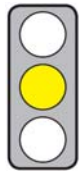


MAIN ISSUES

Objective of the Directive: The Directive introduces EU-wide harmonised requirements for the authorisation and conduct of managers of "alternative investment funds" (AIF), in particular private equity and hedge funds.

Parties affected: Managers of "alternative investment funds", investors, banks.



Pros: (1) Obliging AIF, which finance investments by leveraging, to provide information improves the supervision of the stability of financial markets.
(2) The cross-border marketing of AIF shares is facilitated.

Cons: (1) Limits to the maximum amount of leverage are not necessary.
(2) AIF Managers, which do not finance investments through the use of leverage, should not be obliged to prove the effectiveness of their risk liquidity management.
(3) AIF Managers should not be subject to minimum capital requirements.

CONTENT

Title

Proposal COM(2009) 207 of 30 April 2009 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.

Brief Summary

► Preface

- "Alternative investment funds" (AIF) are funds that (Art. 3 lit. a, 31 (4), 32, Recital 5):
 - are mainly marketed to "professional" investors to invest their funds and
 - must not be authorised as investment funds in terms of the UCITS Directive (funds to be publicly marketed to retail investors) [cp. Proposal COM(2008) 458, [CEP Policy Brief](#)].
 This includes private equity funds, hedge funds, commodity funds and real estate funds.
- The Directive does not apply to (Art. 2 (2)):
 - banks, reinsurers, direct insurances and life assurances as well as institutions for occupational retirement provisions,
 - managers of hedge funds with a volume of less than € 100 million and
 - managers of private equity funds with a volume of less than € 500 million who do not use leverage effects for their investments and do not grant to their investors redemption rights during the first five years.
- Managers of AIF may be legal or natural persons (Art. 3 lit. b).
- An EU-wide common supervision is to be imposed on managers of AIF since their conduct may "spread or amplify risks through the financial system" (Recital 2). Hereby the Commission explicitly stresses that many funds systematically use a high degree of leverage (e.g. bank loans) to finance their investments ("leverage effect", Art. 3 lit. l).

► Authorisation and business conduct of AIF Managers

- Persons wishing to provide management services to AIF and/or to market shares of AIF in the EU must be authorised by the Member State where they are domiciled (Art. 2 (1), 4 (1) and 3 lit. b).
- The head office of an AIF must be seated in the same Member State as its manager (Art. 5).
- The management and marketing of AIF in the EU is permitted only if the manager
 - acts "with due skill", in the best interest of its funds, the investors and "the integrity of the market" and ensures that all investors are treated fairly (Art. 9);
 - identifies and avoids any conflict of interests through "reasonable steps" (Art. 10 (1));
 - ensures through a risk management system, to be reviewed once a year, that:
 - a due diligence process is implemented to "appropriately" measure and monitor all risks and chances associated to the risk profile of each investment,
 - the existing risks of a fund are monitored through "appropriate" stress tests at all times,
 - the fund investments actually correspond to the agreed investment strategy,
 - risks associated with short selling are "adequately" managed (Art. 11);
 - ensures through an "appropriate" liquidity management system that all investments comply with the fund's rules on the redemption of shares and the liquidity profile of all investments allows for servicing liabilities (Art. 12),
 - own funds to the amount of at least € 125.000 are available; where the value of the managed portfolio exceeds € 250 million, additional own funds equal to 2 cents per each further € 100 (= 0.02%) must be available (Art. 14) and own funds must never be less than 25% of the fixed overhead costs from the preceding year (Art. 14).

► Option to authorise AIF for retail investors

Member States are entitled to allow the marketing of AIF also to retail investors on their territory. For that purpose they may impose stricter requirements on AIF Managers and additional requirements to AIF (Art. 32).

► **Disclosure to investors and supervisory authorities**

- Prior to any investment, Managers of AIF must provide interested investors with information on:
 - the investment strategy and the objectives of the fund, all risks associated with the techniques employed (e.g. short selling), liquidity risks and the circumstances and potential degree of the use of leverage;
 - the procedures by which the fund may change its investment strategy;
 - termination rights, fees, charges and expenses (Art. 20).
- The manager of an AIF must regularly report to the competent authorities on:
 - the principle markets and categories of assets in which the manager actively trades and the instruments it employs there,
 - the risks and risk concentration its funds are exposed to and how these risks are managed,
 - which investment assets are illiquid and which liquidity management measures are taken,
 - which short sellings have been effected (Art. 21).
- The manager of an AIF must submit an audited annual report to investors and to the competent authorities containing a balance sheet, an income and loss statement as well as a report on the activities of the financial year (Art. 19).

