1) to AIFM which manage portfolios of AIF directly or indirectly through a company with which the AIFM is linked by common management control or by a substantive direct or indirect holding is to a company with which the AIFM is linked and not to which an AIF is linked, and thus would not appear to be a reference to a master fund.
1.5 The Directive contains no transitional provisions to cater for the situation where the assets under the management of an AIFM unexpectedly exceed the threshold, whether by virtue of movements in the market or by virtue of the receipt of an unexpected subscription into one of the AIF which it manages. Similarly, there are no provisions to cater for the situation where the assets under management of an AIFM are reduced below the threshold, whether by virtue of redemptions or market movements.

1.6 The Directive also does not apply to AIFM established in the EU which do not provide management services to AIF domiciled in the EU (“EU funds”) and do not market AIF in the EU. This would appear to suggest that an EU AIFM which currently provides management services to AIF domiciled outside the EU (“non-EU funds”) could establish a separate marketing affiliate to market its non-EU funds in the EU and thus avoid the application of the Directive. However, whilst it is clear that such a marketing affiliate would not be able to benefit from the marketing passport granted to EU AIFM under the Directive, it is not clear whether when the Directive comes into force entities whose principal activity is to market AIF will continue to be able to do so even under the national private placement rules currently in effect in the various EU member states (see 4.4).

1.7 A further provision which was introduced in the last draft of the Directive before the final text was published excludes from the ambit of the Directive EU credit institutions (such as banks). This means that such credit institutions which operate as AIFM and provide management services to AIF will not be subject to the Directive so long as they do so through a branch or division and not through a separate company. This seems highly discriminatory and inequitable given the objectives of the Directive which, in essence, are to reduce the risks which the activities of AIFM potentially cause to investors, creditors and trading counterparties of AIF and to the stability and integrity of the financial markets. It is to be noted that the Preamble states that the Directive should not apply to the management of assets “held on own account” by credit institutions and it may be that this is what the provision in the Directive itself was intended to reflect, rather than a blanket exclusion of such institutions. As mentioned above, the extent to which such institutions would be permitted to market AIF is also unclear since the marketing passport will not be available to them (see 4.4).

1.8 Also excluded from the application of the Directive are managers of pension funds and of non-pooled investments such as endowments, supranational institutions, insurance and reinsurance undertakings, and sovereign wealth funds.

2. Which AIF are covered?

2.1 The Directive defines an AIF as any collective investment undertaking (whether domiciled in or outside the EU) whose object is the collective investment in assets and which is not an investment fund that is subject to the UCITS Directive, and thus includes not only hedge funds but also funds of hedge funds, private equity funds, listed closed-end funds, real estate funds, infrastructure funds, commodity funds, long-only funds which are not UCITS funds and even UK non-UCITS retail funds. The Preamble expands on this definition, in terms which originally were included in the Directive itself, by referring to collective investment undertakings as those which raise capital from a number of investors with a view to investing it in accordance with a defined investment policy on the principle of risk-spreading for the benefit of those investors.

2.2 Accordingly, the Directive includes within the definition of AIF not only open-ended investment funds but also listed closed-ended funds which are already subject to a broad range of regulations under the Prospectus, Transparency and Market Abuse Directives, certain of the provisions of which conflict with the provisions of the Directive (for example, in relation to the types of investor to whom their shares may be marketed) and it will be necessary for this inconsistency to be clarified.

2.3 In relation to the master fund in a master-feeder structure, it might be possible to argue that, at least where it has only a single feeder fund, it falls outside the definition of an AIF on the grounds that it is not raising capital from a number of investors but rather from one only. This argument might be of interest to EU affiliates of non-EU AIFM (such as UK affiliates of US hedge fund managers) which manage the investments of the master fund only. On the other hand, given the more onerous conditions with which the feeder fund would have to comply if it were a non-EU fund and the non-EU AIFM wished to market it in the EU (see 6), it may be more beneficial for such an EU affiliate to seek authorisation under the Directive.

3. Who is the AIFM?

3.1 It has been assumed to date, at least by hedge fund managers, that it is they who would qualify as the AIFM. It is not entirely clear, however, that this is in fact the case. The Directive defines an AIFM as any person whose regular business is to manage one or several AIF and provides that it applies to all AIFM established in the EU which provide management services to AIF. Management services is defined to mean
the activities of managing and administering one or more AIF on behalf of one or more investors. However, in the Preamble there is a statement that investment firms authorised under the MiFID Directive are not required to obtain authorisation under the Directive in order to provide investment services in respect of AIF. Such investment firms would include investment managers of all types. Further, the Impact Assessment appears to suggest that the activity of administering an AIF refers to valuation, safe keeping, audit and prime brokerage on the ground that AIFM are responsible for all decision-making in relation to such matters and includes a statement that AIFM appoint administrators, valuers, depositaries, prime brokers and auditors. It appears, therefore, that the concept of a manager of an AIFM is more akin to that of a management company of UCITS under the UCITS Directive. The fact that the definition of management services refers to the activity of administering AIF, which is not normally a responsibility performed by an investment manager, may support this interpretation. In addition, the Preamble refers to the Directive as covering managers of all collective investment undertakings which are not required to be authorised as UCITS. This is unfortunate since in the UCITS context the concept of management company is employed in relation to so-called common funds, such as unit trusts and common contractual funds, which have no legal personality of their own and are thus not in a position to act by themselves and have to act through a manager. The UCITS Directive recognises, however, that even UCITS may also be established in the form of investment companies which are self-managed in that they do not appoint a separate management company and which themselves directly delegate functions to investment managers, administrators and depositaries. It would be very inappropriate if the Directive had the effect that existing investment companies which have not appointed a manager with the same responsibilities as the management company of a UCITS were required to re-structure themselves so as to do so. Further, it seems that this would usurp the function of the board of directors of an investment company.

3.2 It will be clear from the above that clarification is required as to which entity is to be regarded as the AIFM. In this regard it will also be necessary to clarify the position of offshore, non-EU managers of AIF which are prevalent in many hedge fund structures, but which are generally merely part of the contractual matrix and do not perform any activities themselves. Similarly, it will be necessary to clarify the position of offshore, non-EU investment managers (such as US hedge fund managers) which delegate part or all of the investment management function to an EU affiliate (such as a UK affiliate).

4. Marketing of AIF—General

4.1 The Directive provides that an AIFM authorised in accordance with the Directive to provide management services to one or more AIF is also entitled to market shares of those AIF (but apparently not of AIF to which it does not provide management services) to professional investors throughout the EU subject to the conditions laid down in the Directive. Marketing is defined to mean any general offering or placement of shares in an AIF to or with investors domiciled in the EU, regardless of at whose initiative the offer or placement takes place (and thus extends to responding to unsolicited approaches from investors including therefore to so called “reverse enquiries”).

4.2 Professional investors are defined to mean investors within the meaning of Annex II of the MiFID Directive. As a result, UK hedge fund managers wishing to market shares in an AIF to an individual prospective investor will be required to determine that the investor not only meets the “qualitative test” in Rule 3.5.3(1) of the FSA’s Conduct of Business Sourcebook, as is currently the position, but also the “quantitative test” in Rule 3.5.3(2). The consequence of this is that it is likely in practice to be far more difficult to market shares in AIF to high net worth individuals and the like once the Directive is in force.

4.3 As mentioned in 1, listed closed-ended investment companies fall within the definition of an AIF. Under the terms of the Prospectus Directive shares in such companies may currently be marketed generally throughout the EU to certain retail investors, that it is to say to investors which fall outside the definition of professional investors in Annex II of MiFID. It would appear that the Directive will have the effect of prohibiting such marketing, save where an EU member state expressly permits such marketing in its own territory.

4.4 Prior to commencing the marketing of shares of an AIF in its home EU member state, an AIFM is required to submit a notification to the regulatory authorities of that member state in respect of each AIF that it intends to market there. The notification must contain certain information and documentation set out in the Directive, including the “AIF rules” or its constitutional documentation. The expression “AIF rules” is used in many provisions of the Directive and is thought to extend to the prospectus of an AIF, though this is nowhere mentioned expressly. It is to be noted that earlier drafts of the Directive included an express reference to the provision of a copy of the prospectus of the relevant AIF in addition to the AIF rules. Since many of the terms on which investors invest in an AIF are set out in its prospectus or private placement memorandum, rather than its constitutional documentation, it would be helpful if this could be expressly stated in the
Directive itself. The relevant regulatory authorities have ten working days after receipt of a complete 
notification from an AIFM to inform it that it may start marketing the relevant AIF in the AIFM’s home EU 
member state. Similar provisions apply in relation to an AIFM which intends to market shares in one or more 
EU member states other than its home EU member state. It is to be noted, however, that the Directive provides 
that arrangements for the marketing of AIF in any host EU member state are subject to the laws and 
supervision of that member state, which could give scope for certain EU member states to introduce 
restrictions on the marketing of AIF even to professional investors.

4.5 The position of entities which do not manage AIFM but only market shares therein is unclear. The 
Directive provides that “entities” which are neither authorised under the Directive nor, in the case of AIFM 
not covered by the Directive, authorised in accordance with the domestic law of an EU member state, shall 
not be allowed to market shares of AIF within the EU. This provision could be read as meaning that only 
AIFM which are authorised in accordance with the domestic law of an EU member state and not other entities 
which are so authorised, may market shares of AIF in the EU. This would have the effect that even EU 
authorised investment firms whose principal activity is to market shares of AIF (such as placement agents) 
would be prohibited from doing so within the EU even where that is currently permitted under the national 
private placement rules of individual EU member states (see 1.6 in relation to EU credit institutions). More 
fundamentally, it would appear that this provision can be interpreted to mean that investment firms which are 
not authorised in the EU (wherever in the world they may be established) may be prohibited altogether from 
marketing shares of AIF in the EU.

5. Marketing of non-EU funds by EU AIFM

5.1 Although AIFM established and authorised in an EU member state under the Directive will be granted 
a passport to market the AIF which they manage to professional investors throughout the EU, this is subject 
to a requirement that each EU member state in which such an AIFM wishes to market a non-EU fund has 
entered into an agreement with the country in which the non-EU fund is domiciled to share information on 
tax matters which complies fully with the standards laid down in the OECD Model Tax Convention and which 
ensures an effective exchange of information in tax matters.

