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Directive on Alternative Investment Fund Managers

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NOTE:
(Q) refers to a question in oral evidence
(p) refers to a page of written evidence

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SUMMARY

This report examines the proposed Alternative Investment Fund Managers Directive which introduces an EU-wide approach to the regulation of Alternative Investment Fund Managers, including hedge fund and private equity fund managers. The Directive aims both to increase the stability of the financial system and to facilitate the single market in Alternative Investment Funds.

The financial crisis created the political imperative for the expansion of regulation to all financial activities, a view clearly expressed in the G20 conclusions of April 2009. However, discussions regarding the introduction of regulation of hedge funds and private equity funds at an EU level had taken place before the crisis. Two reports of 2008 prepared by MEPs in the European Parliament outlined the concerns about the effects of the activities of these funds which are no longer a niche or alternative industry, but important operators in the mainstream financial market.

We recognise that the aggregate activity of hedge funds could cause risk to financial stability, and so welcome the aspects of the Directive that attempt to reduce risk posed by fund managers. We think that coordinated regulation and supervision of managers at EU level will be beneficial to the single market and to the EU economy as a whole. We welcome the idea of introducing a passport for AIFs as it would help to develop a single market in alternative investment funds.

We have, however, serious concerns over some aspects of the proposal as originally drafted. We found in our inquiry that if the Commission had followed its own Better Regulation principles, many of the shortcomings of the Directive could have been dealt with at a much earlier point.

The Directive as originally proposed covers all non-UCITS funds. We are concerned that this one size fits all approach fails to acknowledge the differences in how AIFs are structured and operate. The Directive should be tailored in a way that respects the differences between the types of funds it covers to avoid unintended regulatory consequences.

The Directive also introduces requirements for disclosure to supervisors by managers. These requirements will enable supervisors to identify where managers pose excessive risk to financial stability, which would then enable steps to be taken to reduce this risk. We found that these requirements should take into consideration the different types of alternative investment funds. Requirements on provision of information should be proportionate and carefully thought out to ensure that the Directive provides supervisors with the relevant data and that supervisors have the resources to analyse this data.

On the tools provided for supervisors to limit risk, we argue the proposal for a single leverage cap on managers in the Directive should be replaced with a provision for national supervisors to have the power to impose leverage caps where appropriate, based on the aggregated information they receive from fund managers. We also discuss the proposed rules for remuneration of managers.

Most importantly, we express concerns in the report that a European Union Directive to regulate fund managers should be in line with, and complement, global arrangements. Coordination with the US regulatory regime in particular is essential to avoid a situation in which the EU alternative investment fund industry loses competitiveness at a global level as a result of regulatory arbitrage.

Linked to this, we argue that EU investors should be able to continue to invest in non-EU funds, a situation that the Directive may prevent. We are concerned that it will be difficult, if not impossible, for third-country regimes to achieve the equivalency required for managers to obtain access to the EU passport and therefore access the EU market. We therefore support the continuation of national private placement regimes to maintain options for investors, which is in the best interests of the whole EU.

These two aspects on the global market in alternative investment fund managers are crucial for maintaining the importance of the City of London and the EU in the finance industry. The Directive will seriously damage the EU and UK economies unless it is fully compatible with the global approach to the regulation of fund managers and the Government should withhold agreement on the Directive until these concerns are addressed.

Directive on Alternative Investment Fund Managers

CHAPTER 1: INTRODUCTION

1. Alternative Investment Funds (AIFs) include hedge funds, private equity funds, venture capital firms, commodities and real estate funds and are part of the investment management sector. In the wake of the recent financial crisis some Alternative Investment Funds (AIFs) have become the subject of attention from regulators, despite many industry observers concluding they played a limited role in the crisis. Previously, the AIF industry argued that AIFs fared better under light touch regulation, which allowed for flexibility, financial innovation and high profitability, as they were primarily a sophisticated domain for professional investors. Discussions regarding the introduction of additional regulation, however, had taken place before the crisis. Policy makers were caught in the dilemma of whether tighter regulation would be beneficial to the industry and the economy as a whole, or would unnecessarily restrict investment.

2. The distinctions between hedge fund, private equity funds and other types of Alternative Investment Fund are becoming increasingly blurred. However, in general hedge funds invest in relatively liquid assets, and hedge market investments with the aim of achieving absolute returns, independent of the state of the overall market. Private equity funds are typically involved in investment in private companies, a relatively illiquid asset. Hedge funds tend to use tools such as short-selling and derivatives, while private equity funds generally do not use such tools. We discuss the distinction between different types of hedge funds further in Chapter 2.

BOX 1

Private Equity and Hedge Funds

Private equity is money invested in companies that are not publicly traded. Private equity companies have fewer public disclosure requirements than public companies. Capital for private equity funds is raised primarily from institutional investors. Leveraged buyouts (LBOs) are one of several types of private equity strategies. Not all private equity strategies use financial leverage. Between 2000–2005 debt averaged between 59.4% and 67.9% of total purchase price for LBOs in the United States.[1] According to the Financial Services Authority's Impact Assessment, global private equity assets were approximately €1 trillion as of June 2009 while global hedge funds assets under management dropped to €1 trillion by the end of 2008.[2] Hedge fund strategies are described in further detail in Box 4 below.

3. The operations of Alternative Investment Funds have important financial implications for the investor population as a whole, despite being the domain of institutional and high net worth investors. Many institutional investors, including pension funds and charities, include Alternative Investment Funds

1 Trenwith Group *M&A Review* (Second Quarter, 2006)

2 Charles River Associates report for FSA Impact of the proposed AIFM Directive across Europe.

in their investment portfolios and so any person who holds a pension is therefore affected by Alternative Investment Funds and the regulation of them.

The Proposal

4. On 29 April 2009, following a limited consultation process[3], the Commission published a draft Directive proposing a regulatory regime for Alternative Investment Fund Managers (AIFMs); we henceforth refer to this draft as the Directive. The proposal was issued as we completed taking evidence for an inquiry into financial regulation and supervision.[4] As we had not been able to examine this matter in detail previously, we decided to launch a specific inquiry on the topic. Since the onset of our investigations into the Directive, we have been concerned with the speed of legislation and the effects this proposal could have on the global financial market. These aspects are considered further in Chapters 6 and 7.

5. The main aim of the Directive is to introduce a harmonised, comprehensive and effective regulatory framework for AIFMs in the EU. It seeks to enhance investor protection and develop the single market for AIFs through better monitoring of macro-prudential risks.[5] The Directive will implement this framework through the process of registration and authorisation of AIFMs.

6. The Directive defines AIFs as any investment not covered by the existing UCITS Directive (Undertakings for Collective Investment in Transferable Securities).[6] The Directive therefore covers hedge funds, private equity funds, venture capital firms, commodities and real estate funds, among others. It has become clear during the inquiry that the Directive was designed with two specific types of funds in mind: hedge funds and private equity funds. The debate and the evidence we received has therefore tended to concentrate on hedge funds and, to a lesser extent, on private equity funds. We comment largely on these funds as a result.

7. The Directive seeks to regulate the conduct of the managers, as opposed to the funds themselves. The choice of regulating the managers rather than the funds has been the subject of debate and we discuss this further in Chapter 3.

8. The Directive proposes a wide range of new rules, including:

   - Authorisation: AIFMs managing a portfolio of over €100m of assets for hedge funds or €500m for private equity funds must obtain authorisation from regulators.
   - Capital requirements: AIFMs must have an initial and ongoing capital base of at least €125,000 to ensure the continuity and regularity of their management services. AIFMs managing portfolios that exceed €250 million must have further capital equal to 0.02 % of the amount by which the value of the portfolios exceeds €250 million.
   - Disclosure: AIFMs must provide key information to supervisors about the AIFs they manage and strategies they employ.

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3 The Commission provided us with a detailed breakdown of all relevant consultations in their written evidence (p. 130).

4 European Union Committee, 14th Report (2008–09), *The future of EU financial regulation and supervision* (HL Paper 106).

5 Macro-prudential risks are risks that affect the whole financial system.

6 UCITS funds are retail funds regulated at EU level which can be freely marketed across Europe to retail and other investors. Managers of pension funds, national central banks and non-pooled investments are excluded from the Directive's scope.

- Leverage limits: AIFMs must not exceed the leverage limits set by the Commission.
- Passport: once authorised, AIFMs established in the EU will be able to market EU funds across Europe to professional investors. Non-EU funds and non-EU managers working for EU funds must meet more stringent requirements to be able to operate, or continue to operate, in the EU.
- Depositary: AIFMs must appoint an EU credit institution as a depositary.
- Independent valuation agent: AIFMs must appoint an independent valuation agent to calculate the value of assets under management for each fund managed.

9. Speaking at the launch of the proposal, Commissioner Charlie McCreevy said that the aim of the Directive "was not to drive the industry out of Europe and beyond the reach of European supervisors or to create burdens out of proportion to the risks [but] to secure a robust framework to ensure that the sector operates safely and responsibly, subject to regulatory oversight."[7]

Initial reaction

10. Early reactions to the proposal varied: some argued that the Directive was not sufficiently ambitious, whilst industry representatives judged it to be protectionist and disproportionate. They claimed that it would cause AIFMs to leave London and the EU and thus be detrimental to the European financial industry as a whole. The Government told us that they saw the draft as originally proposed as being "a threat to Europe … as it would significantly limit investor choice in Europe and it would drive the hedge fund industry out of Europe" (Q 41). Many were also worried about the effects of the Directive on the investment opportunities of institutional funds, such as pension funds. We consider this risk in Chapters 3 and 6.

11. The President of the European Socialist Party (PES), Poul Nyrup Rasmussen[8], said the proposal had "more holes than Swiss cheese" and argued that it did not go far enough.[9] In his written evidence to us, he explained that the potential negative impact of the Directive on investors should be viewed against the detrimental effects of AIFs on the real economy. The cost for investors, he suggested, was not the most important factor in assessing the value of financial regulation; rather, the overall benefit to the economy should be considered (pp 294–5). The view was echoed by the Foundation for European Progressive Studies (FEPS), a Brussels based think-tank. They argued that the cost for investors was not "the right metric" for a legislator who should also take account of the total costs to the real economy and society as a whole (Q 292).

12. The recent evaluation and impact assessment commissioned by the European Parliament (see Chapter 8) concluded that the proposal would

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7 Speech of Commissioner Charlie McCreevy, European Commissioner for Internal Market and Services, Press Conference on Financial Package, Brussels, 29 April 2009 available at: http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/09/206&format=HTML&aged=0&language=EN&guiLanguage=en.

8 When he said this, Mr Rasmussen was an MEP. He retired in 2009 as an MEP but remained leader of the PES during the inquiry.

9 Party of European Socialists Press Release, 29 April 2009, available online at http://www.pes.org/en/news/draft-directive-has-more-holes-swiss-cheese

dampen European financial market volatility, but reduce EU GDP growth by up to 0.2% annually.[10]

Political context

13. Political unease about the activities of alternative investment funds had been growing in the EU well before the onset of the financial crisis, and indeed various efforts had been made to corral these funds. This unease was fuelled partly by the growth in size of this sector. Two reports in 2008 by MEPs Poul Nyrup Rasmussen and Klaus-Heiner Lehne outlined the concern felt in some quarters of the European Parliament about the activities of hedge funds, pointing out that they were no longer a small part of the alternative funds industry but important operators in the mainstream financial markets.

14. The desire to regulate was also fuelled by anxiety about the perceived aggressive behaviour of some hedge fund managers. They were often activist, an example being the continued demands by The Children's Trust, a US hedge fund, which built up a substantial (15% in 2005) stake in Deutsche Boerse and was publicly critical of their strategy and corporate governance in a way that was found disturbing by the German political and business establishment. Similarly, hedge fund managers engaged in practices that were publicly unpopular, such as short selling of shares in corporates that they believed to be overvalued. Continental markets in particular were not used to activist practices of this sort and felt it was disruptive to the conduct of business to the point where it affected the real economy unfavourably.

15. Hedge funds were not the only perceived villains; politicians particularly in France and Germany were becoming increasingly uneasy at the increased size and influence of private equity funds, which, although often medium to long-term investors, were buying whole companies or very substantial shareholdings and taking the whole entity off the public market and, it was felt, away from scrutiny and public influence often also with perceived detrimental effects on employment and job security.

16. A further statement of objection was that both hedge fund managers and private equity fund managers had carved out positions of privilege and substantial over-remuneration for themselves at the expense of long-term investors and, in the case of private equity funds, at the cost of jobs and job security in the undertakings in which they invested.

17. Against this background, the Commission were under some pressure to introduce legislation to regulate alternative investment funds, even in the absence of a financial crisis and as the dimensions of the crisis started to become clear this pressure increased as two of our witnesses confirmed. According to Dr Syed Kamall MEP "the European Commission resisted regulating hedge funds for two years. But politicians in the EP have seized on the credit crunch as a reason to look again at regulating hedge funds and private equity" (p 257). Martin Power, head of Charlie McCreevy's cabinet in the Commission, endorsed the point, telling us that "the raison d'être for this proposal came very much from a political initiative taken in the European Parliament" (Q 345) The Parliament indeed used a provision under Article 192 of the EC Treaty[11] which enables them to call on the Commission to

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[10] Study by Europe Economics for the European Parliament, *Ex-ante Evaluation of the proposed Alternative Investment Managers Directive*, December 2009, p. 10.

[11] Article 225, Treaty on the Functioning of the European Union.

bring forward proposals that the Parliament considers necessary. As the financial crisis developed a perception had grown that the regulation of financial markets was too light touch and "enormous pressure was put on the Commission to bring forward a proposal in this respect" (Q 345).

18. In the UK there has been a similar impetus to reform regulation of AIFs. The Turner Review advocated regulation for all significant unregulated financial institutions. It proposed that regulators and central banks should gather extensive information on hedge fund activities and that appropriate prudential regulation should be applied to them.[12]

19. The pressure to regulate unregulated financial activity was also significant at an international level. At the G20 meeting held in Washington in November 2008, world leaders pledged "to strengthen our regulatory regimes, prudential oversight, and risk management, and ensure that all financial markets, products and participants are regulated or subject to oversight, as appropriate to their circumstances."[13]

20. It was well understood in the Commission and elsewhere, however, that the principal causes of the financial crisis lay in the investment banking sector, and the high level group chaired by M. de Larosière which reported in February 2009 concentrated their proposals for reform on that sector. The Report indeed specifically made it clear that the alternative investment funds had not been the cause of the financial crisis, and this judgment was accepted by all our witnesses (see Chapter 2). It is objectively the case that losses by the Prime Brokers, the banks who lend to hedge funds, were minimal, and the losses—substantial in many cases—fell on the equity investors in hedge funds, which while distressing for investors does not threaten the stability of the financial system. M. de Larosière recommended that regulation should be extended to alternative investment funds because they are a large part of the financial system, albeit not one that turned out to be harmful to financial stability.

21. It has been suggested that the remuneration practices employed by some AIFMs set a bad example to the banking system, encouraging bankers to employ high risk strategies in order to achieve similar remuneration levels to AIFMs. According to this argument, the level of remuneration received by a successful AIFM was higher than that of professional bankers and gave rise to a culture where bank employees tried to achieve similar levels of remuneration by taking higher risks with the deposits and capital available to them. However, witnesses commented that the models adopted by investment bankers differed significantly from those of AIFMs. Many hedge funds, for example, had remuneration policies that included so-called high-water mark provisions. With a high water mark, a hedge fund must recover any losses, that is, return to the last high-water mark, before incentive fees can be charged. Moreover, some hedge funds subject their portfolio managers to so-called claw-back provisions which imply that money that has accumulated in a bonus pool over several years can be clawed back if losses occur in the future. Several banks, in contrast, allowed their employees to receive large bonuses after booking short-term unrealised profits on transactions that turned out to be hugely loss making in the long-term. The bank bonuses were not clawed back from employees after it became apparent that their actions led to large losses.

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12 Financial Services Authority, *The Turner Review: A regulatory response to the global financial crisis*, March 2009, p. 7.

13 Declaration of G20 Summit on Financial Markets and the World Economy, Washington DC, 15 November 2008, p. 3.

22. According to the impact assessment conducted by the Charles Rivers Association (CRA) for the Financial Services Authority (FSA) (see Box 11), risks that financial entities pose to the stability of financial markets can be divided into (i) a credit channel and (ii) a market channel. Witnesses explained that AIFs posed little or no threat through the credit channel, as there was no evidence that banks suffered losses in their prime brokerage divisions as a result of the collapse of hedge funds. According to the FSA/CRA report, AIFs did contribute to instability through the market channel, as they liquidated their position and this selling depressed asset prices. This was, however, no different from many other financial entities which also sold assets during the downturn to reduce their risk exposures.

23. The proposition—that alternative investment funds had not caused the crisis, but that they must be brought into the system of financial regulation proposed by the Commission in 2009 and set out in our last Report—has met with universal agreement, even from the AIFMs themselves. We have not found a single witness to suggest that these funds should not be regulated in order to ensure that they do not threaten financial stability. The difficulties which have been encountered in trying to reach agreement on this Directive, and which have defeated the Swedish Presidency's intensive effort to complete the Directive are caused by two factors, the first being an attempt to impose on alternative investment funds which are designed for professional investors well qualified to engage in intensive due diligence on any investment they choose to make,. The second set of problems arise from a continuing anxiety about the activities and influence of these funds.

BOX 2

EU regulation that already applies to alternative investment firms

The European asset management industry is already subject to several European Directives, including:

- The Markets in Financial Instruments Directive (MiFID)—MIFID affects hedge funds since it imposes requirements on funds for (i) the establishment and implementation of adequate risk management policies and procedures, (ii) a client classification and a 'best execution policy' for clients' as well as (iii) pre- and post-trade transparency.
- The Capital Requirement Directive (CRD)—The CRD requires funds to explain all the risks that are relevant to that business and to produce a capital requirement figure.
- The Market Abuse Directive (MAD)—MAD prohibits abuse behavior such as insider dealing and market manipulation and applies to all market participants including AIFs.
- The Transparency and Prospectus Directives—The Transparency Directive affects hedge funds by requiring disclosure of major shareholdings, for example, and the Prospectus Directive affects closed-end listed AIFs.
- National regulation in some Member States—Hedge funds are regulated in many EU states but regulations including restrictions on retail investors differ from country to country.

