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Accompanying the

Proposal 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

IMPACT ASSESSMENT

{COM(2009) 207}
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TABLE OF CONTENTS

1. INTRODUCTION

Sections 1.1 - 1.3 of this introductory chapter describe the size and composition of the alternative investment industry in the European Union, the structure and geographical location of alternative investment funds (AIF) and their managers (AIFM), and the nature of the investors in these funds. Sections 1.4 and 1.5 then discuss the risks associated with the activities of AIFM and how they have manifested themselves during the financial crisis. Section 1.6 introduces the core concern of this impact assessment: the extent to which the nationally-fragmented regulatory environment for AIFM provides an effective and efficient framework for the regulation and oversight of this industry, in particular for the monitoring and management of risks that are of cross-border concern.

1.1. The investment fund universe

In the EU, investment funds can be broadly categorised as UCITS (undertakings for collective investment in transferable securities) and non-UCITS (or non-harmonised) funds.[1] UCITS funds are those that comply with harmonised rules as laid down in the UCITS Directive (85/611/EEC) and are authorised for sale to the retail market.

Non-harmonised funds (hereafter referred to collectively as alternative investment funds, or AIF) do not form a homogenous class of investment fund.[2] AIF invest in a wide variety of asset types and employ very different investment strategies. Inter alia, hedge funds, private equity funds (which can be broken down further into large buy-out funds, mid-cap investment funds and venture capital funds), infrastructure funds, commodity funds and real estate funds can all be classed as AIF. 'Special funds' or 'institutional funds', which exist in many Member States and take various legal forms but are not limited to a specific asset class or investment strategy and can therefore not be attributed to a particular fund type, can also be included in this category.

It is these AIF and more specifically the AIFM that form the focus of this impact assessment. As shown in Table 1, over €2 trillion are currently invested in EU-domiciled AIF.

Table 1: Breakdown of Non-UCITS funds by category (1)

	30/09/2008		**31/12/2007**	
	€ bn	**Share**	**€ bn**	**% chg** (2)
Special/Institutional funds	914	41%	945	-3.3%
British investment trusts	55	2%	79	-30.8%
French employees saving funds	76	3%	85	-10.6%
Luxembourg other funds (part 2)	84	4%	102	-17.7%
Real-estate funds	213	10%	208	2.6%
Other	166	7%	170	-2.6%
Sub-Total	*1,508*	*68%*	*1,589*	*-5.1%*
Sub-Total incl. Ireland	*1,663*	*75%*	*1,696*	*-4.9%*
Hedge funds	566	25%		
Total	2,229	100%		

(1) Excluding Ireland for which no data breakdown is available. (2) End September 2008 compared to end 2007.
Source: EFAMA for non-UCITS; Morningstar for Hedge funds (various reporting dates, mainly in Q4 2008).

1 A glossary of technical terms and acronyms can be found in Annex I, references are provided in Annex XII.

2 Categories of non-harmonised funds (non-UCITS) can be found in Annex II

The table below shows that the UCITS sector is about three times larger than the EU-domiciled AIF sector, although the figures do not include funds managed by EU-domiciled hedge fund managers (around €560bn) or private equity funds (around €76bn funds raised in 2007[3]). Together, investment funds hold more than €6.1 trillion assets under management in the EU, equivalent to half the gross domestic product of the EU.

Table 2: Total net assets of the investment fund industry in the EU end December 2008 (2007)

<table>
<tr><th colspan="2">All funds</th><th colspan="2">UCITS funds</th><th colspan="2">Non-UCITS funds</th></tr>
<tr><td>Number of funds*</td><td>Net assets, €</td><td>Number of funds*</td><td>Net assets, €</td><td>Number of funds*</td><td>Net assets, €</td></tr>
<tr><td>51.232
(46.942)</td><td>6.141.704
(7.872.614)
-22,3%</td><td>35.722
(32.682)</td><td>4.593.081
(6.160.328)
-25,4%</td><td>15.510
(14.260)</td><td>1.548.623
(1.749.002)
-11,5%</td></tr>
<tr><td colspan="2">Share in all funds:</td><td>70%
(70%)</td><td>75%
(78%)</td><td>30%
(30%)</td><td>25%
(22%)</td></tr>
</table>

** End September 2008 data;*
http://www.efama.org/images/stories/international_statistical_release_2008_q3__3_.pdf
EFAMA, Quarterly Statistical Release, February 2008;
http://www.efama.org/index.php?option=com_docman&task=doc_download&gid=872&Itemid=-99

1.2. Structure and location of AIF and AIFM

As a part of the asset management value chain, AIFM are responsible for the management of investment portfolios. Their tasks include the provision of internal governance structures, risk management, the delegation of functions to third parties and relations with investors. AIFM are typically located on-shore in the EU. They are generally (but not always) subject to registration and supervision in the countries where they are established. Other elements of the value chain include:

- the fund, AIF, itself which is primarily a legal shell;
- administrators, appointed to issue and redeem interests and shares and to value the fund portfolio;
- prime brokers, which provide inter alia leverage and trading services;
- depositaries, credit institutions entrusted with safeguarding the interests of AIF investors, in particular through the safe-keeping of assets.

Some of these functions can be performed either by the AIFM or third parties. The precise nature and distribution of functions varies according to the particular business model. Depending on national rules, administrators and depositaries can be domiciled either within the EU or off-shore.

Within the EU, the management of hedge funds is highly concentrated in the UK, with around 80% of European hedge fund assets managed from London. AIFM for other types of AIF, for example commodity, real-estate and special funds, are more evenly distributed throughout the EU.

The AIF is a structure through which aa legal entity distinct from the AIFM. The AIF may be located onshore or may, especially in the cases of hedge funds and private equity, be located

3 Source: EVCA Yearbook 2008. The size of private equity funds can not easily be compared to other investment funds as their usual measure, 'assets under management', does not correspond to the measure of private equity funds, 'capital raised': The former is a value of stock, while the latter is a value of flow. The 'assets under management' of private equity funds can not be calculated as their investments - the portfolio companies - are usually not listed and not valuated at regular intervals.

in an off-shore jurisdiction for reasons of tax efficiency. AIF span a wide range of legal structures, including closed and open end funds and partnerships. However, the AIF is merely a legal structure to pool assets and hold investments. It has no economic life of its own: the key decisions in relation to the management and marketing of AIF are taken by the AIFM.

EU-domiciled AIFM may manage funds that are domiciled on-shore, or in off-shore jurisdictions. At the end of 2007, for example, 52% of global hedge funds were registered offshore; while, according to Morningstar database, almost all commodity funds that are registered for sale in the EU are also domiciled in the EU.

With regard to private equity, the UK has a large share of the headquarters (or main offices) of private equity firms within the EU. In 2007, UK-based private equity firms raised more than 50% of the funds raised in Europe by country of management, followed by France (9%) and Germany (7%). Nearly 50% of the (equity) investments made during 2007 were by private equity funds managed from the UK, followed by France (17%) and Germany (10%).[4]

1.3. Investor base of AIF

Unlike UCITS, which are designed to be suitable for distribution to retail investors, many AIF are regarded as entailing too much risk, or having other features which render them unsuitable for retail investors.[5]

Specifically, the returns on these investments are often much more volatile than for retail products, with the result that the risk of incurring large investment losses, or even total loss of assets through the default of the AIF, is considerably higher. AIF also typically lock investors in for a longer period than retail funds, affording them the opportunity to earn a premium from investment in less liquid assets. More generally, AIF investment strategies tend to be more complex and therefore harder for prospective investors to assess.

For all of these reasons, access to many AIF has traditionally been restricted to professional or institutional investors[6], who are both better able to understand the risks their investments entail and as a result of their large and diversified investment portfolios are generally able to absorb the potential losses associated with these investments. These restrictions take the form both of practical barriers to investment, e.g. the imposition of investment thresholds (which vary, for example, from €125,000 (Ireland, Luxembourg) to €500,000 (Italy), although some Member States apply lower thresholds where the fund is domiciled and authorised locally) and legal restrictions imposed on AIFM and financial intermediaries by national regulators. The presumption that most AIF are only suitable for professional or institutional investors has been reinforced by the experience of the financial crisis (see Section 1.5 below).

However, some types of AIF such as open-ended real estate funds and funds of hedge funds are directly accessible to retail investors in some Member States. While there has been some increase in direct or indirect retail exposure to different forms of AIF in recent years, research indicates that on aggregate this exposure is marginal.[7]

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4 Source: EVCA Yearbook 2008. See also Annex III.
5 See Annex IV: Key investor protection safeguards.
6 See Annex V: Definitions of Qualified Investor, Professional Client and Eligible Counterparty.
7 http://ec.europa.eu/internal_market/investment/docs/other_docs/study_non-harmonized_funds.pdf

1.4. Risks associated with AIFM activity

The activities of AIFM give rise to risks for AIF investors, counterparties, the financial markets and the wider economy over and above the investment risk that is intrinsic to any financial investment. Table 3 summarises the main sources of risk in the AIFM sector.

Table 3: Overview of key risk areas[8]

Macro-prudential (systemic) risks, relating in particular to the use of leverage	• Direct exposure of systemically important banks (as the providers of leverage) to the AIFM sector • Pro-cyclical impact of herding behaviour, risk concentrations in particular market segments and ('forced') deleveraging on asset prices and market liquidity
Micro-prudential risks	• Possible weaknesses in internal risk management systems with respect to liquidity risks, market risk, counterparty risks (credit and settlement risks, especially in the case of short selling) and operational risks
Investor protection	• Gaps in investor disclosure on investment policy, risk management, internal processes etc as barrier to effective due diligence • Conflicts of interest and failures in fund governance, in particular with respect to remuneration, valuation and administration
Market efficiency and integrity	• Impact of dynamic trading and short selling techniques on market functioning • Potential for market abuse in connection with certain techniques, for example short-selling.
Impact on market for corporate control	• Lack of transparency when building stakes in listed companies (e.g. through use of stock borrowing, contracts for difference), or concerted action in 'activist' strategies
Acquisition of control of companies by AIFM	• Potential for misalignment of incentives in management of portfolio companies, in particular in relation to use of debt financing • Lack of transparency and public scrutiny of companies subject to buy-outs

The types of risk associated with the activity of particular categories of AIFM vary as a function of the investment strategy, the investment techniques employed and the markets in which they participate. However, some risk types are common to several or all AIFM business models, as illustrated in Table 4.

Table 4: Risk Map[9]

	Relevant to:				
Potential sources of risk:	Hedge Funds	Private Equity	Commodity funds	Real Estate	Infra-structure
Macro-prudential risks					
- Use of leverage (by AIFM)	X		X		
- Herding	X		X		
Micro-prudential risks					
- Market risks	X	X	X	X	X
- Funding liquidity risk	X			X	
- Counterparty risk	X		X	X	X
- Operational risks	X	X	X	X	X
Investor protection					
- Potential for weakness in investor disclosures	X	X	X	X	X
- Conflicts of interest, failures in fund governance	X	X	X	X	X

8 These risks are described in greater detail in Annex VI.

9 The table does not contain an assessment of the relative intensity of the risks, which may vary significantly between business models. Discussion of whether existing regulatory regimes and industry practices are capable of effectively mitigating these risks follows in Section 3.

Market efficiency and integrity	X				
Use of short-selling / other techniques	X		X		
Impact on market for corporate control		X			
Use of 'activist' strategies	X				
Accountability of AIFM acquiring and managing companies		X			

Given the global nature of their activities, many risks posed by AIFM have an important cross-border dimension. Investors, counterparties and service providers may be located in jurisdictions other than that of the AIFM. AIFM trade on international financial markets and invest in portfolio companies in other Member States. As discussed further below, some types of AIFM are major players in financial markets and can therefore have a substantial impact on asset prices and market liquidity in markets throughout Europe and beyond.[10] The impact of risks crystallising in the AIFM sector in one Member State will therefore be felt beyond national borders.

1.5. AIFM and the financial crisis

The importance of AIFM to European financial markets and the significance of the risks their activities present - both for their investors and the stability of the financial markets - have been underlined by the events of the financial crisis. As active participants in European financial markets, AIFM activities make a significant contribution to market liquidity and efficiency. However, adverse market conditions have severely affected the sector and have provided evidence of the role of AIFM in exacerbating market dynamics.

Macro-prudential risks

Certain types of AIFM have exhibited considerable appetite for credit derivatives and asset-backed securities (including mortgage backed securities) and thus have contributed to the rapid growth of these markets. AIFM – in particular those managing large, leveraged AIF - may also have contributed to asset price inflation in many markets, where they were active momentum traders in the period to mid-2007.

These same actors may have contributed to the speed and scale of the market correction witnessed over recent months. On average, AIF lost significant value during 2008 and assets managed by EU-domiciled AIFM contracted by 11.5%. In addition to adverse market conditions, many AIFM were faced with increased redemption demands from investors and with tighter lending conditions from banks. Leveraged funds were forced to unwind positions and to scale back leverage - hedge fund leverage in particular has declined from around 3 to 1.5.[11] Faced with such pressures, funds (particularly hedge funds) were often forced to sell assets into declining markets – thereby realising losses and adding further momentum to declining asset prices. This **pro-cyclical behaviour** may have undermined financial stability and contributed to a deepening of the crisis.

Micro-prudential risks

The financial crisis has also highlighted **failings in risk management and due diligence** across the financial system. Excessive reliance on counterparties and trend-following at the expense of sound risk management and due diligence were observed by many market

10 "For example, in 2005 the consulting firm Greenwich Associates estimated that while hedge funds accounted for 15% of trading volumes in US fixed income markets, this proportion rose to 45% of trading in emerging market bonds, 47% in distressed debt, and 58% in credit derivatives." Financial Stability Forum: Update of the FSF Report on Highly Leveraged Institutions (May 2007).

11 See Annex VI.

participants, including AIFM. AIFM also faced severe risk management and valuation challenges, as asset prices plummeted, key counterparties failed (including prime brokers), credit and market liquidity dried up and redemption requests increased.

The combination of increasing redemption requests and illiquid asset markets resulted in major **funding liquidity risks** for several business models. Many sectors experienced net outflows of funds. Others unable to exit illiquid investments had to activate gate provisions in order to limit withdrawals. Others offered lower fees in exchange for longer lock-up periods. Smaller funds were particularly vulnerable to these risks, since market participants reportedly observed an increased preference by investors to reallocate their funds to larger hedge funds that could afford and prove adequate risk controls and reliable operational infrastructures.

The **counterparty risks** faced by hedge fund managers were demonstrated by the near-failure of Bear Stearns and the bankruptcy of Lehman Brothers that highlighted the importance of monitoring the security of the cash and security balances held with prime brokers.

Box 1: The impact of the financial crisis on particular AIFM strategies

Hedge funds shrank by a quarter in value when measured by assets under management during the course of 2008. While this compares favourably to retail equity funds, it has triggered a crisis of legitimacy for hedge funds – which were able to charge high fees on the grounds that they could deliver absolute returns even in declining markets. The rapid unwinding of the leveraged positions associated with these and other types of AIF has had severe consequences for asset prices and financial stability. "If hedge funds increasingly fail to retain their investors, the possibility of further sizeable position unwinds by the sector may pose a challenge to financial markets." (ECB, Financial Stability Review, December 2008)

Funds of hedge funds faced a serious mismatch between liquidity and redemption intervals. While many apply relatively short redemption periods, their investments in hedge funds could not be liquidated as quickly due to the much longer redemption periods and some hedge fund closures. Therefore, they had to resort to emergency measures (fund closure, gates, etc.) in order to manage redemption requests. Some funds were also hit by exposures to the Madoff scheme in the US.

Private equity funds have experienced a different set of challenges, relating to the availability of credit and the financial health of their portfolio companies. The inability to obtain leverage has significantly reduced buy-out activity and those companies that have been subject to leveraged buy-outs are in some cases struggling to roll over the debt on their balance sheets. "It is estimated that, at the global level, more than USD 500 billion of leveraged loans and high-yield bonds will have to be refinanced between 2008 and 2010." (ECB, Financial Stability Review, December 2008). Although these figures do not relate to private equity alone, it is likely that tightened credit conditions will lead to stresses in corporate credit and CDS markets. The resulting difficulties for portfolio companies of private equity funds might backfire on the returns of the funds and might lead to detriment effects in the real economy, at least at local or regional level.

The volume of newly extended **leveraged buyout (LBO) loans** declined sharply in 2008, to just above €47 billion (in the months from January to October).[12] This corresponds to around one third of the LBO loan volume in the same period a year earlier. In addition, about one-third of the 2008 issuance volume was accounted for by transactions mandated in 2007, which the banks were committed to underwrite. Difficulties in syndication processes are likely to have put pressure on banks' funding costs and capital requirements, as high risk-weighted assets have had to be warehoused longer than expected on banks' balance sheets. Indeed, forced selling by leveraged investors is likely to have contributed to further drops in the already depressed prices in the US and European secondary loan markets.[13]

Real estate funds: In Q4 2008, German open-ended real estate funds (OEREFs) faced significant redemption pressure following withdrawals primarily from institutional investors, but also private retail investors that depleted their cash reserves. As a result, such funds, representing about €32bn, temporarily suspended the redemption of shares in October 2008 for an initial three month period. This marked the second time in their history that such funds had temporarily suspended redemptions, following the turmoil in the German open real estate market at end 2005. In February of 2009 a majority of real estate companies decided to extend the suspension period for up to twelve months. The companies said they did this because of an inability to raise cash

12 See Standard & Poor's, "Leveraged Commentary & Data", November 2008
13 ECB, Financial Stability Review, December 2008

levels within the three month period to adequate levels, but also to resist pressure for property fire sales that would negatively impact the funds' performance. The BVI, Germany's asset manager association, has proposed new measures for managing the liquidity in OEREFs by imposing compulsory 12-month notice periods for institutional investors in retail mutual funds.[14]

Market efficiency and integrity

AIFM, in particular hedge fund managers, have also been central to the ongoing debate about the impact of certain trading practices on the integrity of financial markets. In particular, curbs on short-selling in several jurisdictions reflected unease over the impact of such activities. But AIFM were also a cause of concern in 2008 when prices in some commodity markets, in particular food prices, increased dramatically. Allegedly, speculation in futures markets had a distorting impact on spot markets with adverse impacts on the real economy, particularly on the poor who have to rely heavily on these products.[15]

1.6. Focus of impact assessment

Recent events and the risks that they have exposed necessitate a comprehensive review of regulatory and supervisory frameworks for all significant market actors, including AIFM. As described in the Commission's recent Communication for the Spring European Council and in accordance with the conclusions of the G20, the Commission is committed to ensuring that '*all relevant actors … are subject to appropriate regulation and oversight*', which requires filling gaps in areas where European and national provisions are incomplete.

The core concern of this impact assessment is therefore the extent to which the current combination of national and European regulatory provisions and self-regulatory codes constitutes an effective framework for monitoring and managing the risks associated with the activities of AIFM. In particular, it seeks to establish whether the current arrangements represent a sound basis for organising the regulatory and supervisory oversight for AIFM, given the organisation of the industry in Europe and the transmission of risks across the EU.

2. PROCEDURAL ISSUES AND CONSULTATION OF INTERESTED PARTIES

This impact assessment draws on the results of a series of workstreams which addressed issues relating to the cross-border distribution of non-harmonised funds in the EU. Although the focus of these work streams was different to that of the present impact assessment, the input gathered through broad consultation of stakeholders, the gathering of expert views and research contributed significantly to the Commission's understanding of these issues. For this reason they are briefly outlined in this section.

