



**DIRECTORATE GENERAL FOR INTERNAL POLICIES**  
**POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICIES**

**ECONOMIC AND MONETARY AFFAIRS**

**Quick Impact Assessment on a  
Directive concerning Alternative  
Investment Fund Managers and  
Amending Directives 2004/39/EC  
and 2009/.../EC**

**NOTE**

**IP/A/ALL/FWC/2006-105/LOT1/C1/SC2**





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# **Quick Impact Assessment on a Directive concerning Alternative Investment Fund Managers and Amending Directives 2004/39/EC and 2009/.../EC**

## **NOTE**

### **Abstract**

This Quick Impact Assessment by Europe Economics considers the adequacy of the European Commission's Impact Assessment concerning the so-called "AIFM Directive". It considers impacts, objectives and alternative approaches, particularly in respect of marketing and distribution; third country issues; depositaries; and leverage, having first considered the rationale for intervention across these four areas.

This document was requested by the European Parliament's Committee on Economic and Monetary Affairs.

## **AUTHORS**

Dr Andrew LILICO, Europe Economics  
Jonathan TODD, Europe Economics  
Prof Maurizio CONTI, University of Genoa

## **RESPONSIBLE ADMINISTRATORS**

Josina KAMERLING  
Administrator Financial Services  
Directorate-General Internal Policies of the Union  
Directorate A, Economic and Scientific Policies  
European Parliament  
B-1047 Brussels  
E-mail: [josina.kamerling@europarl.europa.eu](mailto:josina.kamerling@europarl.europa.eu)

Stephanie HONNEFELDER  
Detached National Expert  
Directorate-General Internal Policies of the Union  
Directorate A, Economic and Scientific Policies  
European Parliament  
B-1047 Brussels  
E-mail: [stephanie.honnefelder@europarl.europa.eu](mailto:stephanie.honnefelder@europarl.europa.eu)

## **LINGUISTIC VERSIONS**

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## **ABOUT THE EDITOR**

To contact the Policy Department or to subscribe to its monthly newsletter please write to: [josina.kamerling@europarl.europa.eu](mailto:josina.kamerling@europarl.europa.eu)

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## LIST OF ABBREVIATIONS

|                  |   |
|------------------|---|
| <b>AIF</b>       | Alternative Investment Fund                                       |
| <b>AIFM</b>      | Alternative Investment Fund Manager                               |
| <b>AUM</b>       | Assets Under Management   |
| <b>BVCA</b>      | British Venture Capital Association                               |
| <b>BVI</b>       | Bundesverband Investment und Asset Management                     |
| <b>Community</b> | The European Community (EC)                                       |
| <b>IA</b>        | Impact Assessment   |
| <b>MFID</b>      | The Markets in Financial Instruments Directive                    |
| <b>TFP</b>       | Total Factor Productivity   |
| <b>UCITS</b>     | Undertakings for Collective Investment in Transferable Securities |

## SUMMARY

This is a quick, non-quantitative critique of the adequacy of the European Commission's IA<sup>1</sup> concerning a proposed Directive on Alternative Investment Fund Managers and Amending Directives 2004/39/EC and 2009/.../EC ( « the Commission IA »), with particular regard to impacts associated with provisions concerning marketing and distribution, third country issues, depositaries, and leverage. It contains qualitative analysis of the impacts of the proposed Directive along with potential other issues for detailed consideration under the framework of the Directive as proposed, but begins with an assessment of the Commission IA's analysis of the policy problem and rationale for the Directive in its current form.

### Policy problem (See Section 2)

- **We find the Commission IA's analysis of the policy problem to be vague, sweeping, and inadequate as a basis for justifying regulation.** (*Appendix 1*)
- Our own alternative rationale for regulation considers issues of **market failure** and **regulatory failure**, subdividing market failure into « **narrow** » and « **broad** » issues, and regulatory failure into **property right limitations** and **regulatory get-arounds**.
- **Narrow issues of market failure** include
  - **Asymmetric information**, which can lead investors to make **errors in their assessment of risk**.
  - **Informational asymmetry facilitating misrepresentation**.
- Narrow issues are less likely to arise in respect of **professional investors** than of retail investors, but there may be scope to improve disclosure requirements.
- **Broad issues of market failure** include
  - **Adverse selection** (markets for low-risk products might simply not exist); **moral hazard** (managers take little care after securing funds); and **free riding**.
  - **Systemic risk**, if actions by one economic agent tend to result in a co-ordinated effect across the whole financial system, leading to transitional costs such as periods of unemployment or low credit availability. Relevant to marketing and distribution, (especially in terms of **over-dependence of professional investors on ratings agencies** [« regulatory badging »]), but the main concern is **leverage**.
  - **Leverage** is unlikely, intrinsically, to create risk, but the **bailing out of bondholders** both in the recent financial crisis and in past cases means that **AIFM are likely to have very powerful incentives to over-lever**, and **the current situation is dangerous**.

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<sup>1</sup> European Commission, *Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2004/39/EC and 2009/.../EC, Impact Assessment*, p. 30

- Overall, however, although we argue that **there is a strong case for additional regulation** (especially if governments cannot make credible promises not to bail out AIFM bondholders in future), **the rationale for a directive of this form is weak**. In particular we note that **the Commission IA includes no consideration of how the Market might respond to recent events and to new regulation of the banking sector**. It is by no means obvious either that it is necessary to regulate many of the activities covered by the proposed Directive when carried out by AIFM (as opposed to banks), or that it is actually feasible to regulate these activities (as opposed to chasing them into other, potentially more destructive, areas outside the regulatory net), or that even if they are to be regulated that cannot be achieved through regulating on the side of banks and/or prime brokers. Finally, even if it is best to regulate these activities, it is by no means clear, yet, what are the regulatory holes not covered by other (as yet to be implemented, but very extensive) new regulations of banking activities. **We consider this Directive in its current form poorly constructed, ill-focused, and premature.**

## Impacts

### Marketing and distribution (*Section 3*)

- The proposed Directive is likely to **increase the compliance costs of AIFM** to a much greater degree than the IA acknowledges.
- Early indications suggest that the marketing provision will not achieve what is intended in relation to investor protection.
- The IA gives **little attention to proportionality issues**.
- **Competition, particularly from outside the EU, is likely to be impaired.**

### Third country issues (*Section 4*)

- Provisions restricting professional investors in the EU from investing through non-EU AIFM constitute **a very significant restriction on EU investor choice**. There are also important questions as to whether and how, in practice, such restrictions could be effectively monitored and enforced.
- The proposed provisions can be interpreted as **protectionist** and such measures are often reciprocated in kind. Significant proportions of capital raised by private equity and venture capital come from outside Europe. The potential loss of such funding is one illustration of the dangers of a protectionist spiral.

### Depositaries (*Section 5*)

- **Competition between depositaries may well decline :**
  - Restrictions on the use of non-EU depositaries will reduce the number of players.
  - Liability for losses and other burdens mean that some depositaries may exit the market, whilst others may vertically integrate in various ways.
  - Increased risk exposure may increase capital holdings, creating barriers to entry.

### **Leverage (Section 6)**

- The measurement of leverage is not straightforward and **market participants are likely to seek to game** whatever interpretation regulatory authorities apply.
- The Commission IA does not consider the **transitional costs, disruption or threats to market stability** of the transition from the current regime to the new one proposed, nor the risk that the measure increases market volatility in busts.
- Leverage thresholds are **set so low** that **many hedge funds will cease business**.
- An **alternative approach** : Require all AIFs that are systemically significant to fall under the **prudential oversight of their respective central banks**, and require EU central banks to specify leverage limits for systemically significant AIFs.

### **General (Section 7)**

- If it succeeds in curtailing the innovative activities of the most dynamic parts of the financial sector (which we doubt it would, fully), the Directive could thereby **reduce economic volatility and limit periods of high unemployment, but at the cost of lower growth**. Whether that is an attractive trade-off is a political judgement.

## 1. INTRODUCTION

In this Quick Impact Assessment (IA) Europe Economics is tasked with analysing the adequacy of the European Commission's IA<sup>2</sup> concerning a proposed Directive on Alternative Investment Fund Managers and Amending Directives 2004/39/EC and 2009/.../EC (hereafter often « the Commission IA ») in the following respects:

- (a) marketing and distribution (which includes private placements and disclosure to investors);
- (b) third country issues for EU and non-EU investors and for the funds (including consequences for investors' choice and the cost of compliance);
- (c) depositaries;
- (d) leverage (what will be the impact on price efficiency and volatility and the behaviour of the market, but also in terms of counterparty exposure, supervision and financial stability?)

We call these the « Four Questions ». It should be noted that the scope of this Quick IA does not include quantitative analysis of the Four Questions.

In Sections 3 to 6, taking each of these Four Questions in turn, we shall consider certain issues concerning the proposed Directive, and in particular propose a number of potential additional points that might be addressed and other modifications, and consider what are the likely impacts (including both positive and negative impacts) of the proposed Directive in its current form. Section 7 considers various general impacts, common across the provisions falling under the Four Questions. These sections assume that there will indeed be a Directive of the proposed sort, albeit perhaps modified in a number of ways (some potentially substantial).