5.2 The Directive does not pretend that this requirement has anything to do with the stated objectives of the 
Directive (see 1.7). Rather, as the Explanatory Memorandum explains, it is designed to ensure that national 
tax authorities in the EU may obtain such information from the tax authorities in the country in which a non-
EU fund is domiciled as is necessary to enable them to tax their domestic investors in that fund. Interestingly, 
there is no mention of this purpose in the Preamble which merely refers to the requirement being designed to 
ensure an efficient exchange of information with the tax authorities in the domiciles of EU investors. It might 
be interesting to consider whether Article 47(2) of the Treaty on which the Directive is based is sufficiently 
broad to permit the inclusion in what is a financial services directive of provisions designed to assist taxation 
authorities.

5.3 The passport to market non-EU funds will, however, only become available three years after the rest of 
the Directive has come into force (see 1.6). Until then both the Explanatory Memorandum and the Preamble 
provide that EU member states may allow or continue to allow (as the case may be) AIFM to market non-
EU funds to professional investors under the existing national private placement rules currently in force in 
those member states. It is not clear, however, whether those national private placement rules currently 
permit non-EU funds to be marketed to investors who are not professional investors as defined for the 
purposes of the Directive, marketing to such non-professional investors will be permitted. It must also be 
noted that during this three year period non-EU funds will be at a competitive disadvantage when compared 
to EU funds, particularly in countries such as France and Italy which do not currently allow non-EU funds 
to be marketed even on a private placement basis.

6. Marketing of non-EU funds by non-EU AIFM

6.1 The Directive provides that EU member states may authorise AIFM which are not established (and thus 
not authorised) in an EU member state to market shares of a non-EU fund to professional investors 
throughout the EU, subject to a number of conditions being satisfied. These conditions include a 
determination having been taken by the Commission (rather than the relevant EU member state) that the 
legislation of the non-EU country in which the AIFM is established in relation to prudential regulation (for 
example, as to regulatory capital requirements, to which no US hedge fund manager is currently subject) and 
ongoing supervision is equivalent to the provisions of the Directive and is effectively enforced, that AIFM 
established in the EU are granted comparable effective market access to professional investors in that non-EU 
country and that, as described in 5.1, the non-EU country has entered into an agreement on sharing 
information in tax matters with each EU member state in which the non-EU fund is to be marketed.
6.2 It seems likely that in practice it may be almost impossible for the conditions to which such marketing authorisation is subject to be satisfied. For example, as regards the market access condition, it is notable that regulators in the EU and the US have been endeavouring without success for over 30 years to agree reciprocal access for UCITS funds and their US equivalent. Further, as mentioned in 6.1, it is the Commission which must determine whether a non-EU country has legislation regarding prudential regulation and ongoing supervision equivalent to the provisions of the Directive and whether that country permits EU AIFM effective market access comparable to that granted by the EU to AIFM from that country. This is unfortunate since, at least in the current climate, it is highly likely that the Commission’s determination will be affected by political considerations.

6.3 This arguably introduces a form of protectionism which will not necessarily benefit EU investors. For example, it will result in EU pension funds and similar institutional investors being substantially restricted in the choice of AIF in which they may invest—whilst there are at least 9,500 hedge funds established in the Cayman Islands alone, as well as a very substantial number of hedge funds formed under US law, there are comparatively few EU-domiciled hedge funds. It seems reasonable to assume that if the EU effectively locks out US (and other non-EU) funds in this way, the US may in turn reciprocate and lock out EU funds from its market. This cannot be in the interest of EU AIFM or indeed of their investors. It would also contradict the terms of the communiqué issued by the G20 in April 2009 in which it was agreed that protectionist measures would not be engaged in by the G20 countries.

6.4 Since the above conditions, with the exception described in 5.1, do not apply to AIFM established and authorised in an EU member state, non-EU hedge fund managers wishing to continue to market their non-EU funds in the EU may be forced to establish a place of business in the EU and become authorised under the Directive. Otherwise, as the Explanatory Memorandum recognises, EU AIFM will be provided with a comparative advantage vis-à-vis non-EU AIFM which are not authorised in the EU.

6.5 It has been suggested that the restriction on the marketing of non-EU funds would not impact EU funds of hedge funds adversely, since they would continue to be able to invest in non-EU funds whose AIFM is not established in the EU. However, given the extensive definition of marketing for the purposes of the Directive (see 4.1), it is difficult to see how such funds of hedge funds could in practice invest in such non-EU funds given that the AIFM in question would not be able to market the funds to them.

6.6 Although the Directive only expressly restricts the marketing of non-EU funds by AIFM which are not authorised in the EU, it would be surprising if it was intended that other entities which are not EU authorised, such as investment firms whose principal activity is the marketing of AIF, would continue to be permitted to market non-EU funds in the EU under the existing national private placement rules in force in the EU member states (see 4.4).

6.7 As with the passport which may be granted to EU AIFM to market non-EU funds (see 5.3), the ability of EU member states to authorise non-EU AIFM to market non-EU funds in the EU will only apply with effect from three years after the date on which the rest of the Directive enters into force (see 7). However, in this case it is not entirely clear whether during that three year period EU member states may also allow or continue to allow (as the case may be) non-EU AIFM to market non-EU funds in the EU to professional investors under the existing national private placement rules currently in force in the member states. It would be inimical if such marketing were not to be permitted.

7. When will the Directive come into force?

7.1 Following its publication on 30 April 2009 the Directive has now been sent to the European Parliament and the European Council, where according to the Commission itself it is expected to be the “object of intense political discussion and negotiation”. Interested parties will have an opportunity to influence such discussions and negotiation, both directly and indirectly through HM Treasury, AIMA and other trade associations. The Commission has suggested that if political approval of the Directive is reached by the end of 2009, it could come into force in 2011. Most commentators consider that timing to be somewhat optimistic to say the least. It is more likely that political approval will be reached sometime from the end of the second quarter of 2010 onwards. The EU member states will then have 18 months in which to transpose the provisions of the Directive into their domestic law, with the result that those provisions are unlikely to come into force until January 2012 at the earliest (the “transposition date”).

7.2 The Directive provides that EU AIFM must submit an application for authorisation under the Directive within one year of the transposition date, but it is unclear whether this means within the 12 months preceding the transposition date (which would allow them a period of only six months to submit such an application following political approval of the Directive) or within 12 months following the transposition date. The former would seem to be the more rational position, but since under the Directive an EU member state’s regulatory
8. Independent valuation agents

8.1 An AIFM will be obliged to ensure that each AIF which it manages appoints an independent valuation agent to calculate the value of the AIF’s assets and of its shares. The earlier drafts of the Directive provided that the independent valuation agent should be appointed by the AIFM itself which, in the context of an AIF structured as an investment company, would have usurped the role of the board of directors of the company. It is to be hoped that the amended wording is designed to recognise this fact.

8.2 Where the independent valuation agent is established in a non-EU country, the Commission must first determine that the valuation standards and rules in that non-EU country’s legislation are equivalent to those applicable in the EU. Since there are no generally applicable valuation standards and rules in the EU, and since in practice the valuation rules followed by AIF are usually set out in their prospectus or equivalent document or occasionally in their constitutional documents, and not in legislation, it is difficult to see how this provision will be applied. Further, the Directive provides that the determination by the Commission is to be to the effect that the valuation standards and rules of the non-EU country’s legislation are equivalent to those applicable in the EU, and again it is difficult to see how this will be applied in circumstances where neither a non-EU country nor the EU itself has promulgated any legislation relating to this subject.

8.3 Currently the Directive provides that, as with the marketing by non-EU AIFM of non-EU AIF (see 6), the provision relating to the appointment of independent valuation agents in a non-EU country will only come into force three years after the transposition date. It is unclear whether AIF which have currently appointed non-EU valuation agents will have to replace those valuation agents with EU valuation agents during that three year period, thus resulting in existing arrangements having to be restructured. That would clearly be an onerous obligation.

8.4 Whilst IOSCO, AIMA and the Hedge Fund Standards Board recommend that an independent valuation agent be appointed, they all recognise that circumstances can exist where it is not always appropriate, and it is not yet a generally recognised practice among, for example, all US hedge fund managers. Indeed, it is interesting to note that an earlier draft of the Directive referred to the obligation as being to appoint a valuation agent which was “legally or functionally” independent of the AIFM, which might have permitted certain managers of hedge funds structured as US limited partnerships to segregate the valuation function from all other functions and hence to comply with the requirements of the Directive. It seems, however, that UK AIFM which are affiliates of US hedge fund managers will not be able to comply with the requirements for authorisation as an AIFM, unless each AIF in respect of which they have been appointed as sub-advisor by their US parent has appointed an independent valuation agent complying with the requirements of the Directive. It seems possible that, when faced with compliance with this obligation, many US hedge funds managers who have delegated responsibility for the investment management of the AIF to an AIFM which is a UK or EU affiliate will consider either closing that a Y a Y scheme down or reducing the scope of its activities so that it is no longer carrying on investment management activities, thus leading to a loss of employment in, and tax revenues payable to, the UK or other EU member state.

8.5 A number of criticisms have been levelled at this requirement by the private equity fund industry for reasons specific to such funds. The obligation imposed on the valuation agent to value the assets of AIF at least once a year appears unnecessary in the context of a private equity fund since the value of its limited partnerships interests or shares is unimportant until its underlying investments are realised. Further, in the case of a closed-ended fund whose shares cannot be redeemed and which, if listed, do not trade at their asset value, the provisions requiring the appointment of a valuation agent appear unnecessarily onerous.

