

Directive on Alternative Investment Fund Managers

Association of Investment Companies evidence to the House of Lords European Union Committee (Sub Committee A)

1. The Association of Investment Companies (AIC) welcomes the opportunity to provide written evidence to the Committee's inquiry and would be pleased to provide oral evidence to explain its position in more detail.
2. Investment companies are an important part of the UK's investment landscape. They offer competitive costs, independent governance and access to alternative asset classes. Their shareholders include pension funds, insurance companies, unit trusts, wealth managers and retail investors. They invest in publically traded equities, private equity, property and debt. Some employ hedge fund strategies. (See annex 1 for industry overview.)

Headline concerns

3. Recent market turbulence, and its broader economic impact, creates a case for updating the regulation of 'alternative investment funds' (AIFs). However, in pursuing this agenda, European policymakers should seek to deliver well targeted, effective and proportionate regulation – not simply more regulation. Unfortunately the AIFM Directive ('the Directive') does not achieve this.
4. **Targeting:** The Directive fails to target its regulatory ambitions primarily because it focuses on regulating particular market participants, namely AIFs, rather than abusive activities. For example, the Directive includes measures to increase transparency where EU companies are bought by private equity funds. Whether this is appropriate is debatable. However, if this *is* an appropriate regulatory intervention, it is not clear why the measures are not relevant for, say, private equity funds which are not governed by the Directive, sovereign wealth funds, rich individuals and conglomerates who, as the measures are currently constructed, will not have the same obligations. Similar issues arise throughout the Directive, for example in relation to investing in securitised assets. The failure to target behaviour which causes regulatory concern contrasts with, say, the Market Abuse Directive, which identifies damaging behaviour (insider trading etc.) and seeks to control it regardless who is involved.
5. **Effectiveness:** Where the Directive does impose regulatory obligations it fails to do so effectively. For example, it creates obligations regarding depositories and gearing which purport to reduce risks in the financial system. Unfortunately, instead of controlling these risks these measures threaten to increase them. The proposals on depositories envisage these functions only being carried out by EU credit institutions. At the moment other entities, including for example, American banks, carry out these roles. Limiting these activities to EU credit institutions will ultimately concentrate, and increase, counterparty risks. A crisis for one EU bank could have more significant implications than if these activities were spread more widely.

6. Risks are also increased by the proposed leverage cap. Recent market events highlighted problems of pro-cyclical asset sales, where investors sell assets into falling markets which magnifies market movements. A hard leverage cap, enforced through regulation, creates the prospect that funds with exposure to a particular market sector could be obliged to sell assets where the price of those assets was falling and this raised their relative gearing levels. They would then sell assets to raise funds to reduce their debt. Caps would therefore encourage asset sales into falling markets, which is just the situation policymakers have expressed concerns about. Hard leverage caps applied on a formulaic basis across markets do not represent an effective regulatory intervention.
7. **Proportionality:** The Directive is not proportionate because it threatens serious, negative consequences for all investment companies without providing compensating regulatory benefits. These risks arise regardless of the company's size, assets, domicile or the market on which they trade their shares. Problems include:
 - Preventing share issues, which would stop existing companies managing their share structure in the interests of shareholders and new launches.
 - Stopping boards having full control of the company's activity by creating competing regulatory obligations for the external fund manager. This will create conflicts within the structure and compromise the board's ability to ensure the consumer interest is paramount.
 - Stopping investment companies from using non-EU suppliers (which prevents the employment of managers with regional investment expertise) and non-EU domiciles (which will prevent them offering investment strategies on a tax-efficient/commercial basis).
 - Duplicating existing obligations (where the Directive overlaps with other EU legislation i.e. the Transparency and Prospectus Directives etc).
8. The first three problems identified above could fundamentally undermine individual investment companies. The last threatens to unnecessarily increase costs to investors. Any of these outcomes should be unacceptable. The goal of regulation should be imposing effective and proportionate controls - not preventing some AIFs from operating at all. The Directive threatens the sector's ability to meet investor needs. Its potential impact is far greater than for some other affected vehicles which only face additional compliance burdens and commercial restrictions.
9. The AIC is wary of predicting catastrophic outcomes, as concerns about regulation are often overdone and are normally ruled out by a careful policymaking process. In this case, a lack of consultation and understanding of investment companies' unique characteristics mean that profoundly damaging outcomes are a real threat unless the proposals are adjusted.