But first we shall consider the Commission IA's analysis of the policy problem, which is common to the Four Questions, exploring what are more or less convincing rationales for regulating this sector, and addressing the problem of whether, even if there is a case for additional regulation in the sector (which we believe there is), is this particular form of Directive the correct instrument for addressing the issues; and is its timing and focus, relative to other major regulatory changes, really reflective of recent events?

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<sup>2</sup> European Commission, *Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2004/39/EC and 2009/.../EC, Impact Assessment*

## 2. POLICY PROBLEM

There were arguments made for EU regulation of AIFM (specifically in relation to hedge funds and private equity) prior to the financial crisis, but these were rejected by the European Commission.<sup>3</sup> However, by November 2008 sentiment had changed dramatically, with George Soros, the renowned financier, testifying to the US Congress that "hedge funds were ... an integral part of the bubble which has now burst".<sup>4</sup> The Commission IA specifically identifies the financial crisis as leading it to revise its position.

Financial services and finance markets are, in general, subject to various well-known potential sources of market failure. We divide these into « narrow » issues and « broad » issues. (This distinction should become clear in what follows but, roughly, by a « narrow » issue we mean one that affects particular agent-to-agent transactions, whilst by a « broad » issue we mean one that affects the market as a whole.)

Note that in what follows, we focus particularly on hedge funds and, to a lesser extent, private equity, mainly because consideration of these highlights the main issues that the proposed Directive is seeking to address; and because examples relating to hedge funds and private equity constitute the majority of the discussion in the Commission IA. We believe that it is clear from the Commission IA that the core goals of the Directive relate to the regulation of hedge funds and private equity.

Note also that the vast majority of what follows is our own analysis – the Commission IA's analysis of the policy problem is vague, sweeping, and inadequate as a basis for justifying regulation. We substantiate this assessment in more detail in Appendix 1. But some examples include:

- It is vague in that it lacks any proper economic analytical structure. (We impose our own in what follows.)
- It is sweeping in its bundling together of various only vaguely-related financial entities under the heading of AIF and AIFM.
- It is inadequate in lacking any consideration of how the behaviour of the Market might evolve in the absence of this Directive or in response to other regulatory changes.

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<sup>3</sup> For example, in February 2007 Internal Market Commissioner Charlie McCreevy argued that the decision not to regulate hedge funds on an EU level should be "recognised as swallows of a new European regulatory spring. We are reducing the regulatory pressure post-FSAP and intend to stay there". (Remarks to a conference in London, 20 February 2007).

<sup>4</sup> Testimony of George Soros at Hearing on Hedge Funds, 13 November 2008

## 2.1. Market Failure - Narrow Issues

One well-known driver of narrow issues is informational asymmetry – that is to say, in many financial markets those selling products or services know more about their value and risks than those buying them. This creates a number of potential problems. One is simply that, because buyers are unable to distinguish fully between higher and lower quality products and services, the « good » are lumped together with the « bad », with the overall market price reflecting expectations about the chances one has happily encountered a « good » product or service. The result is that, versus what would happen if sellers disclosed everything relevant, buyers pay « too little » for high quality, low-risk products and services and « too much » for poor quality, high-risk products and services. This is a potential driver of pricing errors, with booms in prices based on the over-estimation of the quality/under-estimation of the risk<sup>5</sup> of products (especially of new innovations, about which information may be limited) followed by busts when the error is identified.

Closely related to the problem of low quality products is the problem that buyers of services may have only limited control over how services are conducted. For example, if you provide money for someone to manage, you may have limited control over how much care and effort is put into managing your money, and how much care and effort the manager applies in, for example, keeping up to date with the latest developments in the sector and in ideas and evidence concerning how best to manage money. (This problem is one variant of the “moral hazard” problem.)

The next potential problem is that because buyers are ignorant, unscrupulous sellers are in a position to mislead them. In a recent study by New York University’s Stern School of Business 21 per cent of hedge funds in their sample had misrepresented past legal and regulatory problems and 28 per cent had made either incorrect or unverifiable representations about other topics.<sup>6</sup> Of course, fraud is already illegal under general law, but surveys such as this suggest that enforcement problems are such that general legal measures may not be adequate to prevent unscrupulous exploitation from materially harming market function.

Focusing particularly on AIFM, perhaps partly as a result of informational asymmetry, but also as a consequence of the private nature of certain contracts fairly common in the AIF sector, there may also be issues of market power (i.e., a form of monopoly).

It is important to emphasise that markets have their own mechanisms for addressing problems of informational asymmetry, and it is naïve to suppose that just because one can tell a story about a financial market transaction in which an informational asymmetry undermines market function, that therefore markets do not function well. This point has particular weight when one is dealing with professional financial market participants. In respect of retail investors, it is common to argue that they cannot employ many of the devices markets often use to address informational asymmetry issues, such as repeat purchasing, because the retail financial products they purchase are bought only once in a lifetime and/or because the failure of a retail financial product can be so ruinous that the opportunity for repeat purchasing after a bad experience would not arise.

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<sup>5</sup> Risk is, of course, just one aspect of quality.

<sup>6</sup> Brown, S., Goetzmann, W., Liang, B. and Schwarz, C. (2009), “Trust and Delegation”, First Draft: June 16, 2009

It is also common to argue that many financial market products are very complex and that retail investors are not well-placed to understand them. Neither of those objections would have any obvious force in respect of professional investors.<sup>7</sup>

The issues mentioned above are perhaps of most relevance to the Market and Distribution aspects of the proposed Directive. The Commission IA mentions in particular:

- (a) that many AIFs may lock investors in to their investment for longer than is acceptable for retail funds; and
- (b) investment strategies are typically complex and often involve investment in illiquid and harder-to-value investments.

We are not convinced by these points. The Commission IA is quick to dismiss the possibility that professional investors may not be troubled by asymmetric information problems. While recent events do seem to add weight to the view that professional investors share in information inadequacies in relation to AIFM, it is dangerous to conclude without further analysis that professional investors necessarily require the same safeguards as retail investors.

However, of more relevance might be whether offering documents produced by AIFM are adequate in terms of their disclosure/analysis in respect of issues such as recent performance of the underlying assets (in particular relative to peers), risks relating to regulatory trends or other factors particular to the market relevant to the underlying assets, jurisdictional/political risks, and exposure to global events. It is also of potential interest to consider whether (and if so, when) it should be permissible for a professional investor to rely entirely upon ratings agency ratings (either of funds themselves or of the underlying assets in which the fund invests). (Does regulation contribute to such (over-)reliance? Has the systemic risk associated with such regulatory badging been adequately reflected upon?). Again, are the diversification criteria applicable to hedge funds and other AIFM adequately understood in terms of systematic risk exposures (e.g., regional risks)?

## **2.2. Market Failure - Broad Issues**

The problem of low quality products and services mingling with high quality products can escalate into a broad issue called « adverse selection ». Adverse selection arises because the mingling of good and bad products means that it is very attractive to sell low quality products and services but much less attractive to sell high quality products and services (particularly if, as one might expect, the high quality products and services are more expensive to produce – e.g., because higher skilled staff must be employed). This can mean that high quality products and services are driven out of the market – the more low quality output is there, the lower the price will be, and the less attractive it will be to offer high quality output. Eventually there is simply no market for high quality output at all – the market is simply absent; it has quite literally « failed ».

(Note that quality might be intrinsically high or low. But there could also be a problem of « moral hazard ». In other words, sellers that are careless or lazy after obtaining funds to manage simply drive out those that are careful and diligent, because the costs of the former are less and the market offers no reward for the latter.)

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<sup>7</sup> This point is made by various commentators and interested parties in respect of the AIFM Directive. See, for example, the Swedish Financial Supervisory Authority, Finansinspektionen, Memorandum on the proposed AIFM Directive, 31 July 2009

Another form of broad issue is that of « free riding ». In many financial market settings, analysis that is costly and difficult can reveal that certain assets are over- or under-priced. But if some have done this analysis, others may be able to follow and free-ride on the analysis done by the few. This will tend to limit the number of agents that actually undertake such analysis, and can undermine the value of such analysis even to those that undertake it. The net result tends to be that less analysis occurs than is efficient.

A fourth « broad » set of issues are those relating to systemic risk. If actions by one economic agent tend to result in a co-ordinated effect across the whole financial system, that can lead to transitional costs such as periods of unemployment or low credit availability.

The clearest of the Four Questions to which broad issues of market failure are relevant is, perhaps, that of leverage, although there are also potential issues relating to Marketing and Distribution. Taking the latter first, as we allude to above, in recent years even professional investors may have come to be over-reliant on ratings from a narrow set of ratings agencies (whether in terms of the robustness of funds themselves or, perhaps more materially, of the underlying assets in which the funds invest). (This may even have been positively encouraged by regulation – e.g., through Basel II.) The use of ratings agencies is one response to the free riding problem mentioned above. But a consequence may be that evaluations of risk are done almost exclusively by a very narrow set of agents. If those agents make a mistake in evaluation (e.g., if they under-estimate risk), then they make that mistake for the whole market, co-ordinating errors. The trend of the past few decades up to 2007 was to chase the « buyer beware » (*caveat emptor*) principle out of financial services and finance markets, and instead to concentrate fundamental analysis of risk in a narrow set of related institutions – central banks, regulators, ratings agencies – and thereby co-ordinate errors and increase systemic risk. It is an open question whether the gains of this regulatory strategy (e.g., from addressing informational asymmetry issues and free rider problems) have really been worth the costs (greater systemic risk). There is surely a strong case to consider whether it is appropriate for even professional investors to rely solely on ratings agency ratings for their risk assessments.

