



Alternative Investment
Management Association

AIMA Position Paper on the European Commission's Draft Directive on Alternative Investment Fund Managers (AIFMs)

9 October 2009



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Note: The AIFM Directive sets out proposals which have relevance to all Alternative Investment Fund Managers. AIMA's comments, however, are restricted to the Directive's likely impact on hedge funds and funds of hedge funds, and their respective managers only.

1. Introduction

- 1.1 The Alternative Investment Management Association (AIMA¹) is the not-for-profit trade association which represents the hedge fund industry globally. Its membership comprises 1,100 corporate bodies in over 40 countries and is drawn from all constituencies which make up the hedge fund sector - including hedge fund managers, fund of hedge funds managers, prime brokers, administrators, accountants and lawyers.
- 1.2 AIMA welcomes the close attention given by the European Commission (Commission) to the issue of how best to regulate and supervise the wider alternative investment fund (AIF) industry in light of the banking crisis which has caused so much turmoil recently to the markets in which such funds operate. The interests of the hedge fund industry are in fact fully aligned with those of policy makers, regulators, and, most importantly, the investors whom they serve - all concerned wish to see the development of an effective regulatory environment based on appropriate and proportionate requirements.
- 1.3 AIMA endorses the principle of a harmonised EU regime, which will provide appropriate levels of investor protection and will help guard against potential systemic risks which may be associated with AIFs. We are not opposed to regulation. Indeed, in some areas we would go further -we would like to see the development of a harmonised global regime, built on the initiatives set out by the G-20 declaration and the subsequent work undertaken by IOSCO.
- 1.4 The Commission's Directive on Alternative Investment Fund Managers (the Directive) contains much that AIMA welcomes and supports.
 - **Registration of hedge fund managers** - AIMA has long led the calls for the registration and authorisation of hedge fund managers globally. Indeed, as explained below, we would prefer the Directive to go further than currently proposed, by removing the *de minimis* threshold for authorisation of alternative investment fund managers (AIFMs) - (see paragraphs 2.1 to 2.7 below).
 - **Disclosure of systemically relevant data to regulators** - AIMA recognises that regulatory authorities need to be provided with systemically relevant data from all applicable market participants, including hedge fund managers. It is important, however, that regulators seek not only the correct type of data but also the correct volume of data.
 - **Enhanced transparency** - An appropriately drafted Directive will lead to AIFMs disclosing more information to counterparties and to investors, which will, in turn, result in greater investor protection. This is in everyone's interest and will allow the alternative investment industry to continue to deliver much needed benefits in associated areas, such as employment and pension provisions.

¹ For further information regarding AIMA, see Annex 1

- **EU Passport** - We welcome the Commission's concept of a pan-European passport which would allow an AIFM who is authorised in one Member State to market funds to specified EU investors in other Member States without requiring further authorisation. Much has been made of the need for regulation of the EU single market in financial services and the pan-European passport is a necessary measure in this regard.

1.5 However, it is our belief that the Directive in its current form is not capable of delivering, to the proper and fullest extent possible, the regulatory conditions necessary to deliver these benefits. A number of its provisions cause us real concern since we consider that they will diminish the returns of EU investors, damage the EU's hedge fund industry (currently worth in the region of €250 billion) and deprive the EU of much needed capital inflow and liquidity.

1.6 Amongst our concerns, which we set out more fully below, are that:

- the rationale of the proposed Directive is questionable in that it addresses 'systemic risk' and yet the role of hedge funds in the global financial crisis was marginal. All significant analysis, including the de Larosière Report² to the Commission and the Turner Review³, has concluded that the hedge fund industry neither caused the crisis nor played a significant role in it. This point is, indeed, accepted in the Explanatory Memorandum which accompanies the Directive. Our view, therefore, is that the current draft of the Directive does not represent a proportionate response on the part of the Commission;
- the Directive does not take into account the current, fully operational and complex regulatory framework already in place in many EU Member States, as well as the need to comply with existing EU legislation, such as Markets in Financial Instruments Directive (MiFID), the Market Abuse Directive, the Capital Requirements Directive (CRD), the Prospectus and Transparency Directives and others;
- the Directive ignores the extensive work carried out in the UK and in the US (which is home to the great majority of hedge fund managers), to produce and develop industry standards. Further work was done this year to harmonise the standards along international lines and in compliance with the request of the G-20 in 2009. These proposals have been presented to the Financial Stability Board and are currently being reviewed by IOSCO. As several policy makers and commentators have argued, AIMA believes that this work should be acknowledged and reflected in the Directive;
- there are a number of areas where the outcome of the Directive's provisions would be detrimental to the EU's standing as an attractive location for investment. Fundamental harm would be caused to investors in AIFs. Since the majority of assets under management by hedge funds and funds of hedge funds globally is now derived from institutional investors, including pension plans (which, alone, account for a third of such institutional investment), endowments, charitable foundations and others, any harm which is caused to the industry will also have a consequential, adverse impact on the individual end users - that is, ordinary citizens, including pensioners across the EU. We examine below (see Section 3A to 3C) the following areas where we believe the Directive could give rise to such damage:

