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CESifo DICE Report

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Suggested Citation: Athanassiou, Phoebus (2010) : The Draft AIFM Directive and the Future of European Alternative Investment Fund Regulation, CESifo DICE Report, ISSN 1613-6373, ifo Institut für Wirtschaftsforschung an der Universität München, München, Vol. 08, Iss. 1, pp. 8-13

This Version is available at:
https://hdl.handle.net/10419/166986

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The Draft AIFM Directive and the Future of European Alternative Investment Fund Regulation

Phoebus Athanassiou*

Introduction

On 29 April 2009 the European Commission published for consultation a proposal for a Directive on Alternative Investment Fund Managers (AIFM; European Commission 2009). The stated objective of the proposal[1] is to establish "common requirements governing the authorisation and supervision of AIFM in order to provide a coherent approach to the related risks and their impact on investors and markets in the Community".[2] In substantive terms, the proposal sought to give effect to concerns expressed at the highest level[3] in the wake of the global financial crisis about the potency of the EU's regulatory and supervisory frameworks in the alternative investments field and, in particular, about the perceived lack of regulation and supervision of non-harmonised funds and their managers. The proposal has drawn criticism from Europe's alternative investment fund (AIF) sector and beyond: some found it to be sweeping and unduly intrusive; others considered it too weak and ambiguous. This paper provides a summary of what has become a controversial proposal, highlighting its strengths and weaknesses and proposing ways in which it can be turned around to better achieve its objectives.

Outline of the draft directive

The draft directive captures all EU-domiciled AIFM, whether natural or legal persons, irrespective of the legal domicile of their funds. AIFM managing small portfolios worth less than EUR 100 million or less than EUR 500 (for non-leveraged funds with no redemption rights over a period of five years after their constitution) are exempted on a de minimis basis.[4] Significantly, while the draft directive seeks to regulate managers rather than funds, it will affect both, as several of its provisions relate, more or less directly, to the funds themselves.

Under the proposal, only authorised, EU-domiciled AIFM are to be allowed to offer their services and market their funds to professional[5] investors within the bloc. Benefiting from the proposal's "European passport", duly authorised fund managers may market their funds and offer their services not only in their home jurisdiction but, also, in other EU member states, subject only to a notification requirement. The proposal imposes upon AIFM a wide range of transparency and information-reporting requirements, vis-à-vis investors and regulators; some of these requirements are of general applicability, while others depend on the type of fund. The proposal also lays down detailed rules on the organisation and operating conditions of AIFM and on the regulation, by the Commission and/or the competent national authorities, of their use of leverage.

Under the proposal, EU-domiciled AIFM are to be allowed to market funds established in third countries at the earliest three years after the expiry of the draft directive's entry into force, provided that the Commission has assessed their home jurisdiction's regulatory and supervisory arrangements as "equivalent" to those of the draft directive, that access con-

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[1] The public consultation period lasted less than six weeks, despite the guidelines stating that consultations should be open for "at least 8 weeks".

[2] European Commission 2009, Recital 2.

[3] The reference is to the European Parliament's Rasmussen and Lehne Reports; to the findings of the de Larosière Group; and, more recently, to the Commission Communication of 27 May 2009 on European Financial Supervision.

[4] Managers falling below the directive's de minimis thresholds may voluntarily opt into its scheme.

[5] The professional-investors-only scope of the draft directive harks back to pre-financial crisis discussions on a possible harmonisation of the private placement regimes of the member states. As retail investors already have access, in several member states, to certain types of funds, draft Article 32 provides that member states may allow retail investor access to AIFs, subject to the fulfilment of stricter, non-discriminatory regulatory requirements on the fund or the AIFM.

ditions for EU-domiciled funds to the relevant third country fund's jurisdiction have been deemed comparable to those to be established under the draft directive and that cooperation agreements are in place between the home fund's jurisdiction and the member state where this is to be marketed, to ensure the exchange of supervisory and tax-related information. In the meantime member states may allow EU-domiciled AIFMs to market third country funds to professional investors in their territory subject to their own national laws.