Our inquiry

24. Our objective in pursuing this inquiry has been to make a positive contribution to the final shape of the Directive by scrutinising the United Kingdom Government's position. We consider that the aim of the Directive should be to ensure that AIFMs are subject to an effective regulatory regime that will ensure financial stability while preserving the competitiveness and soundness of the financial industry in the UK and in Europe as a whole.

25. The inquiry sought to examine some specific aspects of the proposal and their related impact. We focused in depth on the provisions establishing an EU passport regime and the provisions for detecting systemic risks. We also discussed some key overall aspects of the Directive, including the one size fits all approach and the Commission's decision to regulate managers rather than funds. Some consideration was also given to the rules for depositaries and valuation and the role of prime brokers.[14] We discussed provisions on remuneration, although these were not included in the original draft of the Directive. Finally, the inquiry assessed the proposal within a global perspective, especially in relation to US proposals for regulating hedge funds.

26. The membership of Sub-Committee A which undertook this inquiry is set out in Appendix 1. We are grateful to those who submitted written and oral evidence, who are listed in Appendix 2; all the evidence is printed with this report. The evidence taken as part of this inquiry, with two exceptions, was taken between October and December 2009. There is a glossary in Appendix 4. We also thank the Sub-Committee's specialist adviser Professor Robert Kosowski, Assistant Professor in the Finance Group of Imperial College Business School, Imperial College London. **We make this report for debate**.

Emerging conclusions

27. On 10 December 2009, as the Council of Ministers was moving towards a general approach to the Directive, we wrote to the Minister setting out our initial concerns on the Directive. These initial conclusions are reiterated in this report. Most importantly, we argued that the Government should not agree the Directive in a form which was incompatible with an international regulatory regime. In our view the Directive is not compatible with this regime.

28. Key concerns raised by the letter included:

- The provisions related to marketing of non-EU funds and possible restrictions on non-EU managers marketing in the EU could prevent investment in and out of the EU;
- The lack of differentiation between different sorts of alternative investment—the one size fits all approach—would lead to inappropriate unintended consequences;
- Some elements of the proposals for supervision of managers were unnecessary and disproportionate; and

14 Prime brokers are the arms of investment banks and securities firms who provide services to hedge funds.

- The proposal provided an unnecessary level of protection to well-informed institutional investors and banks.

29. We also argued that the Directive should be in line with, and complement, global arrangements and that coordination with the US regulatory regime in particular was essential. We concluded that "the Directive will seriously damage the EU and UK economy unless it is fully compatible with the global approach to the regulation of AIFM and it permits the marketing of non-EU funds in the EU. Restrictions on non-EU managers operating in the EU should also be removed."

30. This letter and the Minister's response to it are reprinted in full in Appendices 7 and 8 respectively.

Scrutiny of the Directive under the Swedish Presidency

31. During the course of our inquiry, the Swedish Presidency (July–December 2009) prepared several documents to facilitate discussion and help Member States reach a compromise. Of these, two are in the public domain. The first one was an "issues note" released on 2 September that identified many of the concerns voiced by both the alternative investment fund industry and EU Member States and set forth some proposals for possible solutions. We refer to this as "the Swedish issues note." The second document was released on 12 November and contained a number of proposed changes to the Commission's original Directive. We refer to this as "the Swedish compromise." The European Parliament rapporteur for this dossier, Jean-Paul Gauzès MEP, published his first report on the Directive in November 2009. We also refer to this report where appropriate. Indeed, one of the greatest challenges in conducting the inquiry was to keep abreast of the latest developments on the Directive, as negotiations were fast-moving.

32. At the time of writing the report, both the Council of Ministers and the European Parliament are considering the proposal under the process of codecision. The Swedish Presidency was extremely active in trying to secure a political agreement in the Council. As its attempts failed, the negotiation on the Directive will be driven by Spain which took over the Presidency on 1 January 2010.

33. When giving evidence to the EU Select Committee on the priorities of the Spanish Presidency, the Spanish Ambassador told us that the Swedish Presidency had done a "great job" in negotiations. He confirmed that the Swedish compromise document would form the basis of discussions under the Spanish Presidency.

34. He recognised that keeping London as a financial powerhouse was in the interests of the entire European Union and that regulation must not prevent the investment industry from working properly. Thresholds, access of third country funds to the EU, depositaries, remuneration and reporting requirements would form the main priorities for discussion under the Spanish Presidency.[15]

[15] Evidence to the EU Select Committee, 19 January 2010, (QQ 16–17), available online at: www.parliament.uk/hleu.

BOX 3

The Swedish compromise and the Gauzès report

The 12 November Swedish Presidency proposal contains a number of suggested changes to the Commission's Directive:

- The compromise reaffirms that the Directive is to apply to AIFMs and not AIFs (which are supervised at national level).
- Tight restrictions on AIFMs managing AIFs established in third countries would be loosened where these AIFs are soundly managed.
- Member States may allow AIFs to be marketed to retail investors.
- Depositaries would no longer be fully liable for defaults and would not be limited to EU registered credit institutions.
- AIFMs would be allowed to delegate the performance of their functions to an entity established in a third country in accordance with this Directive, provided that necessary safeguards such as supervisory cooperation are in place.
- Leverage limits would be removed from the Directive.
- The compromise included provisions on AIFMs' remuneration.
- Each AIFM would be required to produce an annual report providing basic balance sheet information, financial activities, but also information about remuneration.

The substantive proposed changes in the Gauzès report relate to:

- The role of depositary institutions (specifying its liability and requiring an EU depository for an EU AIFM).
- Self-imposed leverage limits on the part of AIFM.
- Restricted access of retail investors to AIFM.
- Detailed position disclosure by AIFM to the regulator (including short-sale positions).

CHAPTER 2: WHAT ARE ALTERNATIVE INVESTMENT FUNDS AND WHAT RISKS DO THEY POSE TO FINANCIAL STABILITY?

35. As described above, the Directive covers a wide range of Alternative Investment Funds (AIFs). Below, we describe the most common types of fund affected by the Directive. The arguments we heard in the course of our Inquiry on risks posed by AIFs to financial stability as well as their benefits to investors and the economy are summarised here.

Hedge funds

36. Hedge funds are privately owned investment companies. Investments in hedge funds are typically available only to high net worth individuals or professional investors such as insurance companies or pension funds and are not advertised for retail investment. Hedge fund managers therefore are able to invest in a variety of asset classes in a flexible manner. As their name implies, hedge funds often seek to reduce risk by hedging their positions using a variety of strategies, that is, taking additional positions that reduce the overall risk of their portfolio.

37. Hedge funds differ from other investment funds such as unit trusts and mutual funds in as much as they aim at achieving absolute returns with relatively low volatility, with returns largely uncorrelated with the performance of markets (e.g. bond or stock markets).

38. The UK is currently the primary location for hedge fund managers in Europe and about 80% of Europe's hedge fund managers are located in the UK. The UK hedge fund industry in 2009 employed an estimated 40,000 people (Coupland Cardiff, p 220). The Alternative Investment Managers Association (AIMA) calculated that the European hedge fund industry had more than €250 billion of assets under management within the EU and generated estimated tax revenues across the EU worth a total of €4 billion a year (p 56).

BOX 4

Hedge fund investment strategies

Hedge funds can embrace a variety of strategies including:

- Relative value or arbitrage, using quantitative strategies to calculate the real value of one asset relative to another and then seeking to exploit pricing inefficiencies between related securities;
- Trading options or derivatives, contracts whose values are based on the performance of an underlying financial asset, index or other investment;
- Investing in deeply discounted securities of companies in distress or potentially subject to corporate events such as mergers; and
- Short selling, selling securities that have been borrowed from a third party with the intention of buying the identical assets back at a lower price at a later date to return to the lender.[16]

[16] Alllenbridge Hedgeinfo provide a useful summary of strategies available to AIFMs in their written evidence (pp 181–82).

39. Witnesses told us hedge funds had the following benefits to the economy and financial markets:

- They contribute to market liquidity (HFSB p 239);
- They lead to more efficient price discovery (that is, they help ensure that stocks are correctly priced) (HFSB p 239); and
- They ensure that investors are able to diversify portfolios and offer the option of high risk high return investment. They are valuable in particular for institutional investors such as pension funds, insurance companies or charities, helping these organisations increase investment returns (HFSB p 239, and Wellcome Trust Q 251).

40. Hedge funds, however, attracted criticism from some witnesses for being "unregulated funds of rich gamblers", for having an unfair trading advantage, for overcomplicating financial markets and for leading the way in excessive risk taking (Mr Chapman p 34).

41. Despite their financial significance, hedge funds have also acquired a reputation for secrecy or for being "bizarre"—to use the words of FEPS (Q 284). Since hedge funds fall outside the regulatory regime that applies to retail funds, the information they are legally required to make public is low. In addition, publicly revealing trading methods and positions would compromise the success of many types of hedge funds' strategies and consequently their profits. For example, FEPS told us that industry has managed for much too long to avoid appropriate disclosure, fostering suspicion about its activities, arguing that the "sun is the best disinfectant" (p 116).

42. In addition to their secrecy, Deutsche Bank observed that the complexity underpinning the work of hedge funds, often means that financial methodologies are difficult to grasp, and accordingly, "when the public does not understand something, they are naturally sceptical" (Q 472).

43. The de Larosière report describes the hedge fund as a parallel banking system. Both Rasmussen and FEPS emphasised that unregulated banking has a tendency to collapse. One of the most frequently cited example of a hedge fund collapse, before the current crisis, is the case of LTCM in 1998. We discuss witnesses' criticisms of hedge funds below.

Private equity funds

44. Private equity funds are investment companies whose strategy is to seek ownership or large equity stakes in private companies. They may also invest in so-called private placements of securities from public companies, that is, securities that are not offered to the general public or traded in public securities markets. Venture capital is a specialised subcategory of private equity funds typically provided for early-stage, high potential growth, companies. The BVCA told us that the UK accounts for some 60% of private equity fund activity in Europe (p 9).

45. We heard diverging views on the value of private equity funds for the real economy. On one hand, we heard that companies owned by private equity funds destroyed more jobs and that private equity investors undermined the value of these companies by burdening them with debt (FEPS p113 and Mr Chapman p 37). Furthermore, Dr Syed Kamall MEP described "antipathy" in Europe towards the way private equity companies "buy and

sell large numbers of shares in companies and the consequent frequency in the change of control of companies" (p 257). This illustrated widespread public distrust in the United Kingdom and particularly in continental Europe toward private equity funds.

46. On the other hand, we heard that private equity funds brought both capital and management skills to the businesses in which they invested. The capital provided by private equity funds supported long-term investment in European business and infrastructure, including in developing areas such as green technology. We heard this was particularly relevant in the context of the financial crisis given the reductions in the spending power of European governments (BVCA pp 9–10 and CVC Capital Partners p 224).

Property funds

47. A property fund is a collective investment scheme with a portfolio consisting mainly of direct property but may also include other property related interests. Property funds take a number of different legal structures depending on their domicile and target investors. Common forms of property funds include Unit Trusts, Open-Ended Investment Company, Limited Partnership and REITs. British REITs, for example, are closed-end investment trusts which are listed on a stock exchange recognized by the FSA. The Property Industry Alliance argued that there was no evidence of property funds playing a role in the recent financial crisis, but felt that the Directive treated these funds in the same manner as hedge funds and private equity funds (p 299).

Risks posed by Alternative Investment Funds

48. One of the aims of the Directive is to "establish a secure and harmonised EU framework for monitoring and supervising the risks that AIFM pose to their investors, counterparties, other financial market participants and to financial stability". To understand how effective the Directive would be in reducing risk, it is important to understand what risks AIFs pose to financial stability. These risks depend greatly on the type of fund and the investment strategies that a manager uses. The evidence on this subject is reviewed below. It suggests that worries about systemic risk are mainly limited to private equity funds and hedge funds. This may, however, reflect the focus of most witnesses on the impact of the Directive upon private equity funds and hedge funds.

BOX 5

What is systemic risk?

Systemic risk describes the inherent risk of collapse of an entire system, as opposed to risk carried by any one individual entity or component of a system. Systemic risk is amplified by interlinkages and interdependencies in a system or market, where the failure of a single entity can cause feedback effects and cascading failures.

Leverage and direct exposure

49. Leverage, or gearing, describes the use of debt to supplement investment. The use of leverage can expose banks to risk if an AIF collapses and the AIFs assets fall below the AIFs liabilities. If an AIF were to fail, any bank that had

direct exposure to this fund would be exposed as a result. Excessive leverage by AIFs could create systemic risk by amplifying the direct exposure of banks. The Commission notes on the Directive identify the main systemic risk of AIFs as "direct exposure of systemically important banks to the AIFM sector."[17] We heard that different funds utilise different levels of leverage: in 2009 the average leverage ratio of a hedge fund was around 2.5, while leverage levels of private equity funds were in general lower than this (FSA Q 221, BVCA p 10). However, there are wide variations between different leverage levels employed by AIFMs, which make accurate comparisons between average leverage levels employed by different types of funds very difficult. This is again an example of the blurred line between different types of AIF.

BOX 6

Long-Term Capital Management

The near failure of a hedge fund managed by Long-Term Capital Management (LTCM) in 1998 is sometimes cited as evidence that hedge funds can pose systemic risk. The Charles River Associates (CRA) report prepared for the FSA summarises the events that led to the decision by the US Federal Reserve to coordinate a $3.5bn rescue of LTCM by a consortium of international commercial and investment banks.

The CRA report states that the rescue was motivated by:

- The risk of LTCM's creditors sustaining losses (since the value of the collateral posted by LTCM had fallen dramatically); and,
- The risk of a downward spiral in asset prices as many assets were unwound into a falling market.

The CRA report lists several features of the LTCM fund that exacerbated its problems during the crisis. These included:

- A leverage ratio of 25 (that is, for every $1 of its own capital, it had $25 of debt);
- The large size of the fund;
- The large size of positions in certain markets relative to trading volume; and
- Poor transparency since LTCM did not provide information to its counterparties about the aggregate leverage.

The consortium that rescued LTCM initially suffered losses of $700 million but eventually generated a substantial profit on the rescue that provided them with 90% of the equity of LTCM.

50. The failure of US hedge fund LTCM is often cited as an example of how the employment of excessive leverage can lead to banks being over exposed to a hedge fund. Mr Rasmussen argued that the rescue of two Bear Stearns affiliated hedge funds by the US Treasury in the recent financial crisis "revealed that hedge funds were *de facto* considered systemically significant" and that high levels of leverage common to both hedge funds and banks

[17] COM (2009) 207, Directive on Alternative Investment Fund Managers, p.3

meant both types of institutions pose systemic risk and therefore require equivalent regulation (p 292).

51. While the Financial Services Secretary to the Treasury, Lord Myners, acknowledged that highly leveraged funds did create systemic risk, several witnesses noted that average leverage levels had fallen significantly; LTCM in 1998 had a ratio of 25, compared to an average of between 2.5 and 3 today (Lord Myners Q 413 FSA Q 221 Deutsche Bank noted that lenders to hedge funds had only suffered very small losses in the last crisis, suggesting there was little link between excessive leverage used by hedge funds and the recent financial crisis (Q 472). Losses were borne almost exclusively by the investor rather than by the lender. If losses caused by the failure of a fund had been borne by the lender, this would have posed significant systemic risk. That is not to say, however, that hedge funds do not employ high levels of leverage or that because average levels of leverage have fallen, hedge funds do not pose systemic risk. We discuss the supervision of leverage in Chapter 4.

52. Private equity funds were also criticised for being "over-addicted to leverage" (Lord Myners Q 412, Mr Rasmussen p 293). The BVCA acknowledged that some larger deals had involved high levels of leverage. They argued, however, that high leverage did not necessarily mean private equity funds posed systemic risk as they contributed only a very small amount to the overall level of debt in the financial system (p 10).

Crowded trades

53. Crowded trades happen when a large number of hedge fund managers follow similar trading strategies and make similar trades. This concentrates risk and may lead to several funds de-leveraging[18] at the same time. If many hedge funds follow similar investment strategies this increases the level of risk, as more assets are hedged on the same risk (Lord Myners Q 38 and FSA Q 256).[19] Crowded trades can force large numbers of hedge funds to de-leverage in a crisis, creating a pro-cyclical effect—selling assets quickly lowers prices, which means more funds sell assets and so on (Lord Myners, Q 414).

54. Witnesses also emphasised that while funds are unlikely to pose systemic risk individually, 100 or 1,000 small failures can cause risk to the financial system, particularly where these failures are in the same area of the market (a crowded trade) (FEPS Q 276). We discuss the need for a supervisor to hold an overall view of the market in Chapter 4.

Short selling

55. Short selling is the selling of securities that have been borrowed from a third party with the intention of buying the identical assets back at a lower price at a later date to return to the lender. It has been cited as contributing to financial instability. If many sellers (including hedge funds) engage in short selling this pushes the overall market value down and can increase financial instability by causing panic in a market (FEPS Q 269 and Mr Chapman

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[18] De-leveraging is the selling of assets to increase a fund's equity to debt ratio, often at a reduced value.

[19] FEPS elaborated that risks were amplified by the fact that hedge funds' unconstrained strategies have become more correlated over time, thereby increasing the potential adverse effects of disorderly exits from crowded trades (Q 269).

Q 69). On the other hand, Blackrock denied that short selling increased market instability and told us that it served a useful function in increasing market liquidity, lowering transaction costs and discovering the fundamental value of securities (QQ 181, 190).

56. The Directive does not include any direct regulation of short selling or other market strategies as these can be used by any market participant, not just AIFMs. The Directive explains this is because market techniques used by AIFMs are not unique to this category of financial market participant and in order "for regulation to be fully effective and coherent, these concerns must be addressed by comprehensive measures which apply to all market participants who engage in relevant activities".[20]

57. Short-selling is regulated at a national level. For six months from September 2008 to January 2009, the FSA implemented a ban on short-selling certain financial stocks in the UK. The success of this ban is still a matter of some debate.