² http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf

³ http://www.fsa.gov.uk/pubs/other/turner_review.pdf

- the Directive as a protectionist measure;
 - reduction in investor choice; and
 - third country marketing;
- in addition, the Directive, as drafted, does not properly accommodate or reflect the way in which the hedge fund industry is structured and operates. On this issue, we deal below (see Section 3D to 3F) with our specific concerns in respect of:
 - leverage;
 - depositories; and
 - master/feeder structures.
- 1.7 It is our strongly held view, therefore, that the many positive benefits which the Directive could bring about risk being undermined unless there is a measured and thorough revision of the Directive's scope and of those provisions which have such undesirable and unintended consequences. Without this work, the Directive will not only fail to deliver the enhanced investor protection that is its stated aim but will, instead, significantly limit the choice and opportunity currently available to EU investors. The effect will be to raise the cost of their investment while depressing the returns they receive from them.
- 1.8 It is inevitable that the Directive will have fundamental implications for the future of Europe's financial markets. It is extremely regrettable that, as a result of political pressure, it has been produced in haste, with inadequate consultation among stakeholders, including the AIF industry and those who invest in it, and without a rigorous impact assessment. Experience shows that the most effective legislation is drawn up following effective and full consultation and drafted by those with technical expertise. In the absence of these, the result is too often, as here, a text which will require substantial clarification and redrafting before it can deliver the benefits which a harmonised regulatory and supervisory framework would bring.
- 1.9 AIMA fully recognises the impetus for greater regulation and supervision of the hedge fund industry. As the voice of the global hedge fund industry, we seek to play a positive and constructive part in the work of reshaping those areas of the Directive where we consider the current provisions require either clarification or revision. We will be working further to prepare, in the near future, specific proposals, which we believe would offer ways to overcome many of the problems which we identify in this Position Paper.
- 1.10 AIMA looks forward to working constructively with the Commission, the Parliament and the Council to produce a revised Directive which:
- introduces appropriate and proportionate levels of protection for professional investors;
 - achieves a sensible and efficient means of regulating and supervising AIFMs;
 - ensures regulators are provided with the data which they require to monitor financial stability effectively within their markets without overwhelming them with additional, but systemically irrelevant, information; and
 - safeguards the interests of the EU's existing investor base while ensuring that the EU remains an attractive market for new investment, thereby providing enhanced returns for EU pensioners along with job opportunities and job security for those many thousands of citizens working in, or servicing, the AIF industry within the EU.

2. Aspects which AIMA welcomes

A Registration of hedge fund managers

- 2.1 AIMA has long supported the registration and authorisation of all hedge fund managers globally and believes that the rules of the UK's Financial Services Authority (FSA), which require this, provide a good model for other jurisdictions to follow.
- 2.2 At present, the Directive is unclear on the fundamental question of which entity is intended to be the AIFM - this issue needs to be clarified as a matter of urgency.
- 2.3 Regardless of this, however, given the difficulty of defining exactly what is, and what is not, a hedge fund manager, we feel that all those who manage relevant assets - whether they are traditional managers, alternative managers or others - should fall under essentially the same regulatory regime. There is no rationale for requiring an AIFM to be authorised while, at the same time, excluding an EU credit institution from the scope of the Directive when it is acting as an AIFM.
- 2.4 AIMA's view is that any entity which acts as an AIFM, regardless of its legal form or structure should be regulated in the same way as other AIFMs. This would not only create a level playing field between different market participants but also ensure that regulators see the whole picture when assessing the risk posed by AIFMs to the financial system.
- 2.5 Whether a fund manager requires to be authorised should be determined by the activities which it carries out, not by the amount of funds it has under management. In setting a minimum threshold for registration of €100 million, the Directive confuses two vital but separate issues - authorisation and disclosure.
- 2.6 In respect of authorisation, there is no logical reason why AIFMs managing under €100 million should not be subject to regulation while those above that level are. Any such threshold would, by its nature, be arbitrary and would allow an AIFM falling below the limit to 'stay out of sight' of its local regulator, so avoiding the requirements which the Directive seeks to introduce. This merely increases the possibility of misconduct going undetected. The threshold for authorisation should, therefore, be zero.
- 2.7 More widely, we believe that both (a) the process used by the FSA to assess whether an entity which has applied for authorisation is "fit and proper" and (b) its supervisory regime for regulated firms could act as good templates on which to build a harmonised pan-European model.

B Disclosure of systemically relevant data to regulators

- 2.8 We agree that regulators need to be provided with systemically relevant data from all applicable market participants, including hedge fund managers. It is important, however, that regulators seek not only the correct type of data but also the correct volume of data. They should take great care to avoid being inundated with information which they have requested, but which they may not have adequate resources or expertise to analyse and/or process, and thereby create an increased risk of moral hazard.

- 2.9 Retaining a disclosure threshold of €100 million would mean that virtually every hedge fund manager would provide its regulator with all information required under the Directive. However, the vast majority of such managers cannot, by any reasonable assessment, be regarded as having any systemic importance. (We would note that, although a number of funds have closed as a result of the current financial crisis, they have done so, almost without exception, in an orderly way and with no impact on the wider market.)
- 2.10 Regulators would, therefore, risk finding themselves overwhelmed with a great deal of data, but data which had very little prudential worth. A disclosure requirement which is set too low is more likely to conceal the build up of problems than it would be to uncover them - the information which regulators might need in order to identify issues at an early stage would be hidden among a mass of essentially irrelevant data.
- 2.11 We believe that the threshold, for disclosure purposes, should be raised to €1 billion - this figure would allow regulators to capture the necessary systemically relevant data without also capturing the surrounding 'noise'.
- 2.12 AIMA has been working for some time with the FSA to develop a reporting template as to the data which would most assist regulators; we would also support collection of such aggregated data at an EU level through cooperation between the national regulatory authorities of the Member States or within the new EU regulatory framework proposed under the de Larosière Report.