Finally, the proposal requires member state competent authorities to cooperate for the exchange of the macro-prudential data necessary for the AIF sector's effective oversight.[6]

Why the draft directive counts

AIFs, in general, and hedge funds, in particular, have in recent years grown dramatically in terms of their assets under management and their overall economic importance. According to recent estimates (Persson 2009), no fewer than 1,785 private equity firms were in operation within the EU in 2009, with the private equity and hedge fund sectors generating EUR 9 billion in tax revenues in 2008; moreover, only the hedge fund and private equity sectors directly employed 40,000 people across Europe in 2008 (of whom 18,000 in the UK); finally, EU-based private equity firms invested no less than EUR 51 billion in European companies, only in 2008. It follows that, although AIFs are relatively small compared to harmonised funds, whose assets under management amounted to EUR 4,788 billion at the end of 2009 or 75 percent of the European investment fund market (EFAMA 2009), they are far from insignificant. On the wider socio-economic benefits associated with AIFs, suffice it to note that their contributions to market efficiency (through the proactive use of their shareholder rights and their input to price discovery), liquidity (especially at times of acute liquidity shortages), financial stability (through the spreading and diversification of risk) and the financing of pension systems are widely recognised, despite the tendency to place greater emphasis, in the public debate surrounding them, on the externalities justifying concerns about their activities rather than on their benefits (Athanassiou 2009, 91–98).

The contribution of AIFM and AIFs to the creation of investment opportunities and jobs as well as their role in the financial system suggest that Community legal rules of relevance to the alternative asset management sector, however necessary or desirable their introduction, need to be the products of mature reflection, as such rules have the potential, if disproportionate, imbalanced or otherwise ill-considered, to damage the sector's growth prospects, depriving several Europeans of their livelihood and Europe's financial markets of their competitiveness and investors of profitable investment opportunities.

Benefits of the draft directive

The Commission's aspiration to extend, through the draft directive, "appropriate regulation and oversight to all actors and activities that embed significant risks"[7] is, no doubt, sensible and fair and has been hailed as such by institutional stake-holders (ECB 2009, paragraph 3). That normative constraints making compulsory the authorisation and supervision of funds and/or their managers only apply in some member state jurisdictions suggests that there is room for regulatory intervention in this field. At least insofar as they affect systemically significant types of funds (i.e., large and highly leveraged ones), it is likelier than not that the existing regulatory lacunae can best be filled through concerted, EU-level action, which has considerable advantages over segmented, national or over-ambitious but, ultimately, unworkable international action. Moreover, that AIFs were not at the root of the financial crisis is hardly a reason to maintain the status quo as it is difficult to predict where the epicentre of a future crisis may be or to assess the contribution of AIFs to exacerbating the economic downturn, inter alia by creating demand for some of the "sophisticated" products that were symptomatic of its creation or by aggravating de-leveraging phenomena in the midst of the crisis (FSA 2009, 72–73).

Although many of the principles behind the draft directive are, therefore, sound, where it is possible to differ with the Commission is on the concrete ways in which the legitimate objectives underlying the adoption of EU-wide legislative measures in this

[6] At the time of the proposal's release, thinking had yet not crystallised within the EU on the post-financial crisis supervisory structure and, in particular, on the creation of the ESRB and the ESMA. Reflections on this issue had yet to mature at the time of writing.

[7] European Commission 2009, Explanatory Memorandum, § 1.1.

field are to be achieved as well as on the details of such measures. Leaving aside, for a moment, the costs that the draft directive would entail for the AIF industry and its investors,[8] we briefly consider, in the following section, what some of its other, more "conceptual", drawbacks are.

Concerns raised by the draft directive

The draft directive raises concerns at various levels. We will, for the purposes of this paper, only concentrate on the following four: (i) the "one size fits all" approach that permeates much of its text, (ii) its troubled relationship with existing pieces of EU legislation and the competition concerns to which some of its provisions give rise (iii) the Commission's ambition to regulate, through the draft directive, the authorisation and marketing, within the EU, of non-EU domiciled funds and (iv) the draft directive's lack of a clear regulatory focus. We briefly examine, below, each of these concerns.

One of the main points of contention surrounding the draft directive relates to the, more or less, uniform regime that this purports to impose on a wide range of disparate AIFs, including purely national funds of no obvious systemic stability relevance, many of which are already regulated nationally, but excluding credit institutions or insurance companies (ECB 2009, paragraph 7). This is despite the fact that the introduction of an EU-wide regime for the monitoring of the risks posed by funds can be justified (and not just as a matter of law) in the case of certain funds only, but not others and that regulatory arbitrage should be discouraged[9] A closely related (but distinct) point is that several of the draft directive's requirements appear unnecessary or seem to single out AIFs, despite their horizontal nature (ECB 2009, paragraph 8). The obligation imposed on all AIFM to appoint "independent" asset valuation agents, the requirement for the assets of all AIFs marketed within the EU to be deposited with an EU-based external depositary (i.e., a custodian bank) and the Commission's prerogative to dictate limits on the use of leverage by AIFM[10] are only some examples of prescriptions that may concentrate (instead of mitigating) risks, increasing legal uncertainties and imposing costs out of proportion with their expected benefits.