Due to the short period of time in which this impact assessment was produced, no formal steering group was established.

2.1. Consultation and expertise

The Commission considered the question of whether there is a need for 'single market solutions for non-harmonised investment funds' in the White Paper on Asset Management (COM (2006) 686) of November 2006. The conclusion was that the question should be approached from two angles. Should some types of non-harmonised funds be granted an EU

[14] http://www.easybourse.com/bourse-actualite/marches/press-releasefitch-sees-liquidity-challenge-for-german-oeref-618339

[15] For a discussion about the causes of the price movements see Commission Staff Working Document SEC(2008)2971: "Is there a speculative bubble in commodity markets?"

passport similar to UCITS to market their funds to retail investors across Member State borders? And should a European private placement regime for the cross-border distribution of non-harmonised funds to institutional or sophisticated investors be established?

This conclusion was, among other things, based on the reports of two industry expert groups on private equity and hedge funds, respectively, and the feed-back provided by interested parties in an open internet consultation on these reports.[16]

To improve understanding of the non-harmonised fund market and in particular the boundary between harmonised and non-harmonised funds, the Commission services launched *two external studies*. The first focused on the differences in the investment strategies, techniques and the main risk-return features of harmonised funds and retail-oriented non-harmonised funds. The study was based on a broad industry survey. The final report has been published on the Commission's website.[17]

The second aims to analyse the actual distribution of non-harmonised funds to retail investors: Which types of non-harmonised funds are being sold to retail investors at national level? What is the size of the relevant markets? What is the regulatory framework in place at national level? Which are the most relevant distribution channels? The final report was published in January 2009.[18]

The Commission also set up an *expert group on open ended real estate funds* in June 2007. This group of industry experts from a wide range of Member States and professional backgrounds presented its report in March 2008. The report was subsequently subject to a public consultation.[19]

Both the final report of the first study and the expert group report formed the basis for a public debate of the issue of retail-oriented non-harmonised funds at an *open hearing* in Brussels on 8 April 2008. This hearing was attended by some 270 participants from industry, investors and public authorities.[20]

As regards non-harmonised funds that target institutional investors, the Commission launched a detailed investigation into whether a European regime should be created for the private placement of these funds across borders. While there was no opposition in principle to such a framework, it was decided to first obtain a better understanding of how private placements are regulated nationally and how they work in practice before entering in the design of a regime that potentially would provide cross-border access for fund products that are not authorised or supervised in the EU in any way. The main questions focused on the definition of the eligible investor and the extent to which and under which conditions products from third countries should be allowed to be privately placed in the EU.

A *call for evidence* in spring 2007 and *two workshops* in January and February 2008 provided valuable input for an *impact assessment on private placement* published in July 2008.[21]

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16 For details on the expert groups, their reports, a summary of the feedback in the public consultation as well as the individual contributions can be found on the Commission website: http://ec.europa.eu/internal_market/investment/ alternative_investments_en.htm#alternative.

17 Study on "investment funds in the European Union: comparative analysis of use of investment powers, investment outcomes and related risk features in both UCITS and non-harmonised markets", http://ec.europa.eu/internal_market/investment/other_docs/index_en.htm#studies

18 http://ec.europa.eu/internal_market/investment/studies_en.htm

19 http://ec.europa.eu/internal_market/investment/real_estate_funds_en.htm

20 http://ec.europa.eu/internal_market/investment/consultations/index_en.htm#hearing0804

21 The executive summary of this impact assessment is attached as Annex VII.

In December 2008 a *consultation on hedge funds* was launched in order to gather views from all stakeholders on a series of issues relating to the activities of hedge funds, impact on financial markets and their interactions with investors and other market participants. Over 100 responses were received.[22] A feedback statement and the individual replies were published in March 2009. A *public conference on hedge funds and private equity* in February 2009 with about 350 participants from all interested sectors focused in particular on financial stability, transparency and investor protection.

Although not originally tailored as input for this impact assessment, all these work streams, - the impact assessment on private placement and the expert groups, consultation and conference on private equity and hedge funds - provide important background and information for the reflections on a potential regime for AIF and their managers. In addition to these inputs, the analysis is also based on extensive desk research taking into account the ongoing international debate on these issues in forae such as the IMF, IOSCO, FSF and G20, as well as work conducted by the industry, such as the hedge fund standards developed by the President's Working Group in the US and the Hedge Fund Working Group in the UK, and the Walker guidelines and EVCA codes of conduct for private equity.

Table 5: Preparatory steps

Major steps / inputs	Timing
Expert groups on alternative investments	January - July 2006
Public consultation on expert group reports	July - October 2006
White Paper on investment funds	November 2006
Comparative study on investment powers	December 2006 - January 2008
Study on the retail distribution of non-harmonised funds	December 2007 – September 2008
Expert group on open ended real estate funds	July 2007 – February 2008
Open consultation on the report of the expert group	March – June 2008
Call for evidence on private placement	April – June 2007
Workshops on private placement	January – February 2008
Open hearing on non-harmonised retail funds	8 April 2008
Impact assessment on private placement	July 2008
Consultation on hedge funds	December 2008 – January 2009
Conference on hedge funds and private equity	26-27 February 2009
Transmission of draft IA report to the IAB	6 March 2009
Examination of the IA by the IAB	18 March 2009

** Publication together with this impact assessment*
Note: for references please see Annex XII.

2.2. How has the opinion of the Impact Assessment Board been taken into account?

The Impact Assessment Board (IAB) concluded that the report did not meet the expected standards as it provided only a partial analysis. It requested significant further work on a number of issues. This included a better identification and substantiation of the risks posed by AIFM and their systemic and cross-border nature; a much more detailed analysis of the options, setting out the concrete measures envisaged. The report should illustrate the principle-based nature of the preferred option and its implications for the different types of AIFM, supervisors, stakeholders and administrative costs. It should better specify the nature of the single market problems and the solution proposed. Finally, international aspects, the potential for an international regulation and the risk for the competitiveness of the EU industry should be analysed and strengthened.

Box 2: Impact Assessment Board Opinion of March 23, 2009:

22 Annex VIII: Summary of responses to Commission consultation on hedge funds

"*General recommendation: The Board acknowledges that the preparation of the report has been affected by the tight schedule for adoption of the related proposal as part of the Commission's response to the financial crisis, and that this has had a significant impact on the quality of the report. The current draft provides only a partial analysis and does not meet the standards expected of an impact assessment. Significant further work is needed on a number of issues: the report should better identify and substantiate the risks posed by AIFM' activities, their systemic nature and their cross-border dimension. Against this background, it should more clearly identify the problematic issues that can be addressed by EU regulatory intervention, provide a much more detailed analysis of the options for such action and set out the concrete measures proposed in sufficient detail in the preferred option. In so doing, the report should ensure that illustrate the principle-based nature of the envisaged regime and its implications for different types of AIFM, national supervisors, relevant stakeholders and administrative costs. The report should also better specify the nature of the single market problems identified and the solution proposed to deal with them. Finally, the analysis of international aspects such as the role of non-EU funds, the potential for international regulation and the risk for the competitiveness of the EU industry should be strengthened*."

On the basis of the IAB's comments the IA report has been thoroughly revised. The most significant amendment is the new Section 5.6 on the substance of the proposal and its impacts on stakeholders and a discussion on proportionality. Other modifications include:

– a revision of the problem definition in Section 3 to strengthen the description of risk transmission channels
– the addition of relevant evidence to Sections 1, 3 and the Annexes
– an assessment of international-level responses
– an expanded discussion of the off-shore dimension
– an improved consistency between the chapters
– better explanation of terminology/jargon.

The revised IA report has been resubmitted to the IAB on 31st March which in turn submitted its second opinion on 8th April. These comments have been taken into account through amendments to section 5.6 in particular.

Box 2a: Impact Assessment Board Opinion of April 8, 2009:

"*General recommendation: The report has been significantly improved. There remain, however, some areas where further clarification would be welcome. These regard: the implications of the on-shore / off-shore structure of the AIF industry, notably with regard to the off-shore provision of valuation and depository services; the justification for the suggested de minimis thresholds; the distribution of supervisory responsibilities within the EU; and the impact on AIFMs domiciled in third countries.*"

3. PROBLEM DESCRIPTION

This section explores whether the current combination of national and European regulatory provisions and self-regulatory codes constitutes an effective framework for monitoring and managing the risks arising from the activity of AIFM. In particular, it considers whether the cross-border impacts of risks are adequately addressed and effective mechanisms are in place to monitor risks on a cross-border basis. It also considers the impact of the fragmented regulatory framework on the development of the single market for AIFM.

The introductory section has described the AIF market and the risks that the activities of AIFM pose for investors, counterparties, the financial markets and the wider economy. It has also described how some of these risks have crystallised during the financial crisis.

In response to the risks described, a variety of regulatory responses have been developed at European and national level. The activities of AIFM are not therefore currently unregulated. Many Member States have introduced legislation for AIFM; however, the scope and content of national measures vary significantly, for example with regard to the requirements for the registration and authorisation of AIFM, their prudential regulation, regulatory reporting requirements and standards for investor disclosure and risk management.

It is important to recall in this context that whereas these regulatory and supervisory frameworks are predominantly national, the risks posed by AIFM domiciled in one Member State are not only of concern to the financial markets and market participants in that Member State. They also have an important cross-border dimension. There are several aspects to this:

- The investor base of many AIFM business models is highly international, as investors seek to optimise and diversify their portfolios by seeking investment opportunities in other countries;
- AIFM may obtain credit from banks / prime brokers in other Member States and will interact with counterparties located throughout the EU, both through on-exchange trading and through bespoke contracts with derivative counterparties;
- AIFM are frequently major players in financial markets outside their domicile and can have a substantial influence on price formation and liquidity in these markets; and
- AIFM investing in companies frequently acquire portfolio companies located in other Member States.

Risks associated with AIFM activity can therefore be transmitted rapidly across borders both through one-on-one relationships with investors and counterparties and through the impact on the stability and efficiency of financial markets.

This implies that investors and counterparties across the EU have a legitimate interest in the effective regulation and supervision of foreign AIFM. Public authorities in 'host' Member States will also have an interest in the interactions between market participants located and supervised in their jurisdictions with AIFM located elsewhere. Similarly, market operators and the authorities responsible for supervising those markets are directly concerned by the risks posed by AIFM from other Member States. This is particularly the case with risks that are potentially systemic in nature; for instance, macro-prudential authorities throughout the EU will be concerned with the activities of large, leveraged AIFM active in their markets.

Two important and related problems flow from this juxtaposition of increasingly interlinked financial markets and nationally-fragmented regulatory approaches to the AIFM sector:

- First, regulatory fragmentation may **inhibit the effective regulation, supervision and macro-prudential oversight of AIFM by failing to take account of the cross-border dimension of their activities**. This may result in incomplete or inconsistent monitoring and control of the macro-prudential, micro-prudential and market efficiency risks described in Section 1; weaknesses in frameworks for ensuring investor protection; and insufficient public accountability of AIFM investing in and managing companies.
- Second, it may also **impede market integration and the development of the single market** by creating barriers to the efficient cross-border distribution of AIFM products.

The discussion of these problems is structured as follows. Section 3.1 provides a brief overview of the current regulatory provisions applicable to AIFM at EU and national level. Section 3.2 explores the effectiveness of existing regulatory frameworks with respect to each of the risk types identified, in particular with regard to their cross-border impact. Section 3.3 considers the implications of the current arrangements for the efficiency of cross-border AIF distribution in the EU and the development of the internal market. Section 3.4 concludes.

3.1. Description of the regulatory patchwork

3.1.1. Community rules

There is at present no direct Community regulation of AIF or AIFM. However, AIFM are subject to Community rules that apply to all market participants, for example, the Market Abuse and the Anti-Money Laundering Directives. When investing in listed companies, AIFM have to comply with disclosure requirements under the Transparency Directive.

In addition, the distribution of AIF is subject to the Markets in Financial Instruments Directive (MiFID). Some AIFM are also directly subject to disclosure requirements under the Prospectus Directive if they publicly offer shares for subscription or launch an initial public offering. Depending on the legal status of the AIFM in a given Member State, relevant provisions of the European Company Law Directives[23] may apply, ranging from initial capital requirements to rules on capital maintenance and capital formation or production of audited accounts and disclosure or risks management and valuation practices.

Some of the major counterparties of AIFM are also subject to regulation at Community level. Banks providing leverage through their prime brokerage activities are subject to the Capital Requirements Directive. Some categories of investor are subject to Community rules on due diligence, in particular through the Solvency regime for insurance companies and the Institutions for Occupational Retirement Provision (IORP) Directive, which influence how the industry's investor base allocates resources and makes investments in AIF.

3.1.2. National rules

The current regulatory environment for the supervision of AIFM varies across Member States and asset classes. Several Member States have introduced national regulatory regimes to provide an environment for the onshore management, constitution and distribution of AIF. Table 6 below provides an overview of the divergence in regulatory approaches to hedge funds, private equity funds and real estate funds in selected EU Member States.

These regimes typically involve registration and oversight of fund managers, as well as structural separation of the manager and the custodian. These regimes may also regulate certain product features or aspects of the investment policy (such as diversification limits, use of leverage, valuation and other portfolio constraints). At present, national legal frameworks governing establishment of the different categories of AIFM and the requirements for registration and authorisation of AIFM differ across Member States, and within Member States for different fund types.

[23] The 2nd Company Law Directive, Take-over Bid Directive, the Shareholders' Rights Directive

Table 6: Regulatory mapping – Hedge Funds, Private Equity Funds and Real Estate Funds

question	UK	FR	DE	LUX	IRL	IT	ESP
Does a regulatory regime exist for Private Equity and Venture Capital Funds (PEF)s?	NO	YES	NO	YES	YES	YES	YES
Does a regulatory regime exist for Hedge Funds (HF)?	YES	YES	YES	YES	YES	YES	YES
Does a regulatory regime exist for Real Estate Funds (REF)?	YES	YES	YES	YES	YES	Only closed ended	YES
question	**UK**	**FR**	**DE**	**LUX**	**IRL**	**IT**	**ESP**
What are PEF called? What is the legal structure/vehicle?	Limited partnership, VC Trust, Limited Liability Partnerhip, Company PLC (not an UCI)	Fonds Commun de Placement à Risques (FCPR), FCPI, FIP and Société de Capital-Risque (SCR) (not an UCI)	Unternehmens-beteiligungs-gesellschaft (UBG, GmbH and GmbH & Co. KG (not an UCI)	FCP (Part II), SICAF/ CISAV (Part II), SIF, SICAR, SOPARFI (not an UCI)	Qualified Investor Scheme, Professional Investor Scheme (Investment Limited Partnership, Common contractual fund, Unit trust)	Fondi Chiusi (closed end structures)	NRV: non-regulated vehicles RV: Regulated private equity contractual (FCR) corporate (SCR)
What are HF called? What is the legal structure/vehicle?	Limited Partnerhips	1. OPCVM Aria (OPCVM Aria simples, OPCVM Aria à effet de levier, OPCVM Aria de fonds alternatifs), 2. OPCVM contractuels; 3. FCIMT	Sondervermögen mit zusätzlichen Risiken (funds with additional risks), Dach-Sondervermögen mit besonderen Risken	FCP (Part II), SICAF/SICAV (Part II), SIF	Qualified Investor Scheme, Professional Investor Scheme (Investment Limited Partnership, Common contractual fund, Unit trust)	Fondi Speculativi, Fondi Riservati	Instituciones de Inversion Libre (IICIL), Instituciones de Inversion colectiva de IIC de Inversion Libre (IIC de IICIL)
What are REF called? What is the legal structure/vehicle?	Limited partnership, Limited Liability Partnerhip, Unite Trust, Open-ended real estate Trust, OEIC	OPCI (FPI, SICAV), SCPI, SIIC, SCI (not an UCI)	Special-sondervermögen, Immobiliten-Sondervermögen, Geschlossene Immobilienfonds	FCP (Part II), SICAF/ CISAV (Part II), SIF, SICAR, SOPARFI (not an UCI)	Investment Limited Partnership, Common contractual fund, Unit trust	Fondi Immobiliare, SIIG (note an UCI)	Fondos de Inversion Inmobiliaria, Sociedades de Inversion Immobiliaria
question	**UK**	**FR**	**DE**	**LUX**	**IRL**	**IT**	**ESP**
Are PEF set up under the law of a general CIS?	YES (since PEF not regulated)	YES (since PEFs no legal entity)	NO			YES	YES (RV), NO (NRV)
Are HF set up under the law of a general CIS?	YES	YES	YES	YES	YES		
question	**UK**	**FR**	**DE**	**LUX**	**IRL**	**IT**	**ESP**
Is public distribution of PEF permitted?	NO	YES	n.a.	YES	YES	YES	NO
Is public distribution of HF permitted?	YES	YES	NO	YES	YES	NO	NO
Is public distribution of REF permitted?	YES	YES	YES (only open ended funds)	YES	YES	YES (only closed ended funds)	YES

question	UK	FR	DE	LUX	IRL	IT	ESP
Are PEF accessible to retail investors?	NO	YES (Sujbect to minimum subscription requirements)	NO	Sujbect to minimum subscription requirements	Sujbect to minimum subscription requirements	YES in principle, NO in practice (only qualirifed investors)	NO
Are HF accessible to retail investors?	YES (only for NURS, very limited public distribution)	NO (high subscription requirements)	NO	YES	NO	NO	NO
Are REF accessible to retail investors?	YES	YES (subject to minimum subscription requirements)	YES	YES	YES	YES (for closed ended funds)	YES
question	**UK**	**FR**	**DE**	**LUX**	**IRL**	**IT**	**ESP**
Is Private Placement an alternative to distribute PEF retail investors?	YES	NO	YES	YES	YES	YE	NO
Is Private Placement an alternative to distribute HF to retail investors?	YES	NO	YES	YES	YES	NO (€50.000 min)	NO
Is Private Placement an alternative to distribute REF retail investors?	NO	Restricted to certain products	YES	YES	YES	YES	NO
question	**UK**	**FR**	**DE**	**LUX**	**IRL**	**IT**	**ESP**
Is Management Company managing PEF required to have initial capital?	YES	YES	YES	YES	YES	YES	YES (RV)
Is Management Company managing HF required to have initial capital?	n/a	YES	YES	YES	YES	YES	YES
question	**UK**	**FR**	**DE**	**LUX**	**IRL**	**IT**	**ESP**
Are there specific requirements (autorisation, etc.) for Managament Company of PEF?	YES	YES (since PEFs no legal entity)	NO	YES	YES	YES	YES (RV), NO (NRV)
Are there specific requirements (autorisation, etc.) for Managament Company of HF?	YES	YES	YES	YES	YES	YES	YES
question	**UK**	**FR**	**DE**	**LUX**	**IRL**	**IT**	**ESP**
In what financial assets can PEF invest?	ANY	ANY	ANY			ANY (for funds to qualified investors)	ANY (for NRV)
In what financial assets can HF invest?	n/a	ANY	limited	ANY	ANY		
question	**UK**	**FR**	**DE**	**LUX**	**IRL**	**IT**	**ESP**
Are there any limitations for PEF investments?	NO	YES for FCPR, FCPI, FIP and SCR, NO for FCPR contractual	YES			YES	YES (for RV)
Are there any limitations for HF investments?	n/a	YES	YES	YES	YES		

3.2. To what extent are existing rules effective in responding to the risks?

The experience of the financial crisis indicates that a number of the risks posed by AIFM have been underestimated and are not sufficiently addressed by the current combination of national financial and company law regulation, general EU provisions and self-regulation.