C Enhanced transparency

- 2.13 AIMA supports and encourages moves towards the enhanced provision of information by fund managers to counterparties and investors. AIMA has developed, over a number of years, a series of Guides to Sound Practices and comprehensive Due Diligence Questionnaires, which explain in detail the information which we believe should be made available to each of these parties.
- 2.14 However, it should not be overlooked that the investor base of an AIFM is, primarily, that of institutional and/or sophisticated investors. These may be expected to have both (a) the knowledge and expertise and (b) the commercial weight to be able to insist upon the provision, by the AIFM, of any information which the investor considers necessary.
- 2.15 Nevertheless, we reiterate our support for measures to harmonise such requirements, provided that:
- these are set at a sensible level to avoid creating sources of systemic instability or moral hazard, bearing in mind the nature of the customer;
 - the cost of compliance (and, therefore, the cost to the end investor) is kept proportionate; and
 - reasonable consideration is given to protecting the intellectual property of market participants.

D EU passport

- 2.16 The establishment of a passport for AIFMs to market to specified investors within the EU is a welcome and positive step. If implemented in the correct way, this will reduce existing operating and compliance costs and will equalise opportunities for investors in different Member States.
- 2.17 It is important, however, that the Directive's provisions should not be narrower than, nor should they undermine, the existing national private placement regimes in Member States. Since not all Member States currently allow this, the Directive should make clear that AIFMs may market to Professional Investors (as defined under MiFID) across the EU as a whole, while permitting - though not obliging - individual Member States to allow the marketing of AIFs to a wider class of investors in their own jurisdiction if they so wish.

E Short selling

- 2.18 AIMA supports the development of a global, harmonised short selling regime. We continue to work closely with IOSCO to develop such a framework.
- 2.19 Short selling is widely recognised⁴ as being an entirely legitimate investment strategy which plays a positive role in many respects. Furthermore, it is a strategy which is used by a wide variety of market participants, not only by AIFMs.
- 2.20 Since the Directive seeks to introduce regulations in respect of one sector of the financial markets only - AIFMs - it cannot be the appropriate vehicle by which to develop coherent rules in relation to short selling in general. Instead, the Commission should continue to work in cooperation with IOSCO, CESR and other international and regional bodies in order to agree, so far as is possible, a single comprehensive and coherent short selling framework for all market participants. CESR's recent consultation paper on short selling, for example, seeks the introduction of an EU-wide regime which would be applicable to all those who short sell, rather than being restricted to any specific sector.
- 2.21 We are also aware that the Commission is undertaking a review of the Market Abuse Directive (MAD) and we support this work. The regulatory concerns regarding short selling which have been expressed to date have been based primarily on the fear of potentially abusive behaviour, especially in extreme market conditions. (We would note, however, that no evidence has been put forward to suggest that short selling has, in fact, been used abusively - if such evidence exists, it is in the interests of all that it be made public to deter others who might be tempted to abuse the markets.) The MAD, therefore, provides a far more appropriate framework than the Directive in which to develop rules regarding short selling. AIMA stands ready to provide any appropriate assistance and input to such work.

⁴ See, for example, IOSCO's Final Report, "Regulation of Short Selling" (June 2009) <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD292.pdf> and CESR's Consultation Paper, "CESR Proposal for a Pan-European Short Selling Disclosure Regime" (July 2009) <http://www.cesr.eu/popup2.php?id=5791>

F International cooperation

- 2.22 The Commission's work in developing the Directive must be seen as only part of a global response to a global crisis. AIMA recognises and applauds the measures taken by the Commission in this spirit.
- 2.23 The hedge fund industry has a worldwide scope, covering markets from the Americas to Japan and Australasia and with significant manager bases in all of the main regions of the globe. As mentioned above, it is generally accepted that hedge funds were not the cause of the current financial crisis; they are, though, capable of being part of the solution, bringing liquidity and price discovery to the markets and, even in the most recent difficult markets, providing better investment returns than traditional asset classes.
- 2.24 It is essential that the Commission's work continues to be in line with the G-20 Declaration of April 2009 and that the European market plays its full part in (and accrues the full benefit of) the financial recovery.

G Industry-led standards

- 2.25 In line with the G-20 Declaration of April 2009, and in coordination with the Financial Stability Board (FSB), AIMA, together with a number of other industry bodies (the Hedge Fund Standards Board, the Managed Funds Association and both the Investors' and Asset Managers' Committees of the President's Working Group) have participated in a working group to create harmonised best practice standards for the hedge fund industry, which would be applicable to managers wherever they are based.
- 2.26 A document setting out Principles of Best Practices for Hedge Fund Managers was delivered to the FSB by the above-mentioned working group on 24 June 2009; this is now being evaluated by an IOSCO taskforce to determine potential next steps. AIMA is committed to continuing to assist with this work, which we see as providing an integral and important part of the regulatory and supervisory infrastructure, and one which should help ensure high standards of conduct, enhanced investor protection, increased transparency and cooperation with regulatory authorities.
- 2.27 We firmly believe that such industry-led standards should play a material part in any regime under which hedge fund managers are to be supervised, both across the EU and in the other major regions in which such managers operate.
- 2.28 Specifically, within the EU, detailed standards covering valuation, risk management, disclosure, governance and shareholder conduct have already been developed by the London-based Hedge Fund Standards Board, with the potential for these standards to be adopted at their discretion by national supervisors in those countries with principles-based regulatory regimes. This body of standards, which AIMA publicly supports, is designed to be an adjunct to statutory regulation.

