

# Where does Europe stand on the regulation of alternative investments?

## Dispelling Myths and Challenging Realities

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**E**U co-legislators are having a hard time agreeing on regulation for alternative investment funds (AIFs). Following-up the G-20 commitments, the Commission's proposal – published in April last year – did not manage to convince Member States and Parliament. After long negotiations – chaired by two different presidencies – the compromise issued by the Council late in August signals a consensus on a number of topics, such as the valuation and depositary functions. However, two important and complex topics – third country equivalence and private equity rules – are still under negotiation.

Suspense will reign until the very end. Not only is the future of alternative investments at stake, but also the whole asset management industry in Europe. In the end, the Commission may need to prepare a small revision of UCITS IV (the fourth iteration of legislation governing Undertakings for Collective Investment in Transferable Securities) based on the final outcome of the Alternative Investment Fund Managers Directive (AIFMD) negotiations. The reason for this regulatory action is to ensure financial stability and greater transparency in areas that have so far mostly gone unregulated. But also in the background, a widening pension gap and the need to generate enough returns to meet long-term liabilities worry policy-makers, industry and ultimately families.

### Setting the scene

In a nutshell, the AIFM Directive will shed new light on the more opaque areas of asset management, such as hedge funds and private equity funds. In effect, it brings about a single passport regime for managers of funds not covered by the UCITS Directive. Major categories of non-UCITS funds include:

- Hedge funds
- Private equity funds (buy-out funds, venture capital funds, etc.)
- Commodity funds
- Real estate funds
- Infrastructure funds

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It gives sufficient leeway to managers to market these funds to professional investors in all countries of the EU, within the meaning of the MiFID (Markets in Financial Instruments Directive). As a result, more in theory than in practice, the choice of investors in the EU should be expanded and the asset management industry should be able to fully reap the benefits of the single market. However, both the manager and the fund need to be domiciled in the EU, while the market for alternative investments is essentially global. Funds and managers domiciled abroad will be subject to different provisions that have yet to be determined. To this legal uncertainty, the Dodd-Frank bill in the US Congress<sup>1</sup> and its limitations on proprietary trading and investments by banks in hedge funds and private equity have added further economic uncertainty. In effect, Europe thus may be tempted to pursue a similar crackdown on alternative investments, which aims at curbing the flow of liquidity coming from financial institutions into these funds instead of limiting the use of non-EU funds or propping up their financial structure, as currently is under discussion in Europe. These opposite approaches are producing legal and economic uncertainty due to the global nature of this market and raising questions on how to generate returns in a regulatory environment struggling to reduce systemic risk and financial instability at any cost.

### **Latest developments: The critical points of the Directive**

Despite recent divergences, the latest compromise – published by the Council late this August – seems to have reached consensus on a number of issues. See the table in the annex for a comparison of the Commission’s proposal with the compromise proposals of March and August 2010.

First, the original regime for authorisations included the provision requiring the Committee of European Securities Regulators (CESR) to draft a list of ‘possible investment strategies’ and Member States to decide which among them fund managers could pursue. The discretionary aspects of this provision seemed quite unfortunate, and the Council decided to drop this regime. By all means, coming up with a comprehensive list of strategies is a difficult exercise that may create loopholes and spaces for circumvention. Furthermore, partial authorisations would have put the industry in a straight-jacket, reducing incentives to invest in alternative funds. The latest draft instead finds a more balanced equilibrium foreseeing a simple authorisation to cover all types of portfolio and risk management outside the UCITS regime.