► **Specific rules for AIF financing investments through leverage**

- The Commission is entitled to introduce upper limits to the degree of leverage an AIF can employ, if considered necessary to ensure the stability of the financial system (Art. 25 (3) and (4)).
- A manager of AIF who has employed leverage which, in sum, exceeds the value of the equity capital of the AIF in two out of the past four quarters – mainly hedge funds – must:
 - "regularly" provide to the supervisory authority of its home Member State information on whether the leverage arises from the borrowing of cash, securities or from financial derivatives as well as the five largest sources of borrowed cash or securities and the amounts of sourcing (Art. 24).
 - quarterly disclose to investors the total amount of leverage employed (Art. 23),
- Using the information reported on the degree of leverage, the supervisory authorities examine whether systemic risks to the stability of financial markets exist (Art. 25 (1) and (2)).

► **Specific rules for AIF having controlling influence on companies**

- If an AIF acquires 30% or more of the voting rights of a company, the manager must provide the shareholders and representatives of employees with a development plan and a plan for the avoidance of conflicts of interest (Art. 28).
- Said obligation does not apply to stakes in companies with less than 250 employees, an annual turnover of less than € 50 million and/or a balance sheet of less than € 43 million. (Art. 26 (2)).

► **Specific rules for AIF and managers domiciled in third countries**

- Shares of AIF domiciled in third countries may only be marketed to "professional" investors domiciled in the EU if the third country ensures an effective exchange of information in tax matters pursuant to the OECD Model Tax Convention (Art. 35).
- A manager established in a third country outside the EU may only market AIF in the EU if, in turn, the third country grants effective market access to Community managers (Art. 39).
- Single administrative services and the valuation of AIF may be delegated to managers or entities in third countries if their standards are equivalent to those applicable in the EU (Art. 36 and 37).

► **Measures and investigations by the supervisory authorities**

- To investigate infringements against this Directive supervisory authorities must be able to (Art. 41 (2)):
 - access and copy any document in any form,
 - require information from any person, summon and question any person,
 - carry out on-site inspections both with and without prior announcements and
 - require records of telephone and data traffic.
- If a supervisory authority is requested by the competent authority of another Member State to investigate possible infringements, it may carry out the investigation itself or allow the requesting authority to do so (Art. 47 (1)). In the latter case, the home authority may request that its own personnel assist in the investigation (Art. 47 (2)).
- If a supervisory authority identifies an infringement against the Directive, it must take "appropriate measures" to ensure that the manager complies with the obligations. This includes a temporary prohibition of professional activities and referral to the relevant law enforcement authorities (Art. 41 (1)).

► **Notification procedure prior to marketing AIF shares**

If an authorised manager wishes to market AIF shares in the EU, it suffices to notify the competent authority of its home Member State of this intention and to submit the relevant information on the AIF concerned and the arrangements established to prevent AIF shares being marketed to retail investors (Art. 31 and 33).

► **Adoption of implementing measures**

- The Commission will adopt detailed implementing measures, particularly for the following issues, if a committee consisting of national experts agrees and neither the European Parliament nor the Council veto ("regulatory procedure with scrutiny"):
 - upper limits to the degree of leverage an AIF can apply (Art. 25 (3) and (4));
 - the authorisation of "due" skills, "effective" controls of conflicts of interest, "independent" valuation and "appropriate" risk liquidity management systems (Art. 9 (2), 10 (3), 11 (3), 12 (3), 16 (4));

- requirements for AIF to invest in securitised positions (Art. 13);
- requirements for recognising the standards of supervision, management and evaluation of AIF in third countries as comparable with EU standards (Art. 37 to 39).

Changes Compared to the Status Quo

To date the management of alternative investment funds is not regulated at the European level.

Statement on Subsidiarity

According to the Commission, Member States alone are not able to adequately monitor the cross-border effects of the conduct of AIF managers.

Political Background

The proposal put forward by the EU internal market commissioner McCreevy came into being as a result of pressure from the European Parliament, which has been calling for a regulation of hedge funds for a long time. Also the G20 heads of state addressed this demand during their summit in London at the end of March 2009 and agreed to adequately regulate all players of the financial market.

Status of Legislation

30.04.09 Adoption by Commission
 Open Adoption by European Parliament and the Council, publication in the official Journal of the European Union, entry into force

Political Background

Leading Directorate General:	DG Internal Market
Committees of the European Parliament:	Economic and Monetary Affairs (in charge); Legal Affairs
Committees of the German Bundestag:	Open
Decision Mode in the Council:	Qualified majority (Adoption with a majority of the Member States and 255 of 345 votes; Germany: 29 votes)

Formalities

Legislative competence:	Art. 47 (2) TEC (Right of Establishment)
Form of legislative competence:	Concurrent legislative competence
Legislative procedure:	Art. 251 TEC (Codecision)

ASSESSMENT

Economic Impact Assessment

Ordoliberal Assessment

As is the case for all other financial market players, also for AIF managers, a detailed regulation can be justified only by the aversion of risks for the stability of the financial system.