Lack of transparency and disclosure

58. The Commission's explanatory notes for the Directive argued that lack of disclosure and transparency increased the risks associated with AIFs.[21] Many witnesses concurred, arguing that supervisors did not have sufficient information to identify, let alone tackle, risks to the financial system (Mr Rasmussen p 293 and FEPS pp 113–4).

59. There are four different groups to whom the operations of an AIFM may appear opaque: the general public, the investor, the supervisor and the prime broker. We found that investors were "generally comfortable" with the level of transparency of the AIFMs they dealt with (Wellcome Trust, QQ 251–2). Prime brokers also indicated to us that they were able to carry out effective due diligence on the funds they lent to, indicating a sufficient level of disclosure by AIFMs to this group. The FSA's prime broker and hedge fund surveys have begun to address the lack of transparency at a supervisor level.

60. However, outside the financial sector, Alternative Investment Funds and their managers have acquired a reputation for secrecy or for being "bizarre"; there is little public understanding of the industry (FEPS Q 284). Deutsche Bank agreed that transparency should be increased to reduce public scepticism of AIFs (Q 472). We discuss disclosure and transparency requirements in Chapter 4.

Other concerns raised about Alternative Investment Funds

61. Further concerns over certain aspects of the activity of hedge funds and private equity funds have been raised that are not strictly related to risk. As these are not directly related to the Directive, we do not comment on them in detail. They can be summarised as follows:

- Trading advantages: Several witnesses argued that hedge funds exercised trading advantages and were subject to less regulation compared to other market participants (Mr Chapman Q 68). However, other witnesses disputed this, pointing to the FSA's regulation of hedge funds (FSA QQ

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20 COM (2009) 207, p. 5.

21 COM (2009) 207, p. 3

210, 247 AIMA Q 167). The Wellcome Trust felt that hedge funds gained an advantage through the lack of constraints imposed upon hedge fund managers by investors, in comparison to conventional managers, allowing managers to invest as they wished and, as a result, more effectively (Q 267).

- Taxation: Some witnesses suggested that AIFs are able to escape proper taxation (Mr Chapman pp 38–39). AIMA calculated that the EU hedge fund industry paid a total of €4bn in tax in 2008, in line with the average rate of corporation tax in the EU of around 23% (p 77). The law firm Appleby noted that while funds themselves were often not taxed (as they were based in jurisdictions such as the Cayman Islands) the performance fees of AIFMs often based in London were subject to taxation (p 185).

62. These factors have all played a part in shaping the view in the European Union on Alternative Investment Funds. Whilst not all are related to risk *per se*, it is important to keep in mind the way in which these factors helped shape the Directive as originally proposed.

AIFs, risk and the financial crisis

63. Investment in AIFs will always carry a degree of risk, as will lending to AIFs by groups such as prime brokers. However, both the Turner Review and the de Larosière report[22] concluded that AIFs neither caused nor contributed substantially to the financial crisis. In the case of hedge funds, the de Larosière group also concluded that "they did not play a major role in the emergence of the crisis."[23] Similarly, there have been few claims from our witnesses that AIFs caused the financial crisis. Both reports, however, acknowledge that AIFs, and particularly hedge funds, played a small role in worsening or transmitting the crisis. Individually Alternative Investment Funds do not play a systemic role, but taken as an aggregate they could cause risks to market stability.

64. **We concur with the conclusions of the Turner Review and the de Larosière group that AIFs did not cause the recent financial crisis. However, we note the aggregate activity of hedge funds could increase market instability.**

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22 The Turner review was carried out by the Financial Services Authority and reviewed possible reform of regulatory and supervisory systems in the wake of the financial crisis. The de Larosière report was carried out by an independent group with a remit set by the European Commission to examine the system of supervision of financial markets in the EU.

23 Report of the High-Level Group on Financial Supervision in the EU, 25 February 2009, p. 24.

CHAPTER 3: KEY ASPECTS OF THE AIFM DIRECTIVE

Introducing a new regulatory framework—authorisation and registration of AIFMs

65. In order to ensure that all AIFMs operating in the EU are subject to effective supervision and oversight, the Directive introduces a legally binding authorisation and supervisory regime for all AIFMs managing AIFs in the EU.[24] AIFMs must seek authorisation from their home Member State to market their funds across the EU. Authorisation will entitle AIFMs to market funds only to professional investors, although some categories of AIFs—such as funds of hedge funds[25] and open-ended real estate funds—are currently accessible to retail investors in some Member States including the UK. The Commission told us that a single regulatory regime in the EU will improve the supervision of AIFM, increase supervisors' access to information and increase access of investors to the EU market (p 128). The requirement for the registration of all managers with a supervisory authority is in line with the conclusions of the G20 which agreed "to extend regulation and oversight to all systemically important financial institutions, instruments and markets. This will include, for the first time, systemically important hedge funds."[26]

66. The restriction on marketing AIFs only to professional investors has been proposed on the basis that many AIFs entail a relatively high level of risk and have features which render them unsuitable for retail investors. This is discussed further below.

67. There was wide recognition among witnesses of the need for appropriate regulation of AIFMs especially in light of the growing size of the AIF industry and the regulatory failures in financial services that led to the financial crisis. The Initiative for Policy Dialogue, Columbia University, argued that tighter regulation would restore confidence in hedge funds. If the EU pioneered comprehensive and effective regulation, it would make European markets stronger and more competitive globally (p 250). Equally for the FSA, "there is a case for strengthening the regulation of the management and administration of AIF at European level" (p 91).

68. The FSA asserted that there were substantial benefits in creating common standards which appropriately addressed regulatory concerns over investor protection and financial stability (p 93). FEPS also noted that as the overall hedge fund industry was becoming very large "there is a need for more regulation" (Q 280). Deutsche Bank told us that creating a single regime would allow for a uniform and consistent market while permitting firms all over Europe to distribute their products. It would also enable regulators to collaborate and ensure they could monitor systemic risk holistically (Q 455).

69. Witnesses including representatives of the industry itself were also largely supportive of the idea of introducing authorisation and registration of AIFMs. The Confederation of British Industry (CBI) considered that the creation of a unified approach to authorisation and registration was a positive

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24 COM (2009) 207, p. 8.

25 A fund of a fund is an investment fund that holds a portfolio of other investment funds rather than investing directly in shares, bonds or other securities.

26 Declaration of G20 Summit on the Global Plan for Recovery and Reform, London, 2 April 2009, p. 4.

aspect of the Directive as it would support the flexibility and competitiveness of the industry. Similarly, the Association of British Insurers (ABI) argued that creating a single regulatory regime for AIFMs in Europe would be "a positive step forward." The requirement for AIFM to register only in one Member State to market funds across the EU would simplify the process and reduce the costs of marketing AIFs in the EU (CBI p 217, ABI p 18).

70. The UK Government supported appropriate and rigorous regulation of the alternative investment management industry. The Minister told us that the Directive would bring two significant benefits: it would help establish a single market in alternative fund management bringing major opportunities for UK firms, and it would establish a framework for EU cooperation in mitigating systemic risks that could be cross-border in nature (Q 33). However, he argued that the Directive contained a number of major flaws which need rectification. These are considered further below.

71. **We welcome EU regulation of Alternative Investment Fund Managers. We support the principle of harmonising regulation of AIFMs across the EU on the basis that a robust legal framework at EU level can strengthen the single market and benefit investors. AIFMs we spoke to recognised that some regulation would increase their integrity and public perception of the worth of their activities. We welcome also the elements of the Directive that provide for coherent oversight of AIFMs across the EU by requiring the registration of, and the collection of appropriate data from, managers, in line with the conclusions of the G20.**

Thresholds and scope of the Directive

72. The Directive stipulates that it will not apply to AIFMs managing portfolios of AIFs with less than €100 million of assets, or less than €500 million in case of AIFMs managing only AIFs which are not leveraged and which do not grant investors redemption rights during a period of five years following the date of constitution of each AIF.[27] We heard contrasting evidence on the thresholds, with some witnesses saying that there should be no thresholds and others arguing that the proposed thresholds are too low.

73. The Association Française de la Gestion financière (the AFG), representing the French asset management industry, agreed with the levels at which the thresholds had been set by the Directive, arguing they were low enough to encompass the vast majority of AIFs while leaving out small entities that did not present systemic risks (p 192).

74. The Initiative for Policy Dialogue acknowledged that defining sensible thresholds was not a straightforward task. It argued that excessively low thresholds could be particularly burdensome for funds that provide capital to start-up companies and thus perform a particularly useful function for the real economy. On the other hand, thresholds higher than those set by the Directive would give hedge fund managers the incentive to divide their portfolio into smaller funds in order to avoid being subject to the requirements set by the Directive (p 249).

75. Representatives from private equity funds considered the proposed thresholds too low. The European Private Equity and Venture Capital

[27] COM (2009) 207, p. 8.

Association argued that the threshold for application of the Directive to non-leveraged funds should be increased from €500 million to €1 billion. They also said that private equity funds should remain subject to national regulation as they specialised in the financing of small and medium sized firms at local, regional or national level.[28] The same view was shared by BVCA (p 12).

76. The FSA also believed that the thresholds were too low to ensure the capture of only those AIFs which can pose systemic risks. They told us that the proposed thresholds failed to strike the right balance between controlling additional costs to business and enabling regulators to identify and mitigate systemic risks (p 95). The Minister noted that the low thresholds of the Directive would mean the requirements of the Directive would apply to relatively small companies. In the case of some requirements the low thresholds would lead to unnecessary burdens on companies, such as disclosure requirements where the requirements would extend to capture small private equity portfolio companies (QQ 54, 59).

77. AIMA disagreed: "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, thus avoiding the requirements which the Directive seeks to introduce. This would increase the possibility of misconduct going undetected. The thresholds for application should therefore be zero (p 60).

78. FEPS disagreed with the thresholds set in the Directive, arguing that more than 50% of managers of non-UCITS funds would be left unregulated. They also felt it would lead to an increase of small funds delegating management to third parties in order to avoid regulation, which "may jeopardise the quality and accountability of management" (p 116).

79. The Swedish Compromise maintained the original thresholds. However, it provided that managers of funds falling below these thresholds would "be subject to registration and supervision in Member States". The Gauzès Report however recommended deleting the thresholds so that the Directive, which would include provisions to apply it proportionally to managers of smaller funds, would cover all non-UCITS managers.

80. Establishing appropriate thresholds is a challenging task, especially considering the different types of funds covered by the Directive. **We urge the Government to negotiate a solution that will avoid penalising smaller entities without encouraging managers to attempt to avoid the Directive through threshold manipulation. Thresholds that reflect the differences of the private equity and venture capital industries should also be identified.**

One size fits all?

81. The Directive would cover a wide range of funds. It defines AIFMs in very broad terms and estimates suggest that there are 50 to 100 different fund structures across the EU which would be caught by the Directive.

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28 European Private Equity and Venture Capital Association, Response to the Proposed Directive on Alternative Investment Fund Managers, p. 5.

82. The Commission told us that this approach was designed to combine a broad scope with the flexibility to apply the Directive correctly to individual fund types. If the Directive were to be limited by fund types, there would be a danger of circumvention of the Directive (pp 129–130). Some witnesses emphasised the necessity and the inevitability of adopting this approach as the fund industry is constantly evolving. Mr Rasmussen and FEPS argued that the all-encompassing approach used by the Directive would prevent regulatory arbitrage within the EU (Rasmussen p 294, FEPS Q 286).

83. The majority of witnesses however criticised the Directive for not differentiating between the different types of AIFs. The FSA felt that the one size fits all approach failed to recognise the relative risks posed by the different activities undertaken by AIFMs and the different types of AIF. They argued that the approach did not acknowledge differences in how AIFs are structured and operated and as a result might in fact weaken investor protection (p 93).

84. For the ABI a one size fits all solution did not suit the idiosyncrasies of the various funds, whilst for the CBI the approach limited "the ability of investment management firms to achieve the best returns for their institutional investors" (ABI p 19, CBI p 213). CMS Cameron McKenna told us that the Directive failed to recognise the differences in operation between different asset classes (Q 110). The Association of Real Estate Funds told us that some of the requirements were "simply unworkable" when applied to the property fund industry (p 202). The Investment Management Association agreed that for the commercial real estate sector many requirements were unworkable and unnecessary (p 252).

85. Lovells LLP observed that business models and legal structures of AIFMs are diversified in the EU; there were significant differences, for example, 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. They concluded that an all-encompassing approach should be avoided (p 259).

86. Caledonia Investment told us that the one size fits all approach assumed that all AIFs were primarily a legal shell with all the functions undertaken by an external manager. They argued that by ignoring investment trusts, who had a board of directors, the Directive undermined the authority of the board of directors of a fund (pp 208–9). Several witnesses pointed to where the Directive attempted to introduce regulations to apply to investment companies that were already appropriately regulated by company law, another example of the Directive ignoring the different operating procedures of AIFMs (Investment Management Association, p 252).

87. AIMA asserted that a strong consensus was emerging amongst investors and managers that the one size fits all approach was one of the most fundamental problems with the Directive. AIMA believed that the EU could be faced with many years of debate about the definitions and potential exemptions, unless the discussion could focus on the principles of the Directive. They concluded that the distinctions between different types of funds should be left to Level 2 legislation[29] (QQ 138,143).

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[29] Level 2 legislation is where the detailed aspects of legislation are decided in the comitology procedure, Principles are set at Level 1 and specific details at Level 2.

88. AIMA's view was echoed by Sharon Bowles MEP, chair of the European Parliament Economic Committee. She told us that "one size fits all just does not work" and that "at some point a certain amount of tailoring will have to be done". She regretted that the original intention of regulation had been lost; the Directive should be principles-based "because principles should not change even if types of funds do" (Q 390).

89. The Government agreed. The Minister told us that the argument that a one size fits all approach was inappropriate had gained near unanimous support in the Council. He added: "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" (Q 415).

90. The latest compromise document from the Swedish Presidency maintains a one size fits all approach and affects open-end and closed-end, listed and unlisted funds. No distinction is made, for example, between funds that impose some redemption constraints on their investors and those that do not. Similarly, the liquidity of the funds' underlying assets is not a reason for exemption and AIFs investing in highly liquid assets fall within the scope of the Directive in the same manner as funds which hold illiquid assets.

91. We recognise the need to design a regulatory solution which is resistant to possible attempts at regulatory arbitrage within the EU, due to the evolving nature of AIFs. However, the Directive does not adequately differentiate between the different types of AIFs. **A one size fits all approach will not work. We recommend that the Government seek to tailor the Directive in a way that respects the differences between the types of funds it covers. A possible solution could be to establish broad principles in the Directive.** Detailed requirements could then be developed by the Level 2 legislative machinery within the overall framework established by the Directive, or through other means.

Regulating funds or managers?

92. The Directive regulates the managers of funds rather than the funds themselves. The Commission explained that managers should be regulated as it was their investment decisions that could pose risks to investors, markets or the economy (p 129). Many funds themselves are domiciled offshore. The submission of Maples and Calder provides a useful examination of why funds are often domiciled offshore (pp 269–276).

93. Some witnesses took issue with this approach. FEPS argued that funds must be regulated in order to regulate capital and liquidity effectively and to address tax issues, since most of the funds are located offshore (pp 115–116). Mr Chapman said that by regulating the funds as well, one "would tackle the offshore problem, the evasion of taxes, and also make it easier to tax the hedge funds themselves" (Q 72). FEPS also commented that the view that only managers should be regulated reflected the US and UK approach as the vast majority of fund managers were located in these countries. They argued that it was appropriate to regulate funds in the same way that companies are regulated and not the chairman or the CEO (Q 323). The Initiative for Policy Dialogue observed that the decision not to regulate funds limited the range of regulatory instruments that could be deployed (pp 248–249).

94. Most witnesses agreed that regulating managers was the appropriate approach. In line with the views of the Commission and the International

Organization of Securities Committees (IOSCO), AIMA observed that regulating managers was appropriate as they were the decision makers whilst the funds were "empty shells" (Q 144). The FSA agreed that it was the manager that ran the investment strategy of the fund and made 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. They also explained that the rationale for regulating the funds themselves, as with UCITS funds, was because the funds were sold to retail investors. As hedge funds were not marketed to retail investors, there was no case for such control over the fund. Where countries have tried to regulate the funds "the hedge funds do not go there" (Q 225). The HFSB agreed that it was appropriate to regulate the fund manager, rather than the fund itself, as long as the fund was sold to sophisticated investors only, who did not seek greater investor protection (p 240).

95. The AFG stated that regulating the managers "makes sense" as over-rigid regulation of the funds themselves would not fit with the *raison d'être* of hedge funds or private equity funds which requires a high degree of flexibility (p 191). The CBI disagreed "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" (p 217).

96. Coupland Cardiff Asset Management emphasised that although the Directive ostensibly only regulated the manager, in reality because many obligations imposed would directly impact upon the fund (including the appointment of an EU depositary and caps on leverage levels) it was, in effect, regulating the funds (p 222). Lovells LLP agreed that the Directive introduced product regulation "by the back door" (pp 254).

97. The Government shared many of these views. The Minister told us that "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 regulation of the fund itself is not needed. Authorisation and regulation of funds themselves is necessary [only] for funds sold to retail investors" (Q 39).

98. **We agree that it is appropriate for the Directive to regulate the manager rather than the fund, as the latter is merely a vehicle in which assets are held. Targeting AIFMs will ensure that the risks of AIFs are effectively monitored, irrespective of the domicile of the fund, whilst leaving AIFMs with the flexibility they need to operate. In reality some provisions of the Directive will also have the effect of regulating the funds. We urge the Government to ensure during negotiations that the focus of the Directive is kept on the regulation of the manager rather than the fund.**

Retail level of protection

99. Many of our witnesses commented that the Directive provided a level of protection similar to that applied to investors in retail products, such as UCITS funds, although only professional investors make use of AIFs. Specifically, this is relevant to the requirements for independent valuation of funds and depositaries, which are discussed in Chapter 7. Investors in AIFs are typically institutional investors, such as pension funds or insurance companies, who are able to carry out their own due diligence on funds.