The main objective of the earlier provision – i.e. preserving financial stability – will still be secured since supervisors are given powers to impose restrictions for leveraged AIFs in the event of a menace to macro-stability. Such restrictions include, most prominently, limits on leverage and additional reporting requirements. Hence, no compulsory limits on leverage are set that would affect the whole industry under normal market conditions. There had been proposals to do so from some Member States and MEPs, but evidence suggests that leverage is not currently a problem of the industry as a whole. For instance, hedge funds operate with much lower leverage than banks (see Figure 1). Funds operating with leverage on a ‘systematic basis’ (to be defined) will face these additional reporting obligations. Furthermore, funds will have to give investors information about how they use leverage and the extent of its use. Altogether, the system has clear rationales:

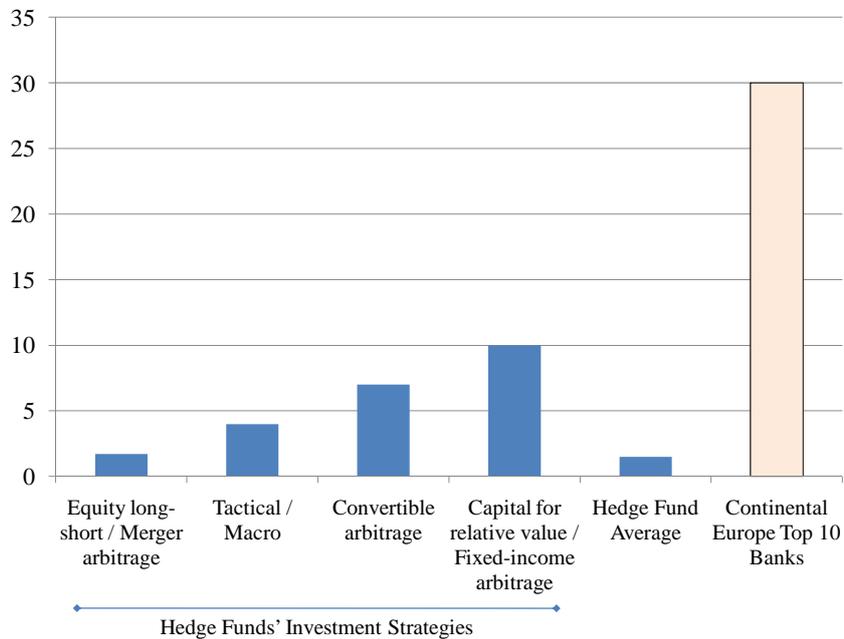
- 1) investment strategies and innovation should in principle not be constrained;

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<sup>1</sup> H.R. 4173, Title IV, Sec. 401-416.

- 2) authorities will receive the reporting that matters for systemic stability separately; and
- 3) investors are not relieved of their responsibility to evaluate the risks they undertake, but are instead given more information to do so.

*Figure 1. Banks' versus hedge funds' leverage (Q2 2008)*



*Note:* The left axis illustrates, for banks, the balance sheet leverage multiple (total assets divided by total equity) of individual banks weighted by asset size; for hedge funds, total assets divided by capital.

*Sources:* IMF (2008), p. 41; and World Bank (2009), p. 5.

Second, another unfortunate provision no longer exists. Member states were given discretion to decide which part of the Directive they wanted to apply to 'small funds managers', which do not need to be authorised unless they want to enjoy the passport.<sup>2</sup> A major risk of this provision was the legal uncertainty due to differences in implementation and potential regulatory arbitrages. Apparently, the game is not worth the candle for three main reasons: i) 'small' funds – even as a whole – are not systematically relevant and they only account for 10% or less of assets under management;<sup>3</sup> ii) compliance costs may potentially compromise their business model, due to their small size; and iii) monitoring them would become impracticable for supervisors, as they account for 70% of managers or more.<sup>4</sup> However, small funds will need to register and provide simplified reporting so that supervisors get the whole picture of the industry. This would certainly increase the transparency of the market, as these funds currently operate out of sight.

<sup>2</sup> By 'small funds', this commentary refers to AIFM under the thresholds of the Directive, that is AIFMs whose assets under management do not exceed €100 million (or €500 million if they are not leveraged and require a 5-year lock-in to investors).

<sup>3</sup> Approximately 90% of assets but only 30% of hedge funds will fall under the thresholds; as for other AIFs, roughly 50% of managers and almost all assets will be captured (see European Commission, 2009, p. 48).

<sup>4</sup> Ibid.