Resolving problems with the Directive

10. The priority should be identifying how the proposals can be improved to deliver better regulation. This should involve integrating the Directive effectively into the existing regulatory context and refining specific proposals to ensure they are appropriate i.e. targeted, effective, proportionate etc.
11. **Integrating the proposals into the existing regulatory context:** Many of the Directive's problems could be resolved by co-ordinating it with existing regulatory obligations which have proven to be effective. For example, the Market in Financial Instruments Directive (MiFID) and Undertakings for Collective Investments (UCITs) Directive have provisions on delegation. These have been tested over time. These models should be used for the Directive, which at the moment offers an alternative approach which is problematic in a variety of ways.
12. Existing regulatory mechanisms should also be used to resolve problems the Directive creates for investment companies. Specifically this would resolve the threats the Directive poses to the current governance structure. The AIC is advocating that the regulatory objectives of the AIFMD be applied to investment companies using existing regulatory mechanisms (i.e. the Listing Rules, Prospectus Directive, Transparency Directive etc) to deliver equivalent obligations for EU listed investment companies. This would involve tailoring those Directives to add-on necessary obligations where there would otherwise be regulatory gaps. This approach would then allow listed investment companies to be safely removed from the ambit of the AIFM Directive, which would resolve key problems. This approach would:
 - deliver equivalent standards of regulation for investment companies regardless of their asset allocation or domicile.
 - avoid any potential for regulatory arbitrage while using a proven route to deliver regulatory control.
 - remove problems with applying the AIFM Directive to funds which are not led by an AIFM and recognise the diversity which exists in the AIF market.
 - allow investment companies to compete with other funds without undermining the ability of the structure to deliver shareholder benefits.
13. Utilising existing regulatory mechanisms, including adopting an alternative regulatory approach for listed investment companies, will allow significant improvement of the Directive. It will also demonstrate policymakers' commitment to proportionality and desire to deliver workable regulation which meets the needs of industry as well as consumers.
14. **Refining specific proposals:** Refining the AIFMD proposals should also focus on the specific obligations it creates. Refining the Directive will remove unintended consequences, unnecessary costs and compliance burdens.

15. For example, the Directive should remove the restriction on investment companies issuing shares (Article 4). The Directive envisages that an AIFM would issue shares and seeks to stop any other entity undertaking this activity. However, investment companies issue shares in their own right, in accordance with company law and under established regulations (e.g. the Prospectus Directive). Shareholders approve new issues and Directors must take into account their interests before acting. There is no reason to end this approach. Suggesting that external managers should be in charge of this process fails to recognise the nature of the investment company structure and the existing rules which underpin it. Stopping investment company share issues would mean the demise of the sector in a few years as no new funds could be raised to compensate for the normal process of capital leaving the sector. This should not be an acceptable outcome of regulating AIFs and the Directive should be revised accordingly.
16. The Directive also currently requires AIFs to have a liquidity profile in their underlying assets which allows them to offer redemption on demand (Article 12). This may be an appropriate requirement for open-ended funds (which may require asset sales to meet redemption demands). It is not suitable for closed-ended funds (where investors realise their capital by buying and selling shares on a market and there is no link to the liquidity of the underlying portfolio). There are benefits of this closed-ended approach, notably facilitating investment in less liquid assets, such as property, infrastructure or private equity. The AIFMD's concentration on open-ended structures illustrates its failure to recognise the diversity of the AIF market and that different types of fund offer different advantages to investors. Again, this provision should be amended.
17. Every aspect of the Directive should be examined and changes made to ensure the regulatory obligations created are appropriate and effective.

Specific questions

18. ***What economic benefits arise from Alternative Investment Funds? What risks to financial markets arise from Alternative Investment Funds? Will the Directive help reduce these risks?***
19. AIFs, such as UK investment trusts, provide capital for investment in European companies, property, and infrastructure. They invest, for example, directly in shares and corporate debt issued by other European companies.
20. AIFs also provide investment opportunities for pension funds and other investors seeking to spread their investment risk. This helps them secure an investment return for consumers (pensioners etc) without concentrating their risk too narrowly. Ultimately this helps provide for the future financial needs of individual citizens across the EU. At the same time, competition between AIFs and other funds bears down on costs and reduces the drag on investment performance. (See annex for discussion on costs in investment companies.)