100. The Wellcome Trust, a professional investor which largely invests in alternative funds, illustrated this point when they told us "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 … we find it hard to understand why this Directive would adopt a different stance and believe that it would not benefit the public good" (Q 251). They told us that the advantage of AIFMs used by institutional investors was that they were trusted by investors who did not impose restrictions for investment upon them. Imposing retail levels of restrictions on investment would reduce this advantage and in turn reduce the profits of institutional investors (Q 267). The Association of Private Client Investment Managers and Stockbrokers (APCIMS) argued that professional investors were already given protections by MiFID and CRD and did not need further protection (p 200). The Minister agreed that professional investors were capable of making their own decisions about where and how to invest (Q 54).

101. Other witnesses, however, argued that professional investors had shown they were incapable of making good investment decisions during the financial crisis. FEPS argued that "just relying on their ability to understand what is going on has proven not to be enough in the recent crisis." The investments of institutions such as pension funds affect the interests of the public who have pensions with such institutions, and so should not be left unregulated (QQ 280–281). Sharon Bowles MEP noted that many professional investors have recently shown themselves incapable of making sensible judgements on risk (Q 399).

102. For the most part, retail investors do not invest in AIFs. Professional investors are able to generate higher returns by investing in AIFs, often on behalf of their retail customers because of the lack of restrictions they place upon AIFMs. Providing a retail level of protection for investors will reduce returns by removing the lack of restrictions. As discussed in paragraph 71, **we agree that AIFMs should be the subject of appropriate regulation. However, the retail level of protection offered by the Directive as drafted is not required by the informed and experienced institutional investors and high net worth individuals who invest in Alternative Investment Funds, who are able to carry out their own extensive due diligence. We recognise that the success of these Funds has an impact on those not directly involved in the investments industry, including through pension funds.**

CHAPTER 4: SUPERVISION OF AIFMS

Registration and Transparency Requirements

103. The Directive would introduce increased transparency and disclosure requirements to identify the risks caused by AIFMs to both the financial markets and investors, as part of the registration requirements. The Directive does not intend to eliminate risk, and as FEPS noted, "risk will remain and is a normal part" of Alternative Investment Fund Managers' activities (Q 279). The Directive would also provide tools for supervisors to act to reduce excessive risk where it is identified. We examine these elements of the Directive in this chapter.

BOX 7

Disclosure and transparency requirements

The Directive differentiates between disclosure to regulators and transparency for investors.

To supervisors, AIFMs would be required to disclose:

- Performance data;
- Data on concentrations of risk;
- The markets and assets in which an AIF will invest;
- Risk management arrangements; and
- Organisational arrangements.

The Directive aims to ensure a minimum level of transparency of AIFs to ensure investor protection and facilitate due diligence. This would involve providing:

- A description of investment policy;
- Descriptions of use of assets and leverage;
- Redemption policy;
- Valuation, custody, administration and risk management procedures; and
- Fees, charges and expenses associated with the investment.

Disclosure requirements

104. Witnesses agreed that AIFMs reporting this data to supervisors would help identify and so reduce risks posed to the financial markets by hedge funds. AIMA welcomed the approach already undertaken by the FSA to collect information relating to systemic risk from the largest hedge funds and to compile and consolidate this data in order to track exposures and leverage (Q 157). The Wellcome Trust told us that further disclosure to supervisors would reassure the investor that the supervisor understood the overall situation in the investment industry (Q 252). Other witnesses including Mr Rasmussen (p 293), AFME (Q 478) and Deutsche Bank (Q 454) agreed that further disclosure to supervisors was, in principle, a positive step. Sharon Bowles MEP summed up the opinion of most witnesses when she argued "that to have more light shone on everything has to be a good thing"

(Q 395). Arcus Investment, a small investment management firm, agreed that greater transparency was a "constructive avenue" for regulation to pursue (p 189).

105. Many industry bodies, however, told us that the Directive was overly prescriptive in terms of what data was collected from managers, and risked overwhelming supervisors with large amounts of information irrelevant to the stability of financial markets. CMS Cameron McKenna told us that AIFMs were not sure what all the information to be disclosed would be used for (Q 125). AIMA argued the Directive should not contain excessive disclosure requirements which led to supervisors "being inundated with information which they have requested, but which they may not have adequate resources or expertise to analyse and/or process" (p 61). AFG described some of the disclosure requirements as disproportionate (p 194).

106. When we put this to the Commission they told us that supervisors would not be overwhelmed with information. They hoped that the information requested would be "appropriate" to enable supervisors "to identify where potential risks occur" (Q 366). The Commission acknowledged that part of the problem of the regulation of AIFMs was that previously supervisors had not had the right information. The disclosure requirements of the Directive aimed to ensure that supervisors had enough information to make informed decisions on risk management. This would enable supervisors to spot where risk was building up in the system (p 128). The European Systemic Risk Board would also have a role in highlighting concerns of a build up of risk in a particular sector or member state (Q 367).[30]

107. The FSA told us that if the Directive allowed the right information to be gathered in the right way then it would reduce the risk to market stability posed by AIFs (Q 209). The FSA has, over the last year, trialled both a hedge fund manager survey and a prime brokerage survey which have provided information on the impact of funds on the market and their use of leverage.[31] If the foundations for information gathering and sharing across Europe were implemented by the Directive, "that would be a very good thing". This information, when used effectively, would allow the supervisor to see a build up of leverage across the system or in a specific fund or identify crowded trades. Action could then be taken where necessary to reduce excessive risk (Q 210). However, supervisors should be able to take a flexible approach to "gather the right data and gather it themselves." The Directive should not be over prescriptive in its data collection requirements and should only require that which is relevant to systemic risk (Q 233).

108. The Minister expressed the Government's support for enhanced oversight of managers through the Directive, the requirements for which were broadly consistent with industry best practice (QQ 33, 54). However, he argued the FSA should be able to choose to collect only what it regarded as systemically relevant data from AIFs. The Directive as originally drafted would mean "that all UK fund managers would be forced to provide the prescribed

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30 The Committee has previously discussed the role of the European Systemic Risk Board (ESRB) in European Union Committee, 14th Report (2008–09), *The future of EU financial regulation and supervision* (HL Paper 106).

31 The FSA told us that these surveys have enabled them to know the positions of all major funds in the UK market. They reassured us that "there is nobody out there that looks anything at all like LTCM" (QQ 214–216).

information to the FSA—irrespective of whether the FSA believes that the information is important for the monitoring of systemic risk" (p 152).

109. The Swedish Presidency put forward a compromise on this issue, which would require all AIFMs to provide a basic data summary to their supervisor. Supervisors would then request further information from those AIFMs from whom data was systemically relevant, in order to build up an analysis of systemic risk without receiving large amounts of irrelevant data. The Government support this approach and the Minister also told us it was "only right" for the ESRB to request information from supervisors to build up an EU wide picture of the investment market (p 152).

110. We have heard near unanimous support in principle for the requirement for disclosure of key information on the activity of funds to supervisors. This will enable supervisors to use the information to compile an overall view of the market and the investments of alternative investment managers, to identify crowded trades and to take action to reduce the risks and leverage levels of individual funds where necessary. **We agree that these requirements could enable supervisors to identify where AIFMs pose excessive risk to financial stability, which should enable steps to be taken to reduce this risk.**

111. It is, however, crucial that supervisors are able to use the information they receive from managers effectively and that they act, where necessary, to tackle risk. **We welcome the work of the FSA to date on their survey of hedge fund managers and prime brokers to build up an overall view of the UK alternative investment industry. We also agree with the Government's support for the Swedish Presidency's compromise to help ensure that only systemically relevant data is collected.** The Government should consider whether this can most successfully be achieved through setting detailed disclosure requirements at Level 2, which allows flexibility, or through another alternative.

112. **The Government should ensure that national supervisors take on the role of data analysis and intervention. National supervisors, including the FSA in the UK, are likely to be most effective at analysing systemically relevant data and taking action to reduce risk. The Government should also work to put in place systems to require national supervisors to provide relevant data to the ESRB and bodies at a global level (in particular the Financial Stability Board) to help ensure that these bodies can identify systemic risks at an EU and global level respectively.**

Transparency requirements

113. Most witnesses welcomed in principle the minimum level of transparency of AIFs required by the Directive to provide investor protection and enable investors to carry out due diligence. Deutsche Bank argued that the requirements would mean "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" (Q 477). The Wellcome Trust agreed, welcoming the transparency requirements although they noted that they "feel generally comfortable" with the level of transparency already provided by the funds they invest in (QQ 251–252). FEPS argued that greater transparency of AIFs would increase public understanding of the

working of the funds and would therefore be good for the public at large (Q 284).

114. We heard, however, serious criticism of the transparency requirements in relation to private equity funds. The Directive would require private equity firms to disclose their business plans for portfolio companies and other information on shareholders and employees. These requirements would apply to around 500 companies owned by private equity funds but not to the other 6,000 companies not owned by private equity funds. US-based private equity funds with no EU investors would also be exempt. The BVCA argued "this would be a huge competitive disadvantage" for companies owned by private equity funds and therefore for the funds themselves (p 13). CMS Cameron McKenna noted that other funds, including sovereign wealth funds, which carry out very similar activities to private equity funds, would also be exempt from the requirements (Q 126). The Association of Investment Companies agreed that it is unclear why "sovereign wealth funds, rich individuals and conglomerates" who operate in a similar way to private equity funds, are not covered by the Directive (p 195).

115. The Minister told us that the Government "strongly oppose the Commission's proposals to impose stringent and costly disclosure requirements on portfolio companies of EU private equity funds". He said that these proposals would place EU businesses owned by private equity funds at a competitive disadvantage compared to both non private equity owned businesses and US private equity owned firms. He went on to describe these proposals as "nonsense." He did acknowledge, however, that further limited transparency requirements for the industry addressed "some of the misunderstandings and fears about private equity" (Q 54).

116. **Transparency requirements could in principle help provide protection to investors in AIFs and increase public understanding of the industry. However, the Government must ensure that such requirements set out in the Directive reflect the variations of different types of alternative investment funds to prevent them placing companies owned by private equity funds at a competitive disadvantage.**

Supervisory tools

117. If it is to be effective in reducing the risks that AIFM pose to market stability, the Directive must provide tools for supervisors to reduce risk where it is identified. The Directive provides controls on leverage used by AIFMs, capital requirements of AIFs and control over AIFMs' stake in companies. Our inquiry focused on leverage requirements as this element provoked the most controversy amongst witnesses, though we also heard some evidence on capital requirements. The Swedish Presidency compromise also introduced the possibility of a cap on remuneration levels of AIFMs. We have received little evidence on the subject. We set out what evidence we have received below.

Leverage cap

118. The Directive would implement a leverage cap, set by the Commission, for all AIFMs within its scope. The Commission argued that while leverage was a "very crude" measure of risk, it was easily measurable and therefore could

work in practice (Q 364). FEPS acknowledged that leverage levels used by hedge funds had fallen but argued they may rise again. Therefore, a cap was an appropriate way to prevent hedge funds employing levels of leverage in the future that would create systemic risks (QQ 324–330). Mr Rasmussen agreed that it was right for the Directive to include proposals on leverage (p 293).

119. Although most witnesses were sympathetic to supervisors having some control over leverage levels there was much opposition to using leverage as a measure of risk and also including a leverage cap within the Directive. CMS Cameron McKenna felt that "most people would believe that there should be some restrictions on leverage", but argued that the Directive and its cap did not recognise the differences in uses of leverage across funds (Q 134). The Wellcome Trust agreed, arguing "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" (Q 259).

120. Whilst agreeing with the application of leverage limits where necessary, the FSA told us that a cap on leverage set by the Commission was the wrong approach in principle. They argued that it was important to give national supervisors flexibility in their attitude towards excessive leverage. It would be more effective for the national supervisor to take a position on individual funds when they had aggregated information, than for a leverage level to be set across the EU by the Commission (QQ 223–5). AIMA (QQ 146–8), Sharon Bowles (Q 383) and Deutsche Bank (Q 468) also agreed that leverage limits should be set where appropriate by national supervisors.

121. Some witnesses argued that applying a leverage cap would increase systemic risk. AIMA said that appropriate leverage levels were "critically dependent on the stage of the cycle." A leverage cap could force many funds to unwind in a crisis, when the value of assets fell, producing a similar risk to that seen with crowded trades. In this case a simple leverage cap would increase the risk to market stability. AIMA concluded that a single leverage cap would be "counterproductive" (QQ 146–148).

122. Blackrock, in contrast, argued that leverage limits should not be part of this Directive at all and were most appropriately dealt with at supplier or bank level and in the Capital Requirements Directive.[32] They suggested that leverage levels did not play an important part in determining the risk posed by a fund manager, so should not be included as a provision to ensure financial stability (Q 198). The Commission confirmed that they had hoped to bring forward proposals on leverage as part of further amendments to the Capital Requirements Directive (Q 364).

123. The Government agreed that determining uniform EU leverage limits could in some circumstances increase systemic risk by forcing a fund or a manager to sell assets. The Minister described the cap as "brutal and blunt" (Q 60). The national supervisor would need to exercise a high degree of judgement in applying leverage caps to individual funds where appropriate, informed by the information collected under the disclosure requirements (Q 413).

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[32] The Capital Requirements Directive sets EU rules on capital requirements for credit institutions and investment firms

124. The Swedish Presidency compromise would remove the simple leverage cap, but maintain requirements for leverage disclosure and give national supervisors the power to impose leverage limits on individual funds or across the board if financial stability was threatened.

125. Leverage ratios are not an absolute measure of risk and so a leverage limit or cap, as proposed by the Directive as drafted, will not automatically cap risk. Indeed, leverage caps have the potential to create systemic risk, rather than reduce it. **We agree with the Financial Services Authority and the Government that supervisors should have the power to impose leverage caps where appropriate, based on the aggregated information they receive from fund managers. We welcome the Swedish compromise on this issue and the Government's support for this proposal.**

Capital requirements

126. The Directive would require AIFMs to hold a minimum level of capital. This is intended to ensure that AIFMs have an appropriate capital base on which to build their investment. Capital requirements did not give rise to a great deal of debate amongst our witnesses, but those views we heard were divided.

127. Mr Rasmussen and FEPS (pp 296 and 115) both expressed support for such capital requirements. Others, however, did not agree a capital requirement should be included in the Directive and felt instead that it should be included in other legislation. The FSA told us that they did not object, in principle, to the Directive setting minimum capital requirements, as long as they were appropriate, differentiated appropriately between different types of AIF manager, and were consistent with other relevant EU capital adequacy regimes (p 95). It was suggested by some witnesses that a cap of €10 million on capital requirements—in line with the UCITS Directive—would be appropriate (Blackrock, p 81).

128. The Minister told us that it was appropriate for fund managers to hold enough capital to ensure they were creditworthy. The requirements however should be more differentiated between the different types of funds covered by the Directive to ensure that they were appropriate (Q 60). **We agree that if capital requirements are set in the Directive, they must differentiate sufficiently between different types of funds covered by the Directive. The Government should also consider whether it will be more appropriate to enforce capital requirements through the Capital Requirements Directive.**

Remuneration of fund managers

129. AIFMs have historically been highly remunerated and continue to be so, and this has given rise to general resentment and anxiety and specific concern of regulators on the basis that large incentives cause financial managers to take risks that contribute to financial instability. The Directive as originally published contained no provision to regulate remuneration, but a clause along the lines of that recently discussed by the G20 was introduced into the deliberations as part of the Swedish Presidency compromise. "Member States shall require AIFM to have remuneration policies and practices that are consistent with and promote sound and effective risk management and

do not encourage risk-taking that exceeds the level of tolerated risk of the AIFM or which is inconsistent with the risk profiles, fund rules or instruments of incorporation of the AIF it manages."

130. As the provision was introduced late in our inquiry we took only limited evidence on remuneration, principally from Blackrock, Citadel and John Chapman. The two hedge funds argued that alternative investment managers in effect entered into a contract with a limited number of professional investors under which they were remunerated only if the investors achieved their target rate of return over the life of the fund (Citadel Q 437). In short they only got paid if and when investors had already been paid out over the life of the fund. Blackrock said "managers are paid and participate in performance: you gain with good performance, you lose with bad performance" (Q 187). On this basis it was argued that detailed regulation was unnecessary and inappropriate since in effect the investors were the regulators. Dr Syed Kamall MEP agreed that 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" (p 258).

131. The purpose of the G20 recommendation was to avoid the sort of remuneration practices that would give rise to financial instability but just as we found that AIFMs had not threatened the credit channels it is clear that where AIF investors lost money, so did the managers. They were working on the basis that the investment had to remunerate investors first and had to be calculated over the life of the fund. This was in sharp contrast to many bankers who were highly remunerated on the basis of a one year performance and not penalised when the positions they had taken in order to achieve short term performance redounded to the disadvantage of investors and depositors in the next year. Banks allowed their employees to receive large bonuses after booking short-term unrealised profits on transactions that turned out to be hugely loss making in the long-term. The bank bonuses were not clawed back from employees after it became apparent that their actions led to large losses.

132. It was however put to us by John Chapman that the AIFMs had been a malign influence on the whole financial system. The levels of remuneration achieved by the successful had been well beyond the aspirations of professional bankers and had given rise to a culture where they all felt entitled to achieve those levels, taking huge risks with the deposits and investments in their charge and engaging in "hazardous financial innovations". In short the hedge fund culture had infected the system (p 34). Some of his concerns were felt by other observers and undoubtedly contributed to the general unease about AIFMs, who in background and training do not greatly differ from managers in corporate and investment banks. Some argue, however, that AIF investors made arrangements with their managers that ensured that they were only highly remunerated on the basis that they achieved a high rate of return for the investors over a number of years, in precisely the manner recently proposed by the G20. The perception of AIFM's pay, however, is a different matter and it may well have had some influence on managers in conventional institutions whose employers were less inclined to take a long and proprietorial view of their assets.

133. The Minister noted that it was necessary to impose controls on bonuses at all significant institutions, in line with G20 agreements. He argued, however,

that it was inappropriate to apply the same structure of regulation in both the Capital Requirements Directive and the AIFMD. The Government were therefore seeking to change the requirements on the deferment of bonuses (pp 152–3).

Role of prime brokers

134. When we discussed the supervision of AIFMs with our witnesses, many referred to the role which prime brokers play in the supervision of hedge funds. Prime brokers lend capital to hedge fund managers to invest alongside their assets, and in doing so have an interest in the hedge funds' activities and success.