Consistency between the draft directive and several existing European directives is another source of concern. By including within the definition of AIF both open-ended and listed, closed-ended investment funds, which are already subject to comprehensive regulation under the Markets in Financial Instruments Directive (MiFID), the Prospectus, the Transparency and the Market Abuse Directives, or by, effectively, imposing upon management companies that simultaneously manage undertakings for collective investments in transferable securities (UCITS) and non-UCITS funds a double licensing requirement, the draft directive introduces elements of legal uncertainty in an area where clarity is of the essence. Similarly, by subjecting to more stringent rules AIFs pursuing activities similar to those of harmonised funds, the proposal is apt to generate level playing field concerns. The extra disclosure requirements for private equity managers – including the obligation to comply with the Transparency Directive – threaten to distort competition since wealthy individuals or the subsidiaries of multinational corporations (that private equity funds are in competition with) are not subject to the same requirements.

The draft directive's ambition to regulate the authorisation and marketing, within the EU, of non-EU domiciled funds is contentious, for two reasons. The requirements subject to which such authorisation is to be granted by the competent member state authorities and the activation of the foreign funds' marketing possibility no less than three years after the directive's entry into force make it unlikely that non-EU AIFM could obtain such authorisation. While this approach might be defended for prima facie being in line with the G-20 Pittsburgh Summit's objective of enhancing transparency in offshore jurisdictions, the restrictions on third country funds and managers are problematic, both because they restrict investor choice and because they are in open conflict with the G-20 London Summit's call for regulators and supervisors to "reduce the scope for regulatory arbitrage" and to "promote global trade and

[8] According to estimates, the directive will cost the private equity and hedge fund industries in the EU between EUR 1.3 billion and EUR 1.9 billion in the first year, with the annual recurring cost being estimated at between EUR 689 million and EUR 985 million. The increased compliance costs for all players along the fund value chain – managers, custodians, administrators and so on – are likely to be passed on to investors, in the shape of higher fees (Persson 2009).

[9] It is telling that the G20 London Summit recommendations stressed the need to focus only on the "systemically important financial institutions, instruments and markets' including on the "systemically important hedge funds".

[10] This is only one of a wide range of areas where the Commission reserves itself a right to modify the directive (others include short-selling, disclosure requirements, valuation standards and marketing rights).

investment and reject protectionism". It is, on the other hand, questionable whether the passport-driven opening of the European fund market to offshore funds and their managers can be a legitimate internal market regulation objective.[11]

Perhaps the greatest defect of the draft directive lies in its lack of a clear regulatory focus: specifically it is not clear whether its focus is on financial stability (as one would expect the case to be, given the timing and motivation for its drafting) or, instead, on investor protection. As a regulatory rationale, investor protection appears to be somewhat inappropriate in the context of AIFs, especially since the proposal's scope is limited to the marketing of funds and to the offer of the services of AIFM to professional investors only. Financial stability, on the other hand, appears to provide a more compelling basis for regulation in this field. While these two regulatory rationales are by no means mutually exclusive, their parallel pursuit is apt to weaken the directive's chances of fulfilling either. If the main focus of the proposal is to be on financial stability it would be sufficient, in order for systemically relevant funds to be caught, that the draft directive's scope be limited to cross-border, highly leveraged funds with considerable assets under management. If, on the other hand, its main emphasis is to be on investor protection, some of its rules for investor disclosure could be reviewed, as they are currently tailored to the needs of retail, rather than professional investors.

European Council and Parliament reaction to the Commission proposal

The proposal, which is being considered at the time of writing by the Parliament and the Council and is to be approved under the co-decision procedure, has drawn strong criticism from various quarters (e.g., Bundesverband Investment und Asset Management e.V.; Swiss Funds Association; Finansinspektionen 2009). Interestingly enough, both the Parliament and the Council have presented their own proposals, which differ considerably in several respects from that of the Commission but, also, from one another.

The former Swedish Presidency's compromise proposal was first published on 12 November 2009 (European Council 2009), while that of the European Parliament (the Gauzès proposal, named after the rapporteur responsible for the Parliament's Draft Report in this matter) was made available on 23 November 2009 (European Parliament 2009). Both texts contain numerous amendments to the draft directive, the sheer volume of which testifies to the widely shared perception that the Commission proposal was fraught with weaknesses. While neither the compromise proposal nor the Gauzès proposal represents the final word of the Council or the Parliament, respectively, on the issue, a summary of their main commonalities and differences is deemed apposite.