3. AIMA's concerns

- 3.1 Although there are many potentially positive aspects to the Commission's proposals (as outlined in Section 2 above), a number of the Directive's provisions cause significant concern. In some instances, this may simply be a result of the haste with which the Directive was produced and the lack of proper consultation through which it went. Clarification, or revision, of the text would suffice to resolve a number of these concerns - AIMA has provided comments on a number of such issues and met representatives of DG Markt in order to help remedy them.
- 3.2 In other cases, however, we believe the outcome of the Directive's provisions would be so detrimental to the best interests of EU citizens and to the EU's standing as an attractive location for investment, that we do not believe that the Commission foresaw fully the consequences of its proposal. We examine these areas first (see Sections 3A, 3B and 3C below).
- 3.3 Finally, the current text shows a misunderstanding as to how the hedge fund industry operates - without appropriate amendment, it could require a potentially major restructuring of businesses and business models in order to comply with the Directive's provisions. The cost of such restructuring would inevitably be passed on to the end investor, reducing returns on investment. We mention below three specific examples, which are of particular importance; namely, those requirements in respect of leverage (see section 3D), depositaries (see Section 3E) and master/feeder structures (see Section 3F).

A The Directive as a protectionist measure

- 3.4 The Directive conflicts, in effect if not in intent, with G-20's global plan for recovery and reform - which calls for regulators and supervisors to "reduce the scope for regulatory arbitrage" and to "resist protectionism".
- 3.5 The Directive in its current draft is protectionist in a number of areas, most notably in the context of third country marketing (see Section 3C below). To create a 'Fortress Europe' would be to isolate Europe from the benefits of globalisation in this most global of industries. The losers at the end of the day would be EU investors, who stand to be denied access to the very large majority - we believe in the order of 90 to 95% - of the funds and fund managers which are available to them today.
- 3.6 An appropriately drafted Directive would deliver, within Europe, levels of investor protection suitable for the type of investor concerned and a proportionate disclosure regime under which national regulatory authorities could monitor financial stability in their markets effectively. Such provisions would underpin the attractiveness of Europe in the eyes of investors and would lead to the continued growth of the EU's alternative asset management industry. Such growth would have a positive impact on employment and create further investment opportunities within Member States. This, however, will not come about if protectionist measures are introduced.

B Reduction in investor choice

- 3.7 For reasons upon which we expand below, the Directive as currently drafted would cause potentially significant damage to the investor community within the EU. The impact would be both direct - hitting the institutional and pension fund investors which invest directly into AIFs - and indirect, affecting the EU citizens who, through their insurance, savings and pension plans are customers of those institutional and pension fund investors.
- 3.8 AIMA considers it vital that due regard be given to the views of investor groups as to the impact that the Directive will have on their business.
- 3.9 In particular, the provisions regarding third country marketing (see Section 3C below) have the potential to lead not only to non-EU funds, and EU funds managed by non-EU AIFMs, becoming unavailable to EU investors but also to the closing of non-EU markets to EU funds and EU AIFMs as a "tit-for-tat" measure.
- 3.10 In addition, operational costs (including compliance costs) for AIFMs within the scope of the Directive will inevitably rise. Some of this additional cost is likely to be borne by the AIFM. But, in an increasingly competitive market, not all firms will be able to absorb these extra expenses in full and some part of the increase will, almost inevitably, be passed on to the investor, reducing the return received and making investment *per se* less attractive.
- 3.11 The result will be an overall reduction in capital inflow into, and investment within, the EU at a time when the EU should be encouraging capital formation, rather than raising unnecessary barriers. We would anticipate that these factors would combine to increase the cost of capital to companies (and also, perhaps, to governments) within the EU.

C Third country marketing

- 3.12 Under the Directive's current provisions, an EU AIFM which is authorised in one Member State but which wishes to market a non-EU fund to an EU investor in another will only be able to do so if the latter Member State has entered into an agreement with the non-EU domicile to share tax information. So, if that latter Member State does not enter into such an agreement, it is able effectively to close its market to these non-EU funds. This is a protectionist measure and one open to abuse by individual Member States.
- 3.13 During the proposed three year transitional period, a Member State may allow AIFMs to market non-EU funds to professional investors under that Member State's existing national private placement rules. Non-EU funds, therefore, will be at a competitive disadvantage to EU funds, particularly in countries such as France and Italy, which do not currently allow non-EU funds to be marketed even on a private placement basis.
- 3.14 Where a non-EU AIFM seeks to market EU or non-EU funds to investors in the EU, this is only to be permitted where, among other conditions:
- the Commission (not the Member State) determines that the non-EU country where the AIFM is established:
 - has 'equivalent' legislation in respect of prudential regulation and supervision; and

- grants EU AIFMs comparable access to market to investors in the non-EU country; and
 - the country of domicile of the non-EU AIFM has entered into an agreement on sharing information on tax with the Member State in which the AIFM is seeking authorisation to market.
- 3.15 As far as agreeing comparable access is concerned, it should be noted that the EU and the USA have been unable to agree reciprocal access for UCITS funds and the US equivalent for over 20 years.
- 3.16 The conditions imposed in respect of non-EU fund managers mean that it would be highly unlikely that any manager would be able to comply. This would result in the manager being unable to obtain authorisation. One possible response which a non-EU jurisdiction might take, if it considers that its managers are being unfairly excluded from the EU market, would be to retaliate by excluding EU managers from its own markets. This is not in the best interests of anyone - the investors, the funds or the fund managers.

D Delegation by AIFM⁵

- 3.17 AIMA's view is that the provisions in the draft Directive in respect of delegation by AIFM should be removed as they are likely to prevent investors within the EU from benefiting from the expertise of non-EU fund managers. The Directive's provisions as to delegation are also unnecessary and the conditions established by the MiFID Directive as to delegation of portfolio management services should continue to apply.
- 3.18 Under the Directive, any delegation by an AIFM of any of its functions will require the prior authorisation of the regulatory authorities in its home EU member state. Any such delegation must comply with certain conditions. In particular, where the delegation is of portfolio management or risk management, the third party to whom the function is delegated must itself be authorised as an AIFM to manage an AIF of the same type. It is surprising that this obligation is more onerous than the conditions imposed by MiFID on the delegation by investment managers of portfolio management services in relation to retail clients. Further, it would seem to prevent an AIFM from delegating part, or all, of the portfolio management function to an investment manager which is a specialist in a particular area, such as emerging markets, but which is not EU-based and, thus, not subject to, or capable of being authorised in, the EU.
- 3.19 An AIFM will also be required to demonstrate that it is in a position to monitor effectively at any time the functions which it has delegated to a third party, to give at any time further instructions to that third party and to withdraw the delegation with immediate effect when this is in the interest of investors. These obligations are more onerous than those to which an investment manager authorised under MiFID is subject, and would seem to be unnecessarily onerous.
- 3.20 It should be noted that the Directive also provides that an AIFM's liability will not be affected by the fact that it has delegated functions to a third party - this appears to imply strict liability, as in the case of delegation by a depositary to sub-custodians.