21. AIFs may create some risks for investment markets. However, these have not been defined for the purposes of the Directive and they may not be solely the preserve of AIFs. For example, recent experience has shown that investment in securitised assets, where investors are uncertain of the risks they incorporate, can create regulatory issues. There may be a case for adjusting the regulatory regime surrounding these instruments to mitigate these risks. The Directive therefore proposes limiting AIF investment in securitised assets to those where the originator retains a 5% interest in the asset. However, if this is the correct approach to reducing risk from this asset class, the Directive is wrong to limit the restriction to AIFs. This is a partial response which, for example, does not cover the proprietary trading activities of banks, despite the fact that these institutions were central to recent problems in financial markets (not AIFs).
22. One difficulty in assessing the effectiveness of the Directive is that the regulatory risks it is supposed to address have not been defined and prioritised. However, as it targets selected market participants rather than behaviour, it is unlikely to be effective in its regulatory ambitions.
23. ***To what extent is there a need to create a single regulatory regime for Alternative Investment Fund Managers in the European Union? Does the Directive achieve its objectives? Should the objectives of the Directive be modified?***
24. The focus of regulatory intervention should be on securing proper regulatory outcomes, not delivering a single piece of legislation. One directive is unlikely to be able to adequately cover all issues and market participants which create regulatory risks. There is no benefit to using one directive to address regulatory issues; instead this creates the potential for regulatory gaps.
25. Rather than focussing on mechanisms (single or otherwise) a better approach would be to define risks and what factors exacerbate them. Specific regulations should then be introduced to target identified problems – whoever is involved, be they AIFs or any other market participant. Unfortunately, the Directive has not been based on this approach. It is therefore unlikely to achieve its intended goals.
26. ***What risks arise from Alternative Investment Funds? Is the Directive proportionate given the role of AIF in the financial crisis? Will the Directive introduce over-stringent regulations or does it not go far enough?***
27. AIFs were not the source of the financial crisis, and this has been recognised by a variety of policymakers. In this context, the adverse effects of the Directive cannot be justified as a necessary response to the financial crisis. Therefore, conventional regulatory processes, and proper cost benefit analysis, should be a priority as policymakers seek to scrutinise and revise the Directive's proposals.

28. There is no question that the Directive will have a disproportionate impact on investment companies in its current form. Just one outcome, preventing investment companies from issuing shares, will ultimately mean the terminal decline of the sector as funds leaving it cannot be replaced. Regulation must be disproportionate if it curtails the operation of a sector which was not responsible for the financial crisis and for no regulatory benefit.
29. The poor construction of the Directive makes it difficult to assess its overall impact. Each provision needs specific analysis. Nevertheless it is clear that overall the Directive's impact is negative and disproportionate.
30. ***Is it appropriate to regulate Investment Fund Managers, rather than the Fund itself? Does the Directive contain appropriate provisions to distinguish between different types of alternative investment? Does the scope of the Directive create a danger of unintended consequences?***
31. Many of the Directive's provisions regulate the AIFM/AIF sector instead of behaviour, which is inherently problematic. However, there are also flaws in introducing proposals which assume that regulation of the manager is the correct approach. For some fund structures this is the right approach. For others, notably the investment company sector, it is not.
32. The AIC is therefore proposing an alternative route to regulating investment companies, based on existing regulatory provisions (see discussion on integrating proposals into the existing regulatory context). This would secure a correct regulatory outcome, without unduly damaging the sector.
33. ***What is your evaluation of the Commission's consultation in the preparation of the Directive?***
34. Consultation before the Directive was published was poor. The Commission issued general calls for views on issues surrounding hedge funds and private equity. However, it did not undertake the customary consultation which would be expected on specific proposals. This has meant the Directive is poorly targeted and creates significant unintended consequences. It also means that it is unlikely to secure the desired regulatory outcome.
35. From a policymaking perspective it is unfortunate that this lack of early consultation could ultimately extend the timetable for introducing regulation. This would arise as the participants in the debate are occupied with issues which might have more easily be resolved before a declared policy position was published. The process may also have needlessly undermined trust in the policy making process, which is undesirable as confidence is invaluable in encouraging open dialogue and formulating an effective policy outcome. It should be a priority for the future to ensure that future policymaking processes do incorporate proper consultation processes as this will produce better outcomes for all parties concerned.