Turning to leverage, the first point to stress is that a key insight of modern finance theory is that the riskiness of a financial asset is given by the real volatility in costs and revenues of the underlying real asset. Unless it affects the management of the underlying real assets (and hence the real returns and volatility in those returns), all that the capital structure does is to distribute the returns from the real assets between different financial claimants.<sup>8</sup> One standard thought is that equity provides a more direct form of monitoring of management than does debt, and that this may be a determinant of the degree of leverage (*ceteris paribus*, when the value of monitoring is higher, the leverage will be lower). An interesting corollary is that, when the nature of equity is different (e.g., when the form that equity takes intrinsically involves a more intimate relationship between shareholders and management, as is the case, for example, with private equity as opposed to, say, listed shares) that may have an effect on the efficient degree of leverage (e.g., theory would predict that when there is private equity, the economically efficient level of leverage will be higher than when there are listed shares).

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<sup>8</sup> To paraphrase one of the favourite illustrations of Merton Miller, who co-authored the Modigliani-Miller theorem, no matter how many pieces you carve the pizza into and to whom you give those pieces, the total amount of pizza there is the same.

The implication, then, is that, from the point of view of the individual company, risk is merely re-allocated (not increased or decreased *simpliciter*) through increased leverage. However, such re-allocation could potentially come with its own implications. For, of course, increased leverage does increase the risk on debt (i.e., increases the risk of default on debts). And an argument could be offered that when there is more debt overall, the risk of discontinuities in returns (non-smooth adjustments, potentially involving transitional costs and unemployment) might be greater, because debt is intrinsically subject to less smoothness in its returns – either returns are constant, or there is default. If debt is bearing more risk, equity (which has a smoother returns profile, albeit with greater volatility and greater risk) is bearing less risk than it would otherwise. (This must be so, since the total risk is unchanged.) It might be argued that, therefore, if debt bears more risk then, even if overall risk is unchanged, the likelihood is increased that downside events will not be able to be absorbed smoothly, but will instead result in crises, transitional costs, and unemployment.

(We shall proceed to consider systemic risks, but before we leave the current topic we should note that it is not obvious that the above argument really goes through as written. For it is not abnormal for debts to be renegotiated when companies might otherwise default, particularly during significant recessions. This reduces the discontinuity of returns. It is simply naïve to imagine that the only alternative to debts being serviced as originally promised is for there to be total default and lengthy liquidation.)

The European Commission sees AIFM leverage as potentially generating a macro-prudential or systemic risk. This is a topic on which there are a range of views, but (although leverage is undoubtedly a key component of classic hedge fund strategies for example, whilst leveraged buy-outs by private equity funds have also been common) AIFs have in recent years, including prior to and during the financial crisis, tended to have levels of leverage that are moderate compared to banks. Thus, whatever role leverage may have played in the financial crisis, this role was assumed to a greater extent by banks than by AIFs.<sup>9</sup> Similarly, though there may be a case that disorderly deleveraging by hedge funds was one factor in financial instability during 2008-9, much larger financial institutions were engaged in similar actions at this time. So, again, whatever role deleveraging may have played in the financial crisis, this role was assumed to a vastly greater extent by banks than by AIFs.<sup>10</sup> Furthermore, research suggests that it is important to consider the adequacy of equity capital relative to the risk of underlying investments when assessing the leverage position of AIFM. On this basis, it was concluded in 2003 that only 2.9 percent of hedge funds were undercapitalised.<sup>11</sup>

Now, one might argue that it is irrelevant how large the role of AIFs was in deleveraging – however large it was, they were co-participants in over-leveraging initially and in disorderly deleveraging later. So if there must be regulation to counter over-leveraging and disorderly deleveraging, then AIFs must be subject to their part in that regulation.

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<sup>9</sup> For a discussion on this point, please see the speech by Dan Waters, FSA Asset Management Sector Leader, FSA International Fund Forum, Monaco, 24 June 2009

<sup>10</sup> *The High-Level Group on Financial Supervision in the EU*, Chaired by Jacques de Larosière, (February 2009), *The Turner Review, A Regulatory Response to the Global Banking Crisis*, (March 2009)

<sup>11</sup> Gupta, Anurag & Liang, Bing, 2005. "Do hedge funds have enough capital? A value-at-risk approach," *Journal of Financial Economics*, Elsevier, vol. 77(1), pages 219-253, July.

But this is not convincing. For it is surely not the *fact* of over-leveraging and disorderly deleveraging that creates the impetus to regulation. If just one small firm over-levered and then went bust, that would not *per se* be any good reason to regulate — we would just say that that firm had been badly run and went bust. That is capitalism in action. No, insofar as over-leveraging and disorderly deleveraging creates a motivation for regulatory intervention, it is because of the scale. And if the scale issue is addressed by regulating banks, it then becomes unclear what motivation or need there could be for regulating AIFs in this regard. If there is really to be an argument here, it cannot be so direct as this.

One relevant alternative consideration might be whether, in the absence of regulations limiting leverage, there could be an incentive to over-lever as a consequence of the bailouts in the financial crisis. If firms believe that, in the event that they are on the point of failure, the government will intervene in such a way as to wipe out equity holders but spare bondholders (a key form of government intervention during the financial crisis), then bonds become a particularly attractive, low-risk (from the investor's point of view) way to finance financial institutions — they are virtually risk-free, since they carry an implicit government guarantee. (This is a form of moral hazard.) In the recent financial sector crisis, the focus of bonds-sparing bailouts was banks, not hedge funds or other AIFM. But in the past, governments have intervened in cases of AIFs that were considered systemically important (e.g., Long Term Capital Management in 1998), and, in the absence of regulation to prevent it, it is certainly possible in principle that AIFM will become systemically important in the future.

As a consequence, unless future regulation or future changes to the culture of government means that governments can credibly promise not to bail out AIFM in the future, we consider it *dangerous* for AIFM to be left without limits on their leverage. The inevitable consequence will be inefficient over-levering, default, collapse, and the calling-in of the bailout promise at great expense to taxpayers and damage to the wider economy. However, it is crucial to note that this argument says only that there should be *some* limit to leverage or other mechanism for constraining leverage. It is not obvious from this argument alone that the same leverage restrictions should apply to all firms, as opposed to, say, leverage being restricted through firm-specific supervisory discretion processes or indeed incentives not to over-lever being a by-product of other regulatory measures. The argument also tells us nothing about how high or low a leverage limit should be set.

### **2.3. Regulatory Failure - Limited Property Rights**

Another class of problems that might be relevant is that of regulatory failure. One important form of regulatory failure is when property rights are not sufficiently clear or robust. This is of particular relevance to the provisions in the proposed Directive relating to depositaries.

This element of the proposed Directive is seen as a response to the Madoff scandal and the collapse of Lehman Brothers. After Lehman collapsed, investors in a hedge fund run by Paris-based Day Trade Asset Management discovered that €3.2 million of their assets were held by Lehman, the fund's prime broker and sub-custodian. However, a French court ordered Société Générale Securities Services, which acted as the depositary bank for the fund, to reimburse these investors. In contrast, investors in the Luxembourg-domiciled LuxAlpha Sicav, which not only fed into Bernard Madoff's scheme but used a Madoff entity as sub-custodian, were left without reimbursement after the collapse of Madoff's businesses. The Grand Duchy's legal framework did not require the depositary, UBS, to bail out investors in the event of the sub-custodian's failure.<sup>12</sup>

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<sup>12</sup> "Depositaries balk at rule change", *Financial Times*, 13 September 2009

There is already evidence that depositaries are seeking to avoid France and preferring to operate in jurisdictions, like Luxembourg, that give them greater legal certainty over the extent of their liabilities (or perhaps simply lower liabilities). The Directive seeks to address this by mandating the use of an EU depositary by EU investors, and raising the level of liability taken on by depositaries across the EU to that imposed upon French depositaries by the recent court decision there. While the wording of the proposed Directive remains contested and the failure of the IA to address this policy in any detail whatsoever did not clarify matters, it seems likely that this will make the depositary liable to the investor for losses incurred through investment in the AIF. Certainly, many industry participants are interpreting the likely liability of depositaries under the proposed Directive as "strict liability".<sup>13</sup>

## 2.4. Regulatory Failure – Regulatory Get-arounds

Another way in which regulation might fail is if its scope allows the activities regulated simply to migrate elsewhere and be conducted there with the same problems the original regulation was seeking to address. Note that both parts of this are crucial – if the process of migration removes the original problem that the regulation sought to address, then the market responding through a regulatory get-around is not a regulatory failure but a regulatory success.

The issue of regulatory get-arounds is of clear relevance to the third country issues raised in the proposed Directive. These are intended to address the danger that firms simply respond to a Directive by moving off-shore, outside the EU/EEA, to some jurisdiction in which there are no equivalent regulations.