9. Depositories, prime brokers and liability issues

9.1 For each AIF that it manages an AIFM is required to ensure that a depositary is appointed to fulfil certain tasks. These include receiving payments made by investors when subscribing for shares and recording them on behalf of the “AIFM” (which should presumably read “AIF” since the monies in question belong to the AIF and not to the AIFM) in a segregated account, safekeeping any financial instruments which belong to the AIF and verifying whether the AIF or the AIFM on its behalf has obtained the ownership of all other assets in which the AIF invests (it is not clear exactly what is intended to be covered by this latter task and, indeed, it is to be noted that it is not a requirement which applies under the UCITS Directive to a depositary appointed to a UCITS).
9.2 As with the valuation agent, earlier drafts of the Directive provided that the AIFM itself was to appoint the depositary and indeed the Preamble still provides that this is the case. It will be important to rectify this in the next draft. Further, the Directive provides that the depositary is to act independently and solely in the interest of the investors in an AIF, but it would be normal for a depositary also to owe duties to the AIF itself, at least where the AIF is established in the form of an investment company. This too will need to be clarified.

9.3 The depositary is required to be an EU credit institution and since the right of the depositary to delegate is expressed as a right to delegate to “other depositaries”, the implication is that sub-custodians must also be EU credit institutions. This interpretation is supported by the provision (see 9.4) permitting a depositary that is an EU credit institution in certain circumstances to delegate to a sub-custodian in a non-EU country which is expressed to be a derogation from the principal right of delegation. Both the obligation to appoint an EU credit institution and the requirement that sub-custodians be EU credit institutions are stricter than under the UCITS Directive itself, which merely requires the depositary of a UCITS fund to be an institution which is subject to prudential regulation and ongoing supervision and imposes no specific obligations in relation to the qualifications of sub-custodians. Given that it is standard market practice in the custody world (the concept of a depositary implies a custody function with additional regulatory responsibilities beyond those normally attaching to mere custodians) for custodians to appoint sub-custodians of securities in the countries in which the issuers of those securities are incorporated, and indeed in certain jurisdictions title to such securities must be held by a local sub-custodian, it will be necessary to make appropriate amendments to these provisions of the Directive. In this regard it should also be noted that some of the largest depositaries/customians currently operating in the EU are not in fact EU credit institutions at all.

9.4 The Directive provides that a depositary shall be liable to the AIFM and the investors in the AIF for any losses suffered by them as a result of its failure to perform its obligations, and further that in the case of any loss of financial instruments which the depositary is safekeeping, it may only discharge itself of liability if it can prove that it could not have avoided the loss which occurred. In addition, the Directive provides that a depositary’s liability shall not be affected by any delegation of its responsibilities to sub-custodians. It appears to be the intention, therefore, to impose strict liability on the depositary, similar to that imposed in France on depositaries of French domestic long only investment funds, for its own failures and for those of any sub-custodians which it appoints. In this regard note that the rules applicable to French domestic hedge funds (ARIA or Contractual Funds) were changed in December 2008 in response to the Lehman failure to allow depositaries to limit their duties in respect of sub-custodians. It is also noteworthy that the equivalent provisions in the UCITS Directive impose liability on a depositary for its “unjustifiable” failure to perform its obligations, which qualification does not appear in the Directive. This is disproportionate and contradicts not only current practice in relation to AIF but in relation to custody generally. It must be doubtful whether depositaries will accept strict liability for sub-custodians in, or which hold securities issued by issuers in, emerging market countries. This could limit the ability of AIF to invest in emerging markets, which is not in the interests of EU investors nor consistent with the EU’s obligations to aid developing countries.

9.5 As mentioned in 9.2, as a derogation from the restriction on the appointment of sub-custodians, the Directive provides that in respect of a non-EU fund the EU depositary may delegate the performance of one or more its functions to a sub-custodian domiciled in the same country as the non-EU fund provided that the legislation of that country is equivalent to the provisions of the Directive (presumably relating only to depositaries) and is effectively enforced. The Commission must also have determined that sub-custodians domiciled in that country are subject to effective prudential regulation and supervision which is equivalent to EU law, that cooperation between the home EU member state (presumably of the AIFM of the relevant AIF) and the relevant authorities of the third country is sufficiently ensured and that the third country is the subject of a decision by the Commission that the standards to prevent money laundering and terrorist financing in that country are equivalent to those laid down in EU law. With regard to the latter requirement, it would be more appropriate to refer to the FATF approved jurisdictions and it is also noteworthy that the tasks ascribed to the depositary itself (see 9.1) do not include any mention of anti-money laundering or terrorist financing. As with the marketing passport (see 5.3 and 6.7), this derogation will only apply with effect from three years after the transposition date.

9.6 The provisions in relation to depositaries and sub-custodians fail to recognise the role of prime brokers in relation to hedge funds despite the fact that the Explanatory Memorandum acknowledges that AIFM interact closely with prime brokers and that it asserts AIFM are responsible for decision-making in relation to prime brokerage. As a result of the requirement that a depositary be an EU credit institution, AIF will be restricted in their choice of prime brokers in that the majority of entities currently providing prime brokerage services are neither EU credit institutions nor have an EU credit institution in their group. Further, this will make it more difficult for AIF to appoint multiple prime brokers as has become increasingly common post-Lehman for reasons of managing counterparty risk. Moreover, where a depositary appoints a prime broker as global sub-custodian, it appears that the depositary will have to accept liability not only for the prime broker itself.
but also for the prime broker’s sub-custodian network. Thus, prime brokerage is likely to become far more cumbersome to operate than at present and prime brokers will be forced to accept having a depositary looking over their shoulders. If no amendment is forthcoming to the restrictions on the appointment of sub-custodians, and since none of the prime brokers currently active in the market are established in any of the non-EU domiciles in which AIF are usually established, such restrictions will clearly make it difficult, if not impossible, for an AIF to appoint or continue the appointment of the prime broker(s) of its choice. Further, if US hedge fund managers are forced to establish a place of business in the EU as an AIFM and become authorised under the Directive in order to market their AIF in the EU, their prime brokerage arrangements will also need to be changed to comply with the Directive’s requirements.

9.7 The obligation to appoint a depositary will also extend to AIF which are US or other limited partnerships. The structure of a limited partnership, which is managed for the benefit of its investors who are limited partners by a general partner that will usually be the AIFM itself or an affiliate thereof, does not lend itself well to the concept of appointing a depositary. As already mentioned in 8.3, it seems likely that, when faced with compliance with this obligation, many US hedge fund managers who have delegated responsibility for the investment management of part or all of the portfolio of an AIF to an AIFM which is a UK or other EU affiliate will consider closing that affiliate down or at least reducing the scale of its activities so that it is no longer carrying on investment management activities, thus leading to a loss of employment in, and tax revenues payable to, the UK or other EU member state.

9.8 The obligation to appoint a depositary extends to private equity funds and closed-ended investment companies. It is arguable that it is wholly unnecessary, given the nature of its investments, for a private equity fund to appoint a depositary and it is to be noted that the UCITS Directive itself exempts certain listed investment companies from the obligation to appoint a depositary subject to compliance with certain conditions.

10. **Leverage limits**

10.1 The Directive contains provisions relating to AIFM which manage one or more AIF “employing high levels of leverage on a systematic basis”. It is notable that this test differs from that espoused by IOSCO, the G20 and the Turner Report which refer to hedge funds which are “systemically important”. Under the Directive the test will be deemed to be met by any AIF which employs leverage exceeding the “value of [its] equity capital” in two out of the past four quarters, in which case certain disclosures to investors and regulators will have to be made. It appears from the Frequently Asked Questions (“FAQs”) issued by the Commission the day prior to the publication of the Directive that “equity capital” means “net assets”. It is unfortunate that the level at which this test has been set will result in almost all hedge funds being deemed to have met it (AIMA recently calculated that the average level of leverage employed by hedge funds is 1 times net assets, and this was also recognised by the Commission in the FAQs). Further, the level at which the test has been set, although phrased slightly differently, appears to be the same level as the maximum level of exposure which UCITS funds are permitted to have via derivatives. It is also unfortunate that the Directive fails to distinguish between hedge funds which use leverage on a “systematic basis” and hedge funds which are “systemically important”. Indeed, the FAQs state that the systemic risk posed by the use of leverage by hedge funds is significantly lower than that of investment banks and if this is the case, one is left to wonder why it was felt necessary to provide for the Commission to set limits on leverage (see 10.3).

10.2 The Directive requires an AIFM managing one or more AIF employing high levels of leverage on a systematic basis to disclose to investors the maximum level of leverage which the AIFM may employ on behalf of the AIF as well as any “right of re-use of collateral” (it is not entirely clear what this disclosure is intended to relate to but it is presumably a reference to assets which are rehypothecated) and also to disclose to investors quarterly the total amount (which should presumably refer to the level) of leverage employed by the AIF in the preceding quarter. In addition, such AIFM are required to provide regular information to the regulatory authorities in the relevant EU member state as to the level of leverage employed by them together with a breakdown between leverage arising from borrowing of cash or securities and leverage embedded in financial derivatives. Such information is required to include the identity of the five largest sources of borrowed cash or securities for each AIF and the amounts of leverage received from each of those entities. It is to be hoped that in the UK this information will not be able to be obtained by third parties from the FSA pursuant to a request under the Freedom of Information Act. The purpose behind this disclosure obligation is expressed to be to enable regulatory authorities to identify the extent to which the use of leverage contributes to the build-up of systemic risk in the financial system or the risks of disorderly markets and in this regard the Directive empowers the regulatory authorities, in exceptional circumstances and when this is required in order to ensure the stability and integrity of the financial system, to impose limits (additional to those imposed by the Commission—see 10.3) on the level of leverage that AIFM can employ, albeit on a temporary basis only.
10.3 The final text of the Directive also contains a provision, which did not appear in any of the previous drafts, which requires that the Commission, “in order” to ensure the stability and integrity of the financial system, adopt measures setting limits to the level of leverage which AIFM can employ (irrespective of whether they otherwise employ “high levels of leverage on a systematic basis”), taking into account the type of AIF, their strategies and their sources of leverage. It is interesting to note that whilst the Directive provides that this requirement is “in order” to ensure the stability and integrity of the financial system, the Explanatory Memorandum states that the Commission is only “empowered” (but not required) to set leverage limits. The Preamble suggests that such limits could either consist of a threshold that should not be breached at any time or a limit on average leverage employed during a given period (such as monthly or quarterly). This provision, which has been the subject of no consultation whatsoever, will rightly be seen by AIFM as unacceptable, particularly since AIFM are unlikely to believe that the Commission will be judicious in setting leverage limits. Moreover, it should be noted that both the Explanatory Memorandum and the Preamble state that it would be disproportionate to regulate the structure or composition of the portfolios of AIF and further the FAQs state the Directive does not regulate investment policies. These statements are contradicted by the inclusion of the requirement for the Commission to adopt leverage limits.