135. Deutsche Bank explained that prime brokers offered a range of services to hedge funds including clearing, custody, asset servicing, client reporting, financing, securities lending, capital introduction, consultancy and risk management advice. In lending to hedge funds, prime brokers carried out due diligence on the fund to manage the risk they took in lending to that fund. They agreed that prime brokers in effect supervise the funds they lend to, as part of managing their own exposure (QQ 454, 475–6). AFME recognised that prime brokers knew hedge funds were high risk customers and therefore undertook low-risk lending in relation to them. This included refusing to lend to a fund manager if their activities were considered too risky (Q 491). Lord Myners also recognised the role of the prime broker, and argued that effective regulation of the prime broker would help prevent hedge funds employing excessively risky leverage levels (Q 413).

136. Whilst neither this Directive, nor this report, comments on the regulation of prime brokers, it is important to recognise the role of supervision they play in the system through due diligence. The effectiveness of this is shown by the small amount of money lost by prime brokers through the failure of hedge funds during the financial crisis (Deutsche Bank, Q 471). Lending to hedge funds is done normally at high margins and is more profitable than much of the lending book. As Deutsche Bank told us, these departments are very well resourced (QQ 470, 475).

CHAPTER 5: TOWARDS AN EU PASSPORT REGIME FOR AIFMS?

137. The Directive provides for authorised managers to market their funds to professional investors across the EU on the basis of a harmonised set of rules, with a view to developing the single market in AIFs. This proposed regime is known as the EU passport. Cross-border marketing will only be subject to a notification procedure.[33]

138. The Directive also provides that managers (both EU and third-country based) of non-EU funds would only derive the benefits of the EU passport under restricted circumstances and only from the third year after the end of the Directive's transposition period. After this period non-EU managers will be able to market their funds in the EU, provided that the regulatory framework and supervisory arrangements in their home country are judged equivalent to those of the Directive, and that EU managers enjoy comparable access to that non-EU market.[34]

EU passport and third country aspects

139. Witnesses were widely supportive of the idea of establishing an EU passport for European based funds. The FSA told us that the EU passport was "one of the most attractive things about this Directive which the UK has long wanted" (QQ 242, 244). AIMA called the EU passport a "welcome and positive step." It would reduce operating and compliance costs for cross-border funds as well as widening opportunities for investors in the EU, if implemented in the correct way (p 61).

BOX 8

Overview of the specific rules in relation to third countries

Marketing of non-EU funds by EU managers:

The draft Directive will enable AIFMs to market non-EU funds in a Member State if the home country has signed an agreement with the Member State for the exchange of information on tax matters which complies with the standards laid down in the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention. The rules allowing the marketing of non-EU funds will come into force three years after the Directive. Meanwhile, non-EU funds will continue to be sold in those Member States which currently permit them to do so.

Marketing of non-EU funds by third country AIFMs:

Non-EU AIFMs may market AIFs to professional investors in the EU where the third country (the country of domicile of the non-EU AIFM has equivalent legislation regarding prudential regulation and supervision). In addition, the third country must provide equivalent access to EU AIFMs. Finally, there should be an appropriate tax cooperation agreement between the third country and the Member States in which the AIFM is seeking authorisation to market their product. These rules would only come into force three years after the Directive is agreed. In the meantime arrangements will be governed by the national law of each Member State.

33 The AIFM will provide relevant information to the home regulator to be transmitted to the regulator in the other Member State in which the AIF is to be marketed. COM (2009) 207 Articles 31–34.

34 COM (2009) 207 Articles 35–39.

140. The AFG argued that the EU passport would “make the single market [in AIFs] a reality”, bringing additional business opportunities for European companies promoting such funds and a wider choice for European investors who will see a larger range of funds actively marketed to them (p 190). FEPS supported the idea of having a passport with stringent rules in order to develop a brand for European products as an indicator of good regulation. Sharon Bowles MEP commented that this was, in essence, another way to look at the passport system as a reward for good behaviour, a “gold standard” for AIFM (Q 387). The AFG told us that the ultimate aim of the Directive was to establish a framework for EU funds that will enable them to compete successfully with non-EU funds—as it was the case with the UCITS Directive, which successfully facilitated the worldwide selling of European mutual funds (p 192).

141. Coupland Cardiff offered a less optimistic view of the possibility of developing an EU single market for AIFMs, arguing that “until there is tax harmonisation and simplification across the EU, the ability to passport funds into other EU jurisdictions 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” (p 222).

142. Despite the widespread enthusiasm for the principle of an EU passport regime, witnesses were critical about the conditions for marketing of non-EU AIFs, and for the marketing of non-EU AIFs by third country managers in the EU. A large number of witnesses defined these provisions as protectionist. It was argued that they would make it harder for non-EU funds and managers to obtain the passport to operate in the EU. In Simmons and Simmons’ view, these provisions “in effect introduce a form of protectionism which will not benefit European investors” (p 303). Lovells also pointed to the risk of establishing a “fortress Europe” and envisaged that other countries, such as the US and Australia, could retaliate and prevent European funds from being sold in those jurisdictions (p 260). The risk of retaliation was also mentioned by HSBC who added that “institutions such as pension funds should have access to the full range of global funds, not just EU funds” (p 245). The FSA argued that “an outright ban of non-EEA funds and managers would restrict the access of European investors to valuable, open and successful markets” (p 95). Sharon Bowles MEP told us that the Directive “ends up being both fortress Europe and prison Europe in that funds cannot get in and money cannot get out” (Q 384).

143. AIMA estimated that the absence of non-UCITS assets as part of European pension funds’ portfolios would cost the pension funds industry €25 billion per annum in lost investment performance (p 57). Many other witnesses identified the potentially negative impact of these provisions in limiting options for the pension industry in Europe. Open Europe told us that they estimated the Directive as a whole would cost the investment industry in the EU between €1.3bn and €1.9bn in the first year, with the annual recurring costs estimated at between €689m and €985m (pp 285–6).

144. The UK foundations, including the Wellcome Trust and other charities who submitted evidence to us stressed that the Directive’s restrictions would cause managers to give up raising capital in the EU rather than comply with onerous regulations. They concluded that “this will significantly restrict the choice for European investors, limit the scope and potential return of our investment portfolio and hence reduce our charitable spend” (p 327).

145. The Swedish Presidency issues note tackled the problems raised by the Directive in respect of investments in non-EU funds and third country managers arguing that an overwhelming majority of Member States were against imposing undue restrictions on investment opportunities.[35] The issues note offers a list of possible solutions on which we sought comments from witnesses (see Box 9).

BOX 9

Solutions suggested by Swedish Presidency issues note regarding third country issues

The issues note states that delegations have expressed concerns regarding Chapter VII (Specific rules in relation to third countries, Articles 35–39) of the AIFMD.

Article 35 of the AIFMD only allows marketing of third country funds to professional investors in the EU if the third country signed an agreement regarding tax conventions and information sharing related to tax matters.

Articles 36–38 impose conditions under which a AIFM may delegate administrative services to entities established in a third country (Article 36), appoint valuation agents in third countries (Article 37) and allow its depository to delegate functions to a sub-depository in a third country (Article 38).

Article 39 imposes conditions under which a member state may authorize an AIFM established in a third country to market an AIF to professional investors in the EU.

The issues note suggests several options regarding articles 35 and 39 including:

- Option 1 (Option 2)—requiring that investing in an AIF in a third country (marketing a third-country AIF) should only be allowed if the AIFM is domiciled in a Member State or information sharing agreements are in place (option 1)
- Option 3—deleting article 39 but retaining Article 35.
- Option 4—deleting Article 39 and retaining Article 35 with provisions.
- Option 5—deleting Articles 35 and 39.

146. AIMA confirmed that option 5 of the suggestions in the issues note would alleviate the protectionist nature of the original proposal. This would have the effect of enabling national private placement regimes to remain in place (QQ 152–4). National private placement regimes are the national rules for the marketing of non-EU funds in the EU. Maintaining these would effectively maintain the status quo alongside the EU passport. The UK has successfully permitted non-EU funds of various types to be marketed locally (that is, only in the UK) for a number of years. Cameron McKenna LLP concurred that option 5 was the most favoured by the industry. This would maintain the status quo for the UK (QQ 128–9).

147. Other witnesses supported the solution of keeping national private placement regimes in place. The AFG argued for an EU passport but said it should be limited to EU-domiciled funds and managers, as is the case for the UCITS

35 Compromise proposal of the Swedish Presidency on COM (2009) 207, 12 November 2009, p. #.

passport. The EU passport should not be extended to non-EU funds as this would create legal and political risks in the case of the failure of a fund. However, as a complementary element to the EU passport system, national regulators should be able to provide non-EU funds with a national visa, allowing the marketing of non-European funds to local investors, but not EU-wide—the continuation of national private placement regimes—"in order to keep national flexibilities in active marketing of non-European funds to local investors" (p 191).

148. Mr Rasmussen argued against national private placement regimes coexisting alongside the EU passport as "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" (p 297).

149. The Commission argued that the EU passport would facilitate cross-border marketing of AIFs in the EU and allow AIFMs to manage AIFs domiciled in other Member States (p 130). They said that national private placement regimes should not be kept in place because on that basis nothing would change and it would also strengthen the hands of those who wanted funds based in Europe to be managed only by European managers by preventing the extension of the passport to non-EU managers. National private placement regimes could not co-exist successfully alongside the EU passport. They told us that the fact that the Directive specifically provided for third countries to be able to demonstrate they applied equivalent standards and thereby for non-EU funds to gain access to the passport would prevent the Directive being protectionist. (QQ 359–363). We discuss equivalence further below.

150. The Minister reminded us that the UK had successfully allowed non-EU funds to be marketed in the UK for a number of years, putting the UK fund management industry in direct competition with the global market in AIFs. He argued "in the same way that that has been good for the UK, it should be good for Europe". He concluded that while maintaining national private placement "would be a missed opportunity to enhance trade and investment across Europe", the Government's top priority was to protect the UK's right to an open market. For this reason the Government supported the compromise proposal of the Swedish Presidency, which is explained in detail below, which in effect maintains national private placement regimes (Q 406).

Equivalence test

151. We heard concerns from many witnesses that third countries would find it difficult to meet the proposed equivalence standards required to obtain the EU passport. The interpretation of equivalence also proved to be a fundamental issue.

152. FEPS argued that, ultimately, equivalence would be met, as "the EU market is too big to be ignored" as investors will realise they will lose money in not complying regardless of its complication (Q 299). Blackrock commented that it "is nice and easy" to obtain a passport if you are an EU manager managing an EU fund. But if you are a non-EU manager managing a non-EU fund, then you would be required to meet equivalence tests which have previously been equivalency of outcome, whilst in this Directive it would be equivalency of rules. Blackrock concluded that "it would be very problematic for a lot of countries to meet those equivalency tests … it would be much harder to run effective global funds or regional funds, emerging market funds" (QQ 192–193).

153. Dechert LLP expressed doubt that any third country, including the US, would be able to meet the proposed standards for equivalence. They questioned the use of an EU passport "if it effectively serves to deprive the market of access to third country managers and funds." They advocated the negotiation of "minimum best practice acceptable to both the EU and elsewhere" (p 229). Similarly, the City of London Corporation suggested that equivalence should not be interpreted as meaning that third countries would have to demonstrate identical regulation and supervision. They argued that the regulatory objectives should be the same, but there should be sufficient flexibility for third parties to determine how these objectives would be met (p 210).

154. Sharon Bowles MEP agreed that the possibility of achieving equivalence depended on how it was determined. She argued that if the interpretation of equivalence was that legislation must have similar objectives then the equivalence could "work quite well." However, if investments could be made only where there was strict equivalence, then it would not be achieved. She noted that this would make it especially difficult for developing countries to achieve equivalence with the result that "we would never invest in Africa" (Q 387).

155. The Commission told us that equivalence would not require "identity" but rather "comparable objectives and outcomes". They revealed that Member States were, in fact, concerned about equivalence for opposite reasons. Some Member States feared that, ultimately, the EU would adopt such strict conditions that no other jurisdictions would be considered equivalent. Other delegations, however, were concerned that there would be political pressure to consider all regulatory regimes equivalent. The Commission explained that equivalence had been implemented in a number of areas and concluded that "equivalence is not impossible, it is a question of willingness to recognise it" (Q 353).

156. When we questioned the Minister on whether the equivalence test could be met, he confirmed that assessment of equivalence of third country regimes would depend upon how one defined and determined equivalence. He commented that it was not clear to him whether this equivalence test was to be an assessment of consistency with high level principles, similar to those set by the G20, or equivalence to the detailed approach set out by the EU. He concluded that if equivalence was based on the G20 principles then it would become an achievable goal. However, the Minister observed that "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" (Q 407).

The Swedish compromise

157. The compromise draft proposed by the Swedish Presidency on 12 November 2009 allows for an EU passport for EU based funds, but does not allow for such a passport for funds outside the EU. However, three years after the Directive comes into force, the EU Commission will be called upon to review whether third country funds may receive such an EU passport. Member

States may however, allow, or continue to allow, AIFMs to market AIFs established in third countries to professional investors on their territory subject to national law. The Gauzès report also suggested the removal of the third country clause on the basis that investors should have the freedom to invest according to the rules laid down in their home Member States.

158. Citadel described the third country private placement as defined by the Swedish compromise as "a step in the right direction" but said it was not just a reinstatement of national private placement rules. Citadel explained that the ability of off-shore managers to continue to market through the private placement regime into the EU remained unclear and concluded that "it it is still going to be more difficult for third-country funds to be marketed in the EU" (Q 434).

159. Commenting on the imminent conclusion of the Swedish Presidency, and the succession by Spain, Lord Myners stated his belief "that the Spanish view is very similar to that now being proposed by Sweden" and that UK investors would probably be allowed to continue to have access to the best fund management products in the world in a way which is consistent with careful management of systemic risk. He concluded by asserting the UK preference for "an open passport to non-EU funds throughout the EU as long as they complied with the G20 principles for the purposes of equivalence" (Q 408).

160. **We support the principle of an EU passport extended to non-EU funds, managed by both EU and non-EU managers. However, we believe that as originally drafted the proposal for a passport for these funds would impose significant obstacles in the way of managers wishing to market non-EU funds in the EU. EU managers should be able to continue to invest in non-EU funds and fund managers located outside the EU should be able to invest in Europe.**

161. **We agree with the Minister that if equivalence is an assessment of whether a third country operates an identical regulatory regime to the EU, as in the draft Directive, then it will be hard, if not impossible, to achieve. We therefore support the continuation of national private placement regimes to maintain options for investors, whilst efforts are made to achieve the principles-based equivalency with third-country regimes that is required for the EU passport to operate effectively.**

162. The third country provisions in the EU passport have proved to be the most critical point of divergence among member states during the negotiation in the Council. We hope that the agreement on this matter will be found under the Spanish presidency. **The Government should continue to negotiate a solution that does not penalise the marketing of non-EU funds which will eventually have negative repercussions on the UK and European financial markets.**

CHAPTER 6: THE AIFM PROPOSAL IN THE GLOBAL CONTEXT

The need for coordinated action at global level

163. The international nature of financial markets means effective regulation of AIFMs can only succeed if there is coordinated and consistent action at global level. This was endorsed and reiterated by the International Organization of Securities Commissions (IOSCO) and the European Central Bank. A global approach to regulation gained momentum at the G20 meetings in Washington D.C., London and Pittsburgh (between 2008 and 2009) where world leaders made a commitment to regulate hedge funds and other unregulated entities.

164. IOSCO, in its Hedge Fund Oversight Report, emphasised "that any regulatory measures or standards need strong collective global action and application as the hedge fund industry is highly global and mobile."[36] The ECB warned the EU against legislating on AIFs unilaterally and pressed for an internationally coordinated response, in light of the international nature of the industry and the risks of regulatory arbitrage. The ECB urged the Commission "to continue the dialogue with its international partners, in particular the US, to ensure a globally coherent regulatory and supervisory framework."[37]

165. Witnesses also emphasised the need for the Commission to coordinate its actions with other countries, especially the US, to ensure a globally coherent approach. The Commission itself admitted that "in an area such as financial services you have to always operate on an international basis" (Q 349).

The US legislation White Paper

166. In the United States, hedge funds have been generally exempt from regulation by the Securities and Exchange Commission (SEC) or any other entity. However, in June 2009, the Administration released a Bill for a "Private Fund Investment Advisers Registration Act of 2009" aimed at strengthening the regulation of financial markets. The proposed legislation required all US-based investment advisers with more than $30 million in assets under management to register with the SEC. This would affect managers of hedge funds, private equity funds and venture capital funds, and other private pools of capital. The legislation as originally drafted would impose new record keeping and disclosure requirements in order to provide regulators with information to evaluate both individual firms and entire market segments. There were originally no plans in the US for leverage caps or constraints on AIFMs' remuneration arrangements. At the time of publication, the Bill had been agreed as part of the Wall Street Reform and Protection Act in the House of Representatives, but had not yet been agreed considered by the Senate.

167. We discussed the US proposals with a number of witnesses, to understand the differences for the EU-proposed legislation. The Commission

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[36] Technical Committee of the International Organization of Securities Commission, *Hedge Funds Oversight*, June 2009, p. 7.

[37] COM(2009)81 Opinion of the European Central Bank on the Directive on Alternative Investment Fund Managers of 16 October 2009, p. 1.

emphasised that the EU and US are going "in the same direction" in legislating for AIFMs. They did not see anything happening in Europe or the US "that shows we are taking diametrically opposed positions in relation to legislation" (Q 348). Mr Chapman commented that "the American Bill is probably a little bit lighter and less detailed than the European Directive" (Q 84).

168. Industry representatives were cautious about the similarity of the two approaches. Citadel told us that the EU and US proposals had similar goals of enhancing investor protection and reducing systemic risk. The US approach was, however, based more on transparency and disclosure whereas the EU proposal was more prescriptive (Q 428).

169. The ABI commented that while the objectives of the EU and US were the same—to mitigate systemic risks and to protect investors—the US requirements seemed much less onerous and much more practical. The ABI's fear is that EU AIFMs could be left at a severe competitive disadvantage by the EU Directive (p 22). Blackrock noted that the USA approach had a narrower scope, whereas the EU approach embraced a larger pool of operators. They said that despite the US's choice to adopt lower thresholds so that all firms have to be registered regardless of the size, "the compliance with that registration would probably be materially less because the focus is more on identifying systemically important firms … those firms which would be almost by definition more systemically important would be held to a greater regulatory compliance" (Q 201).