One of the major weaknesses is the lack of coherence in national approaches to the regulation of the sector and of co-ordination between macro-prudential authorities. An important lesson of the financial crisis has been that risks crystallising in one jurisdiction may have important implications for market participants and financial markets elsewhere. The interconnectedness of financial markets and the mobility of market participants imply that risks originating in one national market will be rapidly propagated to other markets and as such a broader perspective is necessary.

A pre-requisite for the effective control of these risks is that AIFM in the EU are subject to appropriate registration and authorisation requirements. These requirements must ensure that AIFM are suitably qualified to provide management services; that they comply with certain minimum standards in relation to their governance, capital and processes; and that supervisors have an adequate legal basis and access to relevant information to oversee their functioning. The adequacy of existing arrangements with respect to each of the major sources of risk are analysed in the following sections.

3.2.1. Macro-prudential (systemic) risks

The financial crisis has exposed important weaknesses in existing systems of macro-prudential oversight, in particular in relation to those AIFM that make systematic use of leverage and take large (and sometimes crowded) positions in key financial markets (primarily hedge funds and some commodity funds). To the extent that systems exist for the collection and aggregation of relevant data on risk concentrations and leverage, the risk management perspective is currently largely national, whereas many of the risks associated with AIFM activity are cross-border or international in nature.

From recent experience, significant doubts persist as to whether AIFM provide for sufficient transparency towards regulators with regard to key variables such as leverage, risk concentrations, liquidity and the size and volatility of positions. Regulators are not always able to reach a clear and timely view of the existence and scale of systemic vulnerabilities.

An important barrier to effective oversight is the variation in regulatory reporting requirements across Member States. Some national regulators do possess relevant information, for instance on the exposure of major prime brokers to the hedge fund sector. However, such data collection is often voluntary, infrequent and, crucially, segmented along national lines. There are currently no effective mechanisms for the sharing, pooling and analysis of this information at European or international level.

Given the cross-border nature of these risks, the inability to piece together a comprehensive picture of AIFM leverage and activities in all major European markets is a major flaw in existing systems of macro-prudential oversight. These conclusions are supported by the responses received from public authorities to the recent Commission consultation on hedge funds and were echoed by several participants at the recent conference on hedge funds and private equity.

Box 3: Response to question in Commission hedge fund consultation: Do supervisors have access to relevant information to undertake macro-prudential monitoring?

A large majority of respondents, including most public authorities, financial organisations and investors, felt that supervisors do not have enough information to monitor the trading activities of hedge funds and that to that extent, transparency and disclosure standards for hedge funds with regard to the supervisory authorities could be improved and harmonized. A (global) registration of hedge funds and its manager could for instance contribute to improve the transparency towards authorities. Hedge funds could also be required to deliver periodic regulatory reports […] Many respondents argued that the indirect prudential approach needs to be strengthened and be supplemented by direct surveillance measures.

3.2.2. Micro-prudential risks

Just as the potential for AIFM activities to create risks of macro-prudential significance is of cross-border concern, so too is the effective management of micro-prudential risks at the level of the AIFM. Investors and counterparties located in other Member States have a direct stake in the robustness of risk management systems and governance structures of all AIFM with which they interact, irrespective of their domicile. Moreover, the robustness of internal processes is not merely of concern to the immediate investors and counterparties. Failures in risk management can produce ripple effects across the financial markets and hence inconsistencies and inadequacies in risk management practices may be a significant problem for the wider market.

As discussed in Section 1, the financial crisis has exposed important weaknesses in risk management systems throughout the financial system. The management of liquidity risks has posed a particular problem for the AIFM sector (particularly hedge funds and funds of hedge funds), where the combination of illiquid investments and pressure for deleveraging and investor redemption has exposed a severe liquidity mismatch. Counterparty risk management systems have also been tested by the failure of significant counterparties. The illiquidity of key asset markets has also exposed weaknesses in valuation processes and methodologies.

Effective management of the cross-border dimension of these risks necessitates a common understanding of the obligations of AIFM, and clear arrangements to support supervisors in ensuring that risk management systems are sufficiently robust. In this context, a fragmented, nationally-based, approach to the regulation and oversight of AIFM activities appears inefficient and may provoke regulatory arbitrage.

3.2.3. Investor protection

AIF are marketed predominantly to sophisticated, professional investors. It is commonly assumed that these investors have the capacity to understand and to bear the risks that their investments entail. This is reflected in the 'light-touch' approach of regulators to the protection of professional investors in most Member States. When funds are distributed directly to professional investors, disclosure practice is driven largely by contractual arrangements between the funds and their investors. Investors request information to serve as the basis for their due diligence and to ensure compliance with their own investment constraints.[24] Most Member States have in place national private placement regimes, but these vary as to who is eligible to invest and the products that can be promoted.

[24] In some jurisdictions, certain information obligations have been codified through self-regulatory standards, such as those overseen by the Hedge Fund Standards Board in the United Kingdom. Private equity industry also developed European Guidelines governing the standards of AIFM reporting to investors. (EVCA Reporting Guidelines)

The financial crisis has provided cause for reflection with regard to the adequacy of regulatory protections in this area. Inadequacies have been exposed in the due diligence applied by professional investors of all types. While this can in part be attributed to failures on the buy-side, in particular a tendency to follow trends and thus to invest without due scrutiny, another contributing factor was a lack of clear and comparable information on the risks associated with particular investments. The importance of ensuring an appropriate level of investor protection has grown as the investor base of AIFM has expanded to include pension funds, insurance companies and some public authorities, which invest on behalf of a very broad investor base.

Evidence suggests (see below) that the quality and content of the information provided to investors varies considerably, depending in particular on the nature of the AIFM. New investors seek to have the same or comparable level of information and therefore assurance about associated risks and processes and other related indicators from AIFM as they get from traditional asset managers.[25]

Box 4: Evidence on quality and content of information provided to AIF investors:

Survey of institutional investors[26]: A recent survey of institutional investors points to a number of areas of dissatisfaction among investors across a range of issues associated in particular with reporting, risk management and disclosure. Investors complain that a lack of transparency makes it difficult to compare or benchmark performance between various AIF, understand the investment risks and strategies; others voice their concerns as regards standardised valuation reporting and reliability and consistency of valuations for ongoing investments.

Commission consultation on hedge funds: The majority of respondents highlight that the level and the quality of information available to investors often depends on the investors targeted and is quite unbalanced. Some report deficiencies in the disclosures provided, which are either incomplete or not available on an ongoing basis. Most information transparency concerns relate to the transparency of the fund liquidity management, redemption policy and on the equality of treatment of shareholders and side letter practice.

A recent academic study[27] highlighted some of the specific shortfalls in hedge fund reporting practice. In particular: (i) Hedge fund disclosure does not meet investor expectations, (ii) Industry practices fall short of academic standards for hedge fund reporting and (iii) Industry guidelines fall short of providing sufficient guidance. See Annex X.B for more detail.

IOSCO Report on Hedge Fund Oversight[28] refers to current market practices in the hedge fund sector and suggests that some aspects of investor information are not as transparent as necessary. In particular, disclosure of valuation procedures, the existence of 'side letters' and 'gating structures', may not occur consistently. It concludes that the provision of information to the market in general could be described as inconsistent or even opaque and that the provision of information to regulators varies. It is unlikely that any one jurisdiction has a blueprint for others to follow. Specific attention should be focused on: what additional information should be provided by hedge funds/hedge fund managers and associated counterparties and with what frequency, in order to enable regulatory bodies and other market participants to more accurately measure the risks being run by these parties.

Transparency relates not only to the features of the investment (e.g. the investment policy and the risks that entails) but also to the internal processes of the AIFM. Many aspects of AIFM activity and the way in which the AIFM is organised impact directly on the interests of their investors. For example, the processes for valuing the AIF's assets, ensuring that these assets are secure, and for ensuring that conflicts of interest do not drive a wedge between the

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25 A recent study by EDHEC finds that there are 'great differences between hedge fund managers' perceptions of relevant information disclosure and their investors' needs suggest that the industry should rethink its overall disclosure practices.' Hedge Fund Reporting Survey, November 2008

26 PricewaterhouseCoopers – March 2008, Transparency versus returns: The institutional investor view of alternative assets

27 EDHEC Hedge Fund Reporting Survey 2008

28 Hedge Funds Oversight, Consultation Report, IOSCO, March 2009

interests of the AIFM and their investors (or between categories of investor) are also of direct interest to the investor. Effective and well-governed internal processes are thus necessary if an appropriate level of investor protection is to be achieved.

At present, national regulatory regimes do not provide a consistent and effective regulatory baseline for the protection of AIFM investors. In some Member States, requirements that exist have been supplemented with industry-developed disclosure standards. However, such standards have not been applied consistently throughout the EU. Variation in disclosure standards is thus an additional source of uncertainty for investors operating cross-border.

3.2.4. Market efficiency and integrity

As active participants in financial markets, AIFM can impact significantly on the efficiency of the markets in which they operate, both positively and negatively, and may pose risks to the integrity of those markets. Since AIFM frequently trade on markets outside their home jurisdiction, the surveillance of such risks has an important cross-border dimension. However, at present, the provision of information relevant to market surveillance is not consistent and is largely fragmented along national lines.

A recent example of the fragmented approach to the monitoring of risks to market efficiency and integrity has been the response to concerns raised in relation to short-selling. The events of the financial crisis provoked a series of largely uncoordinated national responses to short-selling by AIFM, in particular by hedge funds. While short-selling techniques are available to all market participants and are generally considered to contribute positively both to AIFM risk management and to market efficiency and price discovery, the extensive use of such techniques (in particular ‘naked’ short-selling) by some AIFM may have compromised the efficiency of securities settlement and may have served to undermine the stability of systemically important financial institutions.

A key driver of the uncertainty surrounding these activities was a lack of transparency in stock lending and short positions. This uncertain environment provoked a range of uncoordinated responses from national regulators. Greater co-ordination in data collection and responses to these challenges may have resulted in a more coherent response to these policy concerns, a view also shared by the majority of respondents to the Commission consultation on hedge funds. The significant differences in regulatory approaches to short selling across jurisdictions and the overall inefficiency in this area have also been recognised by the International Organisation of Securities Commissions (IOSCO).[29]

It is important to draw a distinction between these activities and the abuse of markets (for example through the spreading of false rumours to profit from short-selling), which is illegal under European and national law. Nevertheless, a more coordinated approach would facilitate the detection of potentially abusive behaviour and the development of a coordinated response.

3.2.5. Impact on market for corporate control

Some AIFM strategies entail the acquisition of stakes in listed companies and an active role in the governance of those companies. Certain cases of hedge fund 'activism' have attracted adverse publicity. Criticism of these activities centres on techniques that may allow investors to build stakes in listed companies in a manner that is not sufficiently transparent to company management and may be detrimental to the interests of other stakeholders. Examples of such techniques include the practice of voting on borrowed stocks and the use of certain derivatives

[29] See Regulation of Short Selling, Consultation Report, March 2009

instruments, such as contracts for difference. While such techniques are employed by certain categories of AIFM (notably, hedge funds), they are widely available to all market participants.

At European level, the Transparency Directive requires notification of all positions that confer the entitlement to vote, independently of the ownership of the shares and the existence of an economic interest. Certain derivatives and borrowed stock are therefore covered by the disclosure duties set out in the directive. However, the directive's basic threshold of 5% is relatively high and the notification duty, for practical reasons, only becomes effective a few days after the acquisition.

A review of Member States' implementation of the threshold reveals that in some Member States (Germany, Spain, Ireland or the United Kingdom) a stricter threshold of 3% is already applied. In Italy and Portugal, it is even lower, at 2%. In addition, some Member States have acted to impose additional disclosure requirements, for example the UK FSA's recent decision to require disclosure of positions obtained through contracts for difference. However, there is at present no consensus among Member States on the appropriate response to these issues.

It is important to note that the legitimate concerns that exist in the area, while relevant to some types of AIFM, are not limited to the activities of AIFM. The techniques and instruments that may require greater scrutiny in future are widely available and thus, to the extent that there is a regulatory failure in this area, an appropriate response would focus on the technique rather than any particular category of actor.

The Commission plans to review the Transparency Directive in 2009. This review will cover issues including shareholder identification, registration and requirements of shareholders to notify issuers of the proportion of their voting rights. In addition, the Shareholders' Rights Directive is due to be transposed by August 2009.

3.2.6. Acquisition of control of companies by AIFM

In the context of the financial crisis and tightening credit conditions, concerns have arisen in relation to the sustainability of debt assumed by private equity portfolio companies.[30] This has been a particular concern for companies subject to leveraged buy-outs by private equity firms, many of which are currently experiencing difficulty in servicing debt. Some may fail as a result. Similar problems are experienced elsewhere in the financial system where extensive recourse was made to debt finance during a period of low interest rates and a ready supply of credit.

An additional concern relates to the treatment of employees when a company is acquired by private equity, namely that employees do not enjoy the same protection and rights as is the case when a transfer of undertaking occurs. Underlying this concern is the desire to ensure that labour is treated equally in situations in which an AIFM acquires a controlling stake in a company (this acquisition does not result in a legal transfer of the company or a merger[31]) and is therefore in a position to influence and give direction to major strategic changes affecting the company.

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[30] In autumn 2008 there were about 75% of portfolio companies behind schedule in their earnings plans to decrease the debt burden, which clearly reflects the difficulty of accessing credit to re-finance the debt, as was common practice prior to the financial crisis.

[31] As defined by the Directive 2001/23/EC relating to the safeguarding of employees' rights in the event of transfers of undertakings, businesses or parts of undertakings or businesses

***Box 5: Recent evidence[32] suggests the following impact of private equity buyouts on employee relations**:*

- Little change in union recognition, union member density or management attitudes to unions
- Little change in issues over which managers negotiate with and consult unions
- More consultative committees, more influential, increased focus on production, employment and financial issues and future plans
- General increase in high commitment management practices (e.g. team working and training)
- Occupational pension schemes: increase but shift to defined contribution schemes based on investment performance and contribution schemes based on investment performance and contributions open to new members
- Buyout process: 47% did not inform union representatives before

Existing national and European regulatory provisions providing general safeguards accommodate these concerns only partially. The most relevant is the Second Company Law Directive (77/91/EEC), as recently amended by Directive (2006/68/EC) that provides a framework for capital formation, maintenance and alteration of a company. The Directive on Transfer of Undertakings (2001/23/EC) and the framework Directive for consulting and informing employees (2002/14/EC) provides a framework for employee protection. As regards the Directive 2001/23/EC, it applies only in cases where legal transfer of the company or a merger takes place. The Take-over Bid Directive has also limited applicability from the perspective of portfolio companies that are not listed.

The existing regulatory framework and industry codes governing disclosure and information provisions of AIFM do not sufficiently address **the cross-border character of private equity transactions**, both in terms of the geographical location of investors and of the investee companies. About 30% of private equity funds are invested in portfolio companies in Member States other than that of the AIFM and about 24% of funds are raised from investors located in Member States other than that of the AIFM.[33]

However, there is no consistent standard for the level of transparency required in relation to such deals. Consequently, key stakeholders (existing shareholders of target companies and their employees as well as investors in AIF) of these transactions may not receive comparable and consistent information about the intentions of the acquiring AIFM and the strategic implications of such acquisition either at the time of the transaction or on a continuous basis.

In the absence of relevant legislative provisions, national trade associations in some Member States have acted to introduce additional disclosure requirements on their home AIFM with regard to companies subject to buy-outs in their jurisdictions. However, despite recent efforts to deliver a more harmonised approach, these standards are not applied on a consistent basis across Member States and hence the level of transparency towards key stakeholders and public accountability associated with private equity deals varies.

3.2.7. Conclusions

This section has identified important gaps and weaknesses in European and national approaches to the regulation and supervision of the AIFM sector. The core problems relate to a failure to appreciate the cross-border nature of the risks their activities pose.

In particular, the absence of a coordinated approach to the monitoring and supervision of the AIFM sector is a significant barrier to the effective macro-prudential oversight of the sector at

[32] Bacon et al. 2008 study of 190 Pan-European Private Equity buyouts

[33] EVCA Yearbook 2008: in 2006 and 2007, 23% and 24% of funds raised by European AIFM originated from investors in other Member States, 38% and 42% were raised in 2006 and 2007 from domestic investors and the remainder 40% and 34% from investors outside EU.

the European level. The absence of consistent data collection from AIFM and of effective mechanisms to share and process this information prevents regulators from compiling a comprehensive picture of the potentially systemic risks arising from AIFM activity. Enhanced and coordinated information gathering on AIFM activities would strengthen macro-prudential oversight and market discipline.

The effective regulation of the AIFM sector – both from a macro-prudential perspective and in relation to the protection of investors in AIF – requires greater consistency in the regulatory protections provided. Variations in national approaches to the registration and authorisation of AIFM, to risk management and the governance of internal processes and to the provision of key information to investors and regulators all contribute to a fragmented regulatory framework that does not currently provide sufficient assurance that consistently high standards are applied throughout the EU.

3.3. Internal Market aspects

The discussion hitherto has focused on the effectiveness of existing regulatory arrangements in responding to the risks described in Section 1, in particular with regard to the effective monitoring and management of macro-prudential risks. This section considers a second, related, problem: the fragmented approach to the regulation of AIFM may also have significant implications for the efficiency of European financial markets and the development of the single market.

Across Member States, a significant number of different legal entities or structures are used to create and operate AIF.[34] These structures include companies limited by shares, companies limited by guarantee, transparent entities structures with no legal personality and limited partnerships. All these structures have specific characteristics and features often exclusive to one local jurisdiction. Although these fund structures display many similar features in a number of jurisdictions there is no overall harmonisation. These differing approaches may act to inhibit the distribution of AIF on a cross-border basis.

The evidence in the impact assessment on private placement[35] clearly depicts the patchwork that exists at EU level in terms of national provisions governing the possibility of distributing AIF in different Member States.

The discrepancies described above and divergent and distinct national standards and approaches to conditions under which AIFM can distribute AIF on a cross-border basis, result in legal and regulatory obstacles to the cross-border distribution of AIF and manifest themselves in the following areas:

- Requirements to produce local disclosure documents to accompany the offer;
- Restrictions on marketing, promotion, etc;
- Restrictions on placing entities approaching prospective investors;
- Different approaches to defining the population of eligible investors;

34 Study conducted in 9 Member States found more than 60 different legal vehicles used for non-harmonised funds http://ec.europa.eu/internal_market/investment/docs/other_docs/study_non-harmonized_funds.pdf)

35 Private placement is understood as an officially recognised distribution method through which designated market participants can buy and sell financial instruments with each other without having to comply with rules that would usually apply when the same instruments are offered to the public/retail investors (http://ec.europa.eu/internal_market/investment/docs/legal_texts/ia_private-placement_en.pdf)

- Requirements regarding prior approval or registration of instruments;
- Limits on the eligible offerors or intermediaries who are permitted to approach prospective investors.