## 2.5. Overall Evaluation of Policy Problem Identification

Our view is that there is a potential rationale for having more developed regulation of at least some AIFM. However:

- a) The case offered in the Commission's IA seems to us hasty, unconvincing and poorly focused.
- b) The Commission's IA has no serious consideration of how the behaviour of and use of AIFM might evolve in the future, simply through market responses to the financial crisis, and whether (and to what extent) such changes in behaviour and use of AIFM (changes we believe are absolutely certain to occur and which will be inevitably highly material) would themselves address a number of the issues the Commission IA raises.
- c) There is a persistent assertion that the « cross-border » nature of AIFM justifies EU regulation, in spite of the fact that much AIFM activity is not cross-border (e.g., much private equity activity is national<sup>14</sup>) and that which is does not correspond neatly to the EU (e.g., many EU-based hedge funds are as likely to trade on the New York or Tokyo stock exchanges as they are to trade within the EU<sup>15</sup>).

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<sup>13</sup> See page 103 in the CRA report for a discussion on this point. Charles River Associates (CRA), *Impact of the proposed AIFM Directive across Europe*, prepared for the Financial Services Authority (FSA), October 2009.

<sup>14</sup> CRA cite the BVCA *Investment Activity 2008* report to the effect that 43 percent of UK managed private equity funds are invested in the UK, 41 percent in continental Europe, 9 percent in the US and 8 percent in other overseas markets. (Charles River Associates (CRA), *Impact of the proposed AIFM Directive across Europe*, prepared for the Financial Services Authority (FSA), October 2009).

<sup>15</sup> "Investors indicated that they currently choose from funds that are domiciled and managed across the globe and therefore have the ability to choose from the full range of investment approaches on offer". (Charles River Associates (CRA), *Impact of the proposed AIFM Directive across Europe*, prepared for the Financial Services Authority (FSA), October 2009).

- d) The Commission IA optimistically assumes that compliance costs will be minimal, without any convincing basis for this view.
- e) The « all encompassing approach » (i.e., the regulation of all AIFM) has the effect of grouping a highly diverse class of fund. It is very difficult to efficiently regulate such a diverse grouping and the extent to which the provisions of the Directive are appropriate varies by type of fund. This is likely to distort competition, not least as certain investment vehicles (e.g., family offices and sovereign wealth funds) seem likely to have greater potential for regulatory get-around than others. Equally, the « all encompassing approach » will make financial services, like Real Estate Investment Trusts (REITS), which have previously been unregulated or lightly regulated and which seem unlikely to pose material systemic risk subject to much tighter regulation.<sup>16</sup> Also, investment trusts and special funds, which have also never been thought to have any systemic relevance, will be subject to considerable restructuring costs as they transform themselves into compliant structures.<sup>17</sup> Special funds are predominant in Germany, where they have AUM of €800bn, but the trade body in this Member State describes them as “exhaustively and in every respect sufficiently regulated” by a piece of German legislation that only came into force in December 2007.<sup>18</sup> Sufficient time hardly seems to have passed to assess whether this legislation will be effective in securing adequate market functioning for this kind of AIFM.
- f) Many of the issues addressed by the Directive (e.g., tax reporting, portfolio company disclosure, employee protection and short selling) are of general market applicability. We are not convinced that any cogent case has been offered as to why a Directive targeted at AIFM is the appropriate instrument, as opposed to revisions to other Directives, new cross-cutting regulations/Directives relating to activities shared by AIFM and other financial sector players, or regulation under the auspices of the ECB.

As a (non-exhaustive) illustration of our thinking in this area, we believe that a natural thought is that the crisis has exposed the potential systemic relevance of hedge funds. It might follow from this that there are circumstances in which hedge funds large enough or perhaps connected enough to be of potential system significance might require access to lender-of-last resort support from the relevant central bank. The natural pair of the offering of last resort lending is that the central bank that might some day face the decision of whether to provide such lending will need to have prudential oversight in advance. So if hedge funds are to be potential recipients of lender-of-last-resort facilities, they will need to be subject to prudential regulation (e.g., of their leverage). But the correct *agent* for such prudential regulation is surely the central bank that might provide the last resort lending (ECB, Bank of England, Riksbank, etc.), not some separate body. This case is not addressed in the Commission’s IA.

We also believe that there may be a case for regulating the conduct of at least some hedge funds in certain respects, particularly insofar as their dealings involve participation in cross-market coordinated issues such as reliance upon ratings. There is an interesting question of to what extent the activities of banks, in areas that interface with the activities of hedge funds, can be regulated adequately only on the side of the banks themselves (i.e., can all that is necessary be achieved simply by regulating the banks, or do we need to regulate their counterparties, also?).

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<sup>16</sup> This point was made in a letter from the Property Industry Alliance to the Swedish Finance Ministry, the UK Financial Services Authority, and the UK Treasury on 3 July 2009. Please see <http://www.bpf.org.uk/pdf/21411/PIA%20letter%20-%2010th%20July.pdf>

<sup>17</sup> See the CRA report for a discussion on investment trusts. (Charles River Associates (CRA), *Impact of the proposed AIFM Directive across Europe*, prepared for the Financial Services Authority (FSA), October 2009)

<sup>18</sup> BVI, Draft EU Directive on Alternative Investment Fund Managers (AIFM)

A related possibility is that of regulating the interface between AIFM and their prime brokers, rather than regulating the AIFM directly. To some extent the answer to these questions depends upon exactly what regulation of banks and/or prime brokers is to be implemented, and how successful it is in practice. Assessing all potential banking regulation goes beyond the scope of this report. However, we believe that the correct implication of this issue, for now, is that it may be premature to introduce regulation of the activities of hedge funds insofar as such regulation is targeted at their relationships with banks. It could well be better to wait until the final form of banking regulation is clearer, and at that stage, as it were, "fill in the holes" in respect of required regulation of bank counterparties. (We note that the process leading to this proposed Directive was initiated before the events of Autumn 2008, and hence does not reflect developments in regulation in the banking sector. It appears to us that there is a strong case for revisiting thinking about regulation in these areas in an order more reflective of recent events.)

As regards private equity our view is that, if there is a case for regulating its activities, this would be better presented in a standalone regulation. We are not convinced that hedge funds and private equity are such closely related financial institutions that it is either useful or sensible to regulate them together. Financial products like real estate funds, special funds and investment trusts are still more heterogeneous in important respects. For example, the additional investor protection that the draft Directive seeks by requiring independent custody is distinct for private equity (e.g., private company share certificates) or real estate funds (e.g., property) than for funds which invest in financial services or derivative contracts.<sup>19</sup>

We feel there is a distinct risk of regulatory hubris here. The reason for regulating so many sectors under the one AIFM umbrella appears to be along the following lines:

- a) we regulate to restrict certain activities of banks;
- b) those activities might migrate to hedge funds if we did not also regulate those;
- c) so we regulate hedge funds;
- d) but if we regulate hedge funds, such activities might migrate elsewhere in the system – e.g., to other AIFM;
- e) so we regulate other AIFM.

There are a number of serious problems with this chain of reasoning. First of all, let us focus on Step (b), in which activities we regulate in banks migrate to hedge funds. Is this a problem? It is by no means clear we should think that it is. For what is a problem when done by a bank (e.g., because it exposes retail depositors to potential risk) may well not be a problem when done by a hedge fund. Or, similarly, issues of informational asymmetry may be more pronounced in activities of banks than of hedge funds. We are surely not aspiring to regulate simply because we consider certain activities should not occur, *simpliciter*. We want only to forbid or restrict activities if they might create problems of market functioning or add unnecessarily to systemic risks. Would these activities do that if they were activities of hedge funds rather than of banks?

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<sup>19</sup> For a discussion on this point, please see Sally Dewar, Managing Director, Wholesale & Institutional Markets, FSA, FSA Asset Management Conference, 17 September 2009

Next, a fairly obvious problem is that regulatory avoidance may not halt at Step (e). If these activities are so mobile as to be able to shift from banks to hedge funds and hedge funds to other AIFM, why should we expect them to stop there? What is to stop them from migrating to some other, perhaps new and by definition unexpected, area? We note that AIFM that are either divisions of EU banks or insurers, authorised pension fund managers, various categories of sovereign wealth fund or family offices are excluded from the scope of the Directive.<sup>20</sup> It might be that the Directive has the effect of increasing AIFM activity through these channels, which due to the exposure of retail investors to banks, insurers and pension funds, may be less desirable than concentrating this activity in hedge funds.

Up until 2007, the hedge fund sector was not widely thought to present particularly material issues of market functioning. Perhaps we have all updated our view on that, but it remains plausible that issues of market malfunction are less serious in the hedge fund sector than they would be in some entirely new sector that would grow up to accommodate activities driven out past Step (e) above. Are we really sure that we wish to prevent these activities altogether? And, if so, are we sure that we really *can* prevent such activities rather than drive them outside the current regulatory net? And if we are not sure we can really prevent them altogether, might not the hedge fund sector be a fairly attractive and transparent place for these activities to occur?

We do not claim, in this Quick IA, to have provided the definitive answer to these questions. But we do consider them important, and believe that further thought around these issues would be very much warranted.

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<sup>20</sup> For a discussion on those who may not be covered by the Directive see PWC, *The proposed EU Directive on Alternative Investment Fund Managers (AIFM) could have far reaching effects for Real Estate Funds*, (July 2009)

### 3. MARKETING AND DISTRIBUTION

In Sections 3 to 6, we address the Four Questions in terms of the policy objectives and policy options that the Commission has set in respect of them, before assessing the impacts of the policy proposals that the Commission favours. In a number of places we shall suggest alternative policy options that the Commission IA might have considered. This should not always be taken as indicating that we recommend these alternatives — we have not subjected them to detailed analysis or quantified their impacts. Our goal is merely to highlight lines for further thought.