36. ***Will the passport system help create a single market in investments funds within the EU? How will the passport system established affect the EU and the UK industry and particularly their position in the global market?***
37. The passport system is not relevant for investment companies as many can already 'passport' via the Prospectus Directive. Interestingly, the sector has not tended to take advantage of this because of other barriers to developing a single market – notably tax issues.
38. The proposals will also fail to deliver a single market because they deny the passport to funds located outside the EU for a period of 3 years once the proposals come into force. This will apply even where they have an authorised AIFM. There is no regulatory justification for this provision. It is a serious obstacle to any claim that an effective passport will be created.
39. ***Is the threshold for defining “systemically relevant” Alternative Investment Funds appropriate? Should the Directive include provisions on capital requirement? Does the Directive contain appropriate rules on leverage? Is the requirement for independent valuation agents and depositaries for Alternative Investment Funds adequate?***
40. The Directive will affect funds which are not systemically relevant. For example, VCTs with an external fund manager which breaches the thresholds set by the Directive will be caught by the proposals. This is despite the fact the majority of these VCTs manage only a few tens of millions of pounds/Euros and create no systemic risk.
41. This issue could be resolved by creating an additional 'fund' threshold of, say, 100m Euro. Under this approach the AIFM would be subject to the provisions of the Directive where it breached the current thresholds, except in respect of funds which fall under the 'fund level' threshold. This would exclude from the regime funds which have no conceivable systemic impact.
42. ***Will the provisions strengthening disclosure requirements help to create a more transparent market or do they go too far?***
43. Listed investment companies are already subject to substantial public disclosure obligations through the Transparency Directive and Prospectus Directive. The AIC is unconvinced that the Directive's proposals offer any substantive improvements in transparency for these entities.
44. We are aware of current reviews by the Commission of these two aforementioned Directives. Our understanding is that these reviews have not identified any significant gaps likely to cause consumer detriment. In any event, before imposing additional obligations of funds already covered by these measures, it would be appropriate to await the results of these reviews.

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

The AIFMD threatens a range of unfortunate outcomes for European capital markets. In particular, insofar as it threatens market entry by non-EU funds it creates the potential for retaliatory action from other jurisdictions. This would be a highly unfortunate outcome which could have unintended consequences – not least a reduction in sources of capital for EU companies. The Directive could also reduce choice for institutional investors and increase costs.

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Annex 1: Overview of investment company sector

The UK's investment company industry is comprised of some 519 companies, including UK investment trusts, Venture Capital Trusts, and non-EU domiciled companies (which are overwhelmingly located in Guernsey and Jersey). All have shares which are traded on a public market and are aimed primarily at UK investors. The sector currently manages some Euro 111 billion of assets.

Most investment companies are officially listed on EU regulated markets and are governed by Listing Rules (as set out in the Consolidated Admissions and Reporting Directive, or CARD), the Transparency Directive, Prospectus Directive, Market Abuse Directive (MAD) and, where they are domiciled in the EU, Company Law Directives.

Investment companies are 'closed-ended'. European regulation defines a closed-ended fund as a fund where the investors have no right to redemption of their shares out of the assets of the company. Investors in closed-ended funds therefore generally realise their investment by selling through the stock market, which has no effect on the underlying portfolio. In open-ended funds, the manager may need to sell investments in order to meet redemption requests from investors. Closed-ended funds are therefore particularly suitable for unquoted assets (property etc), as the fund manager does not ever have to realise investments to raise money to meet redemptions.

Each investment company is governed by a board of directors, which provides strategic oversight of the company. The directors ensure that the portfolio is invested in line with the investment policy agreed by the shareholders. It monitors the performance of the external fund manager. The day-to-day management of the portfolio is normally subcontracted to a UK regulated fund manager who can be replaced by the board, for example, in the event of persistent poor performance. Since the start of 2004 the contracts of some 40 portfolio managers, or around 10% of the sector, have been terminated and new managers appointed. This exemplifies the role the board plays in adjusting the operation of the company to fulfil their duties to shareholders.

Short of replacing a manager, the board offers value by challenging potential conflicts of interest and testing the manager's approach to ensure it is focussed on shareholder interests. This helps secure lower costs for investors. AIC research published in 2008 found that investment companies (excluding those with split-share structures or VCTs) saw their charges as a percentage of assets fall for the third year running. The proportion of investment companies with TERs under 1% increased from 25% two years ago, 28% a year ago, to 30% when the survey was published.