Both the compromise proposal and the Gauzès proposal discard the idea that natural persons can act as AIFM (acknowledging, nonetheless, that self-managed funds would themselves qualify as AIFM); however, contrary to the Council's definition of AIFM, the one proposed by the Parliament provides that a manager will not qualify as an AIFM unless it both manages a fund and assumes responsibility for doing so. The compromise proposal and the Gauzès proposal also differ in terms of their approach to the Commission's de minimis exemptions: these are retained by the Council (subject to minor amendments) but discarded by the Parliament (subject, nevertheless, to the application of the principle of proportionality, to avoid imposing unnecessary burdens on small AIFs). The Council and the Parliament do not see eye to eye on the issue of the proposed appointment of an independent valuator for all AIFs (contrary to the Council, the Parliament favours retaining it, except for private equity funds) nor on the proposed limits on the use of leverage by AIFM (the Council favours restricting the possibility for the competent member state authorities to impose limits on leverage and removing the Commission's power to set such limits, whilst the Parliament retains the latter possibility, albeit in exceptional circumstances only and subject to prior determination of the European Securities and Markets Authority). Issues over which the Council and the Parliament broadly agree (despite their differences in the details) are on the need to (i) scrap the proposed EU passport for non-EU domiciled funds (this is to be restricted to EU-established AIFs, marketed to professional investors by authorised AIFM), (ii) delete the provisions subject to which non-EU managers would be entitled to market non-EU domiciled funds, (iii) ensure that AIFMs apply remuneration policies and practices consistent with sound and effective risk management (an issue in connection

[11] Rather than restrict the cross-border distribution eligibility of foreign funds stronger incentives could be given for third country funds to transfer their domicile to the EU.

with which the Commission had tabled no proposals) and (iv) relax the original proposal's depositary provisions.

Recommendations for an improved draft

It is suggested that, whatever the fate of the proposals presented by the Council and the Parliament and whatever the initiatives likely to be taken by the new Spanish Presidency, about which a recent issues note provides some hints (European Council 2010), the draft directive's rules need to be (re)drafted with certain fundamental principles and objectives in mind. An EU-wide legal act in this field should, in this author's view, seek to achieve the following objectives:

a) Distinguish between different types of funds, exempting from the directive's scope of application funds with little or no systemic risk relevance; unless the proposal's scope of application is narrowed down to funds considered to raise systemic instability risks, its rules could prove to be unworkable.
b) Free up investor choice by dropping protectionist elements or extra-territorial pretensions; replacing these with a reasonable requirement for "prudential regulation and supervision" in the country of the establishment of the AIF or AIFM concerned would not only be sufficient but it could also encourage offshore jurisdictions to step up prudential controls over funds established in their territory.
c) Bring the directive's organisational, investor disclosure and reporting requirements in line with its actual objectives, rather than follow the model of existing legal acts (e.g., the UCITS Directive, which caters for a different market and a different set of public policy concerns).
d) Rationalise discretionary restrictions on specific investment policies (e.g., limits on leverage or the extra requirements for private equity firms); reducing the Commission's powers to add to or amend the directive after its adoption would not only be conducive to greater legal certainty but could also help guarantee equal treatment of like cases.
e) Last but not least, readjust the directive's regulatory emphasis, clarifying what information AIFM need to report, whom they need to report it to and for what purpose; reporting obligations should focus on data relevant to the monitoring of financial stability, paving the way for the monitoring tasks of the European Systemic Risk Board; unless this is done, there is every probability that an EU-level legal act in this field may fail to achieve its objectives and, possibly, risk creating a false impression of oversight.

Concluding remarks

The tight schedule for the draft directive's preparation and the conflicting interests that it seeks to serve have resulted in the Commission producing a proposal that, however much seeking to serve legitimate goals, is objectionable in some of its details. While it is more or less clear that an EU-level legal act is eventually to be adopted in this field, its precise contents are still open, with no European consensus in sight on whether the rules proposed by the Commission should be watered down or reinforced and, if so, how. An EU-level agreement is unlikely to be reached before the first half of 2010, in which case the directive would not come into force before late 2011 or 2012. If our brief analysis of the proposal's areas of improvement is anything to go by, its contents appear likely to evolve significantly prior to its final adoption. One hopes that some of the concerns raised by the Commission proposal will be addressed and that its scope of application will be carefully considered and readjusted. If some, at least, of the principles and objectives highlighted in this paper are adhered to, it is likelier than not that, whatever its precise contents, the final product will come close to achieving the valid purposes that underlie its adoption.

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