Third, independent valuers will not be required in all cases. AIFM may use internal or external valuers, as long as the independence of the valuation function is ensured via functional and managerial separation. In order to balance this additional flexibility, Member States are granted the power to impose audits of internal valuations on a case-by-case basis. According to a report commissioned by the UK Financial Services Authority (FSA) (2010), external valuers are the most costly burden imposed by the Directive.

Fourth, regulators are determined to prevent ‘Madoff-style’ frauds. Safekeeping of assets will need to be entrusted to a separate entity and the function will be – in principle – incompatible with prime brokerage. Although this is the second-most important source of cost according to the FSA study, there have been no concessions. Depositaries will face quasi-strict liability and reversed burden of proof, which will cause a major structural change in the industry. Depositaries do not only provide accounts to deposit financial instruments but also assume risks coming from custodian services. The strict liability may push them to be more involved in the formulation of investment strategies and in the day-by-day custodian operations of funds. Insiders speak of the “custodian who will sit next to you at the trading desk”. Thus, these regulatory changes will add to the ongoing boom of the asset servicing industry. Yet, as potential risks rise so will costs; and the number of depositaries may go down, raising concentration risks.

Besides, the UCITS regime may need to be updated soon – some call it UCITS V – to adapt it to the AIFMD, in particular with regard to the depositary and valuation functions. The new provisions may be even more stringent than for AIFs, since UCITS are targeted to non-professional investors.

*Table 1. Other areas where consensus has been reached*

<i>Reporting to supervisors.</i> This provision aims at enhancing their capacity to control the build-up of systemic risk.
<i>Disclosure to investors.</i> Among others, this regime will benefit small professional investors. However, some investors claim that may not require that level of protection, which certainly comes at a cost.
<i>Managers Remuneration.</i> A binding annex on remuneration has been added in order to ensure that risk managers are compensated independently from the fund performance. It has been criticised because of its level of detail (closer to ‘Level II Lamfalussy’ than to ‘Level I’) and because the limits to variable remuneration may induce higher employee turnover.

Finally, there are two areas where consensus has not yet been reached:

On the one hand, uncertainty surrounds the regime for non-EU funds or non-EU fund managers. The initial proposal of the Commission envisaged a passport for foreign fund managers subject to stringent requirements in terms of supervision and tax cooperation. Member States were in great disagreement on this point, which in the end led the passport rules to be dropped altogether. The Council made clear that third country rules “should not limit the choice of European investors nor should they be used as a barrier to impede the marketing [of non-EU funds] [...] or prevent the EU to comply with WTO rules”.<sup>5</sup> The industry complains that foreign funds are being discriminated against for

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<sup>5</sup> Compromise Proposal of March 2010. Recital 19aa.

their status of non-EU funds with a big cloud around the principle of equivalence, i.e. when a non-EU fund or manager should be allowed to market in the EU. The Belgian Presidency has listened and brought the passport back to the negotiations, but they acknowledge that agreement is not close. This point may be subject to a separate discussion.

On the other hand, a consensus is more likely to be reached for private equity. The Compromise Proposal imposes some sort of notification and annual reporting when a fund acquires a controlling stake in a non-listed company. The rationale for these obligations is unclear, however, given that not only private equity funds hold stakes in a non-listed company. In order to ensure a level playing field, it would be better to regulate this matter in a horizontal manner; otherwise, problems could arise concerning definition and thus the possibility to circumvent the legal obligation with no consequence whatsoever. The case of private equity recalls the sequel on short-selling that was originally included in the AIFMD and then later separately discussed in a new proposal. However, while short-selling will be the subject of ad hoc regulation, an important measure for the market for corporate control will be included in a piece of regulation that does not necessarily have a direct link with its important allocative function. If regulators are trying to solve an issue related to the transparency of these latter actions, they should modify the specific regulation dealing with the market for corporate control. In effect, the use of an ‘institutional approach’ to regulation (rules for specific entities) instead of a ‘functional approach’ (rules for specific services and functions performed for the market) increases the complexity of the regulation and the risks of circumvention.