170. The differences between the two approaches led us to become increasingly concerned about the risk of regulatory arbitrage. Questioned on this point, Citadel told us that "there is a great drive now to harmonise the approach" among international regulators. They went on to express confidence that the new rules in the USA treated US and non-US managers equally (QQ 429, 432).

171. Sharon Bowles MEP, commenting about a recent visit to Washington to discuss US progress with the legislation, told us that the US was keeping an eye on what the EU was doing because they wanted "to gain a little bit" from any regulatory arbitrage. She added, "We do not want to find ourselves too painted into a corner that we have no flexibility in response." She continued that "the majority of the people … were saying they do not want any regulatory arbitrage … but that does not mean to say we do not have it in the back of our minds" (Q 383).

172. Deutsche Bank also voiced concerns about the risk of regulatory arbitrage, envisaging a movement of AIFMs to where the most favourable regime is located. They argued for "a globally consistent regime which really does address some of those very valid concerns in relation to investor protection and systemic risk" (Q 462).

173. While the majority of witnesses were concerned about regulatory arbitrage, FEPS provided a different view on how to proceed with legislation at international level. FEPS stressed that it would be important for the EU to go ahead with the proposals regardless of the direction of the US legislation. They argued 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." They continued, "our own view [the EU approach] … may be good for the USA

also" (Q 318). We saw a certain overconfidence in this argument which did not dissipate our concerns.

174. The EU is taking a more forceful and prescriptive approach to regulation of AIFMs than the United States. It is important that countries work together to ensure regulation is complementary as AIFMs may gravitate to a country with a lighter regulatory regime. **The Government should ensure that EU regulation is in line with, and complements, global arrangements. We believe that the Government should not agree the Directive unless it is compatible with equivalent legislation with regulatory regimes in third countries and in particular in the United States, in order to avoid a situation in which EU AIFMs lose competitiveness at a global level.**

CHAPTER 7: DEPOSITARY AND VALUATION

Custody/depositary

175. The Directive seeks to ensure that service providers to AIFMs, such as depositaries, are also subject to appropriate regulation. A depository provides services to AIFMs including custody services and securities settlements and may also provide fund administration services.

176. The Directive stipulates that EU fund managers will be required to appoint an independent depositary which must be an EU credit institution. The Directive also requires that any custody functions can only be delegated to another EU credit institution and makes depositaries liable for the failure of any sub-custodians they appoint.

177. Simmons and Simmons told us that this requirement represented a departure from current regulatory practice and was stricter than the UCITS Directive. Some types of AIFM, e.g. a hedge fund manager, often maintained custody of the assets of their AIF with their prime broker, either directly or through sub-custodians in different countries in which the fund's assets were held. It was also becoming standard practice for hedge funds to appoint more than one prime broker with a view to reducing counterparty risk and the prime broker might be outside the EU (p 303).

178. While there was a recognition among witnesses of the need for independent custody of assets, these provisions were also heavily criticised. Some witnesses argued that the requirement for the depositary to be an EU credit institution and the restrictions on delegation would make it difficult for AIFMs to invest in funds that were not domiciled inside the EU. Coupland Cardiff noted that the majority of emerging markets required locally incorporated custodians and as a result any AIFM investing outside the EU would be unable to continue operations in the EU (p 223).

179. Similarly, the Association for Financial Markets in Europe (AFME) remarked that in many non-EU jurisdictions there may be no EU credit institution able to carry on the local business of holding the assets. 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" (Q 495).

180. The City of London Corporation identified delegation as the single most important issue to resolve in the Directive as it could have a major impact on asset managers managing global, regional and national portfolios. They argued that the focus should be on how the assets were managed, as opposed to where (p 211). Fidelity International told us that depositary requirements would restrict choice and add to cost (p 236).

181. The Minister told us that restriction on delegation could impose substantial burdens by requiring firms to repatriate activities carried on outside the EU. He argued that funds domiciled outside the EU should be allowed to appoint local depositaries, subject to appropriate regulation (QQ 59–60).

182. Some witnesses were concerned with the provisions that would make depositaries liable for risks and losses they cannot control, potentially reducing the number of institutions able to carry out this service and

therefore leading to a concentration of risk. Deutsche Bank gave the example of a sub-custodian in the Middle East or Asia which failed leaving the custodian or depositary to make good to the investor. That was not something that the depositary could control and would lead to a concentration of counterparty exposure. If there were to be some sort of insolvency event, it would be more troublesome for the underlying fund. They concluded that it "is an example of where risk is concentrated and therefore increased" (Q 46). HSBC and Simmons and Simmons shared these concerns (pp 246, 303).

183. Finally, AFME pointed out that prime brokers will find it hard 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. AFME explained the key difference between UCITS funds and hedge funds is that under UCITS the depositary holds the assets in custody and executes the clearing and settlement of instructions, whereas for hedge funds the assets of the fund are pledged to the prime broker and therefore are held in his account and not in the fund's account (Q 478).

184. Witnesses however, recognised the progress made by the Swedish compromise. Deutsche Bank observed that "the compromise proposal has softened the liability provisions" (Q 465). AFME further explained that the Swedish Presidency has proposed helpful new language which would permit a non-EU fund with an EU manager not to have a depositary so long as it was not marketed to investors under the passport. AFME observed "in its original form, the Directive would have cut off EU investors from access to some of the best managers in the world" (Q 478).

185. Requiring the depositary of an AIF to be an EU credit institution will reduce the number of available custodians and therefore will concentrate deposits in a limited number of institutions, increase counterparty risk and ultimately increase costs for investors. **We urge the Government to press for an amendment to the Directive which would enable AIFMs to use non-EU depositaries, and to sub-delegate custody functions so long as they are suitably regulated and supervised.**

186. **We do not support the Directive's provision that depositaries should be liable for risks and losses of sub-custodians that they cannot control. We recognise the improvements included in the Swedish compromise and we urge the Government to support this aspect of the compromise during the negotiation under the Spanish Presidency.**

Valuation

187. The Directive proposes that all assets of the AIF must be valued at least once a year and each time shares or units of the AIF are issued or redeemed, by an independent entity. The valuation rules to be applied would be those of the country in which the AIF is domiciled. AIFMs must ensure that the valuation agent has appropriate and consistent procedures to value the assets in accordance with the applicable accounting standards and rules.[38]

188. Much written evidence contested the requirement for the fund's assets to be valued by an independent valuation agent as it would pose significant

[38] COM (2009) 207 Article 16.

difficulties and differs from the model prescribed in the UCITS Directive. The concept of the independent valuation agent does not exist under UCITS. The FSA observed that UCITS had been operating successfully without the requirement for independent valuation for many years. They argued that in certain instances requiring independent valuation would in fact weaken the investor's protection as valuations would be undertaken by persons less familiar with the AIF's investments, who would not be subject to the same level of supervision as the AIFM (p 96). The Managed Funds Association (MFA) agreed that the proposal would deprive the valuation process of important expertise. They also noted that it was not clear what types of entities could be able and qualified to carry out this function at present (p 264). The ABI agreed; as an investor they felt that independent valuation would in most cases be no better informed than that done by the AIFM (p 21).

189. The AFG opposed the proposed valuation provision on three grounds. First, in many cases the establishment of the value of the assets acquired by AIFs relied on the knowledge of the AIFM itself and could not be done without his involvement. Second, independent valuation could increase costs for investors. Third, if the management company was not responsible for the valuation, they might be less diligent which could be detrimental to investors. They concluded that valuation should be "part of the management function" (p 193).

190. For the European Private Equity & Venture Capital Association the proposed requirement had no recognised benefits for investors in private equity funds and would create unnecessary additional costs.[39] The BVCA agreed that "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" (p 13).

191. On the other hand, AIMA observed that placing responsibility for assets valuation with the AIFM introduces a conflict of interest as an AIFM's fees are calculated by reference to the value of the assets of the AIF which it manages (p 67). The Government told us that independent valuation was "very widely adopted as best practice for UK hedge fund managers". They said that the best practice standards established by the Hedge Funds Standards Board recommended independent valuation except where this was impossible because the expertise needed to value the fund's assets was not available externally. They proposed an approach where managers would retain the option of valuing internally, provided they appointed an independent firm to verify the valuation methodology (Q 60). Coupland Cardiff also agreed that independent valuations were already standard practice in the AIF industry and that for UK based AIFMs it was virtually impossible to market a fund unless it had an independent Administrator (p 223).[40] Allenbridge Hedgeinfo agreed that "independent valuation agents should be used where possible" (p 185).

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[39] European Private Equity & Venture Capital Association, Response to the Proposed Directive of the European Parliament and Council on Alternative Investment Fund Managers (AIFM), 26 June 2009, p. 5.

[40] Fund administrators' provide services such as net asset value reporting, shareholder interaction, and maintenance of financial records.

192. The Swedish compromise removed the requirement for each fund to appoint an independent valuation agent and replaced this with a requirement on the manager to ensure, where appropriate, the functional independence of the valuation function and the portfolio management function in view of the nature, scale and complexity of each fund that it manages. The Gauzès Report retains the requirement for an independent valuation agent, but exempts private equity funds from this requirement.

193. We believe that some form of independence in the valuation process is necessary but we are not convinced that the requirement for an independent valuation agent is the best approach to ensure appropriate valuation for all AIFs. In particular, the requirement to appoint an independent valuation agent appears disproportionate for private equity funds. **In this respect we agree with the suggestion made in the Gauzès Report whereby private equity funds would be exempt from the requirement for an independent valuation agent. We urge the Government to negotiate a valuation mechanism which is consistent with the operational reality of AIFs, such as that proposed by the Swedish Presidency.**

CHAPTER 8: BETTER REGULATION

194. There has been widespread criticism among our witnesses that the Commission did not undertake adequate consultation when preparing the Directive and that the Impact Assessment that accompanied the proposal was not sufficiently informed. The main points of the Commission Impact Assessment are described in Box 10. The Financial Services Authority commissioned the Charles Rivers Association to conduct an impact assessment on the proposal, the main points of which are summarised in Box 11. We noted above that the Parliament had used a provision under Article 192 of the Treaty to push the Commission to bring forward proposals on this issue.

BOX 10

The Commission Impact Assessment

The Commission impact assessment, which accompanied the original draft of the Directive, commented on the basis for the monitoring and controlling of systemic risks provided by the Directive. Key findings included:

- The current fragmented regulation of AIFM does not represent an effective basis for the monitoring or control of cross-border risks associated with AIFM.
- The absence of consistent standards of supervision was a source of continuing uncertainty for investors.
- The report found a horizontal approach to be an appropriate model for regulation, providing it was proportionate and targeted. It acknowledged that regulation must be sensitive to differences in business models.
- It acknowledged that ideally EU action would be coordinated with international action.
- The executive summary states that "Due to uncertainty about costs, it is not possible to assess or to quantify precisely the impact of the proposal on the competitiveness of EU-domiciled AIFM".

BOX 11

The FSA Impact Assessment

The UK Financial Services Authority commissioned Charles River Associates (CRA) to prepare an Impact Assessment, *Impact of the proposed AIFM Directive across Europe*, on the Directive. The report examined whether the Directive would be effective, what unintended consequences it may have and its proportionality. Headline findings included the following:

- Under the proposed Directive, 40% of hedge funds, 35% of Private equity funds, 19% of Venture Capital funds and 2% of Real Estate funds would effectively be no longer available to EU investors.
- If no AIF were available in Europe in any form, portfolio returns for European investors that use AIF would be reduced by around 25 basis points (0.25%). Combining this with estimates above, the report suggests that EU investors could be expected to lose 5 basis points or €1.5bn assuming EU Pension funds have around €5 trillion of assets under management.
- Benefits can be expected to accrue from the passport which brings access to funds not previously marketed in certain member states.
- The Directive would impose estimated one-off compliance costs of up to €3.2 billion on AIFM and ongoing compliance costs of around €311 million. These costs would be passed on to investors thus reducing returns.

BOX 12

The European Parliament Impact Assessments

The European Parliament's Economic and Monetary Affairs Committee (ECON) commissioned European Economics to produce two further impact assessments on the Directive.

The first "quick" Impact Assessment considered impacts, objectives and alternative approaches. Key conclusions included:

- The Commission Impact Assessment's analysis of the policy problem was vague, sweeping, and inadequate as a basis for justifying regulation.
- Although it argued there was a strong case for additional regulation the rationale for a directive of this form is weak.
- It found the Directive poorly constructed, ill-focused, and premature.

The second Impact Assessment, published in December 2009, was a quantitative assessment of the impact of the Directive. Key findings included:

- The annual growth rate of EU GDP would fall by around 0.1–0.2 per cent, and booms and busts would be around 0.8 per cent of GDP less.
- There would be a short-term rise in unemployment of 0.8 per cent of current employment as the AIFM sector adjusted, whilst in the longer term peak unemployment would be around 1.3 per cent less as an consequence of busts being smaller.
- There is also the potential for non-EU domiciled investors to withdraw their funds in the short term, and, in the longer-term, EU investors to move their capital to compliant non-EU domiciled fund managers. However, capital outflow from Europe is likely to be modest in the short-term.

195. The ABI noted that the publication of the Directive was preceded by a consultation lasting seven weeks, and focused solely on hedge funds (p 20). Other AIFMs were not consulted. Lovells LLP argued the consultation process has been "insufficient and inadequate" (p 223). AFG regretted that stakeholders were not publicly consulted "contrary to what is usually done". They noted, however, 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" (p 192).

196. The Initiative for Policy Dialogue, Columbia University disagreed. They observed that the consultation period was shorter that for MiFID, but was comparable to that for the Directive on credit rating agencies. They argued that long consultations do not necessarily enhance the quality of the legislation since they increase the risk that legislation will be influenced by groups with "vested interests" in minimising the regulatory burden and not primarily concerned with the stability of the financial market (p 249). In this context it should be noted that we concluded in our previous report that the Commission had not followed its Better Regulation principles in relation to the Directive on credit rating agencies.

197. The predominant view among witnesses was, however, that the legislation was rushed. Sharon Bowles MEP told us: "we know that the legislation was issued in haste, although some of it had been brewing for a long time" (Q 372). The FSA argued 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" (p 94). Citadel remarked that it took four years for the USA to agree the Security Act of 1933 and the Securities and Exchange Act of 1934 that followed the financial crisis in 1929 (Q 452). This reaction is in line with our preliminary findings on the Directive as expressed in our report, *the future of EU financial regulation and supervision*, which concluded that "rapid action must not come at the expense of thorough consultation, impact assessment and risk analysis by the Commission in line with their own Better Regulation principles."[41]

198. The Government commented on the efforts made by key stakeholders to improve the draft Directive and reflected that "if the EU had followed its own best regulation practices and had carried out detailed consultation … [and] a proper impact assessment then some of the failings … would have been headed off at a much earlier point" (Q 410).

199. When we asked the Commission about the consultation process, they pointed to several previous consultations on related subjects which contributed to the formulation of the Directive (p 130). They also referred to the "enormous" pressure placed on the Commission by the European Parliament to come up with a proposal on the regulation of hedge funds and private equity funds. They acknowledged that this meant the Commission had to produce a proposal "much quicker" than would normally be the case (Q 345).

200. Particular attention was drawn to the lack of adequate research included in the Commission's Impact Assessment. The Polish Financial Supervisory Authority (KNF) argued that Directive lacked any clear assessment of its impact on the financial market as a whole and on the national market. The KNF complained that the Commission's Impact Assessment did not estimate the implications of the legislation to the industry and the danger of a potential withdrawal of the affected alternative investment industry from the EU. Lovells also noted that the Directive's impact on sectors other than hedge funds and private equity funds seemed to have been ignored (pp 298–299).

201. During the course of the inquiry, the Committee on Economic and Monetary Affairs of the European Parliament (ECON) commissioned two impact assessments on the Directive. Carrying out impact assessments is not a common practice in the European Parliament. We discussed the issue with Sharon Bowles, the Chairman of ECON. She explained that the Committee was not satisfied with the Commission's Impact Assessment and had decided to produce their own. She explained that this was not the first time the EP has undertaken impact assessments; "it is unusual but not unheard of." The EP decided to commission a short initial Impact Assessment to assess some crucial issues (including leverage, depositaries and marketing of EU funds in third countries) in order to feed in to the rapporteur's report. The second Impact Assessment was to be completed at a later stage to look specifically at the impact of the proposal on the real economy and competitiveness and some other aspects. Sharon Bowles considered that the Impact Assessments would significantly influence the EP approach to the Directive. She

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[41] European Union Committee, 14th Report (2008–09), *The future of EU financial regulation and supervision* (HL Paper 106), p. 26.

acknowledged that the impact assessments were carried out on a proposal that was inevitably going to be changed, but thought the impact assessment helped point to "the way forward in terms of what those changes should be" (QQ 372–381).

202. **Had the Commission followed its own Better Regulation principles, the shortcomings of the Directive could have been dealt with at a much earlier point or might not have been there in the first place. The Government must put pressure on the Commission to ensure that future proposals are subject to the better regulation agenda.**

203. We are pleased to see that ECON is taking the better regulation agenda seriously as there is no obligation for the European Parliament to scrutinise the Commission's Impact Assessment. **We welcome the initiative of the Committee on Economic and Monetary Affairs in the European Parliament to commission two independent impact assessments to understand the impact of some critical aspects of the proposed Directive.**[42]

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42 The Committee will comment on Impact Assessments in a forthcoming report expected to be published in March 2010.

CHAPTER 9: SUMMARY OF CONCLUSIONS

What are alternative investment funds and what risks do they pose to financial stability?

204. We concur with the conclusions of the Turner Review and the de Larosière group that AIFs did not cause the recent financial crisis. However, we note the aggregate activity of hedge funds could increase market instability (para 64).