The aforementioned inconsistencies in national approaches to distribution of AIF support the argument that the existing regulatory framework impedes the efficient functioning of the single market in this area. This situation has the following consequences for the main actors concerned:

- *Public Authorities*: The lack of a common approach to supervision of AIFM obliges national supervisors to make complex and comprehensive assessment of foreign AIFM which intend to sell and distribute AIF to professional investors in their jurisdiction. The absence of a common regulatory baseline applicable throughout the EU complicates this task, with the result that additional costs are incurred both by the AIFM and the national supervisor.
- *AIFM*: AIFM are usually the pro-active party in initiating approaches to prospective investors and are the ones most immediately confronted with problems associated with the cross-border distribution of AIF. They incur much of the cost and legal risk associated with these transactions.
- *Investors*: Investors' choice of investment propositions and their potential for portfolio diversification are significantly restricted in smaller markets due to the barriers and obstacles described. The increased competition among AIFM could also benefit professional investors through lowered costs and/or improved performance.
- *Businesses, enterprises*: Fragmentation along national lines deprives companies across Europe from access to funding. Since neither companies nor AIFM can exploit fully the benefits of single market, it leads to a sub-optimal capital allocation in European economies. Existing restrictions of fund-raising prospects for venture capital funds in particular, can have an adverse impact on the financing of small and medium-sized companies and of innovation.

Nationally fragmented regimes may therefore act as a barrier to market integration by raising regulatory compliance costs for foreign competitors. Burdens associated with compliance with multiple regimes constrain cross-border business, with an attendant impact on the efficiency of AIF markets. AIFM are therefore unable to take full advantage of the available economies of scale (e.g. through increased fund size and cost reduction). Investors do not have access to the complete universe of AIF in the EU and therefore might not be able to diversify their portfolio optimally and to choose the funds with the best risk-return features for their investor profile. These problems are compounded by differences in national provisions on investor protection and disclosures.

3.4. Conclusions

There are no specific provisions of Community law that relate specifically to the activities of AIFM. However, EU provisions influence the general regulatory and company law environment in which AIFM operate. Most AIFM are subject to registration and supervisory oversight in the Member States in which they are established. However, the nature of that oversight varies across Member States and asset classes.

This divergence has important consequences for AIFM, their investors, counterparties and for supervisors. From the perspective of professional investors, many of which are highly mobile and active in more than one European market, the divergence in standards creates uncertainty about the extent of the regulatory protections in place. From a supervisory perspective, the current patchwork of national regulatory arrangements does not represent a comprehensive or effective basis for monitoring and responding to the risks posed by AIFM to their counterparties and the financial system. When judged from an EU perspective, these deficiencies become even more pronounced. Gaps and inconsistencies in approaches to the registration and authorisation of AIFM in the EU may impede the effective oversight of the sector and varying standards may provoke regulatory arbitrage between jurisdictions. The European dimension of the 'public good' to be protected by regulation/supervision is not sufficiently taken into account, that is the impact of crystallising risks on investors, counterparties and financial markets in other jurisdictions. The focus of any national regulation or supervision is currently largely national.

The geographically fragmented approach to the supervision and macro-prudential oversight of these entities is compounded by the fact that information gathered from AIFM and different requirements imposed in different Member States. This significantly complicates the task of piecing together an overarching view of the impact of AIFM on market conditions or of their behaviour vis-à-vis other market participants.

Table 7: Evaluation of key risks posed by activities of AIFM

Source of risk	Summary of analysis
Macro-prudential (systemic) risks, the use of leverage	The absence of a consistent approach to the collection of macro-prudential data (on leverage, risk concentrations etc) and of effective mechanisms for the sharing of this information between prudential authorities at the European or global level is a significant barrier to robust macro-prudential oversight. Existing arrangements do not take sufficient account of the cross-border nature of risks arising in the AIFM sector.
Micro-prudential risks	AIFM in the EU are not currently subject to consistent requirements as regards their risk management procedures and processes. Weaknesses in risk management practice present risks for investors, counterparties and the market at large. Greater consistency in regulatory standards in this area would provide greater assurance for domestic and cross-border investors and counterparties and would reduce opportunities for regulatory arbitrage.
Investor Protection	Although the majority of investors in AIF are professional and qualified, the financial crisis has demonstrated that even this category of investors requires reliable and comprehensive information from AIFM on an initial and ongoing basis. National regulatory approaches to disclosure practice and governance vary and do not appear to provide a consistent regulatory underpinning for AIFM practice in this area.
Market efficiency and integrity	AIFM activity may impact not only on financial stability but also on the efficiency and integrity of the markets in which they operate, irrespective of the location of those markets. One area of particular recent concern has been the impact of short-selling on financial markets and institutions. Some AIFM engage heavily in such activity for both risk management and speculative purposes. However, the activity of short-selling is a legitimate trading technique and is not the exclusive preserve of the AIFM sector.
Impact on market for corporate control	Concerns raised in relation to AIFM activities as minority 'activist' shareholders in companies throughout the EU are not unique to AIFM. Certain techniques for the acquisition of voting rights (e.g. through derivative positions and stock borrowing) raise important questions in relation to the transparency of stake building to companies and other stakeholders. However, insofar as these techniques are available to all market actors, this does not constitute an AIFM-specific issue.
Acquisition of control of companies by AIFM	Concerns in relation to the impact of private equity activity on their portfolio companies relate to: (1) the sustainability of the debt taken on by the portfolio company in a leveraged buy-out transaction and (2) the rights of employees throughout the buy-out transaction in particular. Empirical evidence on these points is not conclusive. There are national and European regulatory provisions providing general safeguards to accommodate these concerns. However, greater transparency and public accountability of private equity activities would help to ensure that the interests of all relevant stakeholders are taken into account in the governance of the

	portfolio companies.

The fragmentation of the regulatory environment also impacts on the efficient functioning of the respective markets, with the result that AIFM are unable to take full advantage of the available economies of scale (e.g. through increased fund size and cost reduction) and investors are not able to diversify their portfolios optimally and to choose the funds with the best risk-return features for their investor profile

The following sections consider how this situation could be rectified.

4. OBJECTIVES

This section transforms the problems identified above into a set of objectives in relation to the activities of AIFM and explains how these objectives relate to other ongoing regulatory reform initiatives. Certain of the risks described in previous sections are considered to relate not just to AIFM activity but also to the actions of other market actors. In these cases, it is argued that the risks are better addressed by market-wide initiatives. However, there remains an important set of risks that relate directly to AIFM activity and are the object of the remainder of this impact assessment.

The previous section has described the fundamental weaknesses in the current regulatory and supervisory arrangements for AIFM in the EU. While the risks posed by the activities of AIFM - both for their investors and counterparties and the stability of the financial system at large – are cross-border in nature, existing regulatory and supervisory arrangements are highly fragmented along national lines. In particular, the lack of transparency in the AIFM sector is compounded by a failure to share and analyse the available data at European or international level: a significant lacuna in existing systems of macro-prudential oversight.

The absence of a common regulatory and supervisory baseline may also impede the smooth functioning of the single market, since supervisors, investors, counterparties and market operators based in one EU jurisdiction do not always have sufficient assurance with regard to the regulatory and supervisory arrangements applying to AIFM in other jurisdictions; and differences in regulatory arrangements create additional costs and legal uncertainty for AIFM themselves.

In view of these shortfalls in existing arrangements, the **overarching objective** of this work is to provide a **clear and consistent framework for the regulation and supervision of AIFM in the EU**. This objective is fully consistent with the G20 appeal for appropriate regulatory and supervisory arrangements to apply to all systemically relevant market actors, and with the conclusions of the European Council's Spring Summit.

Objectives of market-wide action

However, in formulating **specific objectives**, it must be recognised that not all of the risks described in previous sections are exclusive to the AIFM sector. On the contrary, the financial crisis has exposed generalised failings throughout the financial system in the breadth and quality of macro-prudential oversight; in risk management by financial institutions of all types; and in relation to the transparency of an array of financial entities, markets and products.

To rebuild market confidence and to prevent a repeat of recent events, all of these failings will require remedial action. The problems of the AIFM industry should not therefore be viewed in isolation: action taken elsewhere in the financial system will also impinge on the activities of the AIFM sector. In particular, the comprehensive package of reforms announced in the recent

Commission Communication on Driving European Recovery[36] will have significant repercussions for all market actors, including AIFM, and will respond in part to the risks discussed in this impact assessment. For instance:

- Proposals on the establishment of a new European body to oversee the stability of the European financial system, and on the reform of the European financial supervision system, will impact, at least indirectly, on all market actors, including AIFM.
- Ongoing reform of European banking regulation will affect the regulation of prime brokers and their relationships with the AIFM sector.
- Ongoing work on centralising the clearing of OTC derivatives and increasing the transparency of derivatives and complex financial products will affect the markets and products in which some AIFM are major investors.
- The forthcoming recommendation on remuneration in the financial services sector will apply to AIFM.

In other areas, planned work will respond in full or in part to some of the specific risks identified in this impact assessment. This is the case in areas where concerns relate to specific techniques or instruments that are available to all market participants and where the discriminatory treatment of particular market actors would create distortions and would not respond in a comprehensive manner to the risks posed. These areas include:

- **Market efficiency and integrity**: Short-selling and its associated impacts on market efficiency and integrity are not the exclusive preserve of the AIFM sector. To the extent that stricter regulatory controls and/or greater transparency is required in this area, actions would be better targeted at all market practitioners. The Commission is considering these issues as part of the ongoing reviews of the existing acquis.
- **Market for corporate control / transparency of minority shareholders**: many of the concerns expressed in relation to the activities of activist AIFM relate primarily to the transparency of particular instruments and techniques, e.g. stock borrowing and certain derivative instruments. Such techniques are available to all market players and as such are better examined on a market-wide basis, in particular in the context of the Commission's review of the Transparency Directive.

Objectives of AIFM-specific action

However, these broader reforms do not respond to the specific problems arising from the particular services and activities of AIFM. Certain regulatory and supervisory failings relate directly to AIFM activity. Risks and vulnerabilities relating to the macro-prudential oversight of the AIFM activity, the micro-prudential supervision of AIFM and the protection of investors in AIFM all require action targeted at this particular sector. The remainder of this impact assessment will focus on these AIFM-specific risks.

A comprehensive response to these risks requires a clear and consistent regulatory and supervisory framework for AIFM. Specifically, such a framework would aim to achieve:

- **Appropriate authorisation and registration requirements** for all AIFM operating in the EU: specifically this would require all AIFM to respect and satisfy a common set of

[36] For an outline of measures proposed in Commission Communication COM(2009) 114 of 4 March 2009 see annex IX.

requirements (minimum capital, fit and proper, transparency, etc.) before operating across the EU.

- **Improved monitoring of macro-prudential risks** through the provision of relevant information to prudential authorities. To take due account of the cross-border dimension of these risks, relevant information would need to be pooled at European or global level. At operational level, this objective would require the collection of relevant data on *inter alia* leverage, trading activity, risk concentrations and performance, and appropriate information-sharing mechanisms to be established.

- **Enhanced management of micro-prudential risks** through the imposition of strict risk management controls on market, liquidity, counterparty (credit and settlement, especially in case of short selling) and operational risks.

- A **common approach to protecting investors in AIFM-managed funds** is required, including improvements in investor disclosures to ensure that due diligence can be performed effectively. Ensuring the proper management of conflicts of interest and imposing independent controls and processes in key risk areas, in particular valuation and custody functions, would also help to achieve this specific objective.

- **Greater public accountability of AIFM investing in and managing companies** should be achieved so as to ensure that such activities are subject to an appropriate level of public scrutiny. The operational objective related to this is to impose additional transparency requirements on AIFM when they acquire controlling stakes in companies with the aim to actively engage in and influence these companies' future management.

- The **removal of barriers to the efficient cross-border distribution of AIF** should allow an internal market in AIF in the EU to develop which is grounded in a robust and consistent regulatory supervisory framework.

It is against these objectives, summarised in Table 8, that possible actions in relation to AIFM will be assessed.

Table 8: Objectives

General objectives	Specific objectives	Operational objectives	Problem addressed
A complete and consistent framework for the supervision and prudential oversight of AIFM	All AIFM are subject to appropriate authorisation and registration requirements	Ensure that all AIFM satisfy a specific set of requirements (minimum capital, fit and proper, transparency) before operating across the EU	Registration and authorisation of AIFM
	Proper monitoring of macro-prudential risks	Enhance transparency of AIFM activity, including the systematic use of leverage, to enable the effective monitoring of systemic risks Ensure that relevant macro-prudential data is shared at European level	Macro-prudential (systemic) risks, the use of leverage
	Proper monitoring and limitation of micro-prudential risks	Impose risk management controls on major risks to which AIFM are exposed (market, liquidity, counterparty – credit and settlement risks (especially in case of short selling) and operational risks)	Micro-prudential risks
	Common approach to protect professional investors in AIFM-managed funds	Reduce potential for weakness in investor disclosures as barrier to effective due diligence Ensure proper management of conflicts of interest. Impose appropriate controls and processes in key risk areas, such as valuation and custody	Investor protection
	Greater public accountability of AIFM holding controlling stakes in companies	Increase transparency of AIFM when acquiring a controlling stake in, and managing, companies	Acquisition of control of companies by AIFM; Impact on market for corporate control
	Develop the single market in AIF	Remove barriers to the efficient cross-border distribution of AIF to professional investors without compromising the effectiveness of regulation and supervision	Market efficiency and integrity
	Ensure that actions are proportionate to the risks posed and appropriately differentiated to take account of differences in AIFM business models.	Focus action on AIFM of systemic relevance and, in addition to actions of relevance to all fund types, impose requirements that are calibrated to specific activities and behaviours.	Relevant to all

5. OPTIONS – ANALYSIS OF IMPACTS

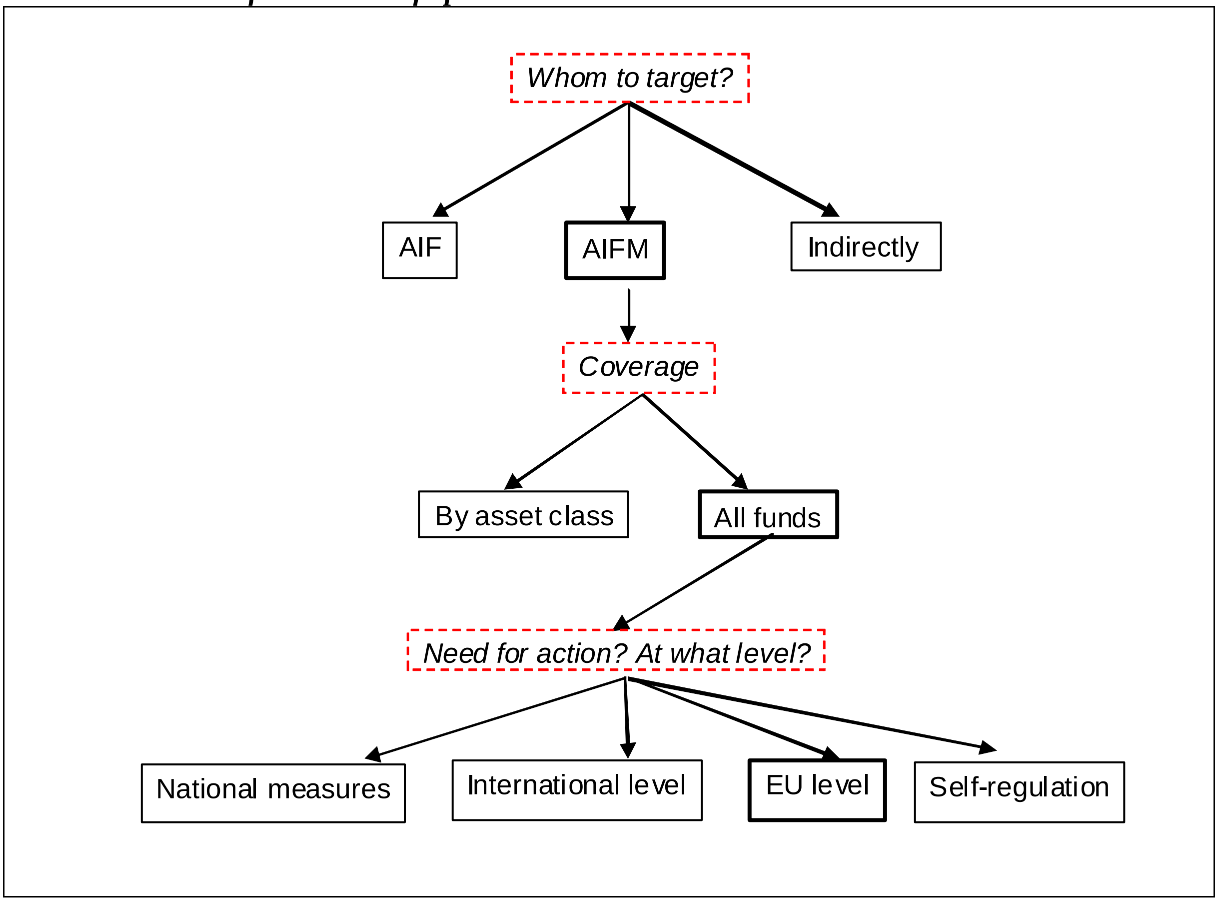
This section discusses the options available to deliver on the objectives outlined in Section 4. It considers four key questions. Which parts of the value chain should be targeted by action in this area? Can a horizontal approach provide the appropriate degree of differentiation between asset classes, or would a more targeted approach be preferable? At which level should any such action be taken? And how much of the AIF value chain should be required to be located in the EU for action to be effective? The final subsection considers to what extent the preferred set of options complies with the principles of subsidiarity and proportionality.

This section will consider the options available to respond in an effective and comprehensive way to the stated objectives. The discussion will focus primarily on four key questions:

- Which parts of the value chain should be targeted by action in this area: the AIFM, AIF or other service providers (valuators, depositaries etc)?
- What is the appropriate scope for action: should specific AIFM business models be targeted, or is a more horizontal approach preferable?
- How much of the AIF value chain should be required to be located in the EU for action to be effective?
- What is the appropriate level for action (industry, national, European, international)?

Building on the conclusions to the discussion of these questions, Section 5.6 will then consider in greater detail how a measure could be designed to deliver on the specified objectives, while ensuring that requirements placed on AIFM are proportionate to the risks posed and sufficiently calibrated to the diversity of business models in the AIFM sector.

Chart 1: Structure of discussion of options



5.1. Target of measure

As a first step, it has to be decided which parts of the value chain should be targeted by action in this area. Broadly, the options are:

- Targeting the AIFM, as the entity responsible for the management of the AIF, including third party service providers, such as valuators and depositaries;
- Targeting the fund vehicle (AIF) directly; or
- Imposing requirements indirectly on AIFM/AIF via other actors with whom fund managers interact closely for instance, prime brokers.

These approaches are not necessarily mutually exclusive. We consider the merits and drawbacks of each of these approaches in turn.

Targeting the AIFM

The primary reason for focusing on the AIFM is that the risks associated with the management of AIF lie almost exclusively at the level of the AIFM. The AIFM is responsible for almost all decision-making in relation to the management of AIF, such as:

- investment decisions, including trading and the use of leverage;
- the development and maintenance of the governance structure and internal systems for risk management and the avoidance of conflicts of interest;
- the management of relationships with investors, counterparties and regulators, including the provision of information; and
- the organisation of administrative functions (including valuation), safekeeping of assets and audit, even if these functions are delegated to third parties.