#### 3.1. Objectives

The specific objectives set out in table 8 on page 30 of the Commission's IA are as follows:

- (a) "All AIFM are subject to appropriate authorisation and registration requirements;
- (b) "Proper monitoring of macro-prudential risks;
- (c) "Proper monitoring and limitation of micro-prudential risks;
- (d) "Common approach to protect professional investors in AIFM-managed funds;
- (e) "Greater public accountability of AIFM holding controlling stakes in companies;
- (f) "Develop the Single Market in AIF;
- (g) "Ensure that actions are proportionate to the risks posed and appropriately differentiated to take account of differences in AIFM business models."

It is not entirely clear how to convert these very broad objectives for the proposed Directive into specific objectives in respect of each of the Four Questions. However, we attempt to do so, as follows. In so doing, it appears that the European Commission threatens to breach (g) in the list above on several counts.

The specific objective (d) seems most relevant to marketing and distribution. The Commission allocates an operational objective to each specific objective and the part of the corresponding operational objective that seems most relevant to marketing and distribution is the following:

"Reduce potential for weakness in investor disclosures as barrier to effective due diligence".

So, the Commission aims to have AIFs that are marketed and distributed to EU investors to provide for investor disclosure in a way that secures effective due diligence for investors.

## 3.2. Policy Options

Articles 31-34 of the draft Directive focus solely on the issue of the marketing and management of services by AIFM. The main features of the provisions set out in the Commission's draft Directive in relation to marketing and distribution are as follows:

- (a) An authorised AIFM will be able to market the AIF to professional investors (as defined by Mifid) in the home Member State, subject to notifying the competent authorities in its home Member State in respect of each AIF that it intends to market.
- (b) Member States may, however, allow for marketing to retail investors within their territory should they so choose and will retain the prerogative to apply additional regulatory requirements and safeguards for this purpose.
- (c) Compliance with the requirements of the Directive means that an AIFM would also be entitled to market an AIF to professional investors in other Member States. The only requirement placed on an AIFM in this respect would be the filing of appropriate information with the supervisory authority in the host state.

### 3.2.1. Comment

- *The proposed Directive is likely to increase the compliance costs of AIFM to a much greater degree than the IA acknowledges.<sup>21</sup>*
- *Early indications suggest that the marketing provision will not achieve what is intended in relation to investor protection. Open Europe research shows that only 2 per cent of AIFM clients presently have a favourable view of the Directive and 46 per cent have a negative view, which, given that the Directive seeks to strengthen protections for investors, is a striking conclusion.<sup>22</sup>*
- *The Directive seeks to deepen the Single Market, which is presently constrained by various administrative, legal and cultural barriers, by creating a passport to market throughout the EU. While the possibility of a deepening of the Single Market is to be welcomed, it is worth considering whether gains in terms of economic growth, productivity and investor choice will be cancelled out by losses in these respects through loss of trade with third countries.*
- *The IA gives little attention to the proportionality aspects related to these provisions. For example, AIFM that are engaged in the purely national management of funds, without systemic relevance, are likely to be subject to disproportionate regulation. Why is there not an exemption of the sort that applies in UCITS for AIFM that are purely national?*

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<sup>21</sup> Charles River Associates have estimate one-off compliance costs of up to €3.2bn for AIFM and ongoing compliance costs of around €311m for all market participants from the proposed Directive. (Charles River Associates (CRA), *Impact of the proposed AIFM Directive across Europe*, prepared for the Financial Services Authority (FSA), October 2009). Open Europe conclude that on average private equity and hedge funds would see their compliance costs increase by 31.5 percent under the proposed Directive. (Open Europe, *The EU AIFM Directive: Likely Impact and the Best Way Forward*, September 2009)

<sup>22</sup> Open Europe, *The EU AIFM Directive: Likely Impact and the Best Way Forward*, September 2009

- *These provisions cover both passive and active types of marketing, thereby restricting professional investors in the EU from investing through non-EU AIFM (if they are not domiciled countries which are considered as having equivalent supervisory and prudential regulations as those applied in the Community). This is a very significant restriction on EU investor choice and the Commission IA does not consider whether such a restriction is proportionate. There are also important questions as to whether and how, in practice, such restrictions could be effectively monitored and enforced.*

### 3.2.2. Possible Alternatives

- *The current proposals require that all AIFM meet the authorisation criteria set out in the Directive in order to be able to market anything to professional investors in their own member state or in any other. To the extent that this may impose unnecessary burdens on those AIFM managing funds as a national level only, might some sort of op-out clause be designed through which only those actively engaging in cross-border activity or wishing to engage in it have to comply with the provisions of the Directive (i.e., they would remain subject to supervisions at the national level as they currently stand – cf UCITS).*
- *Amending the definition of marketing to cover only active forms of marketing, as opposed to active and passive. Such an amendment would serve to preserve a significant degree of investors' freedom to seek out investments with the best return and to maximise the diversification of their investment portfolios.*
- *Requiring an AIFM to obtain from a professional investor placing funds into an AIF a statement that he/she has not relied entirely upon agency ratings.*
- *Requiring offering documents (prospectuses/offering memoranda) of AIFs/AIFM to identify (alongside basic information such as the capitalisation of the fund) (a) recent performance of the underlying assets; (b) risks relating to regulatory trends or other factors particular to the market relevant to the underlying assets; (c) jurisdictional/political risks; and (d) exposure to global events.*

## 3.3. Impacts

### 3.3.1. Competition

The proposed Directive could enhance competition, as far as marketing and distribution is concerned, if it were to deliver deeper integration within the Single Market (the mechanism would be a more common regulatory framework, facilitating competition), *ceteris paribus* (i.e., neglecting the impact of the third country issues provisions). However, competition from non-EU AIFM is likely to fall (perhaps very materially), so the overall impact on competition is unclear.

### 3.3.2. Compliance and Administrative Costs

The proposed Directive is likely to increase the compliance costs of the AIFM. The Commission's IA acknowledges the likelihood of the increase but assumes that its scale is not likely to be large. It offers no adequate justification for this assumption.<sup>23</sup>

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<sup>23</sup> See footnote 21.

### 3.3.3. Investors

An important potential additional benefit might be an increased variety of products for EU investors arising from the deepening of integration within the Single Market. This benefit may, however, be cancelled out by restrictions on access to non-EU AIFM; not least if these restrictions prevent access to "best in class" funds.<sup>24</sup> Investors in hedge funds fear this restriction acutely as 94 percent of global hedge fund AUM are domiciled outside the EU.<sup>25</sup>

### 3.3.4. Cross-Border Trade within the EU

The Commission's IA discusses the abolition of barriers to trade among Member States associated with the existence of multiple and different regulations across Member States. This is potentially an important benefit of the Directive because the development of a Single Market in this sector may lead to lower costs because of both the likely increase in the average size of the AIFM and the intensification in the competitive pressure in most national markets. However, the reduction in costs due to the increase in the AIFM' size crucially depends on the importance of scale economies in the technological structure of the sector, which the Commission's IA does not consider.

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<sup>24</sup> Analysis by CRA concludes that 40 percent of hedge funds, 35 percent of private equity, 10 percent of venture capital funds and 2 percent of real estate funds will effectively be no longer available to EU investors as a result of the proposed Directive. (Charles River Associates (CRA), *Impact of the proposed AIFM Directive across Europe*, prepared for the Financial Services Authority (FSA), October 2009).

<sup>25</sup> Charles River Associates (CRA), *Impact of the proposed AIFM Directive across Europe*, prepared for the Financial Services Authority (FSA), October 2009

## 4. THIRD COUNTRY ISSUES

### 4.1. Objectives

It seems particularly difficult to discern the Commission's objective in relation to third countries. However, we presume that the Commission aims to ensure that all parts of the value chain are only exposed to third countries in a way which is consistent with managing the relevant risks as they perceive them: macro-prudential (systemic) risks, the use of leverage; micro-prudential risks; investor protection; market efficiency and integrity; impact on market for corporate control; and acquisition of control of companies by AIFM.

### 4.2. Policy Options

Chapter VII (articles 35-40) focuses solely on provisions in relation to specific rules to third countries and sets out rules in relation to the following:

(a) Conditions for the authorisation of AIFM located in third countries — the provisions set out in this area include:

- Member States may authorise an AIFM domiciled in a third country to market shares or units of an AIF provided that the supervision and legislation with regards to prudential regulation are at least equivalent to those applied in the Community. The Commission is to introduce implanting measures to establish general equivalence criteria.
- The third country, from which the authorised AIFM is domiciled, must provide reciprocity of access that is comparable to that granted by the Community.

(b) Conditions for marketing in the Community of AIF domiciled in third countries — the provisions set out in this area include:

- An authorised AIFM domiciled in the EU will be permitted to manage and market an AIF domiciled in a third country. This is providing the third country has signed an agreement which complies fully with the standards established in Article 26 of the OECD Model Tax Convention.
- According to the Explanatory Memorandum of the draft Directive, these rights will be granted after a delay of three years after the transposition period. During this three-year period Member States may, however, choose to allow (or continue to allow) AIFM to market AIF located in third countries to professional investors subject to national law.