⁵ This section has been added on Version 2.0 dated 9 October 2009

- 3.21 The Directive also contains a specific provision relating to the delegation by an AIFM of administrative services to a non-EU entity and provides that such entity must be authorised to provide administration services in the non-EU country in which it is established and must be subject there to prudential supervision. As with the provisions relating to marketing of non-EU funds, the appointment of non-EU valuation agents and the appointment of non-EU sub-custodians, such delegation is only permitted with effect from three years following the transposition date and, thus, again raises the issue of whether administration services which are currently delegated to a non-EU entity must be restructured.

E Leverage and product level restrictions

- 3.22 AIMA's view is that the Commission should not seek to impose leverage limits for hedge funds.
- 3.23 Attempting to mitigate risk through leverage limits will always be problematic since leverage is not a good proxy for risk. Implementing leverage caps is overly simplistic, since the impact of leverage on the level of risk within a portfolio (and, consequently, the need to liquidate positions in times of stress) will depend on the characteristics of the assets being leveraged. Leveraging government bonds, for example, does not entail as much risk as leveraging small company or emerging market stocks. The crucial point of difference between 'leverage' and 'risk' is one which the Directive, in its current draft, fails to address satisfactorily.
- 3.24 Leverage limits for banks have long been part of the structure of systemic risk oversight. Extending the regime of mandatory leverage limits to hedge funds, however, could, in certain circumstances, be pro-cyclical. Such limits would force liquidations of positions during market dislocations as a fund's capital base erodes due to mark-to-market losses and would thereby exacerbate the pressure on asset prices. All market participants and policy makers are, rightly, highly concerned about reinforcing pro-cyclical behaviour.
- 3.25 Further, it is also important to remember the benefits brought about by the appropriate use of leverage. Leverage enables investors to earn reasonable returns from otherwise less interesting investment strategies. Markets benefit from being more efficient and are less prone to price distortions and more liquid as a result. In turn, this reduces the costs of placing and funding government and corporate capital. Leverage can also be used to multiply the impact of risk capital, which is currently in very short supply.
- 3.26 If leverage limits for hedge funds are to be imposed (and we hope that they will not), then these must be implemented intelligently. The Directive's current approach is too 'broad brush' and fails to appreciate the number of different purposes for which leverage is used in the alternative investment funds industry. The Directive also fails to accommodate the fact that a single, all-embracing, definition of 'leverage' is not feasible (see further Annex 2 below). The attempt to impose a single limit, intended to cover all types of investment strategy and asset class, is overly simplistic and would cause significant commercial damage to the hedge fund industry and its investors.
- 3.27 By concentrating on notional leverage (i.e., where leverage is calculated using the gross value of all securities and the notional value of all derivatives) as the only measurement, the Directive will inhibit or prevent AIFMs from pursuing a number of strategies which are currently followed. This will result in diminished returns to investors and removing much needed liquidity from Europe's markets without increasing investor protection or safeguarding markets from financial instability to any significant degree.

- 3.28 In all but the most straightforward circumstances, simple notional measures of leverage are of little or no assistance in assessing underlying risk. Hedge funds - particularly those specialising in interest rate or currency investment strategies - routinely construct portfolios with high notional leverage, but modest risk. Even a well-run bank would be likely to measure its leverage ratio, using notional exposures, in the hundreds or the thousands.
- 3.29 Active participants in these markets express their investment strategies by building portfolios which cover a wide variety of instruments, markets, issuers and countries. There will be many instances of offsetting exposures, and the underlying instruments will vary greatly in their level of risk - some (such as short-dated government bonds) may be of very low risk. In these cases, the overall level of risk cannot be properly assessed by a simple calculation of notional leverage.
- 3.30 Further, a cap on leverage measured in notional terms (as currently suggested) would encourage riskier assets to be bought - managers faced with strict restrictions on the amount of leverage which may be employed would not wish to 'waste' limited available leverage by purchasing more mundane assets which have a low chance of an outsized return - instead, managers would be likely to invest in more risky strategies.
- 3.31 These issues are already well understood by practitioners and regulators, and practical ways to address them have already been worked out. The Basle II Accords set out a standard method to calculate a bank's capital requirement given its exposure to risks. That regime defines the relationship between bank capital and riskiness of its assets; it incorporates adjustments for the risk characteristics of an asset and for exposures that are offsetting, and is altogether a better way of defining leverage.
- 3.32 Article 25(3) of the Directive states that the Commission "shall" adopt implementing measures to set limits to the leverage AIFM may employ. This concerns us greatly. We see no justification for the Commission being required to intervene in the workings of commercial markets within the single EU market by the introduction of product-level controls and we query the Commission's ability properly to assess the market effects of its actions. We would also point to the damage caused to the efficient working of the market when hedge funds are forced to deleverage quickly and simultaneously, as was seen during recently when counterparties withdrew lines of credit.
- 3.33 The primary focus of the Directive is, quite rightly, not on product-level regulation, being directed at the manager of an AIF, rather than at the AIF itself. An investment contract in this context is one which is made at arm's length between consenting commercial counterparties - in the case of the typical hedge fund, the client is a professional investor (i.e., highly knowledgeable and expert in determining those funds in which it decides it wishes to invest, following due diligence of the fund, its aims and - through the Prospectus - its 'terms and conditions'). As a matter of general market philosophy, a sophisticated professional investor, provided with sufficient information to enable it to make a fully informed decision, should be entitled to invest in an AIF of its choice without the Commission determining on its behalf what are, and what are not, acceptable degrees of risk for it to assume.
- 3.34 An appropriate, yet effective, way for a regulatory authority to assess the market level of hedge fund leverage and effectively monitor any developing problems of financial stability, is for it to ascertain how much is being lent to hedge funds by their prime brokers. The FSA undertakes an ongoing review of counterparties to this end and we believe it is far preferable to develop a template through which regulators can obtain necessary information than to impose an artificial borrowing limit on individual AIFMs without reference to the underlying characteristics of their portfolio.