Key aspects of the AIFM Directive

205. We welcome EU regulation of Alternative Investment Fund Managers. We support the principle of harmonising regulation of AIFMs across the EU on the basis that a robust legal framework at EU level can strengthen the single market and benefit investors. AIFMs we spoke to recognised that some regulation would increase their integrity and public perception of the worth of their activities. We welcome also the elements of the Directive that provide for coherent oversight of AIFMs across the EU by requiring the registration of, and the collection of appropriate data from, managers, in line with the conclusions of the G20 (para 71).

206. We urge the Government to negotiate a solution that will avoid penalising smaller entities without encouraging managers to attempt to avoid the Directive through threshold manipulation. Thresholds that reflect the differences of the private equity and venture capital industries should also be identified (para 80).

207. A one size fits all approach will not work. We recommend that the Government seek to tailor the Directive in a way that respects the differences between the types of funds it covers. A possible solution could be to establish broad principles in the Directive (para 91).

208. We agree that it is appropriate for the Directive to regulate the manager rather than the fund, as the latter is merely a vehicle in which assets are held. Targeting AIFMs will ensure that the risks of AIFs are effectively monitored, irrespective of the domicile of the fund, whilst leaving AIFMs with the flexibility they need to operate. In reality some provisions of the Directive will also have the effect of regulating the funds. We urge the Government to ensure during negotiations that the focus of the Directive is kept on the regulation of the manager rather than the fund (para 98).

209. We agree that AIFMs should be the subject of appropriate regulation. However, the retail level of protection offered by the Directive as drafted is not required by the informed and experienced institutional investors and high net worth individuals who invest in Alternative Investment Funds, who are able to carry out their own extensive due diligence. We recognise that the success of these Funds has an impact on those not directly involved in the investments industry, including through pension funds (para 102).

Supervision of AIFMS

210. We agree that disclosure requirements could enable supervisors to identify where AIFMs pose excessive risk to financial stability, which should enable steps to be taken to reduce this risk (para 110).

211. We welcome the work of the FSA to date on their survey of hedge fund managers and prime brokers to build up an overall view of the UK alternative investment industry. We also agree with the Government's support for the Swedish Presidency's compromise to help ensure that only systemically relevant data is collected (para 111).

212. The Government should ensure that national supervisors take on the role of data analysis and intervention. National supervisors, including the FSA in the UK, are likely to be most effective at analysing systemically relevant data and taking action to reduce risk. The Government should also work to put in place systems to require national supervisors to provide relevant data to the ESRB and bodies at a global level (in particular the Financial Stability Board) to help ensure that these bodies can identify systemic risks at an EU and global level respectively (para 112).

213. Transparency requirements could in principle help provide protection to investors in AIFs and increase public understanding of the industry. However, the Government must ensure that such requirements set out in the Directive reflect the variations of different types of alternative investment funds to prevent them placing companies owned by private equity funds at a competitive disadvantage (para 116).

214. We agree with the Financial Services Authority and the Government that supervisors should have the power to impose leverage caps where appropriate, based on the aggregated information they receive from fund managers. We welcome the Swedish compromise on this issue and the Government's support for this proposal (para 125).

215. We agree that if capital requirements are set in the Directive, they must differentiate sufficiently between different types of funds covered by the Directive. The Government should also consider whether it will be more appropriate to enforce capital requirements through the Capital Requirements Directive (para 128).

Towards an EU Passport regime for AIFMS?

216. We support the principle of an EU passport extended to non-EU funds, managed by both EU and non-EU managers. However, we believe that as originally drafted the proposal for a passport for these funds would impose significant obstacles in the way of managers wishing to market non-EU funds in the EU. EU managers should be able to continue to invest in non-EU funds and fund managers located outside the EU should be able to invest in Europe (para 160).

217. We agree with the Minister that if equivalence is an assessment of whether a third country operates an identical regulatory regime to the EU as in the draft Directive, then it will be hard, if not impossible, to achieve. We therefore support the continuation of national private placement regimes to maintain options for investors, whilst efforts are made to achieve the principles-based equivalency with third-country regimes that is required for the EU passport to operate effectively (para 161).

218. The Government should continue to negotiate a solution that does not penalise the marketing of non-EU funds which will eventually have negative repercussions on the UK and European financial markets (para 162).

The AIFM proposal in the global context

219. The Government should ensure that EU regulation is in line with, and complements, global arrangements. We believe that the Government should not agree the Directive unless it is compatible with equivalent legislation with regulatory regimes in third countries and in particular in the United States, in order to avoid a situation in which EU AIFMs lose competitiveness at a global level (para 174).

Depositary and valuation

220. We urge the Government to press for an amendment to the Directive which would enable AIFMs to use non-EU depositaries, and to sub-delegate custody functions so long as they are suitably regulated and supervised (para 185).

221. We do not support the Directive's provision that depositaries should be liable for risks and losses of sub-custodians that they cannot control. We recognise the improvements included in the Swedish compromise and we urge the Government to support this aspect of the compromise during the negotiation under the Spanish Presidency (para 186).

222. In this respect we agree with the suggestion made in the Gauzès Report whereby private equity funds would be exempt from the requirement for an independent valuation agent. We urge the Government to negotiate a valuation mechanism which is consistent with the operational reality of AIFs, such as that proposed by the Swedish Presidency (para 193).

Better regulation

223. Had the Commission followed its own Better Regulation principles, the shortcomings of the Directive could have been dealt with at a much earlier point or might not have been there in the first place. The Government must put pressure on the Commission to ensure that future proposals are subject to the better regulation agenda (para 202).

224. We welcome initiative of the Committee on Economic and Monetary Affairs in the European Parliament to commission two independent impact assessments to understand the impact of some critical aspects of the proposed Directive (para 203).

APPENDIX 1: EU SUB-COMMITTEE A: (ECONOMIC AND FINANCIAL AFFAIRS, AND INTERNATIONAL TRADE)

Sub-Committee A

The members of the Sub-Committee who conducted this inquiry were:

Baroness Cohen of Pimlico (Chairman)
Lord Haskins
Lord Jordan
Baroness Maddock††
Lord Marlesford††
Lord Moser
Baroness Northover
Lord Renton of Mount Harry*
Lord Steinberg†
Lord Trefgarne††
Lord Trimble
Lord Watson of Richmond*
Lord Woolmer of Leeds

† died on 2 November 2009

* Member until 12 November 2009

†† Member since 24 November 2009

Lord Browne of Madingley declared an interest as a member of the Brevan Howard Advisory Board, and as Managing Partner and Managing Director of Riverstone LLP, and withdrew from the inquiry on 16 October 2009.

Baroness Hooper declared an interest as Chairman of the Advisory Committee of two Barclays European Infrastructure Funds and withdrew from the inquiry on 16 October 2009.

Declaration of Interests

Baroness Cohen of Pimlico
Non-executive Director of London Stock exchange plc.
Vice Chairman of Borsa Italiana SA
Non-executive Director of Management Consulting Group plc
Chairman, Trillium Partners Ltd

Lord Haskins
No relevant interests

Lord Jordan
Chairman, Homes and Communities Agency Pension Scheme

Baroness Maddock
Non-executive Director, Idex Energy UK Ltd

Lord Marlesford
Adviser, Board of John Swire and Sons
Adviser, Sit Investment Associates (Minneapolis)
Non-executive Director, Gavekal Research (Hong Kong)

Lord Moser
No relevant interests

Baroness Northover
No relevant interests

Lord Renton of Mount Harry
Ownership of agricultural land in Sussex with wife.
Partnership with wife and son in Mount Harry Vines

Lord Steinberg (deceased)
Life President of Genting Stanley Plc
Executive Chairman, E.G.M.I.
Non-executive Director, Medgenics
Director and Chairman, Stanleybet UK Investments

Rt Hon the Lord Trefgarne
Director and Shareholder, Scotty Group Plc—A UK AIM listed company in the telecoms section

Lord Trimble
Non-executive Director, CRC Capital Release Fund plc (from week beginning 1 February 2010)

Lord Watson of Richmond
Chairman, CTN Communications
Chairman, Havas Media
Chairman, The Cambridge Foundation
President, The European Atlantic Movement
Chairman, Nexus Publishing

Lord Woolmer of Leeds
No relevant interests

A full list of registered interests of Members of the House of Lords can be found at http://pubs1.tso.parliament.uk/pa/ld/ldreg/reg01.htm

APPENDIX 2: LIST OF WITNESSES

The following witnesses gave evidence. Those marked ** gave both oral and written evidence; those marked * gave oral evidence only.

	Allenbridge Hedgeinfo
**	Alternative Investment Management Association (AIMA)
	Appleby
	Arcus Investment Limited
**	Association of British Insurers (ABI)
*	Association for Financial Markets in Europe (AFME)
	Association Française de la Gestion financière (AFG)
	Association of Investment Companies
	Association of Private Client Investment Managers and Stockbrokers (APCIMS)
	Association of Real Estate Funds (AREF)
**	BlackRock Inc.
*	Ms Sharon Bowles MEP
**	British Venture Capital Association (BVCA)
	Caledonian Investments Plc.
**	Mr John Chapman, ex-Civil Servant and Journalist
**	Citadel
	City of London Corporation
**	CMS Cameron McKenna LLP
	Confederation of British Industry (CBI)
	Council of Bars and Law Societies of Europe (CCBE)
	Coupland Cardiff Asset Management
	CVC Capital Partners
	Dechert LLP
	Deutsche Bank
**	European Commission
**	Foundation for European Progressive Studies (FEPS)
	Fidelity International
**	Financial Services Authority (FSA)
	Hedge Fund Standards Board
	HSBC Group
	Initiative for Policy Dialogue
	Investment Management Association
	Dr Syed Kamall MEP

Lovells LLP

Managed Funds Association

Maples and Calder

** Lord Myners CBE, Financial Services Secretary, and Ms Sue Lewis, Head of Savings and Investment, HM Treasury

Open Europe

Mr Poul Nyrup Rasmussen, President, Party of the European Socialists

Polish Financial Supervision Authority (KNF)

Property Industry Alliance

Simmons and Simmons

** Wellcome Trust

UK Foundations (Church Commissioners, Esmée Fairbairn Foundation, Nuffield Foundation, Paul Hamlyn Foundation, The Henry Smith Charity, and the Wellcome Trust)

APPENDIX 3: CALL FOR EVIDENCE

Call for Evidence

EU Sub-Committee A, chaired by Baroness Cohen of Pimlico, is conducting an Inquiry into the European Commission's proposal for a Directive on Alternative Investment Fund Managers (COM (2009) 217), adopted on 29 April.

This proposal represents the Commission's response to the G20 pledge to regulate unregulated financial markets, including hedge funds and private equity firms. The proposal would create a regulatory regime for investment fund managers managing funds worth more than €100 million. There is currently no specific EU regulatory regime at all for alternative investment funds, although some regulation does occur at both EU and Member State level. The proposal aims to provide a robust and harmonised regulatory regime for the whole single market, creating greater transparency for investors and public authorities and enabling more effective macro-prudential oversight of the sector.

The aim of our inquiry is to provide an opinion on the Commission's Proposal, with a view to informing the debate surrounding the Directive within the UK Government and the EU institutions.

Particular questions raised by the Commission's draft Directive to which we invite you to respond are as follows (there is no need for individual submissions to deal with all of the issues):

All questions refer to the draft of the Directive proposed by the Commission on 29 April 2009.

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. 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?

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?

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?

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

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?

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?

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

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?

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?

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

We also would welcome your views on any other aspect of the Commission's draft directive. Written submissions need not address all questions

Interested parties are invited to submit a concise statement of written evidence to this inquiry by Wednesday 9 September 2009.

APPENDIX 4: GLOSSARY

ABI	Association for British Insurers
AFG	Association Française de la Gestion financière
AFME	Association for Financial Markets in Europe
AIF	Alternative Investment Funds
AIFM	Alternative Investment Fund Mangers
AIMA	Alternative Investment Management Association
APCIMS	Association of Private Client Investment Managers and Stockbrokers
AREF	Association of Real Estate Funds
Arbitrage	See regulatory arbitrage
BBA	British Bankers' Association
BIS	Bank for International Settlements
BVCA	British Venture Capital Association
Capital	Cash used to generate income through investing in business or property
CBI	Confederation of British Industry
CCBE	Council of Bars and Law Societies of Europe
CEO	Chief Executive Officer
CLC	City of London Corporation
CRA	Charles River Associates
CRD	Capital Requirements Directive
Crowded trades	when a large number of hedge fund managers follow similar trading strategies and make similar trades
Depository	provides services to AIFMs including custody services and securities settlements and may also provide fund administration services
DG Competition	Directorate-General for Competition, European Commission
DG Markt	Directorate-General Internal Market and Services, European Commission
EC	European Community
ECB	European Central Bank
ECOFIN	Economic and Financial Affairs Council
ECON	Committee on Economic and Monetary Affairs of the European Parliament
EEA	European Economic Area
ESRB	European Systemic Risk Board
ESRC	European Systematic Risk Council

FEPS	Foundation for Progressive European Studies
FSA	Financial Services Authority
FSB	Financial Stability Board
FSF	Financial Stability Forum
Gauzès report	Report prepared by the rapporteur in the European Parliament on the Directive, published on 27 November 2009
GDP	Gross Domestic Product
Gearing	See Leverage
G20	Group of Twenty (G-20) Finance Ministers and Central Bank Governors
Hedge Funds	Privately owned investment companies
IOSCO	International Organisation of Securities Commissions
Leverage	The use of debt to supplement investment
Leverage ratio	The ratio of debt to equity applied by a fund
Liquidity	The ability to turn an asset readily into cash
LTCM	Long-Term Capital Management
Macro-prudential risks	Risks that affect the whole financial system
Macro-prudential supervision	The analysis of wide economic trends and imbalances and the detection of risks that these trends may pose to the financial system
MAD	Market Abuse Directive
MEP	Member of the European Parliament
Micro-prudential risks	Risks that affect an individual firm
Micro-prudential supervision	The supervision of individual financial institutions
MiFID	Markets in Financial Instruments Directive
Moral Hazard	The incentives for those involved in financial institutions benefiting from actual or expected government protection or insurance to behave less carefully (e.g. undertaking risky investments) just because of the existence of the protection or insurance
OECD	Organisation for Economic Cooperation and Development
PES	Party of the European Socialists
Prime brokers	The arms of investment banks and securities firms who provide services to hedge funds.
Private equity funds	Investment companies whose strategy is to seek ownership or large equity stakes in private companies

Property fund	A collective investment scheme with a portfolio consisting mainly of direct property but may also include other property related interests
Regulatory Arbitrage	Financial engineering which exploits the difference between economic and regulatory positions to avoid unwanted regulation. It can also refer to a financial institution structuring and locating itself to take advantage of the least burdensome regulator.
SEC	Securities and Exchange Commission
Short selling	Selling securities that have been borrowed from a third party with the intention of buying the identical assets back at a lower price at a later date to return to the lender.
Swedish Presidency issues note	A document prepared by the Swedish Presidency highlighting the issues raised by the Directive
Swedish Presidency Compromise	A compromise proposal presented in November 2009 in attempt to reach a general approach in the European Council on the proposal.
Systemic risk	The inherent risk of collapse of an entire system, as opposed to risk carried by any one individual entity or component of a system.
UCITS	Undertakings for Collective Investment in Transferable Securities. UCITS are retail funds regulated at EU level which can be freely marketed across Europe to retail and other investors. Managers of pension funds, national central banks and non-pooled investments are excluded from the Directive's scope

APPENDIX 5: NOTE ON SUB-COMMITTEE MEETING WITH JEAN-PAUL GAUZÈS MEP, RAPPORTEUR ON THE AIFM DIRECTIVE, 4 NOVEMBER 2009

Present:

Jean Paul Gauzes

Baroness Cohen of Pimlico

Lord Haskins

Lord Jordan

Lord Moser

Baroness Northover

Baroness Cohen opened the meeting and thanked M Gauzès for meeting the Committee. She invited M Gauzès to make an opening statement.

M Gauzès thanked the Committee for allowing him to provide evidence.

M Gauzès explained that he was rapporteur for this Directive, which was very complicated and raised a number of issues, particularly for the City of London.

M Gauzès told the Committee that the Mayor of London had recently visited him, and other Members of the European Parliament, to discuss the Directive. M Gauzes assured the Committee that he had no intention of damaging the City, nor to "destroy the United Kingdom" or its finance industry. He was aware that finance is a very important service industry for the UK.

M Gauzès described the situation around the production of the proposal. For a number of years the Parliament had pushed Commissioner McCreevy to usher in regulation to the financial services sector, which he had refused to do, believing that the markets would regulate themselves. However, the crisis changed this position, leading to him wanting to usher in regulation. Time was against him and the Commission services did not have the time available to them for reflection or for mutual consultation. The text that has been tabled therefore requires some improvement.

M Gauzès then suggested areas in which the Directive should be improved:

- Effectiveness of rules.
- Pragmatism—rules needed to be enforceable. Measures must tally with objectives.
- Avoidance of over-regulation and formalities where they are not required.
- Removal of provisions increasing financial burden and decrease profitability of sector.

M Gauzès told the Committee that even if the AIFs were not at the heart of the crisis and did not start it, generally speaking the crisis brought attention to the fact that the globalised world needs a reasonable degree of regulation.

M Gauzès said he had tried to make people understand what was good and bad about the Directive—what may be in the interests of investors, of the industry, and of the European economies.

Europe when regulating "cannot be an isolated ivory tower, whereby it hands down regulation". M Gauzes did not believe financial stakeholders would leave the UK as a result of the Directive, but it must be ensured that the European economy is not weakened by inadequate regulation. International negotiations must be held to ensure that all countries active in finance are able to avoid distortions of competition.

Baroness Cohen thanked M Gauzès for his opening speech. She asked M Gauzès how the proposals as drafted will help prevent a future crisis.

M Gauzès replied that it was a question of how we might avert a future crisis, rather than how. There were two arguments related to this. The first said that the world advances in fits and spurts and there will be crises whatever happens—this is the US stance. The second, more European stance, said that there may have been crises, but it is Europe's obligation to look at how the crisis happened to warn how this may occur in the future.

M Gauzès told the Committee that damaging banking practices had resumed after the crisis. This provided the motivation for ensuring regulation improves as a result of a crisis.

He continued that before changing the rules, it must be ensured that what works well at that time would not be adversely affected, in particular relating to Private Equity and disclosure rules. The Commission divided investment funds in the Directive into UCITS funds and everything else. However, funds were not homogenous; for example, hedge funds differ from private equity. It was therefore not sensible to have the same set of rules for everything that is not UCITS.