The AIFM is therefore uniquely placed to identify the full spectrum of risks posed by AIF management, to monitor these risks on an ongoing basis and to take mitigating action as necessary. The AIFM is thus also in a position to report on these activities to regulatory authorities, investors or counterparties as appropriate; and to implement the requirements of regulatory authorities as necessary.

The focus on the AIFM does not imply that the AIF itself is not effectively monitored. Rules on the AIFM would determine how the AIF and the associated risks are managed. Information on the characteristics of the AIF could therefore be collected via the AIFM, regardless of the location of the AIF.

Risk-based reasoning therefore militates in favour of focusing action on the AIFM. This focus is consistent with the conclusions of the IOSCO Task Force on Unregulated Financial Entities, which found that 'progress towards a consistent and equivalent approach of regulators to hedge fund managers should be a high priority'.[37]

Role of third party service providers

As noted, a number of key functions in relation to the management of AIF are typically performed by entities other than the AIFM. These activities can play an important role in protecting the interests of investors. Fair and appropriately independent valuation is necessary to mitigate potential conflicts of interest between AIFM and their investors. Likewise, the

[37] IOSCO Task Force on Unregulated Financial Entities, March 2009, p.32

depositary performs an essential role in protecting the interests of investors, in particular through the safe-keeping of fund assets.

It is essential that the entities to whom these responsibilities are delegated are capable of performing the functions assigned to them and are subject to appropriate rules and oversight. Consequently, while actions targeted at particular service providers will by definition only serve to mitigate a subset of AIFM-related risks, such actions are an indispensable part of a comprehensive response to risks in this sector.

Targeting the AIF

Existing EU fund regulation - the UCITS Directive – contains in addition to rules on the management company rules on the fund itself and portfolio composition. It prescribes the type of assets that can be bought for a UCITS, the minimum degree of diversification of the portfolio, the maximum level of leverage, etc.

The case for 'product rules' in the UCITS context relates primarily to the protection of retail investors. The investment strategies of AIF are more diverse and involve investment not only in liquid financial securities but also in a wide variety of illiquid assets such as, for example, real estate or private equity. The greater flexibility of investment strategies and invested assets is consistent with the predominantly professional investor base and offers considerable advantages to these investors. UCITS-style regulation of the product itself would undermine these investment strategies and would not be a proportionate response to the risks posed.

A focus on the AIF would also fail to address in a comprehensive way the identified risks. As explained earlier, the AIF and the AIFM are separate legal entities. In many cases, the former is purely a legal shell for the pooling of assets and even then, the assets of the fund are usually not held by the AIF but by a custodian or depositary, depending on the business model. The AIF has no economic life of its own – the AIFM is the key decision-maker.

Rules on the fund itself would not therefore respond to any real regulatory need, given the professional nature of the investor base. As noted, all major decisions in relation to structure, systems and AIF management are taken by the AIFM. Other important risks, notably those relating to valuation and asset safe-keeping, could be addressed by provisions focusing on the providers of those services.

'Indirect approach'

Risks posed by AIFM could also be monitored indirectly by third parties, in particular banks/prime brokers. This 'indirect approach' is currently central to the supervision of hedge fund-related risks, where there are only a few global banks providing prime broker services to the vast majority of hedge funds. Prime brokers are not only the primary financiers of hedge funds, they usually also provide a number of additional services. This puts them in a favourable position to monitor and assess the risks associated with the AIFM. This monitoring is essential for counterparty risk management and compliance with prudential regulations.[38] It can also provide the basis for regulatory reporting on hedge fund exposures, as is the case in the UK.

Indirect supervision of this sort is important and necessary but does not constitute a full response.[39] Large hedge funds typically use the services of several prime brokers and hence

[38] The prudential regulation of the prime broker is currently the main regulatory tool for preventing the potential transmission of risk from the hedge fund sector to the banking sector.

[39] Views expressed in the public consultation on hedge funds were relatively equally split on the question whether indirect supervision would suffice. However, even some of those who thought that indirect

none of them necessarily has a complete overview of the AIFM activities and creditworthiness. More generally, while the use of prime brokerage services is common for hedge funds this is less so for other types of AIFM, although they might have privileged relations with a bank. Finally, monitoring by prime brokers can only capture those risks relevant to the bilateral relationship between the prime broker and AIFM. It cannot capture the full range of risks: for example, risks to investor protection and the impact of AIFM activities on wider markets.

The indirect supervision of certain types of AIFM is therefore an important part of the picture but is not a substitute for actions targeted directly at the AIFM and key service providers.

Conclusions on the locus of regulation

<u>Targeting the AIFM is the most direct and effective approach to addressing the risks posed by the AIFM sector in a comprehensive way</u>. All of the objectives can in principle be addressed through an AIFM-focused approach, since the AIFM is the key decision-maker, has access to all relevant information and is directly responsible for risk management and relations with investors. The AIFM also has access to all relevant information regarding the characteristics of the AIF. The AIFM option is also preferable in relation to its flexibility, since the approach is applicable to all business models.

It should be noted, however, that the options are not mutually exclusive. Third party service providers play a key role in mitigating potential conflicts of interest and other risks to investors. The achievement of the objectives therefore requires that these providers are appropriately qualified and regulated. The effective management of potentially systemic risks propagated through the credit channel also necessitates prudent risk management on an ongoing basis by prime brokers. Further work is being conducted in this area. However, as discussed, indirect monitoring cannot address all of the problems identified.

5.2. Coverage of measure

The AIF sector is diverse, incorporating a wide variety of business models and strategies, investing in an array of different asset classes and employing different techniques. The precise characteristics of a particular business model determine the type and intensity of the risks that the activity of that AIFM presents. In view of this diversity, this section considers a second important question: should action to address the identified risks seek to apply a common approach to the full spectrum of AIFM, or take an 'asset by asset' approach, focused on specific business models?

'Asset class by asset class' approach

An approach whereby separate measures would be implemented for managers of each of the relevant asset classes (e.g. managers of hedge funds or private equity) would have the advantage that it could address issues that are specific to a certain AIF type more directly. This could be achieved without creating unnecessary burdens for other AIF types, or ambiguities about the applicable rules. Such measures could be sensitive to the specific risks posed: problems related to hedge funds, for example, are quite different from those associated with real estate funds or private equity.

However, such an approach suffers from a number of serious shortcomings. There would be a need to define clearly in each case the respective asset class, which would be a significant

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supervision would be sufficient to insulate the banking system did not think that this would suffice to address all other relevant risks.

challenge. For example, the public consultation on hedge funds confirmed that there is serious doubt regarding the feasibility of developing a sound and enduring definition of a hedge fund.[40] At present, no common approach is found in national regulatory regimes, which adopt very different approaches to the regulation and supervision of AIFM (see Annex 5 in IOSCO report[41]). In many cases, there are no specific definitions in national law of particular AIFM types. There is therefore a significant risk that even the best attempt to define AIFM business models would leave room for interpretation and therefore legal uncertainty.

Furthermore, it would allow the funds concerned that do not wish to comply with the new rules to amend their strategy so as to fall outside the definition and thereby to circumvent the rules. This is particularly problematic since this impact assessment has shown that many of the risks identified are not confined to particular investment strategies but may materialise to a greater or lesser extent in a number of AIFM strategies. Action in respect of a subset of these AIFM may simply result in migration towards those that are not covered. <u>An approach that focuses on certain AIFM but does not address the same risks in other AIFM will not therefore constitute a comprehensive and effective response to these risks</u>.

The advantages of an 'asset class by asset class' approach, in particular the opportunity to tailor actions specifically to a particular business model, would be outweighed both by definitional obstacles and by the difficulty of establishing a comprehensive framework for the management of risks in the AIFM sector in a piecemeal way. It would also not be 'future-proof': a new process would need to be initiated each time a new relevant asset class emerged.

'All encompassing' approach

The alternative would be a measure covering all AIFM, that is, all non-UCITS fund managers. Such an approach would offer considerable advantages over an 'asset class by asset class' approach, both in terms of the coverage of risks in the sector and in avoiding the pitfalls of rigid legal definitions of fluid business models.

<u>An 'all encompassing' approach would ensure that risks were addressed irrespective of where they arose in the AIFM sector. It would permit a focus on specific behaviours or activities, and the risks associated with them, rather than the labels attached to particular business models</u>. As discussed above, an attempt to single out particular business models may fail to deliver sufficient traction over the risks, since those AIFM not captured by the definition, but generating similar risks, would not be subject to the measure. It would also avoid the difficulties associated with developing robust legal definitions of specific business models and would thus eliminate opportunities for regulatory gaming within the AIFM sector.

A related advantage concerns the innovative nature of the AIFM industry and the potential for the emergence of new AIFM business models. A horizontal measure would automatically apply to all new AIFM, irrespective of their strategy or techniques employed. If the approach were not all-encompassing, new bespoke actions would be required whenever new models emerged.

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40 About 80% of the respondents expressed the view that the asset class was too heterogeneous to distinguish them properly from other asset classes. In addition, the sector would develop fast. Any definition would therefore become obsolete very quickly. For a summary of the replies see: http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm#hedgefunds

41 IOSCO: Hedge Funds Oversight, Consultation Report, March 2009, http://www.iosco.org/library/pubdocs/pdf/IOSCOPD288.pdf.

The 'all-encompassing' approach is consistent with the recommendation of the IOSCO Task Force that regulatory oversight should be risk-based[42] and with the conclusion of the G20 that all financial market actors should be subject to appropriate regulation and oversight.

A drawback of a horizontal approach is a possible failure to take due account of objective differences between business models. This could in principle mean that measures that are appropriate for one business model are applied to models for which they are not. This would clearly be disproportionate.

However, an 'all-encompassing' approach is not synonymous with a 'one size fits all' approach. An appropriately designed measure could be made sensitive to the differences in business models and calibrated to the risks posed. This could be achieved by supplementing a set of provisions common to all business models (for example in relation to internal risk management, investor relations and other basic prudential requirements) with tailored requirements for AIFM engaging in particular activities, for example the use of leverage. The need for such differentiation can be seen in the following table.

Table 9: Relevance of objectives for different types of AIFM

Relevant to Objective:	Hedge funds	Private Equity	Commodity Funds	Real-estate funds	Other
All AIFM are subject to appropriate authorisation and registration requirements	X	X	X	X	X
Proper monitoring of macro-prudential risks	X				
Systematic use of high leverage	X		X		
Proper monitoring and limitation of micro-prudential risks	X	X	X	X	X
Common approach to protect professional investors in AIFM-managed funds	X	X	X	X	X
Greater public accountability of AIFM holding controlling stakes in companies		X			
Develop a single market in AIF	X	X	X	X	X

The design of a proportionate measure will be discussed in greater detail in Section 5.6.

Conclusions on the scope of action

The option of an 'asset class by asset class' approach suffers from three fundamental flaws: the need to precisely define the asset classes while trying to prevent arbitrage; an incomplete coverage of the risks associated with the sector, potentially exacerbated by regulatory arbitrage; and the need to adopt a new measure when new asset classes emerge in the future.

These serious shortcomings lead to the exclusion of this option and the preference for an 'all encompassing approach'. An appropriately differentiated horizontal approach to the AIFM sector could offer a comprehensive, consistent and proportionate approach to the risks identified, wherever those risks crystallise, while avoiding the definitional challenges and arbitrage risks associated with a sectoral approach.

[42] Op cit.

5.3. How much of the AIFM value chain should be required to be in the EU?

The previous sections have argued that action in this area should be targeted at the managers of all types of AIF.

The implication of this is that the AIFM must be domiciled in the EU in order to manage, administer and market funds in the EU. This would enable EU competent authorities to supervise and enforce compliance of the AIFM with the relevant requirements and thereby address the primary sources of risk associated with AIFM activity.

However, the question arises as to whether effective oversight requires other parts of the AIFM value chain to be undertaken on-shore, subject to the direct control and enforcement of EU authorities in order to address real risks to the market or to investors.

AIF: For certain business models, it is commonplace for the AIF itself to be located in a third-country, often in so-called off-shore jurisdictions which are beyond the direct reach of EU legislative provisions. It is important to recall, however, that the AIF is merely a legal structure for the pooling of assets: the risks in relation to the management and marketing of AIF are created and managed by the AIFM. Moreover, information on the AIF can be collected via the AIFM. Given that the AIF is not in itself a source of risk, the off-shore location need not undermine effective risk management. AIFM may be required to notify domestic regulators of the AIF they intend to manage and/or market and to provide information about them, but there is no risk-based case for imposing direct requirements on the AIF or for distinguishing between AIF domiciled on- or off-shore.

Third-party service providers: As discussed, AIFM appoint third-parties to perform key services, including administration, valuation, the safe-keeping of assets, auditing and prime brokerage. While the AIFM is ultimately responsible for putting in place appropriate arrangements, it is also vital that the third-parties appointed are fit to perform their functions. If they are not, this is a potentially significant source of risk for the AIF and its investors.

If the service provider is located in the EU, then appropriate regulatory provisions can be applied (as is the case, for example, through the regulation of banks providing depositary services). However, if the service provider is located in a third-country jurisdiction, domestic supervisors will not be in a position to assess these arrangements directly.

In response to these risks, it could in some cases be required that such services be provided on-shore. This may be the case with respect to administration/valuation functions. In other cases, off-shore service provision may be permitted provided that certain conditions are met. For instance, if assets are to be held with a depositary (credit institution) in an off-shore jurisdiction, domestic authorities will need sufficient assurance that the depositary is subject to appropriate regulation and supervision in its jurisdiction. Appropriate agreements would be required between on- and off-shore regulators for this purpose.

The analysis of this section implies that European action targeted at the AIFM would be capable of providing domestic regulators with an appropriate degree of oversight and control over the risks their activities generate, irrespective of whether the AIF they manage are domiciled on- or off-shore. However, if AIFM are to be permitted to use the services of certain third-parties domiciled off-shore, effective oversight of the sector will require off-shore regulators to provide sufficient reassurance that the risks associated with these activities are effectively managed. In the case of valuation, for example, accounting standards and rules used by valuators established on its territory are equivalent to those applicable in the Community. As regards depositary tasks, the third country must provide standards to prevent money laundering and terrorist financing that are equivalent to those laid down in Community law and sub-depositaries domiciled in that country have to be subject to effective prudential regulation and supervision which is equivalent to the provisions laid down in Community law.

5.4. Appropriate level for potential action

The preceding analysis has concluded that the most promising approach to achieving the specified objectives would be to:

- focus on the AIFM as the only actor in a position to monitor and control the full spectrum of risks associated with AIF management, as well as key third party service providers; and
- adopt an 'all encompassing approach' to the sector, focused on activities and risks rather than rigid definitions that would risk being arbitraged, with measures applied in a proportionate way according to the location and intensity of risks.

In this section, the options available for implementing this approach are analysed. The section begins with consideration of the status quo and then proceeds to assess four potential 'levels' for action: action by the industry (self-regulation); and regulatory action at the national, European and international levels.

'Do Nothing'

Without targeted action in relation to AIFM, there is no reason to believe that the risks highlighted by the crisis will dissipate. Some behavioural change is to be expected in the coming months as a result of continued adverse market conditions, the vulnerability of many financial institutions and a generalised loss of investor confidence. However, the underlying risks associated with the AIFM industry will remain, as will the cross-border channels for the transmission of those risks. The incomplete and nationally fragmented regulatory and supervisory system for AIFM would not therefore be a solid foundation on which to rebuild the European financial system. In addition, the EU would forego the benefits of single market integration in that area.

This is not to say that the European regulatory environment would remain static without action in this area. As described in Section 4, the reforms announced in the recent Commission Communication cover a wide array of themes and industry sectors. While in some cases relevant to AIFM, these measures are not targeted specifically at the risks posed by AIFM and do not respond directly to the particular problems of the AIFM sector. For instance, an overhaul of the European architecture for the monitoring of macro-prudential risks would not in itself address concerns relating to the lack of transparency of the AIFM sector. Such a system could only work effectively if AIFM were subject to appropriate regulatory controls and disclosure requirements. Planned market-wide measures are therefore a complement to, not a substitute for, targeted action in this area.

Self-regulation by AIFM industry

Industry associations have developed a range of self-regulatory instruments at national, EU and international level. These instruments concern in particular, but not exclusively, hedge funds, private equity and real estate funds. They range from illustrative lists of best practices to voluntary codes of conduct, to 'mandatory' guidelines. Most of these instruments have been adopted only in recent years.

How are the concerns identified earlier addressed by existing self-regulatory frameworks? Existing standards address many of the risks described above, including corporate governance, risk management, valuation and disclosure practice. Some of these codes are not specific to the European market but are designed to be applied internationally.

The role of industry codes and best practice guidelines is in some areas to enhance existing regulatory regimes; in others they have emerged as a substitute for direct regulation. They thus have the potential to compensate for the some of the weaknesses in the regulatory framework outlined in previous sections.

However, the effectiveness of standards and best practice guidelines in influencing the behaviour of AIFM depends critically on the coverage of those codes and the effectiveness of mechanisms instituted for monitoring and enforcing compliance with their provisions. Without the latter, such initiatives will lack credibility and hence will not provide the necessary reassurance that best practices are being widely applied.

An analysis of the coverage and effectiveness of the self-regulatory framework applicable to the private equity and hedge fund sectors provides a good indication of how, if codes do not fulfil the effectiveness criteria, their ability to exert influence and to affect the behaviour of those to whom they apply or should apply will be limited.[43] The analysis shows that the professional codes and standards at national and EU level do not ensure full coverage of all relevant issues and market players.

Moreover, there is also significant doubt regarding the level of compliance with such measures. Self-regulatory instruments are not legally binding and enforcement mechanisms are generally weak. Sanctions are not foreseen for the majority of these instruments. They can not therefore on their own ensure that all relevant risks are addressed in a credible way.

Another concern in relation to self-regulatory approaches relates to their patchy coverage. There is evidence of certain industry sectors working towards more harmonised or unified codes. However, a comprehensive response would require agreement on a harmonised approach bringing together the current set of very diverse initiatives across Member States and sectors to ensure that all concerns are addressed for all relevant players and activities.

However, there has been no attempt to develop 'cross-sectoral codes' for different types of AIFM. Newly emerging asset classes, which often carry new risk features, would potentially fall outside the scope of existing codes until the asset class had grown to a certain maturity and had developed its own codes. As long as codes are not integrated into a single instrument it might be that amendments would have to be integrated into various codes at national and EU level in parallel.

Moreover, unless these standards were recognised beyond national barriers, they would not adequately address the cross-border nature of the risks posed nor provide a foundation for the further development of the single market.

The major advantage of industry-developed standards is their flexibility. As they can be updated or amended relatively easily, future developments could be smoothly integrated.

This is not to say that self-regulatory initiatives could not play a role in the future. The experience and expertise reflected in existing codes could provide a valuable source of inspiration for legally-binding measures adopted at national, European or international level. Moreover, the industries concerned could continue to play a role in elaborating the principles contained in legislative measures.

However, such initiatives could not on their own respond to the risks because:

- They are partial in their coverage, both in terms of addressees and content.
- There is a lack of co-ordination between competing and overlapping codes.

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[43] See Annex XI

- Most importantly, they lack credibility and effective monitoring and enforcement mechanisms.

In Europe, the capacity of such initiatives to mitigate market failures is thus debateable and thus does not provide a sufficient response to the substantive and coordination problems flowing from the fragmented regulatory framework for AIFM.