The largest risk for the stability of financial markets emanating from AIF is that their managers may leverage investment with money borrowed from banks. If a great number of investments financed through leverage fail, then the lending banks might suffer severe liquidity shortfalls.

Obliging AIF managers – who systematically and to a high degree finance investments through leverage – to report to the competent authorities on the extent and source of the leverage employed, is to be welcomed.

This information helps supervisory authorities to better assess risks and to improve the macro-prudential supervision over the stability of the entire financial system.

However, the introduction of an upper limit to the degree of leverage in AIF is to be rejected. First, such a undifferentiated requirement is not appropriate, since the employment of leverage does not necessarily bring about higher investment risks. AIF can also finance relatively low-risk investments through leverage. Secondly, the default risk becomes systemically relevant at the level of the lending banks. However, these banks are already regulated in a risk-oriented manner by the Capital Requirements Directive: the higher the risk of default for a loan, the more own capital must be deposited. This rule applies to bank loans to AIF as well.

To improve the risk assessment of loans being granted by banks to AIF, an international credit register should be established which – similar to the German evidence centre on large loans – provides anonymous information on the usage of large loans by hedge funds. However, in the end the lending bank should be free to decide whether and under which conditions it wishes to participate in risky AIF businesses.

The second risk for the stability of the financial system emanating from AIF is that particularly hedge funds acting under herd behaviour can dissolve large and equal positions in the financial market simultaneously.

Regular reports of managers on the markets in which they trade, the instruments they employ (e.g. short selling) and the resulting risks can help to convey a clearer picture of the systemic risks to supervisory authorities.

However, as with all investors of a certain volume, such risks cannot be completely excluded for hedge funds. Temporary measures such as the prohibition of short selling or the interruption of stock exchange trading can reduce these risks.

The **obligation for all AIF managers to prove the effectiveness of their internal systems for the risk liquidity management is too far reaching** and cannot be justified with the financial market's stability.

In particular, those AIF which do not finance their investments through a high degree of leverage and which invest in relatively illiquid assets do not put the stability of the financial system at risk. Normally, these are investment companies investing large amounts of own funds in real estates or in shares in unlisted companies.

The proposed rules on disclosure to investors are to be rejected, since in the case of AIF, investor protection is not as necessary as with public funds. AIF compete with each other and canvass a relatively small group of professional investors who deliberately run high risks up to the total loss of their capital invested. This competition can better serve the information demands of investors than any rigid statutory obligation. Therefore, **the minimum own capital requirement** of € 125.000 or 0.02% of the managed assets **is unnecessary**. Investors should be free to decide for themselves whether and to which extent they deem a risk buffer necessary.

Impact on Efficiency and Individual Freedom of Choice

The tying by the Directive of authorisation and conduct requirements to the right to manage AIF EU-wide to professional investors **improves the operation of the internal market**. However, it would help to reduce administrative costs if the head office and business seat of managers – as is the case with UCITS investment funds – did not have to be domiciled in the same Member State.

Impact on Growth and Employment

Insignificant.

Impact on Europe as a Business Location

Improved supervision can improve the EU's financial markets' stability. However, due to the intertwining of global financial markets, this stability also depends on supervisory standards in other parts of the world.

Legal Assessment

Legal Competence

The legal competence is laid down in the freedom of establishment (Art. 47 (2) TEC).

Subsidiarity

Unproblematic.

Proportionality

If a Member State allows another Member State to carry out investigations on its territory, it should be free to decide whether it wishes to assist with its own personnel. The proposed rule, which only grants the requested Member State the right to make an application, represents excessive intervention in national sovereignty.

As a large number of implementing measures will be adopted by the Commission at a later point of time – in the regulatory procedure with scrutiny –, assessing the proposal's proportionality is not possible at this time. The fact that important detailed provisions are missing for the time being causes considerable legal uncertainty.

Compatibility with EU Law

As all funds which are not classified as investment funds under the UCITS Directive are considered AIF, the Directive lacks a positive definition of AIF. On the other hand, this ensures that there are no regulation gaps in the financial market supervision and that all imaginable new investment structures are subject to AIF regulation.

Compatibility with German Law

In particular the German Investment Act (*Investmentgesetz – InvG*) would have to be revised substantially. Art. 112 et sqq. InvG relate to marketed funds, whereas the proposed Directive sets requirements for funds managers.

Alternative Policy Options

An international register for bank loans granted to AIF should be established.

Possible Future EU Action

Many important implementing measures of the Proposal will be substantiated in the committee procedure.

Conclusion

The disclosure obligations for AIF managers, which use leverage to a high degree, will enable authorities to better monitor possible risks to the stability of financial markets. Upper limits to the level of leverage and minimum own fund requirements are not necessary. Business conduct rules for AIF Managers, which do not employ leverage, or do so to a very small degree and which invest in relatively illiquid assets, are dispensable. An international register on the granting of bank loans to AIF is necessary.