11. Capital requirements

11.1 An AIFM authorised under the Directive will be required to meet a minimum own funds capital requirement of €125,000 plus a further own funds requirement equal to 0.02% of the amount by which the aggregate net assets of all of the AIF which it manages exceed €250 million (ie approximately €5,000 in respect of each tranche of €25 million above the threshold). Unlike the position of UCITS management companies from which this requirement is taken, there will be no cap on the amount of additional capital required to be held—the cap for UCITS management companies is an additional own funds requirement of €10 million. No regulatory capital requirement is imposed on an AIF itself.

11.2 According to the Preamble, the minimum capital requirements are designed to ensure the continuity and regularity of the management services provided by AIFM and to cover the potential exposure of AIFM to professional liability in respect of their activities. According to the FAQs, the requirements are intended to enable investors to claim damages in the case of fraud or other wrongdoing by the AIFM. It is unusual to impose regulatory capital requirements on investment managers by reference to the level of assets under their management. Rather, such requirements are normally based on the level of their expenditure and are designed to ensure that they have sufficient capital to enable them to operate in circumstances where their fee income is reduced. Indeed, it is for this reason that investment managers authorised by the FSA are required to have financial resources equal to at least one-quarter of their annual audited expenditure.

11.3 In the event that the investment manager of an AIF is determined to be its AIFM (see 3), it is likely that in many cases the amount of regulatory capital required to be held on an expenditure basis will exceed by some margin the minimum capital requirements imposed by the Directive (other than perhaps in the case of small start-up hedge fund managers and certain managers of private equity funds).

12. Conduct of business rules

12.1 The Directive imposes on an AIFM an obligation to act in the best interests of the AIF it manages, the investors in those AIF and the integrity of the market. In this regard it should be noted that the interests of the AIF itself and of (some) investors may not necessarily always be aligned as is recognised by the provisions relating to conflicts of interest (see 12.3). The AIFM is also required to ensure that all investors are treated fairly and in this regard it should be noted that as a matter of English law the position is that all investors holding shares “of the same class” must be treated fairly but the law recognises that this may not be appropriate as between investors of different classes and it is to be hoped that the provisions by which this obligation are transposed into English law will reflect this distinction appropriately.

12.2 The Directive also provides that no investor in an AIF may obtain preferential treatment unless this is disclosed in the AIF rules (see 4.3 as to whether it should be made clear that this is a reference to the prospectus or other offering document of an AIF). It will need to be clarified whether the obligation is to make a general disclosure as to the possibility of treatment which is not preferential or whether more specific disclosure as to the detailed nature of the non-preferential treatment will be required. It is suggested that preferential treatment might be defined by reference to the definition of a “material term” for the purposes of side letter disclosure under the FSA rules. That definition reads in material part: “Any term the effect of which might reasonably be expected to be to provide an investor with more favourable treatment than other holders of the same class of share which enhances that investor’s ability either (i) to redeem shares of that class or (ii) to make a determination as to whether to redeem shares of that class, and which in either case might, therefore, reasonably be expected to put other holders of shares of that class who are in the same position at a material
disadvantage in connection with the exercise of their redemption rights”. The provisions of the Directive relating to disclosure to investors also contain an obligation of disclosure in this regard (see 14.7).

12.3 Where an AIFM is a subsidiary of a non-EU AIFM, such as the UK subsidiary of a US hedge fund manager, which manages only a portion of an AIF’s portfolio, it may be difficult for the AIFM to comply with this requirement.

12.4 The Directive also contains an obligation on an AIFM to take all reasonable steps to identify conflicts of interest between the AIFM and investors in the AIF which it manages, or between one investor and another that arise in the course of managing one or more AIF. It is difficult to see how this obligation would apply as between investors in different AIF. Further, it should be noted that where the AIFM is in fact an investment manager and is already authorised as an investment firm under MiFID, it will already be subject to an obligation in relation to the management of conflicts of interest. It should also be noted that the Directive requires AIFM to maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps to “prevent” conflicts of interest from adversely affecting the interests of an AIF and its investors, whereas the equivalent obligation in relation to UCITS management companies under the UCITS Directive is to “minimise” conflicts of interest. This is disproportionate and the latter obligation is preferable since preventing conflicts of interest altogether is unlikely to be feasible.

12.5 The Directive also requires that an AIFM ensure that its risk management and portfolio management functions are segregated. This will be a potentially onerous obligation for small hedge fund managers.

12.6 The Directive further provides that an AIFM which engages in short selling must operate procedures which provide it with access to the securities or other financial instruments at the date when the AIFM committed to deliver them and must implement a risk management procedure which allows the risks associated with the delivery of short sold securities or other financial instruments to be adequately managed. Further, the Directive requires the Commission to adopt implementing measures (see 16) specifying any arrangements needed to enable AIFM to manage the risks associated with short selling transactions, including any restrictions that might be needed to protect the AIF from undue risk exposures. The Explanatory Memorandum and the FAQs both acknowledge that short-selling is not the exclusive preserve of AIFM and that the Commission is considering short-selling on a broader front. It would therefore have been more sensible for the treatment of short-selling to have been dealt with in a broader context, whether on an EU or international basis.

12.7 An AIFM will be required to employ an appropriate liquidity management system and to adopt procedures which ensure that the liquidity profile of the investments of an AIF which it manages comply with the AIF’s underlying obligations (this appears to be a reference to its redemption policy). It is unclear how this obligation differs from that also imposed by the Directive requiring an AIFM to ensure that each AIF it manages has a redemption policy which is appropriate to the liquidity profile of the investments of the AIF. Imposing this obligation on the AIFM itself would appear to usurp the role of the board of directors where the AIF is structured as an investment company, and appears to be wholly unnecessary in relation to a closed-ended fund which by its nature is under no obligation to redeem shares at the request of investors.

12.8 The Directive also provides that the Commission must adopt implementing measures (see 16) specifying the minimum liquidity requirements for AIF which redeem shares more often than half-yearly. It is unclear why these measures should be determined by the Commission, and it could lead to restrictions being imposed by the Commission on the ability of AIF to impose gates or to suspend redemptions in relevant circumstances. It could also lead to certain AIF reducing their redemption cycle from monthly or quarterly to half-yearly in order to avoid the restrictions, which would not generally be in the interests of investors.

12.9 In addition to the restriction on investment policies referred to in 10.3 in relation to leverage limits, the Directive also requires the Commission to adopt implementing measures laying down requirements which must be complied with by the originators of securitised investments in order for an AIFM to be allowed to invest in securities or other financial instruments of this type issued after 1 January 2011, including a requirement that the originator retain a net economic interest of not less than 5%, and further requires the Commission to adopt measures imposing qualitative requirements that must be met by AIFM which invest in these types of securities or financial instruments on behalf of one or more AIF. It is expected that the latter requirements will reflect the due diligence risk assessment requirements expected to be imposed on EU credit institutions through a proposed amendment to the EU Banking Consolidation Directive.
13. **Delegation by AIFM**

13.1 Any delegation by an AIFM of any of its functions will require the prior authorisation of the regulatory authorities in its home EU member state. Any such delegation must comply with certain conditions. In particular, where the delegation is of portfolio management or risk management, the third party to whom the function is delegated must itself be authorised as an AIFM to manage an AIF of the same type. It is surprising that this obligation is more onerous than the conditions imposed by the MiFID Directive on the delegation by investment managers of portfolio management services in relation to retail clients. Further, it would seem to prevent an AIFM from delegating part or all of the portfolio management function to an investment manager which is a specialist in a particular area, such as emerging markets, but which is not EU based and thus not subject to authorisation, or capable of being authorised, in the EU.

13.2 An AIFM will also be required to demonstrate that it is in a position to monitor effectively at any time the functions which it has delegated to a third party, to give at any time further instructions to that third party and to withdraw the delegation with immediate effect when this is in the interest of investors. These obligations are more onerous than those to which an investment manager authorised under the MiFID Directive is subject, and would seem to be unnecessarily onerous.

13.3 It should be noted that the Directive also provides that an AIFM’s liability will not be affected by the fact that it has delegated functions to a third party, which appears to imply strict liability as in the case of delegation by a depositary to sub-custodians (see 9.3).

13.4 Since the Directive provides that an AIFM which is authorised under the Directive to provide management services to AIF is also entitled (it would seem automatically) to market shares of those AIF to professional investors in the EU, it will be necessary to clarify whether the appointment of a sales or placement agent by such an AIFM would constitute delegation of one of its functions, such that the AIFM would have strict liability for the actions of such agent.

13.5 The Directive also contains a specific provision relating to the delegation by an AIFM of administrative services to a non-EU entity and provides that such entity must be authorised to provide administrative services in the non-EU country in which it is established and must be subject there to prudential supervision. As with the provisions relating to marketing of non-EU funds, the appointment of non-EU valuation agents and the appointment of non-EU sub-custodians, such delegation is only permitted with effect from three years following the transposition date and thus again raises the issue of whether administration services which are currently delegated to a non-EU entity must be restructured (see 3.1 in relation to which entity performs administration services).

14. **Disclosure to investors and regulators**

14.1 The Directive requires an AIFM to ensure that investors in the AIF which it manages receive certain information before they invest in the AIF, as well as notice of any changes in such information. The information is not dissimilar in some respects to that which is required to be made available to investors by signatories to the best practice standards published by the Hedge Fund Standards Board. Certain of the requirements will, however, need to be clarified and/or amended.

14.2 One of the requirements is that there be disclosed a description of “all” of the assets in which an AIF may invest. Elsewhere in the Directive, however, reference is made to the disclosure of the “types” of assets in which the AIF may invest, which is more appropriate given that it would be in practice impossible to describe all such assets. Linked to this is a requirement to disclose “all” associated risks which again is likely to be impossible to comply with and should preferably be amended to refer to “the” associated risks.