Member State action

Contrary to some claims, AIFM are not currently unregulated. Their activities are subject to Community regulation as well as to national provisions. Many AIFM are subject to authorisation requirements and to ongoing scrutiny from national regulators. However, as described in Section 3, these frameworks have been developed within Member States and are therefore very specific to the national context. This has led to gaps and inconsistencies in macro- and micro-prudential supervision and oversight, and a failure to take full account of the cross-border impacts of the risks posed by AIFM, in particular those relating to financial stability.

Achieving greater coherence in national regimes and enhancing cooperation and information sharing between regulators would in principle be achievable through simultaneous adjustment of national regimes by Member States. In order to achieve effective risk control, Member States would have to review national regimes and then to ensure some degree of commonality to avoid inconsistencies or loopholes. As the coverage of national regimes in terms of asset class differ widely it would also be necessary to ensure consistency and full coverage in this area.[44] Market participants could only benefit effectively from internal market rights if Member States could ensure a high degree of harmonisation of rules.

From past experience it would require an immense effort by the 27 Member States to develop and implement a co-ordinated approach. Well-known limits exist to such coordination exercises in multi-jurisdictional environments. Information sharing between authorities has been a source of contention in several sectors. Moreover, the failure to achieve a minimum degree of harmonisation would imply that barriers to efficient cross-border service provision would remain. Finally, any future amendments to such a regime would be as difficult and time-consuming to achieve as the harmonisation itself. Given these limitations, this option would not be a promising or efficient way to achieve the specified objectives.

EU-level action

EU-level action would require the adoption of new legislation to harmonise to some extent the fragmented regulatory framework for AIFM that currently prevails. This could be designed in such a way as to provide harmonisation of the key elements of the regulatory framework for the registration and authorisation of AIFM, whilst providing the flexibility in specific provisions to take account of the risks associated with different business models.

The establishment of common regulatory standards through Community legislation would provide greater comfort to investors and counterparties investing through AIFM located in other Member States. It could also be designed to take due account of the impact of AIFM activity on financial markets in other Member States, for instance by creating obligations for supervisors to cooperate and to share information of common macro-prudential interest.

[44] The major point here would be that Member States have taken different approaches as to how to regulate AIF. While some have decided for a broad approach with only a few specific requirements, others have opted for a more product-specific approach with special laws for individual fund types like hedge funds or real estate funds.

An EU-level response would deliver advantages not only in terms of the management of risks but also in relation to the removal of barriers to the efficient pan-European distribution of AIF. The harmonisation of key regulatory and supervisory requirements in relation to AIFM could offer advantages for AIFM while providing a high level of assurance to national regulars in relation to the activities of AIFM domiciled in other Member States.

The creation of an EU regime would potentially offer a number of benefits to fund managers. As discussed, fund managers that are properly authorised and comply with the requirements of the EU legislative measure would be able to distribute their funds to professional investors in all Member States. Recognition of a secure and effective regulatory regime in Europe may also provide EU-domiciled AIFM with a comparative advantage vis-à-vis non-authorised third country fund managers. This might even turn into a significant 'pull factor', attracting more fund managers to the EU, if a widely recognised label similar to UCITS evolved.

There are two primary disadvantages of developing actions at European level. First, the process of adopting legislation can be lengthy and securing agreement on a legislative text challenging. Following adoption, a further period would be required for transposition into national law. Any subsequent modifications would also be time-consuming and hence the measure may lack flexibility in response to market developments. Second, a European approach may fail to take sufficient account of the specificities of national markets and of the business models that are specific to particular national contexts.

However, these drawbacks can be mitigated by the choice of instrument and process. The use of the 'Lamfalussy approach' would allow for the broad regulatory framework to be established at Level 1, followed by the development of more detailed implementing legislation at Level 2.[45] This would also provide for greater flexibility in amending details at Level 2. The choice of a Directive would also allow Member States flexibility in incorporating provisions into national law.

International-level action

The effects of many of the risks described are felt not only across borders within the EU but also at international level. The global financial system is tightly interlinked: the crisis has demonstrated how systemic risks crystallising in the United States, for example, may have a serious impact on the stability of the European financial system. As discussed above, parts of the AIF value chain are located outside of the EU and hence regulatory improvements elsewhere may have a direct impact on the risks associated with AIFM activity. There is therefore a strong argument for designing a framework to monitor and control these risks at the global level.

However, there are significant legal and practical barriers to reaching consensus at global level in a timely fashion. There is some evidence of convergence of views on the regulation of AIFM, as evidenced, for example, by the conclusions of the G20 Finance Ministers and Central Bank Governors meeting in March. However, agreement on broad principles falls short of specifying detailed global standards. This is due to the challenges of international coordination (in particular in relation to an industry of which a large part is domiciled off-shore) and of the differences in regulatory approach that exist between the main global financial centres.

In addition, the institutions do not exist to design and implement legally binding provisions at global level in this area. To the extent that agreement can be reached on principles, the

45 Annex XI provides a description of the Lamfalussy approach.

policies would still require implementation in the legal systems of each of the parties to that agreement. Action at international level is therefore unlikely to achieve the objectives specified in a comprehensive and timely fashion.

Nevertheless, action at national or European level does not preclude parallel or subsequent international level activity. For example, the collection and analysis of relevant macro-prudential data at national or European level could feed into the monitoring of systemic risks at global level (for instance, by the Financial Stability Forum or International Monetary Fund). It may also complement action at national or European level and, in due course, may foster greater convergence in regulatory approaches to the AIFM sector.

Conclusions

This discussion has highlighted the advantages and disadvantages associated with each level of action. Each offers an improvement vis-à-vis the status quo – doing nothing and persevering with a fragmented and incomplete regime is therefore not a viable option. However, the effective monitoring and mitigation of AIFM risk requires binding and enforceable measures to ensure a high standard of regulation and oversight throughout the EU. Industry-developed standards may have a role to play in elaborating on legal norms and are sensitive to market developments but they do not on their own provide a sufficient degree of assurance. Member States could in principle upgrade their own regulatory and supervisory arrangements. However, a piecemeal response would risk failing to take account of the cross-border nature of risks and binding cooperation and information-sharing agreements may prove elusive.

Therefore, in comparison with industry and national action, EU-level action has clear advantages, both in terms of effective risk monitoring and control and in providing a secure framework for pan-European AIF distribution. There is a risk that such an approach would not take adequate account of the international dimension. However, international-level agreements would take considerable time to conclude and would likely be limited to broad principles. The development of a robust framework in Europe could nevertheless provide a good starting point for global discussion and sharing of information, and effective cooperation will be essential for the monitoring of those parts of the value chain located off-shore.

The table below illustrates these conclusions in a schematic way.

Table 10: Achievement of objectives – Level of action

	Effectiveness of risk control	*Internal Market*	*Coverage*	*Flexibility and proportionality*
Do nothing	o	o	o	o
Self-regulatory instruments	+	o	o	+
Member State action	+	+	+	+
EU-level action	++	++	+	+
International	+	o	+	+

o: no effect;+/++: improvements in relation to 'do nothing'

5.5. Subsidiarity

Any potential EU action must respect the principle of subsidiarity. According to the protocol on the application of subsidiarity and proportionality, EU action could be justified if:

- Transnational aspects could not be satisfactorily regulated and the proposed objective could therefore not be sufficiently achieved by the Member States;

- Action by Member States alone would conflict with the requirements of the Treaty;
- Action by Member States would significantly damage Member States' interests;
- Action at Community level would produce clear benefits by reason of its effects of scale compared with action at the level of the Member States.

The preferred approach of EU level action targeted at the AIFM takes into account the above principles. The objective to remove market fragmentation could not be satisfactorily achieved by Member States action and the level of harmonisation achieved. The risks in question are inherently transnational in nature and hence consistency is required in the way in the requirements placed on AIFM and in the information collected from them.

The choice of instrument is also crucial in finding an appropriate balance between EU-level and national action. In this case, the choice of a Directive would appear to provide for the appropriate balance between harmonising key risk control measures and allowing Member States the flexibility to incorporate these provisions in their national. Any such regime could also provide sufficient flexibility for Member States to implement additional requirements to AIFM operating in a purely domestic environment; and if appropriate to provide a regime for the distribution of certain types of AIF to retail investors.

The EC Treaty provides a legal basis for EU-level action in this area through Article 47(2).

Action at EU level must also respect the principle of **proportionality**. The proportionality of a proposed measure would depend critically on the design of that measure. The following section 5.6 explores in detail how an all-encompassing legislative approach to AIFM at EU level could be designed so as to provide an appropriate degree of security while ensuring that the provisions are sensitive to the risks posed by particular business models.

5.6. Provisions of a potential proposal and expected impacts

The analysis of the previous sub-sections has indicated that the most effective method of delivering a secure and coherent framework for AIFM regulation and supervision, the coordinated monitoring of macro-prudential risks and an efficient internal market for AIF would be to develop a measure:

- targeted at the AIFM and other key service providers;
- applicable to all AIFM but differentiated to take account of differing risk profiles; and
- at EU level.

This sub-section discusses how such a measure could be designed so as to deliver the specified objectives while respecting the principle of proportionality. It presents the elements that such an EU level measure would have to include and discusses how effectiveness can be ensured, while minimising unintended consequences. Particular attention is paid to increasing administrative burdens, adverse impacts on the competitiveness of AIFM concerned or on the economy, in particular small and medium-sized enterprises (SME). It will also assess whether the proposed measure would be proportionate.

Box 6: Principal elements of the proposed Directive:

Scope and definitions:

In order to ensure that all AIFM operating in the EU are subject to effective supervision and oversight, the proposed Directive introduces a legally binding authorisation and supervisory regime for all AIFM managing AIF in the EU. The regime will apply irrespective of the legal domicile of the AIF managed.

For reasons of proportionality, the Directive will not apply to AIFM managing portfolios of AIF with less than 250 million€ of assets. A manager authorised in accordance with the UCITS Directive requires an additional authorisation to operate under the AIFM regime.

General provisions:

Operating conditions and initial authorisation:

To operate in the EU, all AIFM will be required to obtain authorisation from the competent authority (CA) of their home Member State. All AIFM operating in the EU will be required to demonstrate that they are suitably qualified to provide AIF management services and will be required to provide detailed information on the planned activity of the AIFM, the identity and characteristics of the AIF managed, the governance of the AIFM (including arrangements for the delegation of management services), arrangements for the valuation and safe-keeping of assets, audit arrangements, and the systems of regulatory reporting, where required.

The AIFM will be required to satisfy the CA of the robustness of internal arrangements with respect to risk management, in particular liquidity risks and additional operational and counterparty risks associated with short selling; the management and disclosure of conflicts of interest; the fair valuation of assets; and the security of depository/custodial arrangements have to be equivalent to those in the Community. CA will be required to pay particular attention to the robustness of these depository arrangements.

The proposed Directive foresees that the precise requirements, in particular with regard to disclosure requirements, will be tailored to the particular investment strategy employed.

Capital requirements:

The AIFM will also be required to hold and retain a minimum level of capital.

Treatment of investors:

While the marketing of AIF will be limited to professional investors, the proposed Directive provides for a minimum level of service and information provision to such investors, on an initial and ongoing basis, to facilitate their due diligence and ensure a minimum level of investor protection. The proposed Directive requires AIFM to provide to their investors a clear description of the investment policy, including descriptions of the type of assets and the use of leverage; redemption policy in normal and exceptional circumstances; valuation, custody, administration and risk management procedures; and fees, charges and expenses associated with the investment.

AIFM will be required to treat their investors fairly and, if investors are not treated equally, to disclose any such preferential treatment clearly to all investors.

Disclosure to regulators:

To support the effective macro-prudential oversight of AIFM activities, AIFM will be required to report to the CA on a regular basis on the principal markets and instruments in which it trades, its principal exposures, performance data and concentrations of risk.

The AIFM will also be required to notify the CA of the home Member State of the identity of the AIF managed, the markets and assets in which the AIF will invest and the organisational and risk management arrangements established in relation to that AIF.

Specific provisions

Specific requirements for AIFM managing leveraged AIF:

An AIFM employing leverage on a systematic basis above a defined threshold will be required to disclose aggregate leverage, the form of leverage (cash borrowing, securities borrowing, leverage embedded in derivatives), and the main sources of leverage (lending institutions such as prime brokers, banks etc) to the home authority of the AIFM. The proposal does not impose obligations upon CA as regards the use of this information. It however recognises emergency powers for authorities to restrict the use of leverage in respect of individual managers and funds, if the stability and integrity of financial markets so requires. It requires CA for such leveraged funds to aggregate and share, with other CA, information that is relevant for monitoring and responding to the potential consequences of AIFM activity for systemically relevant financial institutions across the EU and/or for the orderly functioning of the markets on which AIFM are active. The proposed Directive requires that this information be transmitted on quarterly basis to the Economic and Financial Committee (or to the yet to be created European Systemic Risk Council) and without delay in the event of threat of imminent instability or counterparty failure.

Specific requirements for AIFM acquiring controlling stakes in companies:

The proposal provides for disclosures of information to other shareholders and interested parties at the time that the AIFM acquires a controlling interest. It also foresees provision whereby the AIFM issues annual disclosure on the investment strategy and objectives of its fund when acquiring control of companies, and some general disclosures about the performance of the portfolio company following acquisition of control. These reporting obligations are introduced in view of the need for private equity and buy-out funds to account publicly for the manner in which they manage companies of wider public interest, control of which they have acquired. The information requirements address the perceived deficit of strategic information about how private equity managers intend to, or have managed portfolio companies which they own. For reasons of proportionality the draft proposal does not extend these requirements to acquisitions of control in SMEs. The draft proposal requires that delisted companies temporarily continue to be subject to reporting obligations for listed companies.

Rights of AIFM under the Directive:
In order to facilitate the development of the single market, an AIFM authorised in its home Member State will be entitled to market its funds to professional investors in any Member State. Member States will not be permitted to impose additional requirements on AIFM domiciled in another Member State insofar as marketing to professional investors is concerned. The cross-border marketing of AIF would be subject only to a notification procedure, under which relevant information is provided to the host Member State and transmitted to the host.
The proposed Directive does not provide rights in relation to marketing AIF to retail investors. Member States may allow for marketing to retail investors within their territory and may apply additional regulatory safeguards for this purpose. Such requirements shall not discriminate according to the domicile of the AIFM.
AIFM shall also be entitled to freely provide management services in Member States other than their Member State of domicile, subject to a notification procedure.

Supervisory cooperation and information sharing:
In order to ensure the secure functioning of the AIFM sector, CA of the Member States will be required to cooperate whenever necessary so as to achieve the aims of the Directive.
Given the cross-border nature of risks arising in the AIFM sector, a prerequisite for effective macro-prudential oversight will be the timely sharing of relevant macro-prudential data at the European level. The CA of the home Member State will thus be required to transmit relevant macro-prudential data, in a suitably aggregated format, to public authorities in other Member States.[46]

To address the risks identified and to achieve the specific objectives outlined above, the provisions of a potential Directive would have to be targeted at the particular risk and the actor and activity behind it. This is in recognition that a crude 'one-size-fits-all' approach carries risks. Yet, as the discussion above has shown, there are a number of risks and concerns that are common to the various types of AIF and AIFM. This holds in particular for the authorisation and registration requirements and the limitation and monitoring of micro-prudential risks and the development of an internal market for AIF and AIFM. This has to be reflected in general provisions applicable to all AIFM that fall under the Directive. The other specific objectives, macro-prudential oversight, investor protection and greater public accountability of AIFM holding controlling stakes in companies are arguably more relevant with regard to some specific activities.

Most of the provisions would therefore be relevant to all AIFM. This includes minimum capital, organisational, and transparency requirements as well as rules on conflict of interest and conduct of business but also management of risks and liquidity. The initiative would require AIFM to ensure that these requirements are fulfilled on an ongoing basis from the time of their authorisation by their home supervisor. Depending on its activities the AIFM might have to comply with additional requirements as explained below.

The following table summarises the main provisions of the potential measure.

[46] Depending on the outcome of the ongoing revision of financial supervision in the EU this might include future EU-level body like the European Systemic Risk Council (ESRC) proposed by the report on financial supervision in the EU by the de Larosiere group. http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf

Table 11: General and specific provisions of the prospective proposal and objectives addressed

Coverage:		Requirements:	Objectives addressed:
Provision:	***Examples:***		
General provisions:			
All AIFM with AuM **above 250mn€**	Exempts the majority of AIFM, in particular AIFM of **smaller funds**, e.g. most venture capital funds	- Capital requirements (125.000€ + 0.02% of AuM in excess of 250mn€) - Organisational requirements (adequate and appropriate resources; independent or independently acting valuator, minimum frequency of valuation; depositary subject to prudential regulation and on-going supervision, liable to AIFM and investors) - Conflict of interest - Risk and liquidity management - Conduct of business - Transparency requirements (annual report, accounting information; disclosure to investors; regular reporting to competent authorities) - Internal market rights: cross-border provision of AIFM services and cross-border marketing of AIF managed	**-** all specific objectives
Requirements specific to:			
AIFM of **leveraged** AIF	Primarily **hedge fund** managers, but potentially also others like AIFM of **commodity** funds	- Disclosure to investors: maximum level of leverage; total amount of leverage of relevant AIF - Reporting to CA: aggregate level of leverage; amount of leverage by major sources	- limitation and monitoring of macro-prudential risks - investor protection
AIFM acquiring **controlling stakes** in companies which are not SMEs	AIFM of **private equity** funds	- Disclosures of information to other shareholders and interested parties at the time of acquisition; - Annual disclosure on the investment strategy and objectives; - General disclosures about the performance of the portfolio company	- investor/stakeholder protection
AIFM **delisting** companies	AIFM of **private equity** funds	- Delisted companies to continue to be subject to reporting obligations for listed companies for two years	- investor/stakeholder protection

Proportionality and administrative burden

Compliance with an EU Directive would constitute a potential administrative burden, primarily in the form of reporting requirements. As they are currently already regulated in one way or other at national level, not all of these provisions create new, additional burden. In any case, but especially when using a horizontal approach for AIFM, it is essential to ensure that any measure is proportionate and reasonable. The benefit of achieving the objectives of the measure and the administrative burden that comes with it have to be balanced. In the current case it would be achieved by a combination of quantitative thresholds and the use of an activity/behaviour-based approach.

Activity/behaviour-based approach

The consistent use of an activity/behaviour-based approach is of crucial importance in ensuring proportionality and efficiency. This approach is based on the fact that the risks to be addressed do not stem from the activity rather than the type of fund. It follows from the fact that an 'all encompassing' approach has to be followed in order to avoid regulatory arbitrage and gaming and serves to ensure that it does not turn into an 'one-size-fits all' that would not be sensitive to the specific features of the types of AIFM and AIF covered. Its major advantage vis-à-vis AIF/AFIM-type specific measures is its comprehensive nature.

Even the **general provisions** of a Directive would not apply to the same degree to every AIFM independent of its size and activities. Rather, the more risk an AIFM takes the more developed its organisational and risk management provisions would have to be. Competent authorities will, for example, assess the liquidity management systems and procedures of an AIFM against the liquidity of its investments (risk-based approach).

However, the activity/behaviour-based approach will also apply more specifically to a number of activities listed in the table above. In these cases there is a clear line drawn between AIFM who use a specific technique or undertake **specific activities** and those who do not. Only the former will have to comply with the respective requirements.