- 3.35 In conclusion, seeking to cap hedge fund leverage without reference to the strategy, liquidity and volatility of the underlying asset class is a clumsy and unhelpful approach. We believe that it is essential that this issue be examined in far greater detail and a more finessed response reached. AIMA is happy to offer any assistance necessary to resolve this vital issue.

F Depositaries

- 3.36 By requiring the Depositary (in hedge fund terms, “prime broker” or “custodian”) to be an EU credit institution, the Directive significantly reduces the choice available to AIFMs, since the large majority of prime brokers and custodians which operate within the EU today, including the top US houses, would not fall within the Directive’s definition.
- 3.37 By Article 17(4), the Depositary would have the right to delegate its tasks “to other depositaries”. Given the definition of ‘depositary’ (see paragraph 3.31 above), it follows that sub-custodians must, therefore, also be EU credit institutions. This does not accord with the structure of the rest of the investment management industry (i.e., including, but not limited to, AIFs): standard market practice is for custodians to appoint sub-custodians of securities in the countries in which the issuers of those securities are incorporated, wherever that may be. Indeed, in certain jurisdictions, such as Japan, it is a legal requirement that title to such securities must be held by a local sub-custodian.
- 3.38 In both these provisions, the Directive applies conditions which are stricter than those under the UCITS Directive. We, therefore, have the anomalous situation whereby higher standards of investor protection would be imposed in respect of the professional investors in an AIF than for retail investors in a UCITS scheme - see also paragraphs 3.41 to 3.43 below.
- 3.39 The Directive also seeks to impose strict liability on the Depositary for its own failures and for those of any sub-custodians which it appoints (again, a stricter requirement than in respect of UCITS). This provision would lead custodians to reconsider whether they are prepared to act in respect of some funds, such as emerging markets, because of the increased risk of being held liable for losses. Where the custodian did decide to act, fees would inevitably be increased (perhaps substantially) in order to reflect the greater risk being assumed. Equally inevitably, this additional cost would be passed to the end investor, resulting in higher costs and lower returns on the investment.

G Master/feeder structures

- 3.40 The Directive similarly fails to accommodate the way in which a significant proportion of the hedge fund industry operates through master/feeder funds.
- 3.41 The master/feeder structure was developed primarily in order to accommodate the different tax needs of US taxable and US tax-exempt investors. It serves to minimise costs by removing duplication of investment and complex administrative adjustments and, as a result, is a structure which is very widely used by the hedge fund industry.

- 3.42 Following lengthy deliberation and consultation, the Council of Ministers recently agreed formal amendments to the UCITS Directive (UCITS IV). As part of this process, the Council was clearly satisfied that UCITS funds structured as master/feeders can be sold safely as such to retail investors. Paradoxically, it remains far from clear how such a structure would be treated under the AIFM Directive, in respect of AIFs which are sold to professional investors. Indeed, at present it is unclear whether master/feeder funds would be able to continue in their current form for AIFs.
- 3.43 If it becomes necessary to restructure AIFs established on a master/feeder basis in order to comply with the Directive, this would have a substantial costs implication which, at the end of the day, would be borne by investors.
- 3.44 Alternatively, such funds might simply avoid being within the Directive's scope and would become, to all intents, inaccessible by EU investors.

H Other concerns

- 3.45 The definition of 'marketing' in the Directive is too broad. One example of the unwelcome consequences that this brings is in respect of EU funds of hedge funds (FoHFs). These would be significantly impacted since, in practice, it is difficult to see how such FoHFs could continue to invest in non-EU funds whose AIFM is not established in the EU, given that the AIFM in question would not be able to market the funds to the FoHFs. It is also unclear whether 'marketing' as defined would entail the client servicing by an AIFM of investments, and the acceptance of additional investment, from existing EU investors.
- 3.46 The AIFM Directive seeks to introduce measures which, in a number of instances, would result in **higher levels of investor protection for professional investors than for the retail investors** at whom UCITS are primarily aimed (see, for example, Section 3E above). This situation is, in the Commission's own words⁶ "evidently not appropriate". It would, however, be fundamentally wrong to resolve the position simply by amending the UCITS provisions up to the levels of the AIFM Directive.
- 3.47 The UCITS brand has been a great EU success since its inception in the mid-1980's. The original UCITS Directive has been amended on several occasions, following lengthy and constructive consultation with industry. The changes which have been made have allowed UCITS vehicles to evolve with the markets and to remain attractive to investors globally. These amendments have been successful because they have premised solely on the issue of their relevance to the UCITS model. This process contrasts favourably with the hurried manner in which the Directive has been introduced.
- 3.48 The Commission must continue to look at UCITS, and the regulations under which they exist, on their own merits, not in light of what may, or may not, be relevant in other sectors of the capital markets. There is, in reality, no simple, clear cut division between the 'UCITS world' and the 'non-UCITS world' as the AIFM Directive seeks to impose - the alternative investment sector is too diverse for a 'one size fits all' approach to be appropriate. Each model should be analysed in