14.3 There is also a requirement to describe “the legal implications of the contractual relationship entered into for the purpose of investment, including information on jurisdiction, applicable law and on the existence, or not, of any legal instruments providing for the recognition and enforcement of judgments on the territory where the fund is domiciled”. It appears that this requirement, which was introduced only in the final text of the Directive, is intended to reflect a concern expressed by some EU member states that aggrieved investors would have to bring proceedings against an AIF in a non-EU domicile in whose courts such member states have little confidence, or if such aggrieved investors were to bring proceedings in an EU member state, that they would not be able to enforce any judgment obtained in the courts of the non-EU domicile of the relevant AIF. This appears to reflect a misunderstanding of the relevant issues, many of which are governed by international conventions and it is to be hoped that agreement can be reached to delete this requirement or to modify it appropriately.
14.4 There is also an obligation to disclose the identity of the depositary and valuation agent, as well as any other service providers, and an investor’s rights “should any failure arise”. The scope of the latter requirement is unclear and appropriate clarification will be needed.

14.5 There is also a requirement to describe the identity of any third party to whom the depositary has delegated any functions, and to the extent that the Directive is amended to permit EU depositaries to delegate to sub-custodians which are not themselves EU credit institutions (see 9.2), it will be impracticable to disclose the identity of all such sub-custodians.

14.6 In relation to liquidity risk management (see 12.6), there is a requirement to disclose how an AIFM ensures the fair treatment of investors and it will be necessary to clarify the scope of this obligation.

14.7 The maximum amount of all fees, charges and expenses must also be disclosed. It is suggested that the solution is to provide for maximum “rates” rather than amounts of fees, which would also resolve the issue that is likely to arise with respect to performance fees, the maximum “amount” of which cannot be calculated in advance given that such fees are calculated by reference to the appreciation in value of shares which cannot be known in advance.

14.8 Where an investor is granted or given the right to obtain preferential treatment, a description of that treatment must be disclosed as well as the identity of the investor. This is likely to be considered to be extremely objectionable not only by AIFM but by investors themselves. Moreover, it is questionable whether this obligation is consistent with the principles behind the EU Data Protection Directive and with Article 8 of the European Convention for the Protection of Human Rights. The following extract from the recitals of that Directive are instructive: “Whereas the object of the national laws on the processing of personal data is to protect fundamental rights and freedoms, notably the right to privacy, which is recognised both in Article 8 of the European Convention for the Protection of Human Rights and Fundamental Freedoms and in the general principles of Community law; whereas, for that reason, the approximation of those laws must not result in any lessening of the protection they afford but must, on the contrary, seek to ensure a high level of protection in the Community”. It is arguable that the obligation to disclose the identity of investors is inconsistent with such principles, not least because it seems to be an excessively intrusive requirement to achieve its aim. Presumably the necessary investor protection could be achieved by disclosing the favourable treatment without identifying the individual investor concerned.

14.9 The Directive also requires that an AIFM shall, for each of the AIF it manages, make available to investors and to the regulatory authorities in its own EU member state an annual report for each financial year no later than four months following the end of the financial year. It is unclear whether this report is to be in addition to the report which AIF themselves are required to make available under the law of their domicile (this obligation generally applies irrespective of whether the AIF is established in an EU member state or outside the EU). It would be unnecessarily onerous to require two separate but largely identical reports to be prepared. Further, listed closed-ended AIF are subject to the Transparency Directive which requires that the AIF itself publish an annual report.

14.10 The accounting information given in the annual report is required to be audited by an auditor established in the EU and this is likely to conflict in many cases with the law of the domicile of an AIF which generally requires that an auditor established in that domicile audit its accounts. This requirement would have the consequence that the accounts of US hedge funds established as limited partnerships would have to be audited by an EU-based auditor. Since such accounts are generally prepared on the basis of US generally accepted accounting principles, it is unlikely that any EU auditor would be prepared or competent to audit them.

15. Acquisition of rights

15.1 The Directive imposes certain obligations on AIFM managing AIF which acquire a controlling influence in companies. These obligations are primarily likely to impact on AIFM which manage private equity and buy-out funds and, perhaps, in certain cases on activist hedge funds. The obligations apply where an AIFM manages one or more AIF which either individually or in the aggregate acquire 30% or more of the voting rights of an issuer or a non-listed company domiciled in the EU, or where an AIFM has concluded an agreement with one or more other AIFM which would allow the AIF managed by those AIFM to acquire 30% or more of the voting rights of an issuer or of a non-listed company.

15.2 Where this obligation applies, various notification and disclosure obligations are imposed. These include disclosing to the issuer or the non-listed company, its shareholders and representatives of its employees the AIFM’s policy for preventing and managing conflicts of interest between the AIFM and the issuer or non-listed company as appropriate. This obligation appears to ignore the fact that shareholders do not generally under existing law owe any duties to a company in which they are invested.
15.3 In addition, where, following an acquisition of 30% or more of the voting rights of a listed company, the shares of that company are delisted, the issuer is required to comply with its obligations under the Transparency Directive for two years from the date of the delisting. This provision appears to be inequitable in that such an obligation does not apply to other “private buyers” which are not AIF.

16. Commission to adopt implementing measures

16.1 Many of the provisions of the Directive provide that the Commission shall adopt implementing measures designed to amend non-essential elements of the Directive by supplementing it. Although these measures are required to be adopted in accordance with the so-called “regulatory procedure with scrutiny”, it is arguable that this gives far too much scope to the Commission to modify and expand the requirements imposed on AIFM and AIF by the Directive, especially in light of the somewhat political approach that has been evident to date in the drafting of the Directive. This could be ameliorated by two amendments. First, by reverting to the earlier drafts of the Directive which provided that the Commission “may” rather than “shall” adopt implementing measures; and secondly, by extending to all implementing measures the obligation that such measures must be adapted to the type of AIFM to which they apply, which currently applies only in relation to the implementing measures relating to disclosure to investors.

17. Key considerations

17.1 It will be apparent from the significant issues described above that the Directive is deeply flawed in many respects due, at least in part if not to a substantial extent, to the lack of consultation undertaken by the Commission prior to its publication and to the lack of opportunity for the industry to provide input into the drafting process. The principal issues which need to be addressed urgently are enumerated below.

17.1.1 Consideration should be given to raising the threshold at which AIFM become subject to the Directive and transitional provisions should be added to cater for AIFM which unexpectedly cross the threshold.

17.1.2 EU credit institutions which operate as AIFM should not be excluded from the ambit of the Directive.

17.1.3 Listed closed-ended funds should be excluded from the definition of an AIF.

17.1.4 How the Directive is intended to apply to master-feeder fund structures should be clarified.

17.1.5 Clarification is required as to which entity is to be regarded as the AIFM in relation to AIF structured as investment companies.

17.1.6 The term “AIF rules” should be defined so as to include an AIF’s prospectus or other offering document.

17.1.7 The position of entities (both EU and non-EU) which do not manage AIFM but only market shares therein should be clarified.

17.1.8 The conditions to which the passport for the marketing of non-EU funds by EU AIFM and non-EU AIFM is subject should be removed.

17.1.9 The provisions to which the appointment of a non-EU valuation agent is subject should be simplified.

17.1.10 AIF should not be required to appoint only EU credit institutions as custodians and the restrictions on the appointment of sub-custodians should be removed. Both of these requirements are stricter than the standards applied by the UCITS Directive.

17.1.11 Depositaries and sub-custodians should be allowed greater scope to regulate their own relationship in terms of where liability falls and the concept of strict liability of depositaries should not be imposed. This requirement is stricter than the standard applied by the UCITS Directive.

17.1.12 The other provisions of the Directive which seek to impose stricter standards than are applied by the equivalent provisions in the UCITS Directive (eg as to verifying whether an AIF has obtained ownership of assets, the absence of an upper limit on the required additional regulatory capital and conflicts of interest) should be relaxed at least to the level provided for by the UCITS Directive.
17.1.13 The Commission should neither be obliged, nor authorised, to set leverage limits for AIF.

17.1.14 Delegation of functions by an AIFM should not be subject to prior regulatory approval and the restrictions on an AIFM’s ability to delegate should be removed.

17.1.15 The Commission should not be obliged to adopt implementing measures and the exercise of any power to do so should be restricted.

EU COMMISSION PROPOSAL FOR A DIRECTIVE ON ALTERNATIVE INVESTMENT FUND MANAGERS

KEY ISSUES FOR US MANAGERS OF HEDGE FUNDS AND FUNDS OF HEDGE FUNDS

BACKGROUND

1.1 On 30 April 2009 the EU Commission published the final text of a draft EU Directive on Alternative Investment Fund Managers (AIFM). While the Directive will apply primarily to any AIFM established in an EU Member State which provides management and administration services to one or more alternative investment funds (AIF), it will also apply to the marketing of AIF in the EU by AIFM which are established outside the EU, including by AIFM established in the US. AIF include both hedge funds and funds of hedge funds.

1.2 This note assumes that, for the purposes of the Directive, the AIFM of an AIF is the investment manager thereof, other than in the case of a limited partnership which has not appointed a separate investment manager when it is assumed that it will be the general partner. The note also assumes that where the investment manager or general partner has appointed an EU affiliate as sub-advisor, the sub-advisor cannot be treated as the AIFM for the purposes of the Directive. The Directive is not clear on these points, which will need to be clarified in due course. In this note the AIFM is referred to as a “fund manager”.

1.3 While this note describes specifically the position of US fund managers, its contents are for the most part of equal application to other non-EU fund managers.

MARKETING AUTHORIZATION

1.4 Under the Directive an EU Member State may authorise a US fund manager to market an AIF of which it is the manager to professional investors (as defined in the MiFID Directive) throughout the EU provided that five conditions are satisfied (see 1.6 et seq). It appears that authorisation is only required to be obtained from one EU Member State and thus not from each Member State in which an AIF is to be marketed, and further that it is not necessary for a US fund manager to establish a place of business in the EU Member State in which it is seeking authorisation (but see 1.20).

1.5 The Directive does not refer in this context only to AIF domiciled in a third country and thus it appears that a US fund manager will require authorisation to market not only AIF established outside the EU (whether in the US, Cayman or elsewhere) but also those established inside the EU (whether in Ireland, Luxembourg or elsewhere). If this is correct, it will not suffice for a US fund manager to establish an AIF in the EU for marketing to EU investors in order to avoid the need to obtain authorisation.