Only AIFM that use **leverage** systematically and on a relevant scale (leverage exceeding the value of the equity capital of the AIF) will have to comply with the respective requirements. The initiative would require them to disclose to (prospective) investors, among others, the maximum potential and the current level of leverage and to report to the competent authority, among others, the level of leverage and the amount of leverage by major sources (prime brokers, banks etc). Competent authorities would have emergency powers to restrict the use of leverage in respect of individual managers and funds, if the stability and integrity of financial markets so requires.[47] This requirement would be needed as the use of a systematically high level of leverage implies that the impact of that activity on the financial system is likely to be amplified.

For all other AIFM no additional burden will be created. The use of this activity-based approach ensures that all relevant AIFM will be covered without any regard to the name or label under which its AIF are being marketed, while AIFM that do not use leverage, or only to a limited degree, that does not pose any major potential threat to financial stability and the functioning of the financial system, will not have to bear unnecessary burden. Competent authorities will not

[47] Competent authorities for such leveraged funds would also be required to aggregate and share, with other competent authorities, information that is relevant for monitoring and responding to the potential consequences of AIFM activity for systemically relevant financial institutions across the EU and/or for the orderly functioning of the markets on which AIFM are active. The proposed Directive requires that this information be transmitted on quarterly basis to the EFC (or yet to be created European Systemic Risk Council) and without delay in the event of threat of imminent instability or counterparty failure.

be confronted with vast amount of information that they do not necessarily need for proper macro-prudential oversight.

The same logic applies to AIFM acquiring stakes in companies: Only if the respective AIF reach a **controlling stake** in a company will they be required to ensure compliance with additional information and disclosure requirements that should allow other stakeholders to accurately scrutinise related activities. In order to address problems related to public accountability the measure would require an AIFM who manages one or more AIF that acquire *controlling stake* in a company, to comply with disclosure and reporting requirements vis-à-vis other shareholders and interested parties (e.g. annual disclosure on the investment strategy and objectives of its fund; performance of the portfolio company following acquisition of control). These disclosure and reporting obligations are introduced in view of the need for private equity funds to account publicly for the manner in which they manage companies of wider public interest. The information requirements address the perceived deficit of strategic information about how private equity managers intend to, or have managed portfolio companies which they own.

The same applies to AIFM that invest in listed **companies** that are then subsequently **delisted:** If as an immediate result of an acquisition of controlling stake in a listed company the AIFM declares its intention to delist this company, the AIFM will have to ensure that these companies continue with their reporting obligations as required for listed companies for two years after the delisting. This is in reaction to concerns raised with regard to the delisting of public companies owned by private equity funds and the subsequent reduction of transparency. The measure would ensure that AIFM can be held publicly accountable for a transitional period so that any sudden change in strategy or performance continues to be publicly disclosed.

Like most of the provisions of the Directive, details regarding reporting requirements would to some degree be elaborated at levels 2 and 3 of the Lamfalussy procedure. A review of their appropriateness and effectiveness, including public consultation, will be foreseen in the final provisions of the Directive.

De minimis thresholds

AIFM that manage AIF of **less than 250 million euro**, on aggregate, will prima facie be **excluded** but have the right to 'opt-in'.[48] This provision should ensure that no unnecessary administrative burden is imposed on AIFM that do not pose relevant risks to financial stability and market efficiency. It has been determined on the basis of an analysis of the size distribution of AIFM distributing AIF in the EU. This has been done for open-ended non-UCITS and separately for hedge funds because of their particular importance for market efficiency and integrity and their systemic relevance. The results of this analysis are summarised in the charts and tables below. In reading them it has to be kept in mind that they refer to AIFM, not to individual AIF, as the de minimis rule under consideration would apply on the basis of total assets managed by AIFM, not on the assets invested in any individual AIF.

In the case of hedge funds, it can be seen that a threshold of 250mn€ would cover about 70% of the net assets. This could be achieved by covering only some 14% of the hedge fund managers. Doubling the proposed threshold to 500mn€ would cover about half of net assets and only less than 10% of the managers. Lowering it to 100mn€ would more than double the share of managers covered while increasing the net assets covered by around 20% only.

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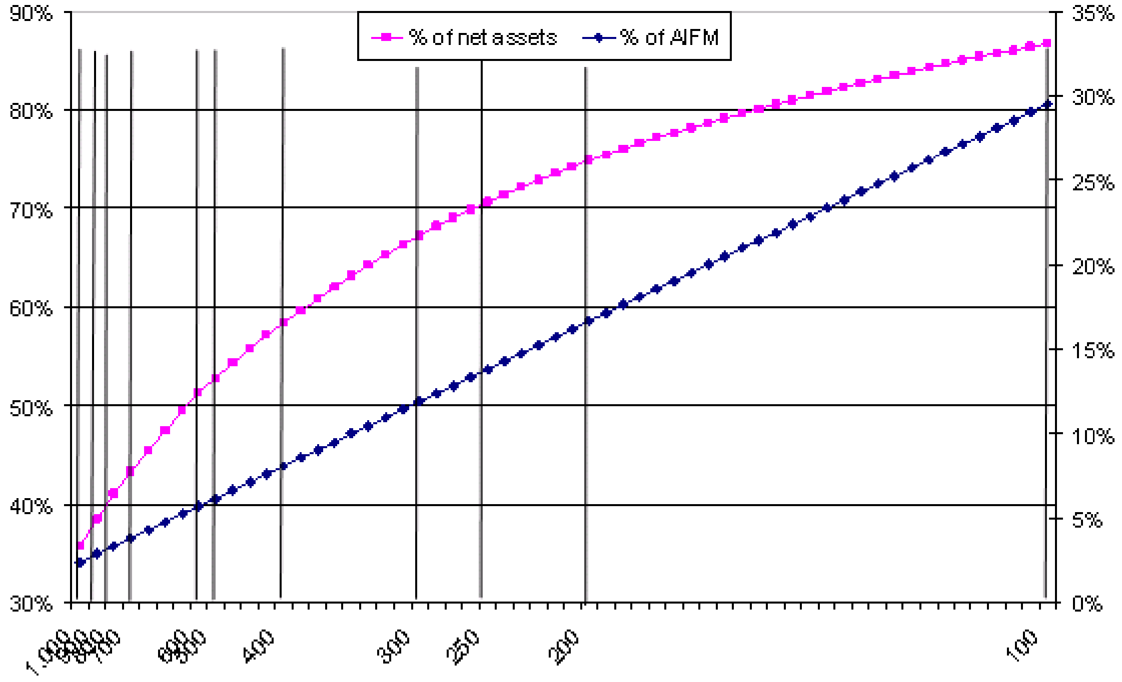
48 The net assets under management of an AIFM have been used as proxy as systemic risks and impacts on market efficiency are closely correlated with size. Furthermore, data availability renders the use of more sophisticated indicators impossible.

Chart 2: Size distribution of Hedge Fund Managers



Managers of hedge funds are available for sale in at least one EU Member State; based on almost 500 funds with the necessary information available in the database; managed by more than 200 managers. The distribution in terms of net assets is plotted against the scale on the right-hand side; the distribution in terms of number of managers covered is plotted against the scale on the left-hand side.
Source: Commission services calculation on the basis of Morningstar Direct database.

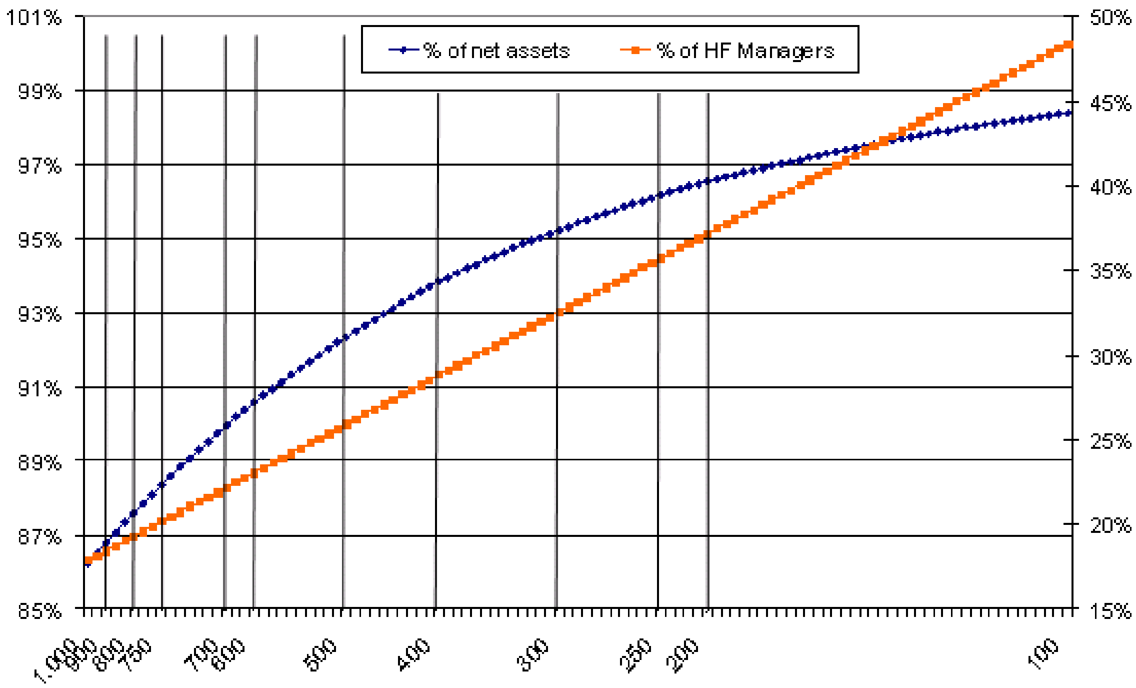
Table 12: Hedge funds: Share of net assets under management and share of fund managers covered

Net assets, EUR, above threshold of:	***Share of net assets covered***	***Share of fund managers covered***
1.000.000.000	33%	2%
500.000.000	51%	6%
250.000.000	**71%**	**14%**
200.000.000	74%	16%
100.000.000	87%	30%
Total	*100%*	*100%*

See footnotes on previous chart.

The concentration of managers of open-ended investment funds that are not UCITS distributed in the EU is much greater due to the fact that this includes some of the major asset management firms in the EU which manage a multitude of often relatively big funds. Here a threshold of 250mn€ would cover more than 90% of the assets under management, but only a bit more than a quarter of the managers. Increasing the threshold to 500mn€ would lower the share of managers covered to around one quarter. Lowering it to 100mn€ would not dramatically change the share of assets covered; but would increase the share of managers covered to around half of the managers.

Chart 3: Size distribution of open-ended non-UCITS fund managers



Managers of open-ended investment funds that are not UCITS and are available in at least one EU Member State; based on a sample of more than 4000 funds (out of more than 13.000 funds with the necessary information available in the database; this sample excludes hedge funds, it mainly consists of equity, money market, commodity and fixed income funds), managed by about 350 managers. The distribution in terms of net assets is plotted against the scale on the right-hand side; the distribution in terms of number of managers covered is plotted against the scale on the left-hand side.
Source: Commission services calculation on the basis of Morningstar direct database.

Table 13: Open-ended non-UCITS funds: Share of net assets under management and share of fund managers covered

Net Assets, EUR, above threshold of:	***Share of net assets covered***	***Share of fund managers covered***
1.000.000.000	86%	18%
500.000.000	92%	26%
250.000.000	**96%**	**36%**
200.000.000	97%	37%
100.000.000	98%	48%
Total	*100%*	*100%*

See footnotes on previous chart.

Capturing the 'big players' ensures that the over-arching objectives of proper macro-prudential oversight and market efficiency and integrity can be achieved. These AIFM are also those with the greatest interest in cross-border distribution. However, the 'opt-in' clause would also allow smaller AIFM to benefit from the Internal Market rights provided by the measure.

As regards these smaller AIFM the additional benefits resulting from achieving the objectives relating to investor protection and micro-prudential oversight are not felt to outweigh the additional costs in form of administrative burden on these AIFM, especially if activities were limited to national markets. As said before, most of these AIFM would not remain unregulated but would be covered by national rules. Given that, in many cases, their focus would mainly be local this seems more appropriate. Finally, it should be recalled that the investors concerned are predominantly sophisticated investors.

Besides this general exemption, the measure would use de minimis thresholds also in the application of specific provisions. For example, AIFM acquiring **controlling stakes** in companies would be exempted from the relevant information and disclosure provisions mentioned above if the portfolio company falls under the EU definition of a small- or mid-sized enterprise (SME) as defined in Commission Recommendation 2003/361/EC of 2003.[49] Obliging AIFM to comply with comprehensive information and disclosure provisions would be a disproportionate burden in the case of small-scale investments and could even result in a reduction of the already relatively low venture capital activity in the EU. This would run counter to the Commission policies with regard to SME and the Lisbon objectives of the European Union.

In order to avoid unnecessary compliance costs, it would be foreseen that an AIFM using **leverage** in its investments only has to comply with the relevant provisions if leverage is used extensively.[50] A low degree of leverage is common and accepted practice for most types of AIF. Obliging all AIFM to report on leveraged investments would therefore result in a vast amount of information 'thrown' on competent authorities. It would then be difficult to deal with this information and to analyse it properly. The marginal additional benefit from full coverage would be achieved against considerable costs for competent authorities and AIFM.

It has to be recognised that the use of any threshold bears the risk of circumvention. However, this has to be weighed against the burden imposed on the AIFM covered. The principle of proportionality, increasing costs versus decreasing additional benefit, has to be applied with caution. In order to avoid or minimise circumvention thresholds refer to the AIFM entity as a whole and not only to individual AIF.

Competitiveness and employment

The prospective Directive will affect AIFM, positively and adversely, through various channels:

- Firstly, AIFM that have to comply with the provisions will face additional administrative burden.[51] These costs will affect their competitiveness negatively. Although the extent of this effect cannot be quantified it seems very likely that, in the light of the mechanisms installed to ensure proportionality, it will not be extremely high and certainly not excessive.
- Secondly, some of the provisions might result in an improved public image of AIFM in the EU. This could increase its attractiveness to institutional investors and increase investor confidence in AIFM and financial markets more generally.
- Thirdly, the improved conditions for cross-border marketing of AIF and cross-border service provision by AIFM should allow the industry to become more efficient by using specialisation advantages and exploiting economies of scale.
- Finally, the creation of an EU level framework could result in the emergence of an EU 'AIFM label'. This could attract fund managers to domicile in the EU. A widely recognised fund manager label could also have positive impact on softening buy-side restrictions that currently restrict cross-border investments of institutional investors like pension funds.

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49 Commission recommendation concerning the definition of micro, small and medium-sized enterprises; http://europa.eu/eur-lex/pri/en/oj/dat/2003/l_124/l_12420030520en00360041.pdf

50 There is no commonly agreed understanding of what constitutes an excessive level of leverage not at least because this depends on the way it is being used and controlled for. And what is more, this "ideal threshold" would certainly change over time in such a dynamic industry. There are good reasons, however, not to set the threshold at zero. It can also be argued that a leverage that exceeds own funds might change perception of risks as one operates with more 'foreign' than 'own' money.

51 However, as mentioned above, for some AIFM the administrative burden might be lower than under current national regimes.

Overall, despite the inherent difficulty of assessing the net impact of such a Directive on the competitiveness of the EU AIFM industry, it seems most likely that the effect of the measure as proposed will be relatively limited. The objective to ensure a complete and consistent framework for the supervision and prudential oversight of AIFM cannot be achieved without imposing some administrative burden. These would only be higher than in the current situation ('do nothing') for AIFM domiciled in Member States with a significantly lower level of supervision and oversight. Furthermore, as the measures proposed are in line with what is being discussed at international level it is likely that even in the short- to mid-term administrative burden will be similar or even higher in other major financial centres.[52]

Under this scenario there might also be a positive employment effect: If international AIFM come to the conclusion that the benefits of the new regime would outweigh the (administrative) costs, they could be inclined to step up their EU-based activities. This would bring not only additional employment in the AIFM but most likely also to ancillary service providers in the EU. However, in the case that AIFM should see the new framework as an excessive burden and move out of their EU domiciles as a reaction this could result in a detrimental effect on employment and economic activity in the EU AIFM sector. It is difficult to assess the likely net effect at this stage. Given the cost sensitivity of the industry and that, like most services, the management of AIF is 'footloose', the net effect will be sensitive to the concrete provisions of the measure. The analysis is made even more difficult by the fact that the United States, as well as other third countries, also consider changing their regulatory framework for (most types of) AIFM.

Impacts on investors and SME

As discussed in the previous section, the measure should result in a harmonisation of protection of investors in AIFM in the EU and thereby increase legal certainty. **Retail investor** protection would be ensured through clauses that prohibit the distribution of these types of AIF to retail clients as long as national rules do not provide a respective framework and safeguards. This is justified by the fact that AIF are generally not seen as (fully) suitable for retail investors.[53]

Furthermore, the development of an Internal Market for AIFM for **professional investors** should benefit these investors as they would have a wider choice of AIF at potentially lower costs due to specialisation gains and increased competition. Here again the right balance between strict oversight and regulation on the one hand and sufficient flexibility and ensuring the functioning of the AIFM business models is crucial: Too strict regulation would not only drive the AIFM industry out of the EU but would also force EU professional investors who want to acquire AIF to buy them off-shore with only low legal protection or at least higher costs in enforcing it.

It should be kept in mind, however, that MiFID rules regarding the test of suitability and appropriateness would still apply for the marketing of AIF in the EU. This means that an AIFM or its intermediaries would not be allowed to market an AIF to a professional investor without ensuring that the AIF is suitable and appropriate for this particular investor. The obligation for sellers/intermediaries to test suitability was the main reason for the choice of the 'professional client' category as defined in the MiFID Directive as the basis for the proposed Directive.[54] Limiting eligibility to 'eligible counterparties' would be too restrictive as would exclude a large

[52] See, for example, the IOSCO Consultation Report "Hedge Funds Oversight" of March 2009 (http://www.iosco.org/library/pubdocs/pdf/IOSCOPD288.pdf).
[53] See chapter 3 above.
[54] On the different definitions of investors in EU Directives see Annex.

number of potential investors which are established investors in many types of AIF at national level.

It is also essential to remain cognisant of the benefits of the AIFM industry and not to destroy the benefits AIFM can bring to the 'real economy'. Such concerns are most prominent with regard to private equity. In a number of Member States private equity represents an (increasingly) important source of finance for SME. The financial resources and the know-how of private equity managers are considered as important factors for a turn-around of the EU economy in the current crisis.

Impact on third countries

For AIF that are domiciled in a third country the competent authority of the domicile of the AIFM managing the respective AIF will have to ensure that its supervisory functions are not compromised by the regulatory and supervisory framework in this country. An AIFM would not receive authorisation if the laws, regulations or administrative provisions of a third country governing one or more natural or legal persons with which the AIFM has close links (including the AIF) prevent the effective exercise of their supervisory functions. The AIFM and its primary depositary will be regulated and supervised onshore, they will be required to furnish information on the offshore AIF and management of offshore funds is only permitted subject to strict controls.

AIFM of AIF domiciled in particularly uncooperative countries might therefore not be able to obtain authorisation to manage and market these funds in the EU. This should ensure that no additional risks arise from the fact that an AIF managed by an EU AIFM but domiciled off-shore poses additional risks for investors or markets.

The ongoing discussions in the various international forae (G20, IOSCO, FSF, mentioned above) should help to minimise the disruptive effects that might result from these provisions. It could be hoped that this EU level initiative will give these discussions a further impetus and contribute to an international agreement on principles at least.

