

EPFSF Briefing

“Alternative Investment Fund Managers Directive (AIFMD)”

Background

The European Commission has for some time been considering how to create a Single Market for alternative investment fund managers. ‘Alternative’ is in this instance defined as the management of investment funds not already covered by the UCITS Directives mainly marketed to professional investors. These managers are involved in a wide range of asset classes, covering hedge funds, venture capital and private equity, real estate funds, infrastructure funds, commodity funds, money market funds, retail non-UCITS funds, investment trust companies, as well as some types of agricultural and charity funds. This is a very diverse universe of assets and strategies.

In line with the European Parliament’s own legislative recommendations (the Rasmussen and Lehne Reports of September 2008 and the two subsequent Parliament Resolutions) the issue was initially to be addressed through a common EU Private Placement Regime complemented by EU registration, disclosure and appropriate prudential requirements. With the financial crisis and the broader political debate on systemic risk the focus of the political debate shifted.

On 29 April 2009 the European Commission proposed the Alternative Investment Fund Managers Directive (AIFMD). The scope of this Directive covers all categories of alternative investment fund managers. The challenge of this proposal will now be to develop an appropriate regulatory and prudential regime for the different asset classes suitable to the policy objectives of the proposed legislation: furthering the Single Market by creating common regulatory standards, restoring investor confidence by establishing appropriate investor protection and the avoidance of systemic risk.

Main elements of the proposal

The Directive establishes harmonised regulatory standards for the authorization, ongoing operation and transparency of the AIFM – this includes capital requirements, conduct of business rules (MiFID-style obligations covering risk management, conflict of interest management and treatment of investors, as well as due diligence requirements) to act in the best interest of the investor. The main objectives of the proposal are investor protection, increased transparency and mitigation of possible systemic risks. EU fund managers of EU funds that fulfill specific requirements will benefit from a European passport and will be able to market AIF to institutional investors in all EU Member States or provide management services to AIF domiciled in other Member States. The AIFMD restricts the possibility of delegation of management, marketing and administrative functions by the AIFM to other AIFMs only. As per the commission proposal, sub-delegation of tasks is currently forbidden. The AIFMD also includes the requirement of the appointment of an independent valuator. Further provisions concern the Depositary of an AIF and go beyond the requirements of the MiFID and UCITS Directives, providing, amongst others, that the Depositary must be an EU credit institution and bringing a reversal of the burden of proof in case of losses suffered by the investors of AIF.

The draft Directive establishes particular regimes for fund managers operating outside of the EU to attract European investors; rules on funds domiciled outside of the EU to be managed by European managers; and European funds managed by non-EU managers. In all cases these rules currently go well beyond existing EU financial market regulation. Additional rules are being proposed on AIF valuation, depositaries, and delegation of portfolio management, risk, and administrative functions from outside the EU. The proposal similarly establishes a mechanism for determining equivalence of non-EU regulatory, prudential and fiscal regimes but the detail for determining these regimes is still open for more in-depth discussion.

As drafted, additional transparency requirements would increase the amount and nature of information that funds are to disclose to investors, supervisors and the public. This does not only extend to the activities of the fund and manager themselves, but also to the disclosure of commercially sensitive information by non-listed companies in which the funds invest. These provisions raise questions regarding the potential conflict between requirements of existing European and national company law and the requirements of the AIFM Directive (e.g. treatment of confidential information, ownership of the information and treatment of stakeholders).

The AIFMD also addresses the use of leverage by alternative funds – imposing leverage limits through comitology measures and delegating authority to impose additional de-leveraging to national regulators during exceptional circumstances. This would come in addition to ongoing discussions at EU level of imposing leverage caps on the supply side of credit via amendments to the banking regulatory capital regime (i.e. the Capital Requirements Directive).

Questions for consideration by the European Parliament

A number of important questions will need to be considered by the European Parliament during the co-decision process. While supportive of a number of measures in the AIFMD, many stakeholders have a number of concerns with other key provisions. Given the very diverse nature of assets and fund managers covered by the Directive, the number of concerns is naturally particularly broad but can be summarised as follows:

Differentiation/tailoring: The AIFMD applies to all non-UCITS funds regardless of their type, investment strategy and target investors. In some cases these funds do not even invest in financial products. This creates a number of questions around the application of “one size fits all” approach of regulation to a very heterogeneous group of fund types. Some stakeholders hold that in situations where the investors do not actually deposit capital with the fund, but rather commit to providing their investment in stages as needed over the life of the fund, should be treated differently from the cases where investors provide up-front investment that can be redeemed subject to contractual agreements. The Directive will also need to create legal certainty in this regard without imposing a widespread restructuring of funds to meet its requirements.

Thresholds: The European Commission’s proposal introduces a two-tier regime of thresholds: a threshold for non-leveraged funds of Euro 500 Million and a threshold of Euro 100 million for all other AIFM. Additionally, AIFMs managing less than Euro 100 million would not be subject to any regulatory oversight. An opt-in regime is necessary but it needs to be proportionate to the risks involved.

Leverage: The AIFMD fails to appreciate the number of different purposes for which leverage is used by different types of AIF. A leverage level for one investment strategy or asset class may be overly conservative or general for another – therefore limits of leverage would not necessarily meet the Commission’s goal of reducing systemic risk.

Level playing field concerns: The AIFMD raises level playing field concerns between AIF and other products not covered under the Directive. For example, Recital 5 currently excludes any type of product other than funds, such as Sovereign Wealth Funds, banks using funds on own account, endowments, as well as some types of structured products. This level playing field concern is particularly relevant to the company law provisions of the Directive.