## **Conclusions**

It is important to note that AIFs play a key role in the economy as sources of long-term finance and, increasingly, as investment opportunities for institutional clients, including pension funds. Aggressive returns help to build diversified investment portfolios and help to meet the liability mismatch of the pension systems, which are burdened by the ageing population and other critical issues. Regulation needs to increase transparency in this area, but this should not affect the way in which these alternative investment funds deal with risks. By definition, these funds are designed to deal with risky assets and they should be allowed to continue to do so.

The AIFMD is an important piece of legislation whose effects need to be thoroughly analysed. A cost-benefit analysis is a difficult exercise but rushing regulation does not serve any public interest, as a ‘poor regulatory action’ may be more damaging than ‘no action’. Further negotiations and discussions may be needed, to strike the right balance between the global nature of this market and the local nature of the investors. Still, it is somehow unclear what this Directive wants to achieve.

The current AIFMD proposal, in the eyes of the regulators, will certainly:

- reduce systemic risk and the use of leverage;
- increase investor protection and transparency;
- enhance market efficiency and integrity; and
- benefit the market for corporate control (less hostile takeovers and short sales).

However, many doubts surround the theoretical framework of asset allocation, and therefore some fundamentals of this Directive remain unchallenged.

### **References in the text**

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FSA (2010), Impact of the Proposed AIFM Directive across Europe, London, October.

IMF (2008), Global Financial Stability Report, Washington, D.C., October.

World Bank (2009), Note Number 11: The leverage ratio, Washington, D.C., December.

### **Legislative acts and steering documents**

The Group of Twenty (G-20) Finance Ministers and Central Bank Governors: Declaration on Strengthening the Financial System. London, 2 April 2009.

Directive 2009/65/EC of 13 July 2009 on the Coordination of Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities (UCITS) (recast).

Directive 2004/39/EC of 21 April 2004 on Markets in Financial Instruments (MiFID).

Compromise Proposal by the Presidency of the Council of the European Union - Proposal for a Directive on Alternative Investment Fund Managers - 6795/3/10. Brussels, 10 March 2010.

Compromise Proposal by the Presidency of the Council of the European Union - Proposal for a Directive on Alternative Investment Fund Managers - 12953/10. Brussels, 27 August 2010.

Proposal for a Directive on Alternative Investment Fund Managers and Amending Directives 2004/39/EC and 2009/.../EC - SEC(2009)576. Brussels, 30 April 2009.