⁶ See page 2, http://ec.europa.eu/internal_market/consultations/docs/2009/ucits/consultation_paper_en.pdf

its own right and regulated accordingly. We make these comments in light of the Commission's recent consultation paper on the UCITS Depositary Function (to which AIMA is responding), in which it is stated that a re-examination of the UCITS regulatory framework is needed as a result of the AIFM Directive's requirements "with a view to increasing the level of the protection of the UCITS investors, at least to the level of protection offered to professional investors". (How it is possible to consider how best to amend UCITS requirements in light of the AIFM Directive's provisions when it is far from clear what the latter will look like in their final form, is another question.)

- 3.49 The Directive, in its final version, must provide greater clarity as to how it **interfaces with the numerous other Directives** which are relevant to AIFMs, such as MiFID, the Capital Requirements Directive, the MAD, and the Prospectus and Transparency Directives. Too often in the current draft, the Directive's provisions are not aligned with, or do not take account of, existing EU legislation with which AIFMs already comply.
- 3.50 We welcome moves to reassess the Directive's proposals on **independent valuation** - these proposals again fail to address the fact that 'one size does not fit all' in the alternative investment sector and to impose a single prescriptive method or model of valuation on the industry would be damaging. We would note that IOSCO's Principles for the Valuation of Hedge Fund Portfolios⁷ recommend an approach to valuations that focuses on a more flexible and substantive approach to the independence of the valuation function. This approach, which is also adopted by AIMA in our Guide to Sound Practices for Hedge Fund Valuation and by the Hedge Fund Standards Board, is one which deals with the diversification in AIFM models. Moreover, to place responsibility for the valuation of the AIF's assets formally with the AIFM introduces a conflict of interest, potentially detrimental to investors, given that an AIFM's fees are calculated by reference to the value of the assets of the AIF which it manages.
- 3.51 Since it severely limits the ability of EU investors to invest in non-EU AIFs, the Directive can be seen as an indirect attack on **offshore financial centres**. Bringing funds onshore in order to fall within scope of the provisions, however, would lead a truly global industry to fragment - local funds would be created, which would be run by local managers for local investors. It is in the EU's best interests ultimately to engage fully with the international nature of the hedge fund industry.
- 3.52 This is a most important piece of new legislation which has a profound impact on a successful and, until recently, growing industry. We regret deeply the **lack of consultation** in respect of its provisions. A number of regulatory authorities introduced emergency restrictions on short selling during the latter half of 2008; these proved again that, more often than not, regulations which are introduced in haste and without proper discussion with the affected stakeholders result in inadequate and ambiguous rules. There are a number of articles in the current Directive where, had more time been spent on the detailed drafting points, or in developing a deeper understanding of the hedge fund industry, a better text would have emerged, which the hedge fund industry could have embraced unequivocally. AIMA is ready to work in cooperation with the Commission, the European Parliament and EU Member States in order to assist in redrafting those articles where greater clarity is required or where a misunderstanding of the way the industry works can be resolved.

⁷ <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD253.pdf>

4. Conclusion

4.1 A Directive which introduces appropriate and proportionate measures which:

- require the registration of hedge fund managers within the EU;
- provide national regulators with the data necessary to monitor financial stability within the capital markets across Member States;
- provide for a pan-European passport for AIFMs; and
- enhance investor protection by increased transparency

will increase the safety of European markets and is to be wholeheartedly welcomed by those who wish to see the EU alternative investment industry strengthened and the region maintain its position as an attractive place in which to do investment business.

4.2 While we applaud the Commission's intentions, the proposed Directive which has been produced will not, in our view, deliver these benefits. Instead, in its current form, the Directive risks significantly limiting the choice available to EU investors (by denying them access to funds domiciled, or managed from, outside the EU) and reducing the returns they make on their investments.

4.3 Professional investors (the group to whom AIFs may be marketed under the Directive) include institutional investors, pension funds, endowments, insurance companies and private banks. If such investors are unable to access the large majority - perhaps as much as 90 - 95% - of the funds in which they may currently invest, the ordinary citizens of Europe, who rely on them for their pensions, savings, financing and even jobs will also be affected.

4.4 Assets in the region of €250 billion are currently managed in the EU by hedge fund and fund of hedge fund managers. Taking into account also the related industries which service the fund managers - investment banks, lawyers, accountants, fund administrators, etc - thousands of jobs within the EU (AIMA estimates perhaps as many as 50,000) depend on the hedge fund industry. These jobs, too, would be put at jeopardy if the current proposals within the Directive remain unchanged, and have the adverse effects which we have concluded they would.

4.5 While a number of the more straightforward issues can be resolved by clarification within the Directive of the Commission's intentions or by minor revisions of the text, there are a number of major areas, outlined above, where we would look to the Commission and the European Parliament to consider very carefully the concerns we raise.

4.6 It is our strongly held view, therefore, that the many positive benefits contained in the Directive risk being undermined unless there is a measured and thorough revision of a number of those provisions which have the unintended consequences outlined above.

4.7 By improving the text of the proposed Directive in these areas, the Commission and European Parliament can deliver a Directive which offers Europe an opportunity to develop a flourishing alternative investment industry for the future. If the appropriate amendments are not made, however, and the above issues not rectified, the existing alternatives industry in the EU will be severely damaged.