CONDITIONS TO BE SATISFIED

1.6 The five conditions which must be satisfied in order for an EU Member State to authorise a US fund manager to market an AIF in the EU are described below.

1.7 The first condition which must be satisfied is that the EU Commission must have taken a decision that US legislation regarding prudential regulation and ongoing supervision is equivalent to the provisions of the Directive relating to such regulation and supervision and that it is effectively enforced.

1.8 The second condition which must be satisfied is that the EU Commission must have determined that the US grants to EU fund managers effective market access comparable to that granted by the EU to US fund managers.

1.9 The Directive provides for a two stage process in relation to these two conditions. First, it requires the EU Commission to adopt implementing measures aimed at establishing (i) in relation to the first condition, general equivalence criteria for the equivalence and effective enforcement of third country legislation on prudential regulation and ongoing supervision and (ii) in relation to the second condition, general criteria for assessing whether third countries grant EU fund managers effective market access comparable to that granted by the EU to fund managers from third countries.
1.10 The Directive requires the EU Commission, when establishing the general equivalence criteria referred to in 1.9(i), to base these criteria on certain requirements laid down in the Directive in relation to EU fund managers, including the obligation (i) to maintain a minimum initial and ongoing level of regulatory capital, (ii) to ensure that the AIF of which they are the AIFM appoint an independent custodian and an independent valuation agent, (iii) to comply with various conduct of business rules, restrictions on delegation (see further 1.22), transparency obligations with respect both to disclosure to investors and reporting to regulators and (iv) to comply with leverage limits which are to be determined by the EU Commission.

1.11 The second stage requires that, on the basis of these general criteria, the EU Commission adopt implementing measures stating that the US legislation on prudential regulation and ongoing supervision of US fund managers is equivalent to that under the Directive and is effectively enforced, as well as stating that the US grants EU fund managers effective market access at least comparable to that granted by the EU to US fund managers.

1.12 In connection with the second condition it is notable that regulators in the EU and the US have been endeavouring without success for over 20 years to agree reciprocal access for regulated UCITS funds and their US equivalent.

1.13 The third condition that must be satisfied is that the relevant regulatory authorities of the EU Member State in which the US fund manager is seeking authorisation must have entered into a cooperation agreement with the “supervisor” of the US fund manager which ensures an efficient exchange of all information that is relevant for monitoring the potential implications of the activities of the US fund manager for the stability of systemically relevant financial institutions and the orderly functioning of markets in which the US fund manager is active. The Directive does not define the term “supervisor”, but it is assumed that, as regards US fund managers, this will mean the SEC or, in certain cases, the Federal Reserve under the reforms proposed last week by the US Department of Treasury. To the extent that a US fund manager is not registered with the SEC as an investment adviser under current legislation or pursuant to such reforms with the SEC or the Federal Reserve, it would seem that this condition would not be capable of being complied with by such fund manager.

1.14 The fourth condition that must be satisfied is that the US must have signed an agreement with the EU Member State in which the US fund manager is applying for authorisation to share information on tax matters which fully complies with the standards laid down in Article 26 of the OECD Model Tax Convention and which ensures an effective exchange of information in tax matters. It is understood that, to date, the US has only entered into such an agreement with Luxembourg but not with any other EU Member State.

1.15 The fifth condition that must be satisfied is that the US fund manager must provide the regulatory authorities in the EU Member State in which it is applying for authorisation with certain information, including information on the identities of its shareholders or members that have a direct or indirect holding in it which represents 10% or more of its capital or voting rights.

1.16 It seems very unlikely, if not impossible, that all of the five conditions referred to above will be able to be satisfied and thus that US fund managers may be prevented from marketing their AIF in the EU under the Directive, unless they establish a place of business in an EU Member State and seek authorisation under the Directive (see 1.20).

**Implementation Delayed to 2014**

1.17 The ability of an EU Member State to authorise US fund managers to market AIF to professional investors in the EU will only apply with effect from three years after the date on which the legislation of the Member States implementing the Directive enters into force (likely to be during the second half of 2014 at the earliest). While EU fund managers will be permitted to market non-EU funds in the EU during this three year period under the existing national private placement rules currently in force in the EU Member States, it is not clear whether US fund managers will also be permitted to do so and this will need to be clarified.

**Meaning of Marketing**

1.18 The Directive defines marketing to mean any general offering or placement of shares or interests in an AIF to or with investors domiciled in the EU regardless of at whose initiative the offer or placement takes place, and thus extends to responding to unsolicited approaches. Accordingly, if a US fund manager receives an unsolicited approach from an EU investor, such as an EU fund of hedge funds, any response to that approach is likely to constitute marketing. Where a US fund manager is approached by a non-EU entity acting on behalf, or which is a non-EU affiliate, of an EU investor, it should be possible for the US fund manager to avoid being treated as marketing to the EU investor so long as it deals only with the non-EU entity, subject to any contrary indication in the legislation of the relevant EU Member State implementing the Directive. In
addition, the provision of periodic reports by a US fund manager to existing EU investors in an AIF of which it is the manager should not constitute marketing to such investors, provided that such reports do not contain any offer to subscribe for additional shares or interests in the AIF. Where an existing EU investor makes its own determination to subscribe for additional shares or interests, the position is less clear and this will need to be clarified.

**Protectionist Effect**

1.19 The five conditions described in 1.6–1.15, which must be satisfied in order for a US fund manager to be authorised to market the AIF which it manages in the EU, in effect introduce a form of protectionism which is unlikely to benefit EU investors. The likely inability of a US fund manager to satisfy the conditions could result in EU pension funds and similar institutional investors being substantially restricted in the choice of AIF in which they may invest. Moreover, if the EU effectively locks out AIF managed by US fund managers in this way, the US may in turn reciprocate and lock out AIF managed by non-US managers from the US market. This cannot be in the interest of EU fund managers or of EU investors. It would also contradict the terms of the Communiqué issued by the G20 in April 2009 in which it was agreed that protectionist measures would not be engaged in by the G20 countries.

1.20 Since these conditions, with the exception of a condition which is similar to the fourth condition (see 1.21), do not need to be satisfied by fund managers established and authorised in an EU Member State, US fund managers wishing to continue to market their AIF in the EU may be forced to establish a place of business in the EU and to become authorised under the Directive. Otherwise, as the explanatory memorandum (Explanatory Memorandum) which forms part of the proposed Directive recognises, EU fund managers will be provided with a comparative advantage vis-à-vis US fund managers. In this regard it should be noted that while it is in theory possible for a UK branch of a US fund manager to be authorised by the UK Financial Services Authority, it has in the past proved impracticable for such a branch to obtain authorisation, although this may change when the UK legislation implementing the Directive comes into force.

1.21 The position of US fund managers differs from that of EU fund managers authorised under the Directive, in that the only condition which must be satisfied in order for an EU fund manager to be authorised to market a non-EU AIF to professional investors in the EU is that each EU Member State in which the EU fund manager wishes to market the non-EU AIF must have entered into an agreement to share information on tax matters with the country in which the non-EU AIF is domiciled. It should be noted that this requirement provides that such an agreement must have been entered into with the country of domicile of the non-EU AIF, while the fourth condition referred to in 1.14 in relation to the authorisation of US fund managers requires that the agreement has been entered into with the US, being the domicile of the fund manager, irrespective of the domicile(s) of the AIF which it manages. The Explanatory Memorandum explains that the requirement in relation to a non-EU AIF managed by EU fund managers is designed to ensure that national tax authorities in the EU may obtain such information from the tax authorities in the country in which the non-EU AIF is domiciled as is necessary to enable them to tax their domestic investors in that AIF. It is difficult to see, however, how this objective will be achieved, particularly in relation to non-US AIF, by requiring the US to have entered into such an agreement with the EU Member State in which a US fund manager is seeking authorisation to market in the EU the AIF which it manages.

**Delegation**

1.22 As mentioned in 1.10, the EU Commission must have regard, when establishing general criteria for the equivalence of third country legislation in relation to prudential regulation and ongoing supervision, to the obligation of EU fund managers to comply with certain restrictions on the delegation of their functions. These include a restriction that portfolio management and risk management may only be delegated to a third party which is itself authorised as an AIFM to manage an AIF of the same type and that the third party may not delegate any of the functions delegated to it. On the basis of these general criteria the EU Commission must then determine that US legislation relating to prudential regulation and ongoing supervision is equivalent to that under the Directive. It remains to be seen how the EU Commission will interpret these requirements in relation to the delegation by US fund managers to their affiliates (whether US or non-US) of portfolio and/or risk management functions and to any delegation of such functions by those affiliates.

**Placement Agents**

1.23 Although the Directive is unclear as to the position, it appears that the EU Commission’s intention is that US based third party distributors, placement agents and the like will only be permitted to market an AIF to professional investors in the EU if such AIF’s US fund manager is permitted to do so on the basis described above.
More Detailed Analysis

1.24 A more detailed general analysis of the Directive is available on request.

EU COMMISSION PROPOSAL FOR A DIRECTIVE ON ALTERNATIVE INVESTMENT FUND MANAGERS

KEY ISSUES FOR INVESTORS IN HEDGE FUNDS AND FUNDS OF HEDGE FUNDS

1. BACKGROUND
1.1 On 30 April 2009 the EU Commission published the final text of a draft EU Directive (Directive) on Alternative Investment Fund Managers (AIFM). The Directive will apply to any AIFM established in an EU member state (EU AIFM) which provides management services to one or more alternative investment funds (AIF), whether the AIF is domiciled inside or outside the EU, whether the AIF is open-ended or closed-ended and whatever the legal structure of the AIF. In addition, the Directive will also apply to the marketing of AIF in the EU by AIFM which are established outside the EU (non-EU AIFM). AIF include both hedge funds and funds of hedge funds.