## Annex. Comparison of the Commission's proposal with compromises of March and August 2010

	Commission Proposal	March 2010 Compromise	August 2010 Compromise
<b>Scope</b>	- Refers only to EU AIFM in its scope but in fact regulates also non-EU AIFM	- EU AIFM - Non-EU AIFM with regard to the marketing of AIF in a MS	- EU AIFM (managers of AIF) - Non-EU AIFM if they manage an EU AIF or non-EU AIF to professional investors
<b>Full exemptions</b>	- Managers of UCITS - Credit institutions (D2006/48/EC) - Occupational retirement schemes (D2003/41/EC) - Insurers and reinsurers	- AIF whose only investor are undertakings and subsidiaries of the AIFMD - Authorised managers of occupational retirement schemes (D 2003/41/EC) - Employee saving/participation schemes - Special purpose entities	- AIF whose only investor are undertakings and subsidiaries of the AIFMD - Holding companies - Authorised managers of occupational retirement schemes (D 2003/41/EC) - Employee saving/participation schemes - Special purpose entities
<b>Small funds</b> AUM < €100m or < €500m if 5 year lock-in	- Total exemption (no registration and no reporting) - No passport but opt-in possible	- MS to decide which parts of the Directive apply to these funds - Compulsory registration and simplified reporting - No passport but opt-in possible	- Compulsory registration and simplified reporting - No passport but opt-in possible
<b>Initial capital</b>	- No differentiation of internally managed AIF - No possibility to allow for guarantees	- Similar provisions to the August Compromise	- EUR 300m for internally managed AIF - EUR 125m for external AIFM - Additional 0.02% up to EUR 10m - MS may allow 50% in the form of guarantees
<b>Authorisation</b>	- Authorisation may be granted for all or certain types of AIF (without further reference) - No mention of non-core services - Compatible with UCITS authorisation	- MS to decide whether authorisation is granted for all or certain types of investment strategies - CESR to produce guidelines to classify investment strategies - No reference was made to MIFID - Compatible with UCITS authorisation	- Distinction between externally appointed AIFM and internally managed AIF - No initial limitations as to the investment strategies - MS derogation possible for management of portfolios under investor's mandate - Non-core services under MiFID - Compatible with UCITS authorisation
<b>Risk management</b>	- No requirement to set a maximum level of leverage and right to reuse collateral (although disclosure to investors is foreseen)	- Similar provisions to the Commission Proposal	- Functionally separate from portfolio management (under proportionality) - Risk profile / Maximum level of leverage and right to reuse collateral - Risk management system / Stress testing / Due diligence - Liquidity management system
<b>Short selling</b>	- Special risk management / Procedures to ensure delivery of commitments - Reporting (for systemic stability purposes)	- Only reporting obligations	- In line with the Commission Proposal
<b>Securitisation</b>	- Requirements for both AIFM and originator - Originator to retain a net economic interest of at least 5%	- Similar provisions	- Similar provisions
<b>Remuneration and conflict of interests</b>	- No rules about remuneration - Avoid conflict and if not possible disclose - Functional separation of tasks and responsibilities affected by conflict - Disclosure of preferential treatment	- Similar provisions - Remuneration guidelines	- Similar provisions - Very detailed binding annex on remuneration (under proportionality)
<b>Delegation</b>	- No delegation of portfolio management and risk management to an entity other than an authorised AIFM - No delegation to depositary, valuer or any other entity affected by conflict of interest - No sub-delegation possible	- No delegation to the depositary - For the rest, similar provisions to the August Compromise	- Notification requirement - Justification on objective reasons + Not undermine effective supervision - Portfolio and risk management can only be delegated to authorised undertakings (subject to cooperation arrangements among supervisors if a third-country undertaking) - No delegation to depositary unless conflicts of interest can be managed - Sub-delegation possible under same requirements
<b>Prime brokers</b>	- Not mentioned	- Not mentioned	- Defined and regulated indirectly
<b>Valuators</b>	- External valuer - Incomplete regime, which does not cover liability and other aspects	- Complex proportionality provision to decide whether external valuer is required - Liability regulated in a less clear way	- Valuer either external or internal but functionally separate (to be notified) - If internal, national authorities may require verification or audit - External valuer liable for negligent or intentional failure but AIFM retains full liability towards AIF and investors (no contractual discharge possible) - No delegation possible