(c) Delegation by the AIFM of administrative tasks to an entity established in the third country – the provisions set out in this area include:

- An AIFM may only delegate administrative tasks to entities domiciled in third countries provided that the provisions set out in Article 18 are met. The third country in which the administrative tasks are delegated must have an appropriate co-operative agreement with the competent authority in the Member State in which the AIFM is domiciled.

(d) Valuator established in the third country – the provisions set out in this area include:

- A valuator established in a third country must comply with the same rules as set out in Article 16 (i.e., that they are independent of the AIF and have appropriate and consistent procedures in place to value assets etc.)
- The valuation standards in the third country in which the valuator is located must be equivalent to those applicable in the Community and the commission will adopt implementing measures specifying the criteria for assessing the equivalence of the standards and rules of third countries.

On the basis of these provisions, not only will an AIFM established outside of the EU be unable to market units and/or shares to investors in the EU (at least without prior authorisation), EU investors will also be unable to invest their funds through an unauthorised AIFM domiciled in the third countries. This latter restriction is largely on account of the following definition of marketing that the Commission applies:

“Marketing; means any general offering or placement of units or shares in an AIF to or with investors domiciled in the Community, regardless of at whose initiative the offer or placement takes place.”<sup>26</sup>

On the basis of this definition therefore, both active and passive marketing would be restricted.

#### 4.2.1. Comment

- *The proposed Directive requires that jurisdictions based outside the EU must meet certain equivalence tests before AIFM are able to market, either actively or passively, within the EU. Given that the majority of hedge fund managers appear to be based in non-EU countries, the restriction upon EU investor choice that this entails is very significant. The scope for investors to diversify their risks is correspondingly curtailed.*
- *Provisions requiring a third country (in which an AIF that an EU-based AIFM wishes to market to is domiciled) to have signed up to a OECD Model Tax Convention agreement with the Member State, are aimed at ensuring the sufficient recovery of tax revenues as opposed to addressing specific risks posed by the AIF in the third country.*

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<sup>26</sup> European Commission, *Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2004/39/EC and 2009/.../EC*, p. 20

- *Further, the IA does not consider the possibility of reciprocal action taken by third parties to restrict their markets. Certainly, these provisions within the proposed Directive can be interpreted as protectionist and such measures are often reciprocated in kind. 59 percent of funds raised by UK private equity and venture capital come from outside Europe.<sup>27</sup> The potential loss of such funding is one illustration of the dangers of a protectionist spiral.*

#### 4.2.2. A possible alternative

- *The Commission may wish to consider more fully the range and scope of regulatory and prudential supervisory approaches used in third countries in advance of demanding that these countries should adopt the EU's approach to regulation in this area.*

### 4.3. Impacts

#### 4.3.1. Competition

The competitive position of non-EU AIFM in respect of the EU market is very adversely impacted and the competitive pressure that they could exert on EU AIFM diminished.

#### 4.3.2. Investors

The range of investor choice seems likely to be reduced. Consequently, their ability to diversify risk will also be curtailed. However, the extent of these effects will depend upon the extent of relocation to the EU by non-EU AIFM, which is presently unknown.

#### 4.3.3. Cross-Border Trade within the EU

The effect on cross-border trade may be positive if some non-EU AIFM relocate to the EU. However, it is not clear that such relocations will occur.

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<sup>27</sup> BVCA Report on Investment Activity 2008, cited in Charles River Associates (CRA), *Impact of the proposed AIFM Directive across Europe*, prepared for the Financial Services Authority (FSA), October 2009

## 5. DEPOSITARIES

### 5.1. Objectives

Given that the Commission IA states that “the depositary performs an essential role in protecting the interests of investors, in particular through the safe-keeping of fund assets”,<sup>28</sup> the specific objective (d) set out in table 8 on page 30 of the Commission’s IA again appears most relevant to depositaries. Part of the corresponding operational objective is the following:

“Ensure proper management of conflicts of interest. Impose appropriate controls and processes in key areas, such as valuation and custody.”

The Commission is seeking to avoid any conflict between the depositaries’ responsibilities in respect of investor protection and other interests which they may have. It is also seeking to “impose appropriate controls and processes” in relation to this responsibility, which are “common” across the EU.

### 5.2. Policy Options

Article 17 of the proposed Directive is wholly devoted to depositaries. It states that the AIFM “shall ensure that a depositary is appointed to fulfil, where relevant, the following tasks:

- (a) “receive all payments made by investors when subscribing units or shares of an AIF managed by the AIFM and book them on behalf of the AIFM in a segregated account;
- (b) “safe-keep any financial instruments which belong to the AIF; and
- (c) “verify whether the AIF or the AIFM on behalf of the AIF has obtained the ownership of all other assets the AIF invests in”.

Article 17 debars the AIFM from being the depositary and states “the depositary shall act independently and solely in the interest of AIF investors”. It “shall be a credit institution having its registered office in the Community and be authorised in accordance with Directive 2006/48/EC of the European Parliament and Council of 14 June 2006”. However, it “may delegate their tasks to other depositaries”. Significantly, Article 17 closes with these sentences:

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<sup>28</sup> European Commission, *Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2004/39/EC and 2009/.../EC*, p. 32/33

The depositary shall be liable to the AIFM and the investors of the AIF for any losses suffered by them as a result of its failure to perform its obligations pursuant to this Directive.

In case of any loss of financial instruments which the depositary safe-keeps, the depositary can only discharge itself of its liability if it can prove that it could not have avoided the loss which has occurred.

Liability to AIF investors may be invoked either directly or indirectly through the AIFM, depending on the legal nature of the relationship between the depositary, the AIFM and the investors. The depositary's liability shall not be affected by any delegation referred to in paragraph.

The proposals therefore constitute an increase in depositaries' duties and responsibilities.

### 5.2.1. Comments

- *Under the proposals in their current form, competition between depositaries would be likely to decline for a number of reasons. First, EU investors would be restricted to the use of EU depositaries, reducing the competitive pressure that non-EU depositaries provide. Second, while the proposed Directive requires that depositaries "shall act independently and solely in the interests of AIF investors", the liability for losses brought about by the actions of AIFM means that depositaries may seek to become part of the same value chain as AIFM in the same financial group. Third, the burdens imposed upon depositaries, in terms of monitoring the activities and strategies of AIFM, are likely to be passed on to investors, and will drive some depositaries out of the market. Fourth, depositaries are likely to hold more capital to cover their increased risk exposure, making markets less liquid and erecting a further barrier to entry in the depositary market. Fifth, many depositaries currently operate through extensive sub-custodian networks, but the shift to "strict liability" will cause depositaries to restructure themselves, making much less use of sub-custodian networks, which are often used by depositaries to serve risky or emerging markets. This shift will have the effect of concentrating risk in a reduced number of depositaries. Sixth, the principle of caveat emptor is effectively replaced by caveat vendor, since the responsibility is shifted from the investor to the depositary, thereby reducing the investors' incentive to be vigilant at the point of investment – surely a paradoxical measure in the light of recent events.*
- *Further, the provisions as currently drafted raise serious questions about how a depositary would be expected to demonstrate that the losses of investor funds (where they may occur) could not have been avoided and therefore determine whether or not they would be deemed as fully liable for returning these funds. These provisions would give rise to considerable legal uncertainty and one would expect the result would be increased costs of capital in the short term and, later, if cases arose to which such vague provisions applied, protracted legal battles in determining liability. The likelihood that depositaries will hold increased capital under the proposed Directive, due to their increased liabilities, will also act to increase the cost of capital, while the likely reigning in of sub-custodian networks will mean that investors are likely to lose out on returns in more risky or emerging markets.*

### 5.2.2. Another possibility

- *It is not clear, particularly as AIFs are only marketed to professional investors, why the Directive proposes to raise the liability standard for depositaries beyond that which the UCITS Directive created for them. It would seem possible to build out of work already underway in the Committee of European Securities Regulators (CESR) and industry best practice to address this problem in a way that raises the liability standard of depositaries to the level of the UCITS Directive, while avoiding all of the negative (and presumably unintended) impacts that seem likely to follow from this provision as currently drafted.*
- *The relevance of this provision to various categories of AIFM (e.g. private equity and real estate funds) is limited, as these models of AIFM do not presently engage frequently enough in trading activity for it to make sense for them to use depositary facilities. While the category of AIFM to which it seems most relevant (i.e. hedge funds) often rely upon their prime brokers for depositary services. Regulation of prime brokers might better address the rationale for this policy, while minimising the associated costs and unintended consequences.*

## 5.3. Impacts

### 5.3.1. Competition

The impact of the provisions regarding competition between depositaries is likely to be negative. This is because the increase in liability and costs for depositaries will lead to market exits.

### 5.3.2. Compliance and Administrative Costs

The mandating of particular practices for depositaries may sharply increase their compliance costs.

### 5.3.3. Investors

The main impact on investors is the higher costs they are likely to face because of the provisions. Depositaries are likely to pass these costs on to investors and they are likely to be highly non-trivial.

### 5.3.4. Cross-Border Trade within the EU

We can expect some (perhaps not inconsiderable) market exits of depositaries due to increases in their costs and liabilities. However, improved access and trading within the EU should be provided to those depositaries that remain in the market. Nonetheless, we would expect the welfare loss associated with the market exits to outweigh any welfare gain in deepening of the Single Market.