2. INTRODUCTION
2.1 The objectives of the Directive are to reduce the risks which the activities of AIFM potentially cause to investors, creditors and trading counterparties of AIF and to the stability and integrity of the financial markets. These objectives are laudable but the provisions of the Directive go considerably further than this and impose requirements designed to benefit professional investors which are more onerous than those imposed by the UCITS Directive to protect retail investors. As currently drafted, the Directive will result in a substantial reduction in choice for investors in the EU and a substantial increase in costs and hence a potentially significant reduction in investment returns.

2.2 At the beginning of August 2009 the Alternative Investment Management Association (AIMA) warned that the Directive could cost Europe’s pension fund industry up to €25 billion per annum if implemented in its current form. More recently the UK Financial Services Authority has commissioned a cost benefit analysis of the Directive which is expected to focus, amongst other things, on the impact of the Directive on costs to AIFM and investors and on the impact on European competitiveness.

3. RESTRICTIONS ON CHOICE

Marketing
3.1 The Directive provides that EU AIFM authorised under the Directive will be granted a passport to market the AIF which they manage throughout the EU to professional investors (defined to mean investors within the meaning of Annex II of the MiFID Directive). The passport is subject to a requirement that each EU member state in which an AIFM wishes to market a non-EU AIF has entered into an agreement with the country in which the non-EU AIF is domiciled to share information on tax matters which complies fully with the standards laid down in the OECD Model Tax Convention and which ensures an effective exchange of information in tax matters. It should be noted that if an EU member states wishes to restrict the marketing of non-EU AIF domiciled in a particular country, it may do so by not entering into an agreement to share information in tax matters with that country.

3.2 The passport to market non-EU AIF will, however, only become available three years after the date on which the legislation of the EU member states implementing the Directive is required to enter into force (the transposition date). Until then EU member states may allow or continue to allow (as the case may be) EU AIFM to market non-EU AIF to professional investors under the existing national private placement rules currently in force in those member states. It is not clear, however, whether where those national private placement rules currently permit non-EU funds to be marketed to investors who are not professional investors as defined for the purposes of the Directive, marketing to such non-professional investors will be permitted. It must also be noted that during this three year period non-EU AIF will be at a competitive marketing disadvantage when compared to EU AIF, particularly in countries such as France and Italy which do not currently allow non-EU AIF to be marketed even on a private placement basis.

3.3 The Directive also provides that an EU member state may authorise a non-EU AIFM to market an AIF of which it is the manager (whether it is an EU AIF or a non-EU AIF) to professional investors throughout the EU provided that five conditions are satisfied. These conditions include a determination having been taken by the EU Commission (rather than the relevant EU member state) that the legislation of the non-EU country in which the non-EU AIFM (not the AIF itself) is established in relation to prudential regulation and ongoing
supervision is equivalent to the provisions of the Directive and is effectively enforced and that AIFM established in the EU are granted comparable effective market access to professional investors in that non-EU country. It seems very unlikely, if not impossible, that all of the conditions will be able to be satisfied. A more detailed discussion of the impact of the Directive on non-EU AIFM can be found in AIMA’s Guidance Note on Third Country Fund Managers and in our note of Key Issues for US Managers of Hedge Funds and Funds of Hedge Funds.

3.4 The ability of an EU member state to authorise non-EU AIFM to market EU and non-EU AIF to professional investors in the EU will also only apply with effect from three years after the transposition date. While EU AIFM will be permitted to market non-EU AIF in the EU during this three year period under the existing private placement rules currently in force in the EU member states as described above, it is not clear whether non-EU AIFM will also be permitted to do so.

3.5 Critical to a consideration of these provisions is the definition of marketing. The Directive defines this to mean any general offering or placement of shares or interests in an AIF to or with investors domiciled in the EU, regardless of at whose initiative the offer or placement takes place. It has been suggested that the definition was not intended to extend to responding to unsolicited approaches from investors, but the EU Commission has subsequently made it clear that it fully intended to capture both active marketing (by an AIFM) and passive marketing (at the initiative of the potential investor) in order to avoid circumvention of the Directive’s marketing restrictions. Accordingly, if a non-EU AIFM receives an unsolicited approach from an EU investor, any response to that approach is likely to constitute marketing by the AIFM.

3.6 The conditions which must be satisfied in order for a non-EU AIFM to be authorised to market the AIF which it manages to professional investors in the EU in effect introduce a form of protectionism which will not benefit EU investors. The likely inability of a non-EU AIFM to satisfy the conditions will result in EU investors being substantially restricted in the choice of AIF in which they may invest. As well as reducing choice, a likely consequence is that many EU investors will have difficulty meeting their investment objectives. Moreover, if the EU effectively locks out AIF managed by non-EU AIFM in this way, non-EU countries may in turn reciprocate and lock-out AIF managed by EU AIFM from their own markets. This cannot be in the interest of EU investors. It would also contradict the terms of the Communiqué issued by the G20 in April 2009 in which it was agreed that protectionist measures would not be engaged in by the G20 countries.

Depositaries, Prime Brokers and Liability Issues

3.7 For each AIF that it manages (whether it is an EU AIF or a non-EU AIF) an AIFM is required to ensure that a depositary is appointed to fulfil certain tasks. The depositary is required to be an EU credit institution and since the right of the depositary to delegate is expressed as a right to delegate to “other depositaries”, it appears that sub-custodians must also be EU credit institutions.

3.8 The obligation to appoint an EU credit institution as depositary is stricter than the requirement under the UCITS Directive, which merely requires the depositary of a UCITS fund to be an institution which is subject to prudential regulation and ongoing supervision. Also, the UCITS Directive authorises the EU member states to determine which categories of institutions shall be eligible to be depositaries. Currently, many of the largest depositaries/custodians operating in the EU are not EU credit institutions and not all EU credit institutions act as depositaries of UCITS. This requirement will unnecessarily and significantly restrict an AIF’s choice of depositary and will effectively concentrate counterparty risk in the hands of a small number of EU credit institutions, which in view of the problems which certain EU credit institutions have faced during the current financial crisis is not in the interests of investors.

3.9 In addition, requiring an AIF to appoint an EU credit institution as depositary will conflict with the laws in certain domiciles in which AIF are established or incorporated and which themselves require a local depositary or custodian to be appointed. Further, the majority of prime brokers on whose services hedge funds are reliant are neither EU credit institutions nor have an EU credit institution in their group. It is also becoming increasingly common for hedge funds to appoint more than one (and sometimes multiple) prime brokers with a view to reducing counterparty risk. Requiring that only one depositary be appointed and that it be an EU credit institution will make it impossible for multiple prime brokers to be appointed and will lead to a concentration of risk.

3.10 Given that it is standard market practice in the custody world for depositaries/custodians to appoint sub-custodians (which may be subsidiaries or other affiliates of the depositary/custodian or third party sub-custodians) of securities in the countries in which the issuers of those securities are incorporated, that in certain jurisdictions title to securities or other assets must be held by a local sub-custodian and that no EU credit institution operates through a branch network outside the EU, the provision of the Directive requiring sub-custodians to be EU credit institutions will be unworkable.
3.11 The Directive imposes what is in effect strict liability on the depositary for its own failures and for those of any sub-custodians which it appoints. This is disproportionate and contradicts not only current market practice in relation to AIF but also in relation to custody generally. Depositaries are not currently compensated for the risk of strict liability and thus are likely to charge substantially more for assuming this risk (which additional cost will be borne by investors) and/or not act for certain AIF and/or not for AIF pursuing certain strategies (for example, emerging market investment strategies). This is likely to be the case whether or not the requirement that sub-custodians be EU credit institutions is removed since even if it were, it must be very doubtful whether depositaries would be prepared to accept strict liability for sub-custodians in, or which hold securities issued by issuers in, emerging market countries. This will limit the ability of AIF to invest in emerging markets, which is not in the interests of investors nor consistent with the EU’s obligations to aid developing countries.

3.12 Where a prime broker is not itself an EU credit institution and thus cannot act as depositary, it will be necessary for the depositary of an AIF which is a hedge fund to appoint prime broker(s) as global sub-custodian(s) and in such case the depositary will have to accept liability not only for each prime broker but also for each prime broker’s sub-custodian network. This is again likely to increase the fees which depositaries charge to AIF and which will be borne by investors. Further, since the demise of Lehman, many prime brokers have been developing modifications to the custody element of their prime brokerage offering, whereby assets in excess of the prime broker’s margin requirement would be transferred to, and held by, a separate custodian so as to mitigate the potential for any loss that might be suffered in the event of the prime broker’s insolvency. The appointment of any such separate custodian will further complicate the issues and is likely to increase the costs borne by investors.

3.13 The provisions of the Directive relating to depositaries, sub-custodians and prime brokers, and depositaries' liability therefor, will reduce the choice of depositaries and prime brokers (and, accordingly, reduce competition), increase counterparty risk, limit the ability of AIF to invest in emerging markets and cause some depositaries to refuse to act for AIF pursuing certain strategies or investing in certain markets as well as to increase their fees.

Leverage Limits

3.14 The Directive obliges the EU Commission, in order to ensure the stability and integrity of the financial system, to adopt measures setting limits to the level of leverage which AIFM can employ in relation to AIF, taking into account the type of AIF, their strategies and their sources of leverage. This provision has been criticised for a number of reasons, including the difficulty, if not impossibility, of defining leverage and setting appropriate limits thereon as well as the undesirability of potentially creating an unlevel playing field vis-à-vis other financial market participants. It is thought likely that if this obligation is retained, it may cause certain AIFM to have to cease marketing certain AIF in the EU or to move outside the EU with the result that they will be unable to market their AIF in the EU, thereby restricting the choice of AIF available to investors in the EU. Further, one EU member state has suggested that, if leverage limits are imposed, investors and counterparties could be induced to reduce their normal due diligence procedures and to relax their risk management standards, which would not be in the interests of investors generally.

Delegation

3.15 The Directive provides that an AIFM may only delegate portfolio management or risk management in relation to an AIF (whether it is an EU AIF or a non-EU AIF) to a third party which is itself authorised as an AIFM to manage an AIF of the same type. This obligation is more onerous than the conditions imposed by the MiFID Directive on the delegation by investment managers of portfolio management services in relation to retail clients. It will therefore prevent an AIFM from delegating part or all of the portfolio management function to an investment manager which is a specialist in a particular area, such as emerging markets, but which is not EU based and thus not subject to authorisation, or capable of being authorised, in the EU. This restriction on delegation could cause existing AIF investing in, for example, emerging markets or with global investment themes to have to close down and new AIF not to be launched. The closing off of access to the specialist skills of investment managers outside the EU is clearly not in the interests of investors generally.