4.8 Momentum is growing, backed by the public statements of well respected commentators, across Europe towards a redraft of the text. AIMA will continue to work constructively with the Commission, the Member States and the responsible committees in the European Parliament to this end.

4.9 In conclusion, AIMA:

- supports the compulsory authorisation of all AIFMs (without any threshold);
- supports an increased threshold of €1 billion for disclosure of systemically relevant data;
- is concerned that much of the proposed Directive fails to take into account the existing hedge fund industry model;
- is working, and wishes to continue to work, constructively with the Commission, the Member States and the responsible committees in the European Parliament to produce a proposal which will (i) resolve areas of uncertainty and (ii) accord better with the realities of the way in which the hedge fund industry is structured and operates; and
- believes that, without significant revision, the Directive will lead to much less choice and greater costs for investors in the EU without achieving the stated objectives of the Directive.

9 October 2009

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Annex 1 The Alternative Investment Management Association Limited (AIMA)

Established in 1990, AIMA is the not-for-profit trade association which represents the hedge fund industry globally. Its membership comprises 1,100 corporate bodies in over 40 countries and is drawn from all constituencies which make up the hedge fund sector - including hedge fund managers, fund of hedge funds managers, prime brokers, administrators, accountants and lawyers.

AIMA's members manage approximately 75% of global hedge fund assets and over 70% of fund of funds assets.

AIMA is not a self-regulatory body. New members are vetted for their bona fides; manager members must be supervised by a recognised regulator in order to qualify for membership.

AIMA's member profile is as follows:

- Hedge fund managers - 43%
- Fund of hedge funds managers - 21%
- Investors - 2%
- Advisers/service providers - 34%

Members in the Europe/ Middle East/ Africa region account for 55% of the association's membership, those in the Americas 22% and those in the Asia-Pacific region 23%. They all benefit from AIMA's active influence in policy development, its leadership in industry initiatives, including education and sound practice guidelines and its excellent reputation with regulators worldwide.

Since its establishment, AIMA has worked with the aim of enhancing the regulatory framework in which its members operate. AIMA has a central tenet that good regulation makes for good business. Over the years AIMA has developed contacts with 150 separate regulatory or policy-making organisations in 62 countries - these have access to the AIMA website (www.aima.org) and also receive, free of charge, all our educational and regulatory publications, such as Guidance Notes for AIMA Members and our responses to consultations.

AIMA has produced, over many years, a number of specific and detailed Sound Practice Guides which have been widely used across the industry; these include Guides on hedge fund management, administration, valuation, business continuity, governance, anti-money laundering and comprehensive due diligence of managers and service providers.

AIMA has worked closely with its counterpart, the Managed Funds Association ("MFA") in the United States, as well as with the UK Hedge Fund Standards Board and the US President's Working Group on Financial Markets' Asset Managers Committee. AIMA is currently involved with the work on unification of best practice standards as requested by the G20 and is working closely with the Financial Stability Board towards achieving this important objective.

AIMA has a history of working closely with institutional investors and recently published the world's first collaborative educational guide for institutional hedge fund investors, *AIMA's Roadmap to Hedge Funds*. As with our regulatory contacts, we service institutional investors free of charge and provide them with access to our website and to our publications.

AIMA is committed to developing industry skills and education standards and is the co-founder of the Chartered Alternative Investment Analyst designation (CAIA) based in Massachusetts - the industry's first and only not-for-profit specialised educational standard for alternative investment specialists. Over 10,000 industry professionals have enlisted in this programme since its launch in January 2003.

Annex 2 Leverage

The following is taken from Appendix E from the Hedge Fund Working Group's "Hedge Fund Standards: Final Report (January 2008) (http://www.hfsb.org/sites/10109/files/final_report.pdf)

Leverage is the sensitivity of the portfolio to changes in risk factors such as market prices. There are several drawbacks that complicate the use or comparison of leverage "numbers":

- There is no single agreed definition of leverage. Definitions cover a spectrum ranging from traditional balance sheet type leverage measures to risk based measures (the latter incorporating underlying risk factors such as Value-at-Risk) and dynamic leverage measures (see table below)
- Classic "financial statement based" leverage is not an independent source of risk, so additional information on the underlying risk factors is required
- Leverage "numbers" have to be considered carefully and may not always contain meaningful information. In some instances, a risk reducing transaction can increase some leverage measures while decreasing others

It may therefore be difficult accurately to compare leverage between different funds. However, in managing a fund and communicating with investors, hedge fund managers should come up with a leverage definition which is meaningful in their context and track changes in leverage over time.

Classic financial statement based leverage definitions are not stand alone risk measures and fail to incorporate off-balance sheet positions (for example, derivatives), which could increase or decrease leverage. Risk based leverage measures try to overcome the shortcomings of classic measures by relating a risk measure (for example, market risk) to the fund's capacity to absorb this risk (for example, the fund's equity). More sophisticated dynamic measures of leverage incorporate a hedge fund manager's ability to adjust its risk position during periods of market stress.

Examples of leverage measures

Type of measure	Definition	Observations
Financial statement/asset based (Classic)	<ul style="list-style-type: none"> • Gross assets/equity • Gross debt/equity 	<ul style="list-style-type: none"> • Does not incorporate on-balance sheet hedges and off-balance sheet instruments
	<ul style="list-style-type: none"> • Net assets/equity • Net debt/equity 	<ul style="list-style-type: none"> • Does incorporate on-balance sheet hedges (therefore "net"), but does not include off-balance sheet instruments
Risk based	<ul style="list-style-type: none"> • Portfolio volatility/equity • VAR/equity • Stress loss/equity • Other loss measure/equity 	<ul style="list-style-type: none"> • Usually incorporates all (on- and off-balance sheet) hedge positions • But does not account for mitigating measures by manager in times of distress