M Gauzès told the Committee that he would propose lighter disclosure requirements for private equity to ensure that businesses who benefitted from capital investment would not find it more difficult to compete than other industries. As the Directive was originally proposed, companies funded by Private Equity investments would have to disclose more information than companies that did not have private equity investment. The Directive needed to be modified to prevent inequality between companies that have private equity investment and those that do not. Private equity disclosure must be reasonable otherwise companies would no longer accept private equity investment.

He went on to discuss the provisions for the valuator of a fund. The original proposal was to have an independent valuator of a fund. However, the process for the valuation of a fund differed for private equity funds and hedge funds.

M Gauzès proposed that there be no requirement for a valuator in every scenario and that the obligation for an independent valuator be softened to prevent the valuator holding a conflict of interest.

Lord Haskins asked about the marketing of non-EU funds within the EU and vice versa, and whether M Gauzès intended to make proposals for amendments to the Directive in this area. Concerns had been raised that this had a protectionist element.

M Gauzès agreed that revision may be needed. It was important not to turn Europe into a fortress by banning marketing of non-EU funds. However, it was also important to avoid loopholes in regulation. M Gauzès said he had not yet taken a position on this point, but he assured the Committee that he did not intend to propose a ban on non-EU funds.

He continued that he wanted to abolish passive marketing—when a company did not have the right to market funds but did so anyway. Alternative investment funds needed to be open to investment professionals. It was assumed that professional investors were able to assess the risk they were undertaking through investing in a fund.

M Gauzès said that the investors should be prevented from investing without having conducted a risk assessment. There existed a risk profit relationship; more risk often meant more profit. However, the investor must be aware of the risk and they must accept it.

Lord Haskins asked whether national private placement should be allowed to continue to exist alongside an EU passport.

M Gauzès noted that this was a popular solution to solve the problem of 3rd country investment in the EU. However, in order to ensure European regulation is effective, different national private placement regimes should be avoided. Effective European regulation involved reduction of different national regulatory regimes, which enabled funds to "shop around" to find where they wanted to be based.

M Gauzès said he would keep this suggestion in mind, but it would not be his preferred solution to the problem. He noted that he had not yet found the ideal solution, but that protectionism must be avoided.

He discussed the issue of equivalency: ensuring that funds regulated abroad are regulated in a similar way as in Europe. Whilst interesting in an intellectual capacity, he noted that this would take some time to put in place.

M Gauzès said he was keen to hear the Committee's ideas on this problem.

Baroness Northover asked whether leverage caps should be used to reduce risk.

M Gauzès answered that leverage caps would be inappropriate as leverage was not necessarily a good indicator of risk. There may be high leverage involved in a transaction, but a low risk, or vice versa.

He noted that financial experts were more creative than legal experts and that generally it was like the police running after the thief, rather than the other way round! A system is required that can adapt to new financial innovations. This is why the fund manager rather than the fund should be regulated.

M Gauzès told the Committee that the Directive should include provisions to ensure the supervisor knows exactly what the fund manager is doing. There should therefore be a distinction between what information the supervisor received and what the public received through transparency requirements. There were no reasons for the supervisor to not receive information on funds' activities; however there were sound reasons why funds' activities should not be disclosed to the general public.

He told the Committee that the Directive should define certain principles, but conditions under which leverage should be monitored by a supervisor should be determined at Level 2.

M Gauzès went on to describe the rapid transactions on which markets are now based, which needed to be acknowledged in calculating risk.

He continued that thresholds for application of the Directive posed similar problems to the articles on leverage. He proposed to drop thresholds from the

Directive and argued that those managers of a small number of funds needed fewer formalities, whilst managers of a larger number of funds needed more formalities. Keeping a specific threshold would lead to a “threshold effect” where loopholes would be exploited to avoid regulation.

Baroness Northover asked for clarification on whether the fund or fund manager should be regulated.

M Gauzès said that the Directive as proposed referred to managers and the European Parliament agreed that there should be no suggestion of regulating the funds themselves, because of problems over definitions of specific funds. Managers should be regulated and not the funds, to provide supervisory oversight over activities of managers to detect where they may be creating risk.

Lord Moser asked how the risk of a fund should be assessed and where M Gauzès thought negotiations were heading on this point.

M Gauzès replied that at this stage there was no pragmatic solution to issues such as leverage and risk. However, principles will be drawn up which will allow a supervisor to view the operation of a fund and draw conclusions on its risk level on a case-by-case basis.

He referred to the poor public opinion of hedge funds, which often blamed hedge funds for the closure of factories and so on. This needed to be taken account of in legislation by informing the public about the operation of these funds.

M Gauzès thanked the interpreters.

Baroness Cohen thanked M Gauzès for his time.

APPENDIX 6: LETTER FROM LORD MYNERS, FINANCIAL SERVICES SECRETARY, HM TREASURY, TO RT HON LORD ROPER, CHAIRMAN OF THE HOUSE OF LORDS EUROPEAN UNION COMMITTEE, 8 DECEMBER 2009

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 3 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 Jan 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.

APPENDIX 7: LETTER FROM RT HON LORD ROPER, CHAIRMAN OF THE HOUSE OF LORDS EUROPEAN UNION COMMITTEE, TO LORD MYNERS, FINANCIAL SERVICES SECRETARY, HM TREASURY, ON THE EMERGING CONCLUSIONS, 10 DECEMBER 2009

Thank you for the evidence you have provided to us on the Commission proposal for an Alternative Investment Fund Managers Directive (AIFMD). EU Sub-Committee A has taken evidence on the Directive from a variety of sources and we set out our emerging conclusions on the document in this letter. In light of the considerable reservations we have with the document as originally proposed we have decided to hold the document under scrutiny. We set out our reservations below.

The G20 concluded that all financial markets, products and participants should be regulated or subject to oversight, as appropriate to their circumstances, and we welcome broadly the Commission's attempt in this Directive to execute this recommendation. We have, however, serious concerns over some aspects of the proposal as originally drafted, specifically:

- The provisions related to marketing of non-EU funds and possible restrictions on non-EU managers marketing in the EU;
- The lack of differentiation between different sorts of alternative investment—the one-size-fits-all approach;
- Some elements of the proposals for supervision of Alternative Investment Fund Managers (AIFM); and,
- The unnecessary level of protection the proposal provides to well-informed institutional investors and banks.

We are concerned that a European Union Directive to regulate Alternative Investment Fund Managers should be in line with, and complement, global arrangements. Coordination with the US regulatory regime in particular is essential to avoid a situation in which the EU Alternative Investment Fund (AIF) industry loses competitiveness at a global level as a result of regulatory arbitrage. The Directive will seriously damage the EU and UK economy unless it is fully compatible with the global approach to the regulation of AIFM and it permits the marketing of non-EU funds in the EU. Restrictions on non-EU managers operating in the EU should also be removed.

We have also considered the compromise proposals of the Swedish Presidency and we agree that its suggested amendments are moving towards making this Directive more compatible with the emerging proposals in the US and the rest of the G20, and less likely to disadvantage investors in the EU.

Risks and supervision

One of the stated aims of the Directive is to improve the supervision of "the risks that AIFM provide to their investors … and to financial stability". There is no evidence that AIFs caused the financial crisis, but activities linked to some AIFs can increase market instability. These activities include herding behaviour by managers (also known as the crowded trade), where funds concentrate risk by taking similar positions to other funds, and rapid deleveraging in a falling market. It is also true that the sheer size of some hedge funds means that any failure could pose a risk to financial stability. We therefore support the broad aims of the

Directive inasmuch as it requires registration of managers, an increase in transparency of alternative investment funds and an increase in disclosure of important information to regulators. We also recognise concerns that the levels of remuneration of hedge fund managers can affect the behaviour of other participants in the finance industry.

In order to achieve the Directive's aims supervisors have to be able to use the information they receive from managers effectively and act, where necessary, to tackle risk. This will involve taking an overall view of the market and the investments of AIFM, in order to identify herding and therefore to take action to reduce the risks that individual fund managers take.

There are, however, serious problems with the detail of the Directive as originally drafted and the tools that the Directive provides for supervisors to tackle risk. The transparency and disclosure requirements of the Directive need to be amended to take into consideration the different types of alternative investment funds. Information requirements have to be proportionate and carefully thought out to ensure that the Directive does not lead to supervisors being swamped with large amounts of irrelevant data. It may be more appropriate to agree that disclosure requirements be set at Level 2, which allows more flexibility than Level 1.

The same problems arise in respect to disclosure requirements as have already been encountered in connection with the regulation and supervision of EU banks, namely whether national supervisors or a pan-European body should collect the data and which body should have the power to act on conclusions drawn from the data. We continue to support the position taken by the Government during negotiations on bank supervision, which was upheld by the Government in the European Council meeting last week; national supervisors should take on the role of data analysis and intervention. Not only will supervision be more effective at a national level but since failed financial institutions or funds can only be supported by national governments with tax raising powers, their supervision can only properly be carried out a national level, in the case of the United Kingdom by the Financial Services Authority (FSA). We commend the research work of the FSA on hedge funds and note that we have found it particularly useful in our inquiry.

The Swedish compromise note stresses the importance of the coordination of supervisory functions and monitoring in the EU including the European Systemic Risk Board (ESRB) and by the Financial Stability Board (FSB) at an international level. Systems should be put in place to require national supervisors to provide relevant data to the ESRB and FSB to ensure that these bodies can identify systemic risks at an EU and global level respectively.

We have heard evidence on the tools that this Directive proposes to reduce risk—including leverage caps and capital requirements. Leverage ratios are not an absolute measure of risk and as such an overall leverage limit or cap, as proposed by the Directive as drafted, will not automatically cap risk and may indeed create systemic risk, by requiring several funds to liquidate positions in a particular company at the same time. We agree however with the FSA that national supervisors should have the power to impose leverage caps where appropriate, based on the aggregated information they receive from fund managers and we therefore welcome the Swedish presidency's proposed compromise on this issue, which would remove the single leverage cap from the Directive and therefore from all AIFM.

Requiring the depositary of a fund to be an EU credit institution will not reduce risk. The evidence suggests that only a few EU credit institutions will be willing to take on the role of depository; this will concentrate deposits in a few institutions and so concentrate and increase risk. It would also increase the cost to the investor. The draft therefore should be amended to allow the use of non-EU depositaries by AIFM.

The Directive in general seeks to provide a level of protection for investor which is not required by the well-informed institutional investors in alternative investment funds. It is a professional market, in which the investor population is small, and who understand the risks they run in any investment. Indeed, institutional investors made it clear to us that they valued the flexible strategies and investment policies on offer from the AIFM as a vital contribution to their own investment policies. Measures designed to protect retail investors should not reduce the value of Alternative Investment Funds to these customers. The Directive also does not acknowledge the role prime brokers play in monitoring the activities of the hedge funds to which they lend.

EU and third country passports

The second main aim of the Directive as originally drafted was to facilitate a single market in Alternative Investment Funds in the EU. We have heard evidence that the introduction of a passport for EU funds is attractive to managers in principle. The passport system would help to develop a single market in investment funds within the EU by creating a brand complementary to the UCITS (Undertakings for Collective Investments in Transferable Securities) funds. Many of our witnesses were concerned that the provisions as originally drafted would only serve to limit or prevent investment in the EU by non-EU managers and investment outside of the EU by EU managers. These provisions were described by many witnesses as protectionist and we were told that it may prevent a substantial proportion of funds currently operating within the EU from continuing to do so. We heard evidence from the Wellcome Trust that these provisions would adversely affect their returns and therefore impact adversely the many charitable beneficiaries. Pension funds would also suffer a reduction in investment returns as a result of these provisions as currently drafted.

EU managers should be able to continue to invest in non-EU funds and fund managers located outside the EU should be able to invest in Europe. We are concerned that it will be difficult, if not impossible, for third-country regimes to achieve the equivalency required for AIFM to obtain access to the EU passport. We therefore support the continuation of national private placement regimes to maintain options for investors while workable rules to achieve equivalence are devised in Level 2. We have heard evidence that an EU passport for funds and managers based in third-countries is an attractive prospect and we hope that it will become possible by achieving the required equivalence at some point in the future. We note that the Swedish Presidency compromise proposal goes some way to addressing the problems on this issue.

One-size-fits-all

The Directive as originally proposed covered all non-UCITS investment funds. The Directive, however, does not adequately differentiate between the different types of AIFs covered, leading to serious difficulties regarding its application in practice and introducing unintended consequences. We welcome the efforts of the Swedish presidency to address this issue.

We recommend that careful consideration is given to tailoring the Directive in a way that respects the differences in the types of funds it covers. We accept that it may be more appropriate to provide principles in the Directive and set detailed requirements for specific types of funds at Level 2.

We intend to publish a full report on the AIFMD in February next year. As we have described above, the achievement of changes to the original document is crucial to the single market and the EU economy. We will continue to hold the document under scrutiny because of our serious concerns over these matters until the publication of our report.

APPENDIX 8: LETTER FROM LORD MYNERS, FINANCIAL SERVICES SECRETARY, HM TREASURY, TO RT HON LORD ROPER, CHAIRMAN OF THE HOUSE OF LORDS EUROPEAN UNION COMMITTEE, 17 DECEMBER 2009

Thank you for your letter of 10 December. I note that you will be keeping this directive under scrutiny. I thought it would be helpful to update the Committee on where negotiations have got to under the Swedish Presidency.

Although containing a number of deficiencies, which we have been working to address, the Directive has the potential to open up the EU market, providing new opportunities for EU managers, and to extend EU cooperation on systemic issues, which the Government supports.

Several meetings have been held by the Swedish Presidency to try and find a compromise that would allow the Council to agree a general approach. However, as some Member States have been unwilling to compromise at this stage, Sweden has decided that it is better to pause the negotiations to allow heads to clear over the Christmas break.

The Swedish Presidency has produced a Progress report and one further compromise text to hand over to the incoming Spanish Presidency (which I attach to the letter). We expect Spain to seek a general approach sometime between March and May.

We had been expecting this for some weeks and are not unduly concerned. In all my dealings with Spain so far they have been clear, much like Sweden, that their focus will be on agreeing legislation which is properly thought through and which works.

I outline below the main changes in the Swedish compromise:

- Leverage—the original Commission proposal gave powers to the Commission and national supervisors to set ex-ante leverage caps. The Swedish compromise removes the Commission's power in this area, leaving it to national regulators to set caps where justified by an immediate systemic risk, which is something we support;

- Portfolio company disclosure—the compromise text maintains the requirement for additional disclosure requirements on private equity portfolio companies but substantially pares back those requirements so that they require only notification to the target once a controlling interest is attained and a summary annual financial statement. It also includes a requirement for private equity firms to disclose leverage in a portfolio company to its supervisor immediately pre-buy-out, 6 months post buy-out and 12 months post buy-out;

- Delegation—the Commission proposal prevented delegation of portfolio management outside of the EU. The compromise text now allows delegation of portfolio management to non-EU firms provided those firms are authorised as asset managers, which we strongly support;

- Valuation—the compromise text makes valuation the responsibility of the manager and removes the requirement for an independent valuer. We welcome the fact that this would remove the independent valuation obligation from classes of fund manager—particularly private equity—for which it is not appropriate, but are seeking clarifications to ensure that managers can continue to use independent valuers where appropriate;

- Capital—the compromise text now aligns capital requirements more closely to the UCITS[43] directive, on the grounds that the original proposal would have created too much of a distortion in requirements between a UCITS manager and an AIFM manager. There is also now an option for small/medium size private equity firms to opt into the directive to benefit from the passport but to have a lower capital requirement of 50,000/60,000 euros (figure yet to be discussed in Council);
- Short selling—removal of rules in this area on the basis that the Commission should bring forward proposals to govern the market as a whole;
- Liquidity—removal of the provision for the Commission to set quantitative liquidity thresholds;
- Passport—as part of the overall compromise, Sweden has proposed restricting the passport to funds both managed and domiciled in the EU. Only EU domiciled and managed funds could be sold without restriction to all EU professional investors. All other funds (i.e. 3rd country funds—even with an EU manager) would be subject to national private placement rules i.e. subject to the marketing requirements in each Member State. EU managers with 3rd country funds would still have to comply with the directive except for the depositary requirements. Some of the larger Member States do not agree with the carve out of the depositary requirements so this will be a key area for discussion on the Spanish Presidency.
- Access to the EU market for third country fund managers—under the Commission's proposal, non-EU managers would only be allowed to sell their funds in the EU where their local regulation had been deemed equivalent to that in force in the EU. Managers which met that test would benefit from the passport. Both of these provisions have been removed. Member States will retain discretion over how much to open their market to third country managers and those managers will not benefit from a passport. The Government broadly supports this as it ensures the UK can maintain its open approach, allowing professional investors access to the best global managers;
- Depositaries—the compromise text clarifies that for assets which cannot sensibly be held in independent custody (e.g. shares in unlisted companies, real property, derivatives) the depositary should be responsible only for verifying that the assets are held by the fund. There is also provision for a broader range of entities to act as depositary including MiFID investment firms and suitably authorised entities outside the EU and clarification of depositaries' liability for loss of assets and other failures;
- Remuneration—The majority view in Council is that these rules should draw heavily on the agreed rules in the Capital Requirements Directive. The initial compromise text had a requirement to defer 40% of the bonus over 3 years 40 % or 60% where the bonus element to fixed remuneration

43 Units for Collective Investments in Transferable Securities.

is particularly high. The latest compromise text removes the hard time limit for bonus deferral and now links it to a time period appropriate to the type of fund. This change and the ability to apply the requirements on a proportionate basis, offers flexibility in making sure that these requirements can be applied sensibly. Nevertheless, we will continue to argue that the quantitative limits of 40 and 60% should be removed; and

- Supervision—Finally, concerning greater discretion for supervisors, there is some support for allowing supervisors discretion to collect additional information where justified on systemic grounds (although a concern from the Commission that such additional requirements should not get in the way of an effective single market). The compromise text tries to balance these positions by requiring certain basic information to be provided routinely by all managers and for other information to be provided on request by the supervisor. We believe this strikes an appropriate balance.