## 6. LEVERAGE

### 6.1. Objectives

Specific objectives (a), (b) and (c) set out in table 8 on page 30 of the Commission's IA and their corresponding operational objectives are relevant to leverage. The Commission has set an objective of having "minimum capital" levels, implying maximum leverage levels, prior to AIFM "operating across the EU". These maximum levels of leverage should avoid both macro and micro prudential risk. They define macro risks in terms of systemic risks. The reference to liquidity means that leverage is seen as relevant to micro-prudential risks in terms of the "major risks to which AIFM are exposed." This is imprecise, as systemic risk is undefined<sup>29</sup>, and confused, as the account of micro-prudential risk gives the suggestion that the objective is to protect AIFM from the risks to which they expose themselves; rather than the risks to which they expose investors, counterparties or the systemic risks that their activities generate.

### 6.2. Policy Options

According to the Commission, an AIFM will fall under the scope of leveraging restrictions where:

"The combined leverage from all sources exceeds the value of equity capital on the AIF in two out of the past four quarters".

The specific provisions placed on an AIFM that fall within the defined scope of employing leverage on a systematic basis are set out in Articles 23-25 of the draft Directive. The main elements of the provisions are as follows:

- (a) The AIFM will be required to disclose information to the competent authorities on the aggregate leverage, the form of leverage, (i.e., providing a breakdown of whether it is cash borrowing, securities borrowing or leverage embedded in financial derivatives), as well as the five main sources of leverage. This information should be provided to the competent authority on a regular basis (which has not yet been specified).
- (b) The AIFM will also be required to disclose information on the level of leverage to investors on a quarterly basis.
- (c) In order to ensure the "stability and the integrity" of the financial system, the draft Directive notes that it will include implementing measures that limit the level of leverage the AIFM can employ.
- (d) The draft Directive also recognises the right of Member States to impose additional leverage restrictions in exceptional circumstances (i.e., where they are required to ensure financial stability and the integrity of the financial system).

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<sup>29</sup> For a discussion on the various interpretations that may be applied to systemic risk, please see Kambhu, Schuermann, Stroh, *Hedge Funds, Financial Intermediation, and Systemic Risk* (FRBNY Economic Policy Review, Forthcoming)

### 6.2.1 Comment

- *In the name of risk minimisation, leverage limits may be imposed by the European Commission or national authorities and AIFM will have to inform investors of their maximum leverage levels. While this information may be of value to regulatory authority authorities, this policy is likely to create both legal and market uncertainty, increasing, rather than minimising, the risk exposure of investors and AIFM. Legal uncertainty would be created for various reasons, not least as the measurement of leverage is not straightforward and market participants are likely to seek to game whatever interpretation regulatory authorities apply. Market uncertainty would ensue as the efficient level of leverage for an AIFM is likely to vary over the quarterly period between informing investors of leverage levels (as required by the Directive). Anticipation of this possibility will lead AIFM to declare a leverage level at the outset of the quarterly period high enough to provide some flexibility over this period. AIFM will be mindful, however, of the possibility that to set too high a level may result in a loss of investor confidence. The proposed Directive heightens the probability of this possibility by encouraging investors to be more vigilant of AIFM leverage.*
- *The Commission IA does not consider the transition costs of moving from market equilibria under the current regulatory regime to new market equilibria under the proposed regulatory regime. Hedge funds that go out of business as a consequence of these changes may unwind their positions suddenly. Other AIFM, in order to avoid being covered by this regulation, may deleverage. The transition costs generated by widespread deleveraging in the present financial environment could be significant. (AIFM may choose to act in this way, even if the cost to their business of the proposed regulation is not particularly high, to be less visible to regulatory and tax authorities, as well as to the wider public. This limited visibility may be desired out of a fear of further regulatory or tax initiatives targeted at them — we think, for example, of the high public profile given to bank bonuses and the political pressure for special taxes on such bonuses.)*
- *Another kind of cost that the Commission IA has not anticipated is that the prescribed leverage limits may increase pro-cyclicality during turbulent financial periods by forcing deleverage upon AIFM as they fight to stay within their prescribed regulatory limits.<sup>30</sup>*
- *The thresholds are set so low as to regulate AIFM that operate exclusively in national markets and are too small to generate anything that might be thought of as a systemic risk. Much of the proposed Directive is justified in the IA by reference to cross-border activities, but this ignores the fact that a significant proportion of private equity, for example, is local and does not cross any border. This is also the case in respect of real estate funds.<sup>31</sup> The thresholds are so low as to make much of this activity applicable to the Directive, in spite of this activity having no systemic relevance (however this may be defined) and being important sources of liquidity for many EU businesses in a markedly more illiquid business environment. Whatever role leverage may play in generating systemic risk, it does not seem credible that AIFM at the lower end of these thresholds can be materially contributing towards this.*
- *There is some scope for regulatory get-around to be achieved by disguising leverage, which does little to improve transparency, or smoothing between periods, which is unlikely to be efficient, but this scope is constrained by the low thresholds.*

<sup>30</sup> See discussion on page 90 of the CRA report. Charles River Associates (CRA), *Impact of the proposed AIFM Directive across Europe*, prepared for the Financial Services Authority (FSA), October 2009

<sup>31</sup> Charles River Associates note: "Most real estate funds managed in Europe (with the exception of many UK managed funds) are understood to be domiciled in Europe ... The current (European) market is highly fragmented". (Charles River Associates (CRA), *Impact of the proposed AIFM Directive across Europe*, prepared for the Financial Services Authority (FSA), October 2009).

### 6.2.2. Possible Alternatives

- *Require all AIFs that are systemically significant to fall under the prudential oversight of their respective central banks. Require that all EU central banks specify leverage limits for systemically significant AIFs.*
- *Provide further consideration of what is deemed “excessive” and how the threshold might be reviewed over time to reflect changes in industry dynamics. It would seem desirable that the provisions do not apply to AIFM that are not systemically significant. Given this, there seems a case for reviewing the thresholds as currently proposed with a view to raising them.*

## 6.3. Impacts

### 6.3.1. Competition

Competition may be distorted by the controls on leverage contained in the proposed Directive. Specifically, we believe that many current firms would cease to operate (exit the market) and new entry (particularly new entry from small and innovative firms that may be particularly dependent upon leverage) would become much rarer than at present. Competitive could decline dramatically. This is likely to lead to a welfare loss for investors.

### 6.3.2. Investors

Investors in AIFM may be exposed to greater risks as AIFM have less access to leverage to diversify risk. However, it is plausible that investors in other assets may have reduced systemic risk, because incentives to over-lever may fall and it is plausible that recent bailouts of financial sector firms and past precedents such as Continental Illinois and Long Term Capital Management mean that there is at present an implicit bailout promise for AIFM sufficiently large, sufficiently connected and sufficiently over-levered to be systemically significant. (However, we note, again, that insofar as this is truly a material problem – and we suspect that it is highly material [indeed, we might go so far as to say *dangerously* material] – it is by no means obvious that this proposed Directive is the best mechanism for addressing it, as opposed to, say, placing all systemically significant AIFM under the prudential supervision of their central banks.)

## 7. GENERAL IMPACTS

### 7.1. Competitiveness of the EU versus Third Countries

The term competitiveness, when applied to a country (or to a group of countries), rather than to a firm, is an elusive concept and, as such, it can be measured differently, especially depending on the time framework of the analysis. However, in the long run, the competitiveness of a country mainly depends on its level of productivity *vis-à-vis* that of other countries. If financial markets work well, AIFM activity will tend to raise productivity levels through more efficient capital allocation; so, if the Directive reduces AIFM activity, as we expect, then productivity and, ultimately, competitiveness will decline.

### 7.2. Economic Growth

In principle, conventional neoclassical growth models predict that in the long run, the sustainable rate of growth in per capita GDP stems from the growth in Total Factor Productivity (TFP). We expect that reduced AIFM activity will reduce TFP, so feeding through, ultimately, to reduced economic growth. In contrast, the economic growth of third countries may increase as AIFM migrate from the EU to these countries.

However, we consider it plausible that alongside reduced growth rates there would also be reduced volatility in growth (and hence fewer periods of high unemployment). We believe it perfectly plausible that, insofar as the regulation can indeed curtail the activities it intends to curtail (about which we are doubtful) there is a growth/volatility tradeoff here. One can have an economy with a more dynamic and more innovative financial sector in which there is higher growth but occasional episodes of systemic collapse, recession and unemployment. Or one can have an economy in which the potentially more innovative parts of the financial sector (such as those covered by AIF and AIFM) are curtailed in their activities, with the result that growth is lower but there are fewer episodes of systemic collapse, recession and unemployment. The choice between these options is to some extent a brute matter of politics. Economists can only explain the tradeoff.

(We note, however, that the remarks above are predicated upon the idea that the activities at which the Directive is targeted can really be prevented, rather than simply diverted to another sector, by regulation. As discussed above, we are extremely doubtful on this point, and feel that the risk of regulatory hubris here is high.)