Third country provisions: Europe currently benefits from significant inflows of investment from around the world available to European companies to grow and innovate their businesses. The proposed equivalence regime for third country investment managers and funds foresees that AIF domiciled outside the Community, and non-EU AIFM, abiding by “equivalent rules” will be allowed for distribution within the Community three years after transposition of the Directive, by way of a “passport”. It cannot be taken for granted that an equivalence agreement will be reached with the relevant jurisdictions in the world within three years after entry into force of the Directive. Without such an agreement the investment flows into Europe may slow down significantly. As far as agreeing comparable access is concerned, it should be noted that the EU and the US have been unable to agree reciprocal access for UCITS funds and the US equivalent for over 20 years.

Coherence with Existing European Legislation:

The draft Directive shows a lack of coherence with the MiFID, UCITS, Prospectus and Transparency Directives. For AIF and their managers to whom all of these Directives will be applicable, contradictory provisions or regulatory gaps are likely to lead to regulatory uncertainties and important additional costs.

Capital requirements: The AIFMD differs from the MiFID and UCITS Directives leading to additional costs of investors without adding any substantial investor protection regarding the capital requirements of the AIFM. The capital requirements are not capped at Euro 10 million and in case of management under delegation both the AIFM as well as the delegated portfolio manager will have to hold capital for the same portfolio.

Delegation: As drafted, risk and portfolio management as well as administrative functions may only be outsourced within the EU to registered AIFM. This is significant as global asset managers generally delegate their risk, portfolio, and administrative functions to entities around the world - this is done in order to take advantage of local expertise for national, regional, and even global funds. This delegation provision as drafted would disallow global asset managers from taking advantage of their global franchise and as such would reduce investor choice, returns, and quality of service. In order to address the Commission's concerns over systemic risk and investor protection the focus should be on how funds are governed versus how they or their functions are domiciled. As such, we would prefer the extension of some of the existing MiFID provisions on delegation. The current provisions also do not recognise the need for the delegation of custody duties to global subcustodian networks. This may have the unintended consequence of eliminating the ability of AIF to invest in non-EU markets and thus reduce the choice of investments available to investors.

Depositaries: In the Commission draft, entities which can serve as a depositary or custodian are limited to EU credit institutions which can only delegate to another EU credit institution. Due to a reduced number of such institutions being able and willing to act as depositaries, such requirement is likely to increase systemic risk and to have the effect that a fund can only hold EU issued assets. Moreover, this clause does not recognise the fact that a fund depositary may hold securities directly in a central securities depositary (CSD) as CSDs are often by law forbidden to be credit institutions. In addition, the draft imposes strict liability on depositaries for assets held. This imposition of strict liability on depositaries will have a number of adverse impacts on investors: (i) some depositaries will leave the market thereby reducing choice and increasing concentration risk; (ii) costs for investors will rise significantly and (iii) investment opportunities will be reduced. The strict liability regime effectively forces depositaries to guarantee the performance of custodians in jurisdictions around the world.

Valuation: The AIFMD differs from current requirements of the MiFID and UCITS Directives by introducing the concept of an independent valuator instead of an independent valuation function exercised by the manager of delegated or assigned to an independent third party. Further, the UCITS Directive, unlike the AIFMD, allows a delegation of the valuation function to one or more third parties, even if established outside Europe, to profit from different types of local expertise for globally diversified portfolios.

Marketing rules / Definition of marketing: The AIFMD defines marketing as offering or placement regardless of the question at whose initiative it takes place. This definition in its current form includes the purchases at the initiative of professional clients. Purchases at the initiative of professional investors should be excluded from the definition of marketing and existing national private placement rules be maintained to allow professional investors to decide which investment suits them best.

International consistency: There is currently much national and international activity aimed at identifying and correcting any regulatory deficiencies in financial services, including those of the alternative investment fund industry. The fund business is a global market, both from an investor perspective, but also from an investing standpoint. An inconsistent application of rules on alternative funds could fragment the global market, restrict investment and lead to regulatory arbitrage causing harm to markets and undermining the confidence of investors.

Grandfathering: Grandfathering provisions could be required for some AIF, particularly closed-ended funds with set investment periods and fund-life. Under these types of funds, redemptions would be impossible, and if significant changes to investor covenants are necessary to accommodate the new obligations or fund restructurings imposed by the AIFMD, the funds themselves may be forced to liquidate holdings or relocate.

Supervision: The Parliament will need to consider the consistency of the AIFMD with the new EU supervisory structure proposals (as published in late September). For instance, Article 25 deals with supervisor-imposed leverage limits and empowers national supervisors to impose additional leverage limits on an AIFM. It is unclear how this process would or could be overseen by the European Systemic Risk Council or one of the European Supervisory Agencies and whether or not it is appropriate to give a European regulator this authority rather than the competent authority of the Member State, by whom they are already authorized and supervised.

Conclusions

Harmonising national regulations over alternative investment fund managers could be beneficial to the market if the outcome is fair and consistent legislation and access to an EU passport. Some considerations remain and a balanced debate is needed to discuss both the ideal outcome of the Directive and its impact on European investors.

The investor perspective is clearly one of the most important to consider. The objective of the regulation should be to enhance transparency, address concerns of systemic risk and provide an appropriate level of investor protection, while at the same time doing no harm to the competitiveness of European businesses – not only the alternative funds business itself, but the broader European economy in which they invest. EU policy makers should therefore give themselves the opportunity to consider the issues at hand carefully.

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

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