

EPFSF Lunch Discussion

3 March 2010, European Parliament, Brussels

“Alternative Investment Funds”

**Speech from Charles Cronin
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Good afternoon ladies and gentlemen, in the limited time I have it would be impossible to discuss the whole Alternative Investment Fund Managers Directive. So I will focus on three areas where our research and member polling adds to the discussion, these areas are scope, valuation and depository, and third country access. By way of introduction, we polled our European membership last October on aspects of the directive and received over 1200 responses. Any percentages that I quote are net of those who expressed ‘no opinion’. Full details of the poll are available from the CFA website under press releases.

So to start with **scope**, **62%** of our membership are in favour of alternative investment managers becoming subject to regulatory authorisation and registration when they market to professional investors. Qualifying that statement, **61%** believe that different types of AIFM should be subject to appropriately differentiated rules within the same basic framework.

Given the apparent linkage of the alternative sector with the financial crisis and its enduring impact on the real economy it seems entirely appropriate to bring alternative managers into the scope of a parallel UCITS style regulatory regime. Others cry that alternative managers had limited impact on the financial downturn and did not represent a risk to the financial system.

It would appear they have short memories; the collapse of two Bear Sterns subprime funds invested in Collateralised Debt Obligations (CDOs) in the summer of 2007 marked the beginning of the crisis. The fact that Bear Sterns demise was due to hedge fund capital flight illustrates that regulatory structures were missing and that hedge funds through excessive leverage and the unwinding of leverage can provoke financial instability with systemic effects.

The private equity sector driven by unsustainable access to cheap credit was also a contributor to the asset bubble. Now many members are finding it very hard to access credit. The same absence of prudential regulation has left many funds over stretched, which has direct consequences on the jobs of the people who work in the portfolio companies they own.

Turning to valuation and depositories, **85%** of our members are in favour of mandated independent third party **valuation**, and **78%** are in favour that the third party retains control over the valuation process. A further **60%** are against location restrictions on valuers, depositories and portfolio managers.

These statements can be put into context with a quick overview of the investor diligence process. Key to the integrity of any investment operation is that the manager can demonstrate beneficial ownership of the assets in the client’s portfolio and that their valuation is fair and consistent. Indeed the only way in which an investor can monitor whether a manager is running the fund consistently with the advertised strategy is to have an independent third party who is capable of affirming what assets are owned and that their value is fair. The Markopolos 29 red flag exposé of the Madoff fraud makes interesting reading (BTW he is a CFA Charterholder). Here is a sample of his red flags: extraordinary secrecy, mathematically impossible returns, lack of external audit, total family control, and ability to manufacture trades.

Markopolos’ bottom line is that Madoff was a grand Ponzi scheme because he chose to source capital from unregulated sources because he could not tap the regulated credit markets. Hence, investors want assurance that there are independent organisations in place to affirm the ownership

and value of the fund's assets. They are not concerned where these businesses are located, all they want is assurance that these businesses are reputable and capable of fulfilling their tasks.

Third country access is a contentious part of the proposed directive. **82%** of our members believe that access from a third country fund should be allowed, providing the third country has regulatory and supervisory standards that are at least comparable with the EU.

The direction is clear, the devil is in the details, on high-level principles we believe in the free movement of capital to promote efficient markets and the directive doesn't seem to impinge on this position. The third country issue is more political, it is a judgement on whether to permit passported access of third country funds, such as those domiciled in the Cayman Islands. As I understand the directive, it does not appear to restrict access to expertise or investment opportunity in developed or underdeveloped markets outside the European Union. I raise the question, how many alternative managers in the EU, managing third country funds market these funds to investors in more than one European state? I think not many.

Time has not allowed me to mention our members views on leverage, short selling, and conduct of business but I am happy to respond to your questions on these three topics. Despite its controversy there are many positive aspects about this directive. There is a clear need from regulation when one considers investor protection. I read that 1 in 10 UK hedge funds of funds invested in Madoff, 1 in 7 in Germany, 1 in 4 in Switzerland and 35% of similar funds in Italy.

Thank you for your time.