### 7.3. Market Volatility

Provided that the Single Market were actually deepened, rather than impaired, by the Directive, and that any beneficial effects of the deepening a Single Market more than outweighed the compliance costs, it is natural to suppose that larger and more diversified AIFM would be less vulnerable to economic shocks. This, in turn, may make their activity less pro-cyclical (for instance, they might be less inclined to avoid investment projects during recessions). This could in turn have important implications for the real economy, because a more efficient AIFM sector could mitigate the impact of recessions and, overall, reduce aggregate volatility in the economy. In turn, a more efficient AIFM sector could also have important implications for economic growth, specifically if it resulted (through financial sector linkages) in improved efficiency of retail credit markets.

Recent academic papers (e.g., Aghion et al., 2007)<sup>32</sup> have found that a more developed credit markets tend to reduce the impact of recessions on long run GDP growth because a more efficient credit sector manages to channel funds to healthy firms during recessions, which then allows the creatively destructive effects of recessions (e.g., the elimination of poorly performing firms, creating space for new innovations and new and more efficient competitive entry) to dominate whilst limiting the negatively destructive effects (e.g., fundamentally healthy and profitable firms being forced to exit the market because of cash-flow problems).

Though natural to assume, and indeed widely asserted before the credit crunch, the above reasoning should now surely be subject to question. First, although it is often thought that greater size increases diversification and reduces risk, in fact standard finance theory has long denied this, instead regarding firms as bundles of projects. According to standard finance theory there is no good reason to suppose that larger AIFM would be subject to lower systematic risks. And in fact in the financial crisis many large financial firms suffered very badly – their greater size did not insulate them from systematic risk exposure in a downturn. It may be true that, in normal times, a larger, more diversified firm is subject to less risk of bankruptcy, but it does not follow from this either in theory or in recent experience that this means that larger firms will be less likely to suffer in a systemic crisis, and hence there is no good reason to suppose that having a more concentrated AIFM sector would mean reduced systemic risk.

#### **7.4. Unemployment**

We believe that, at least as a first approximation, the Directive would not significantly affect the long-term unemployment rate, though there might well be short term impacts on the AIFM sector in some Member States, especially those with a more developed AIFM sector. Given that 9-10 million people in the EU are currently employed by private equity and venture capital funded companies and up to 30 million are employed by businesses that have received such funding in the past, these short term impacts on employment may be significant, particularly given the presently fragile state of most of the EU's economy.<sup>33</sup>

However, insofar as the Directive were successful in curtailing the activity of dynamic elements of the financial sector, with the result that growth would be lower (and hence long-term wealth much lower) whilst volatility was also lower, an important outcome of this would be that (across the economy as a whole, not merely within the AIFM sector) periods of high unemployment would be rarer.

#### **7.5. Wealth within and between Member States**

Depending on the Single Market might entail more intense competition and so potentially reduce the profits of AIFM. This could result in a transfer of wealth from AIFM to investors, as competition between AIFM incentives them to provide higher returns to investors. One potential way to quantify this would consider the reduction in the profit margin of the AIFM. Since the AIFM sector is currently fairly concentrated in a small number of Member States, this, as a first-round effect would imply a transfer of wealth from Member States with AIFM to Member States with investors in AIF.

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<sup>32</sup> Aghion, Angeletos, Banerjee and Manova (2007), "Volatility and growth: credit constraints and the composition of investment", mimeo.

<sup>33</sup> Charles River Associates (CRA), *Impact of the proposed AIFM Directive across Europe*, prepared for the Financial Services Authority (FSA), October 2009

However, this is not the end of the story. For if there were greater development in the Single Market, and if the result of the Directive were not (as discussed above in the sections on growth and unemployment) to be the curtailing of the activities of AIFM, but, instead, greater opportunities for them to market their services within the EU, it would be natural to expect this to present an opportunity for expansion to regions that already have a thriving AIFM sector. And it does appear that there may be material scope for AIFM to increase their operations cross-border within the EU. This might, then, increase the wealth of Member States with a current strong AIFM tradition, offsetting the competition effect above.

However, our view is that the impairment of function in the market would be so material that the redistribution effects should be understood against the background of a general overall reduction in wealth.

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## 8. APPENDIX 1

We note the following as a non-exhaustive list of the weaknesses in the Commission IA as compared with best IA practice.

### 8.1. Inadequate problem description

The problem description or rationale for policy intervention proposed in the Commission IA is inadequate and vague in two senses:

- The description of the problem lacks a robust economic structure (with the lack of this structure creating a lack of robustness that is sustained throughout the Commission IA);
- The significance of AIFM in the financial crisis claimed by the Commission IA exceeds that which other respected analyses of the financial crisis grant AIFM.

There are certain circumstances in which markets are believed not to function well, and in which policy intervention may improve efficiency if the benefits outweigh the costs. However, it is important not to mis-use the label "market failure" by applying it to outcomes which are deemed undesirable on the basis of a value judgement. It is necessary to construct a robust economic analytical structure to establish clarity over the market failure to be corrected by policy intervention. This market failure constitutes the rationale for intervention and policy interventions should be targeted on satisfying this rationale. The absence of a robust economic analytical structure in the Commission IA means that it is inadequate and imprecise both in terms of the market failure to be corrected and the extent to which policy interventions seem likely to satisfy the rationale for policy intervention created by these market failures.

The Commission IA claims: "The importance of AIFM to European financial markets ... have been underlined by the financial crisis".<sup>34</sup> In particular, the European Commission sees AIFM leverage as potentially generating a macro-prudential or systemic risk. In contrast, however, both the de Larosière and Turner Reviews conclude that, while AIFM contributed to disorderly deleveraging during the financial instability in 2008-09, AIFM did not play a major role in the emergence of the crisis.<sup>35</sup>

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<sup>34</sup> European Commission, *Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2004/39/EC and 2009/.../EC, Impact Assessment*, p. 8

<sup>35</sup> For a discussion on this point, please see the speech by Dan Waters, FSA Asset Management Sector Leader, FSA International Fund Forum, Monaco, 24 June 2009

## 8.2. Poorly defined Objectives

The lack of a robust economic structure means that the objectives of this policy intervention are inadequately defined. The Commission IA did not contain, for example, any description of policy objectives that correspond to the Four Questions.

The policy objectives given were also sweeping in that many of the issues addressed by the Directive (e.g. tax reporting, portfolio company disclosure, employee protection and short selling) are of a general market applicability. We are not convinced that any cogent case has been offered as to why a Directive targeted at AIFM is the appropriate instrument, as opposed to revisions to other Directives, new cross-cutting regulations/Directives relating to activities shared by AIFMs and other financial sector players, or regulation under the auspices of the ECB. Moreover, the umbrella of AIFM contains many only vaguely related financial practices and it is sweeping to seek to regulate all of these activities in a single Directive.

## 8.3. Lack of a Counterfactual

Impact assessment requires the development of a baseline scenario, as the European Commission's guide to impact assessment states, "to explain how the current situation would evolve without additional public intervention — it is the 'no policy change' scenario".<sup>36</sup> The European Commission's impact assessment does consider 'do nothing' as a policy option. However, this is quickly dismissed, as the following claim is made: "Without targeted action in relation to AIFM, there is no reason to believe that the risks highlighted by the crisis will dissipate".<sup>37</sup>

This is inadequate because the Commission's IA has no serious consideration of how the behaviour of and use of AIFM might evolve in the future. The financial crisis constitutes a major shock to these markets and it remains to be seen whether market responses to this shock will be sufficient to correct for the problems identified. The Commission IA gives little consideration to the possibility that such self-correction might occur or whether this may be achieved via the many other regulatory and policy responses that the financial crisis has motivated.

## 8.4. Limited Policy Options

An impact assessment should assess a range of policy options which could meet the stated policy objectives. Policy-makers may fail to identify the best policy option if only a single preferred approach is taken into consideration. However, we were able to suggest a range of alternative policy options for purposes of addressing the policy objectives in relation to the Four Questions. This suggests that consideration of policy options in the Commission IA was inadequate by being so narrow as to create the serious risk of precluding a policy option that more effectively and efficiently addresses the rationale for policy intervention.

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<sup>36</sup> European Commission, *Impact Assessment Guidelines*, 15 January 2009, pp. 23

<sup>37</sup> European Commission, *Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2004/39/EC and 2009/.../EC, Impact Assessment*, p. 38

## 8.5. Limited Analysis of Policy Impacts

While analysing the target, the level and the scope of the proposed regulation, the Commission's IA is inadequate in that it fails to assess the content of this regulation. The contents of the proposed regulations would bring sweeping change to the EU depositary industry, for example. But no analysis of this potential impact is provided in the Commission IA. This lack of depth in its analysis also leads to unrealistic and excessively optimistic conclusions being reached. For example, the proposed Directive is likely to increase the compliance costs of AIFM to a much greater degree than the IA acknowledges.<sup>38</sup>

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<sup>38</sup> Charles River Associates have estimate one-off compliance costs of up to €3.2bn for AIFM and ongoing compliance costs of around €311m for all market participants from the proposed Directive. (Charles River Associates (CRA), *Impact of the proposed AIFM Directive across Europe*, prepared for the Financial Services Authority (FSA), October 2009). Open Europe conclude that on average private equity and hedge funds would see their compliance costs increase by 31.5 percent under the proposed Directive. (Open Europe, *The EU AIFM Directive: Likely Impact and the Best Way Forward*, September 2009)