			- Incompatible with depositary functions
<b>Depositaries</b>	<ul style="list-style-type: none"> <li>- Only UE credit institutions</li> <li>- No delegation to entities other than EU credit institutions</li> <li>- Quasi-strict liability + reversal of the burden of proof</li> <li>- No detail as to tasks and responsibilities</li> </ul>	<ul style="list-style-type: none"> <li>- Only UE credit institutions or investment firms (exceptions under national law only for non-leveraged AIF with 5 year lock-in)</li> <li>- For the rest, similar provisions to the August Compromise but definition of tasks and responsibilities less detailed</li> </ul>	<ul style="list-style-type: none"> <li>- Single external entity (AIFM and prime broker cannot act as depositaries)</li> <li>- UE credit institution, investment firm or other (according to national law) located in the home member state of the AIF</li> <li>- For non-EU AIF, it may be a non-EU entity if ESMA deems effective supervision exists in the relevant country</li> <li>- Responsible for checking valuation</li> <li>- Quasi-strict liability + reversal of the burden of proof</li> <li>- Delegation (and sub-delegation) possible under strict conditions</li> <li>- Contractual discharge of liability possible with regard to sub-custodians</li> <li>- Reporting upon request to supervisors</li> </ul>
<b>Passport rules (EU)</b>	<ul style="list-style-type: none"> <li>- Passport granted to EU AIF with respect to marketing to professional investors</li> <li>- Passport granted to EU AIFM with respect to their management services</li> <li>- Member States may allow marketing of AIF to retail investors and may impose additional requirements for such purpose</li> </ul>	- Similar provisions	- Similar provisions
<b>Third country rules</b>	<ul style="list-style-type: none"> <li>- Passport</li> <li>- Requirement for equivalent regulatory regimes and rigorous tax cooperation</li> <li>- Transitional period of three years to allow for the negotiation of cooperation arrangements</li> </ul>	<ul style="list-style-type: none"> <li>- No passport</li> <li>- Non-EU managers to require authorisation for each MS and cooperation agreements among home and host supervisory authorities</li> <li>- Cooperation arrangements should not be used as a barrier to trade</li> <li>- EU managers able to market non-EU AIF subject to most provisions in the Directive</li> </ul>	<ul style="list-style-type: none"> <li>- Authorisation may be denied if third country rules impede supervision</li> <li>- Delegation to a third country undertaking requires co-operation between supervisors</li> <li>- Depositary for non-EU AIF may be a non-EU entity if ESMA deems effective supervision exists in that country</li> <li>- Member States may allow annual reports of non-EU managers to be audited in their home country following international auditing standards</li> </ul> <p><b>PENDING NEGOTIATIONS</b> Passport? (Belgian EU Presidency in favour)</p>
<b>Private equity</b>	<ul style="list-style-type: none"> <li>- Applicable to AIFM who acquire 30% or more of voting rights of an issuer or no-listed company</li> <li>- Exception for SMEs</li> <li>- Compulsory and fast notification to the company and shareholders</li> <li>- Extensive disclosure obligations and annual reporting</li> </ul>	<ul style="list-style-type: none"> <li>- Only applicable to AIFM who acquire 30% or more of voting rights or no-listed company (not of an issuer)</li> <li>- Exception for SMEs</li> <li>- Extension of the notification delay from 4 trading days to 10 working days</li> <li>- Suppression of the need to disclose a development plan for the non-listed company</li> <li>- Less extended annual reporting</li> <li>- Reporting of leverage supported directly or indirectly by the company to supervisors</li> </ul>	<b>PENDING NEGOTIATIONS</b>
<b>Disclosure to investors</b>	<ul style="list-style-type: none"> <li>- Disclosure prior to investment covers a wide variety of information (about investment strategy, leverage, risk and liquidity management, valuation, conflicts of interest, fees and expenses, depositary liability, etc.)</li> <li>- Periodically, the AIFM needs to disclose information about illiquid assets and leverage.</li> </ul>	- Similar provisions	- Similar provisions
<b>Reporting to supervisors</b>	<ul style="list-style-type: none"> <li>- Disclosure of stress test not required</li> <li>- Disclosure of the extent of re-use of the collateral is not required (for any fund)</li> <li>- Main instruments, exposures and concentrations</li> <li>- Special arrangements for illiquid assets</li> <li>- Actual risk profile and management tools</li> <li>- Use of short selling (for systemic stability purposes)</li> </ul>	- Similar provisions to the August Compromise	<ul style="list-style-type: none"> <li>- Main instruments, exposures and concentrations</li> <li>- Special arrangements for illiquid assets</li> <li>- Actual risk profile and management tools</li> <li>- Use of short selling (for systemic stability purposes)</li> <li>- Results of stress tests</li> <li>- If leverage is used on a systematic basis: amount of leverage from borrowing cash or securities and embedded in derivatives (and extent of re-use of the collateral)</li> </ul>
<b>Supervisory authorities</b>	<ul style="list-style-type: none"> <li>- Home Member State of the AIFM responsible for prudential supervision</li> <li>- Host Member State of the AIFM responsible for conduct of business</li> <li>- Wide powers of inspection and intervention</li> <li>- Enhanced co-operation</li> </ul>	- Similar provisions	<ul style="list-style-type: none"> <li>- Similar provisions</li> <li>- ESMA is attributed various roles</li> <li>- Wide powers of inspection</li> <li>- Wide powers of intervention (including the repurchase or redemption of units)</li> <li>- Power to impose limits on leverage or other restrictions to limit systemic risk</li> </ul>

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