Side Letters

3.16 The Directive provides that where an investor is granted or given the right to obtain preferential treatment, not only must a description of that treatment be disclosed to all other investors, but so must the identity of the investor in question. This obligation may cause investors to disinvest from AIF managed by EU AIFM and not to invest in such AIF in future.
Start-Up AIFM

3.17 The Directive requires that an AIFM must ensure that its risk management and portfolio management functions are segregated. This will be an onerous obligation for small AIFM and one with which they may be unable to comply, resulting in them being unable to obtain authorisation as an AIFM and thus being unable to market the AIF which they manage in the EU. This will impose a barrier to entry into the market for small AIFM and thus over time is likely to reduce the investment choices available to investors.

4. Restructuring and Compliance Costs

Who is the AIFM?

4.1 It has been assumed by investment managers of hedge funds and funds of hedge funds that it is they who qualify as the AIFM for the purposes of the Directive. It is not entirely clear, however, that this in fact is the case. The Directive defines an AIFM as any person whose regular business is to manage one or several AIF and provides that it applies to all AIFM established in the EU which provide management services to AIF. Management services is defined to mean the activities of managing and administering one or more AIF on behalf of one or more investors. However, the Preamble to the Directive contains a statement that investment firms authorised under the MiFID Directive (which would include investment managers of all types) are not required to obtain authorisation under the Directive in order to provide investment services in respect of AIF.

4.2 It appears, therefore, that the concept of an AIFM is more akin to that of a management company of a UCITS fund under the UCITS Directive. The fact that the definition of management services refers to the activity of administering AIF, which is not normally a responsibility performed by an investment manager of an AIF, may support this contention. The UCITS Directive recognises, however, that UCITS funds may be established in the form of investment companies which are self-managed in that they do not appoint a separate management company and which themselves directly delegate functions to investment managers, administrators and depositaries. If the Directive had the effect that AIF which are investment companies and have not appointed a manager with the same responsibilities as the management company of a UCITS fund were required to restructure themselves so as to do so, this would inevitably lead to significant costs which would be borne by investors.

Master-Feeder Funds

4.3 Although the EU Commission has recognised that hedge funds are often organised in master-feeder fund structures, it is not clear how the Directive will apply to such structures and if it were to result in such structures having to be reorganised, this could result in significant costs which would be borne by investors.

Prime Brokers as Sub-Custodians

4.4 If, as described above, prime brokers to existing AIF have to be appointed by the depositary as global sub-custodians, such that existing prime brokerage arrangements have to be restructured, this will result in significant costs for investors.

Independent Valuation Agents

4.5 The Directive requires an AIFM to ensure that each AIF which it manages appoints an independent valuation agent to calculate the value of the AIF’s assets and of its shares. Current market practice is for this function to be performed by a third party administrator which, however, sometimes relies on the AIFM to value certain hard-to-value assets the pricing of which the administrator then verifies. If administrators are to be required to assume responsibility for valuing all of the assets of AIF, and assuming that they are prepared to accept this responsibility, it is likely that they will wish to be compensated for the additional responsibility and these additional costs will be borne by investors.

4.6 In addition, as mentioned above, the definition of management services includes the activity of administering AIF and as a result, it may be necessary for the AIFM to appoint the third party administrator of an AIF (by way of delegation), whilst the independent valuation agent is appointed by the AIF itself. This could lead to existing arrangements with third party administrators having to be restructured, the costs of which would be borne by investors.

4.7 The Directive permits an AIF to appoint an independent valuation agent established in a non-EU country, subject to certain conditions compliance with which is to be determined by the EU Commission. However, the Directive provides that these provisions will only come into force three years after the transposition date and it is unclear whether AIF which have currently appointed non-EU valuation agents will have to replace those
valuation agents with EU valuation agents during that three year period, thus resulting in existing arrangements having to be, at least temporarily, restructured at the cost of investors.

4.8 It has recently been suggested by at least one EU member state that the Directive should be amended to provide for AIFM to be responsible for the valuation of an AIF’s assets and of its shares following the UCITS model. An AIFM would not be prevented from delegating this function to an independent valuation agent but the AIFM would retain liability vis-à-vis the AIF and its investors for the performance by the valuation agent of its functions. This would not be in the interests of investors, since most AIFM are likely to be less well-capitalised than independent valuation agents and in the event of a failure by a valuation agent to perform its obligations, investors would have no direct claim against the valuation agent. This suggestion also runs contrary to the recommendations of IOSCO, AIMA and the Hedge Funds Standards Board. Further, it introduces a conflict of interest, which is not in the interest of investors, in that an AIFM’s fees are calculated by reference to the value of the assets of the AIF which it manages.

EU Sub-Advisors

4.9 Depending on how the issue of who is the AIFM is resolved, if a non-EU AIFM (for example, a US manager) appoints an EU AIFM (for example, its UK subsidiary) to manage part of the portfolio of an AIF and that EU AIFM also wishes to market shares in the AIF to professional investors in the EU, the AIF’s custody, valuation and administration arrangements will need to be modified to comply with the requirements of the Directive, causing significant costs to be borne by the AIF and thus by all of the investors therein.

Annual Report

4.10 The Directive requires that an AIFM must, for each AIF that it manages, make available to investors and to the regulatory authorities in its own EU member state an annual report for each financial year no later than four months following the end of the financial year. It seems that this report is to be in addition to the report which AIF themselves are required to make available under the law of their domicile (this obligation generally applies irrespective of whether the AIF is established in an EU member state or outside the EU). This will result in additional costs to investors without any obvious commensurate investor protection benefits.

5. CONCLUSION

5.1 It seems certain that the Directive in its current form will restrict the ability of EU investors to select the AIFM and AIF of their choice, will result in substantially increased initial and ongoing compliance costs and one-off restructuring costs which, ultimately, will be borne by investors, will impose barriers to entry for start-up managers, will reduce competition amongst the providers of depositary services and will effectively lead to a diminution of the responsibilities of independent boards of directors of AIF.

September 2009

Memorandum by UK Foundations including the Church Commissioners, Esmée Fairbairn Foundation, Nuffield Foundation, Paul Hamlyn Foundation, The Henry Smith Charity, and the Wellcome Trust

1. As some of the major charitable foundations in the UK, we would like to highlight our concerns about the potential impact of the proposed EU Directive on Alternative Investment Fund Managers. Our combined investment portfolios are worth an approximate £19.5 billion, and together we spend in the region of £0.9 billion for public benefit each year. Our funding interests range from medical research and education, through to support for the Church’s ministry and to address social inequality. We are concerned that the Directive as currently drafted will significantly restrict our ability to generate funds to pursue our charitable missions and thus reduce our impact for public good.

2. We welcome the intention behind the Directive—to improve regulations and safeguard investors—and we support those provisions of the Directive that aim to ensure greater transparency and expose conflicts of interest. However, we are concerned that some provisions of the Directive will have significant unintended consequences. The following issues are of greatest concern to us:

3. Limitation of Choice of managers and funds (Article 35, 38 & 39): To maximise the returns on our investments, we must have freedom to select the best investment managers and funds, and to select the investment ideas that best meet our individual needs.

4. The Directive as currently drafted will severely restrict our access both to non-EU funds and to non-EU fund managers. This will impact access to private equity funds and to hedge funds. For example, up to 95% of global hedge funds are currently either not domiciled in the EU or have non-EU managers. Similarly,
many private equity firms are likely to be situated in the market in which they invest. We believe there is a significant risk that many of the best will stop raising capital in Europe rather than attempting to comply with onerous EU regulations. This will significantly restrict choice for European investors, limit the scope and potential return of our investment portfolio and hence reduce our charitable spend.

5. Restrictions on access to international assets through limits on depositaries (Article 17): Diversification of an investment portfolio is a core principle of good portfolio management. A key area where diversification can be obtained is by investing internationally. Such a strategy can produce increased returns while reducing the risk of excessive concentration in particular countries.

6. The draft Directive will require all funds under management to have a depositary that is an EU-authorised credit institution. This will introduce significant barriers to owning international assets, and will particularly limit our access to emerging markets. Again, this will reduce the returns on our investments and therefore reduce our spend for public benefit.

7. Uncertainty on whether investment strategies involving leverage will be permitted (Articles 22–25): Many investment strategies employ leverage. From an investor’s perspective, leverage can be a useful tool to adjust the return and risk profiles of a particular investment, and allow the maximum benefit to be obtained by the investor.

8. The leverage limits proposed in the draft Directive are not adequately defined. Greater clarification is required, both about the level of the limits and the mechanisms that would be used to enforce them. This lack of clarity is destabilising and makes it likely that certain investment strategies will not be made available to European investors. As stated above, we regard this restriction of choice as likely to reduce the returns on our investments and, in turn, to reduce our spend on our charitable purposes.

9. We support measures to address systemic risk that arises through excess leverage. It seems to us, however, that systemic risk can better be addressed through a proposal that deals with leveraged organisations as a group, rather than specifically addressing investment funds.

10. In our view, the issues described above should not be dealt with by imposing restrictions, which will have the effect of reducing our freedom to invest in a way that maximises the benefit we can provide. We advocate that one of the Directive’s existing principles, transparency, should also be the approach here. Professional investors should be provided with proper information about the regulatory regime(s), depositary/custodian arrangements and use of leverage of the funds that they propose to invest in, to enable them to make a judgement on these issues as part of their investment process.

11. We note that the Swedish Presidency has released an Issues Note on 2 September 2009 which recognises some, but not all, of these concerns.

12. Maximising the returns on our investment portfolios is an essential part of delivering our Foundations’ missions, for the benefit of society. The draft Directive, while well-intentioned, threatens this goal. We encourage the Committee to take into consideration the potential impact of the Directive on all European investors as part of its inquiry.

September 2009

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99 Estimate by the Alternative Investment Management Association, the global hedge fund body Submission to House of Lords EU Committee inquiry on the European Commission Directive on Alternative Investments Fund