AIFM domiciled in a third country will not be covered by the measure and will therefore not be able to market their AIF or to provide AIFM services in the EU under this Directive unless established/authorised in the EU in accordance with the proposed Directive.

Effectiveness and enforcement

To ensure the effectiveness of the provisions outlined above, an authorisation and supervisory regime has to be implemented. In order to be allowed to provide its services and to market funds managed by it in the EU an AIFM will have to be authorised by the competent authority in its domicile. For this the AIFM will have to provide the authority with relevant documentation. Authorisation will only be granted if the competent authority is satisfied that the AIFM fulfils the conditions of this Directive. This authorisation will then be valid for all Member States.

This means that the AIFM will only have to notify the competent authority of another EU Member State in which it wants to provide its services or market its AIF to professional investors. As a corollary of the high common regulatory standard achieved by the proposed Directive, Member States will not be permitted to impose additional requirements on AIFM domiciled in another Member State insofar as marketing to professional investors is concerned. Member States may allow for marketing to retail investors within their territory and may apply additional regulatory safeguards for this purpose. Such requirements shall not discriminate according to the domicile of the AIFM.

The competent authority may withdraw the authorisation if is not used, if false statements have been made, if the conditions are no longer fulfilled; or if the provisions are seriously and/or systematically infringed. This withdrawal would then have immediate effect in all Member States.

Competent authorities would be given all supervisory and investigatory powers necessary for the exercise of their functions vis-à-vis an authorised AIFM. They would have access to documents and records, and have the right for on site inspections and to request information.

In order to ensure the secure functioning of the AIFM sector, competent authorities of the Member States will be required to cooperate whenever necessary so as to achieve the aims of the Directive. Given the cross-border nature of risks arising in the AIFM sector, a prerequisite for effective macro-prudential oversight will be the timely sharing of relevant macro-prudential data at the European, or even global, level. The competent authorities of the home Member State will thus be required to transmit relevant macro-prudential data, in a suitably aggregated format, to public authorities in other Member States.

Colleges of supervisors could in principle be envisaged as well. However, this idea has been disregarded as it would imply relatively high costs while bringing only marginal benefits. Organisational and distribution patterns of AIFM change more frequently than those of, say, global banks, this would require supervisors to review and reorganise colleges frequently as well which would involve relatively high organisational costs and would distract staff from focussing on the actual supervisory tasks.

Overall, it is likely that the onus on competent authorities will increase. This will be the case in particular in the implementation phase of the Directive when all AIFM will have to request authorisation and competent authorities will have to check the requests. In the long-term additional burden might result from the higher number of AIFM to be supervised compared to the status quo and the additional obligations regarding supervisory cooperation. However, it can be assumed that most of these costs would also occur if Member States would have to step up their supervisory duties unilaterally to better take into account the risks that have materialised in the financial crisis.

6. COMPARING THE OPTIONS: CONCLUSIONS

The analysis of the different options at the various stages led to the conclusion that the preferred option would be an EU level Directive targeting the fund manager and key service providers as the ones taking decisions and carrying responsibility. For the other options it could not be ensured that the objectives set would be achieved or achieved in a timely and effective way. Given the fragile current economic climate, doing nothing or delayed action can not be regarded as appropriate measures. The proposal would be based on Article 47(2) of the EC Treaty.

Addressing the AIF market as a whole when some of the problems lie in particular with a limited range of fund type (e.g. leveraged funds) might not appear proportionate at first glance. The above analysis has shown that a narrow approach might lead to evasion and therefore be ineffective or might not be future-proof in being flexible enough to deal with related problems that might appear in the future. The preferred 'all encompassing' approach, on the other hand, would be flexible enough to accommodate for the specificities of different fund types and future developments.

The Lamfalussy approach combined with a risk-based framework can ensure proportionality of the requirements with regard to the risks posed by specific activities or mechanisms, again the example of leverage can be used: the more leveraged a fund is the higher the reporting and other prudential obligations of the AIFM are.

Furthermore, 'de minimis' clauses would be used to avoid or minimise administrative burden for managers of smaller funds which do not pose particular risks.[55] This would also ensure that the administrative burden that comes along inevitably with the objective of complete and consistent prudential oversight does not impact adversely on other objectives of the Community like a high level of employment or promotion of SME.

The intended approach would also be proportionate in the sense that it does not try to address all the issues that have been identified as problematic in chapter 3. Some of these issues are already being addressed by other initiatives or cannot be reasonably addressed by an AIFM specific measure, e.g. due diligence and risk management at the prime broker or at the buy side (pension funds, insurances, local authorities, etc.).

7. MONITORING AND EVALUATION

The proposed EU Directive would include a final provision stating that a review of its appropriateness and effectiveness, including public consultation, should take place a few years after its implementation. This could cover the following issues:

- How much use is being made of the scheme (how many AIFM have registered with the competent authorities in Member States)?
- Survey AIFM, investors and supervisors about their experience so far:

– Administrative burden on AIFM

– Satisfaction of investors with information they receive

– Increase in cross-border business

– Satisfaction of supervisors with information they receive and the responsiveness of AIFM

– Functioning of supervisory cooperation

– Impact on third countries.

[55] Rough calculations on the basis of the Morningstar database showed, for example, that a de minimis rule of 100mn€ for hedge funds would exempt 70% of funds but would still cover about 85% of the market size (net assets).

ANNEX I: Acronyms

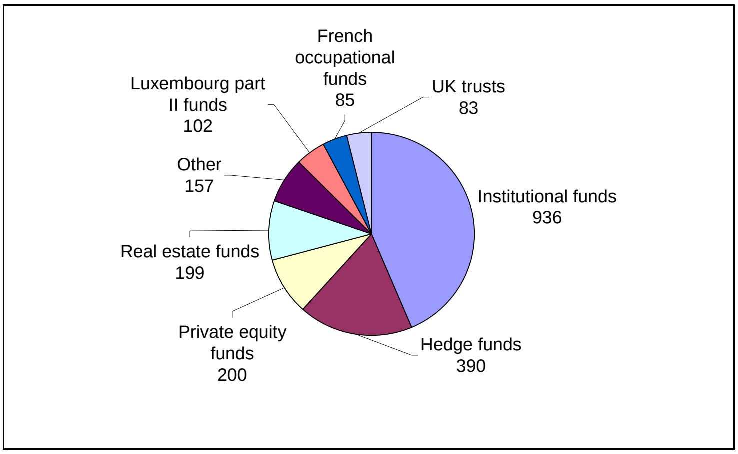
AIMA:	Alternative Investment Management Association; trade association for Hedge Funds, Managed Futures and Managed Currency Funds; http://www.aima.org/
BVI:	Bundesverband Deutscher Investment-Gesellschaften; http://www.bvi.de
CESR:	Committee of European Securities Regulators; an independent body of regulators from EU Member States that advises the European Commission on securities policy issues; http://www.cesr.eu.
CIS:	Collective investment schemes; arrangements that enable investors to pool their assets and have these professionally managed by an independent manager
Closed-ended fund:	Investment funds with restrictions on the amount of shares the fund will issue.
EFAMA:	European Funds and Asset Management Association; European association of national fund associations and corporate members; http://www.efama.org/
ESC:	European Securities Committee
ESME:	European Securities Markets Expert Group
Eurohedge:	http://www.hedgefundintelligence.com/eh/
EVCA:	European Private Equity and Venture Capital Association; European association of the private equity and venture capital industry; http://www.evca.eu/
Expert group on OEREF:	http://ec.europa.eu/internal_market/investment/other_docs/index_en.htm#group
FoHF:	Funds of hedge funds
IAB:	Impact Assessment Board
ICI:	Investment Company Institute, national association of U.S. investment companies, including mutual funds, closed-end funds, ETFs, and unit investment trusts; http://www.ici.org/
INREV:	European Association for Investors in Non-listed Real Estate Vehicles; representing market players in the sector
IORP Directive:	Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision
IPO:	Initial public offering
HNWI:	High net worth individuals; individual investors disposing of a significant wealth to invest in financial assets of one million Euro or more
HFR:	Hedge fund research; https://www.hedgefundresearch.com/
Lipper/Feri:	http://www.feri-fmi.com/FERIFMI/default.aspx
MiFID:	Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments
NHF:	Non-harmonised funds; investment funds that do not benefit from the EU passport of UCITS because they do not comply with the provisions of the Directive
Open-ended fund	Investment funds where the number of units/shares in issue increases as more people invest and decreases as people take their money out.
PD:	Prospectus Directive; "Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC"
PWC I:	Study, February 2008: "Investment funds in the European Union: comparative analysis of use of investment powers, investment outcomes and related risk features in both UCITS and non-harmonised markets"; http://ec.europa.eu/internal_market/investment/other_docs/index_en.htm#studies
PWC II:	Study 2008: "The retailisation of non-harmonised investment funds in the European Union"; http://ec.europa.eu/internal_market/investment/other_docs/ index_en.htm#studies; not published yet
SEC:	US Securities and Exchange Commission
SFC:	Hong Kong Securities and Futures Commission
SME:	Small and medium-sized enterprises
UCITS:	Undertakings for collective investment in transferable securities; EU-regulated retail investor funds

ANNEX II: Categories of non-harmonised funds (non-UCITS)

i) Main product categories

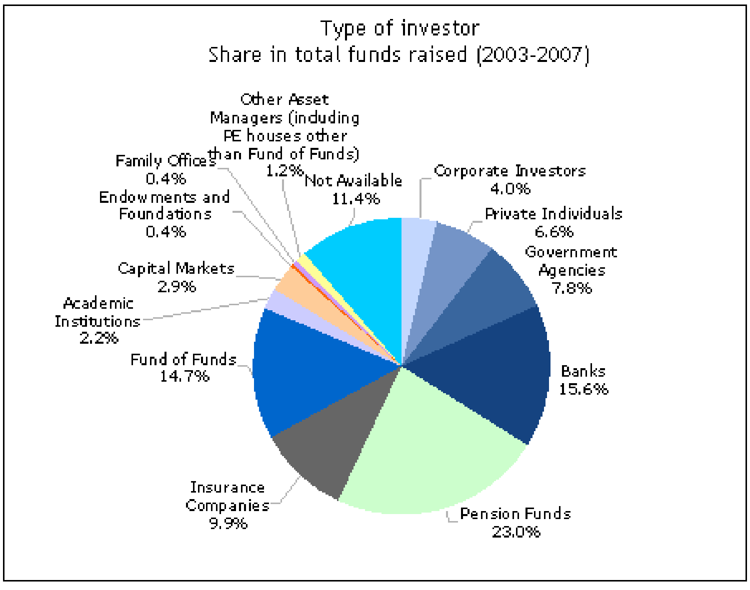
The non-UCITS sector currently accounts for about 2.152 bn€ in assets under management. The main types of fund are hedge funds, real estate funds, private equity and venture capital funds, commodity funds, and funds of funds for most of these fund categories, e.g. funds of hedge funds.

Chart A1: Breakdown of non-UCITS funds within the EU, bn€, end 2007



Source: Figures provided by EFAMA, AIMA, EVCA.
Investors in PEF: http://www.evca.eu/publicandregulatoryaffairs/default.aspx?id=86

The Non-UCITS world also comprises some funds that invest primarily in traditional asset classes (such as equities, bonds and derivatives) and pursue traditional investment strategies. Typical examples are structured funds and guaranteed funds. In this impact assessment these funds are not considered as separate fund types but categorised according to their respective investment policies, i.e. as equity funds, bond funds, etc. Many of these funds comply with the UCITS Directive. For those that do not comply, it can be assumed that they use investment strategies that are not suitable for retail investors, e.g. extended leverage, short-selling etc. They are, therefore, out of the scope of this impact assessment.



The same holds for funds which have been established under particular national regimes for institutional investors, e.g. German 'Spezialfonds'. These funds are by definition not open to retail investors and have deliberately opted for this status. They are, therefore, out of the scope of this impact assessment.

By contrast, alternative investments can be broadly understood as referring to investments other than a long position in stock or bond related holdings. The various alternative asset classes are very distinct in terms of core investment strategy and markets in which they invest, fund structure, investment technique (use of leverage through derivatives or borrowing) and investor base. This makes any attempt to discuss them as a single bloc problematic. In fact, the only uniting element is the non-compliance with the UCITS Directive in at least one (and usually several) significant respects.

The following table describes the main categories of funds which comprise Europe's non-UCITS fund sector.

Table A2: Main constituents of the non-UCITS/alternative investment sector

Product name	**Product characteristics**
Real estate funds	Real estate funds provide investors with exposure to investments in property, land and other property related assets. They can be both closed end (fund units cannot be regularly redeemed) or open ended funds (units can be regularly redeemed, as per UCITS). Property and land are not eligible assets for UCITS.
Private equity funds	Private equity funds provide investors with the opportunity to invest in non-listed companies. By contrast to UCITS equity funds private equity funds are allowed to actively influence the management of the company
Hedge funds	Hedge funds pursue absolute returns on their investments, i.e. profits both in rising and falling markets. They can invest in any asset classes, including asset classes ineligible for UCITS (such as commodities or real estate) and apply non-traditional portfolio management techniques such as uncovered short selling or excessive borrowing.
Fund of alternative investment funds	Funds of funds hold a portfolio of other investment funds rather than investing directly in securities. Funds of Hedge Funds, funds of Real Estate funds or funds of private equity funds are the main non-UCITS funds of funds.
Commodity funds	Commodity funds invest in stocks or derivatives that are correlated with the prices of physical commodities such as oil, metals or foodstuffs or other agricultural assets. UCITS may not invest in physical commodities, but may gain commodity exposure through stocks or derivatives.
Infrastructure funds	Infrastructure funds are funds that invest in assets that support an economy, often in conjunction with, or acquiring stakes from, local or central government. Examples could include investments in roads, railways, bridges, ports, airports, power assets, transmission lines, pipelines, or communications networks. UCITS may not acquire such illiquid assets. They can however invest in companies engaging in infrastructure projects.

The following table analyses the different non-UCITS funds with reference to the five criteria.

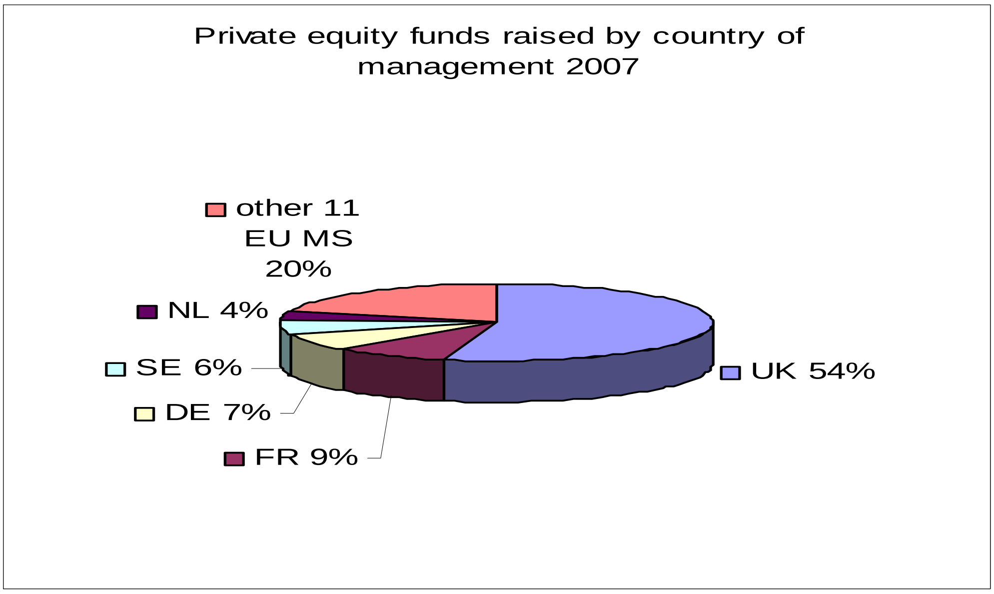
Table A3: Features of non-harmonised fund types

	Open ended real estate funds (OEREF)
Business model	**No**, UCITS may not invest in real estate
Market size	**Yes**, growing EU retail market in excess of 110 bn €
Retail suitability	**Yes**, OEREF deviate from certain UCITS investor protection safeguards, but have equivalent other safeguards in place, provided that they are obliged to redeem units at least quarterly
Proven track record	**Yes**, in Germany OEREF have a track record of more than 40 years. OEREF have been operating in 11 other Member States since the 1990s. In Germany and the Netherlands OEREF experienced liquidity crises and proved to be able to cope with it. Regulatory frameworks and liquidity and risk management have been improved in the aftermath. The UK market seems also to recover from a break-down in 2007.
Interest in cross-border distribution	**Yes**, retail investors in 12 Member States have shown increasing appetite in domestic OEREF, whereas investors in 15 Member States still have no access to OEREF
	Closed ended real estate funds (CEREF)

Business model	**No**, UCITS may not invest in real estate and must be open-ended. Please note, however, that, under certain conditions, CEREF can be distributed cross-border through the passport provided by the Prospectus Directive.
Market size	About 90-100bn€
Retail suitability	Partially, e.g. investments in typical CEREF are usually locked in for seven years or more, whereas the UCITS are characterised by frequent redemptions.
Proven track record	**No**, there is no EU retail market for CEREF. Retail investments in CEREF seem to be rather marginal.
Interest in cross-border distribution	**N/A**, there are neither clear indications for sufficient retail demand nor for interest on the supply side for cross-border distribution to retail investors
	Single hedge funds (SHF)
Business model	**No**, most SHF invest in assets and use investment strategies which are not permissible for UCITS.
Market size	**No**, in almost all Member States retail investors are not allowed to invest in SHF.
Retail suitability	**No**, only rudimentary investor protection safeguards, significantly higher risk exposure, insufficient transparency.
Proven track record	**No**, there are no retail markets for SHF
Interest in cross-border distribution	**Partially**, there is some evidence for retail investor demand for indirect exposure to SHF (e.g. through substitute products (certificates)). The industry did not show any interest in EU level action for retail access.
	Funds of hedge funds (FoHF)
Business model	**No**, FoHF do not comply with the fund of funds rules for UCITS since their target funds do not invest at least 70% of their assets in UCITS.
Market size	**Yes**, FoHF have an EU market size of approximately 68 bn €; note however that less than half of the investors are retail investors.
Retail suitability	**Partially**, depends on the national regulatory regime. Often FoHF deviate from UCITS investor protection safeguards and it is hard to say whether the safeguards in place are equivalent.
Proven track record	**Partially**, the FoHF market is still relatively young and untested.
Interest in cross border distribution	**Yes**, both direct and indirect investments through substitute products (e.g. certificates) indicate a growing retail investor demand.
	Private equity funds (PEF)
Business model	**No**, UCITS may neither predominantly invest in non-listed companies nor exercise significant influence over the management of target companies.
Market size	**No**, there is currently no significant retail market for PEF.
Retail suitability	**No**, the investor protection standard of PEF is not comparable with that of UCITS, e.g. high exposure to few companies, illiquidity of assets (due to the lack of a listing, no or very limited redemptions), partly because PEF have not been designed for retail investors.
Proven track record	**No**, no track record as a retail product.
Interest in cross border distribution	**No**, there are neither clear indications for sufficient retail demand nor for interest on the supply side for cross-border distribution to retail investors
	Commodity funds
Business model	**No**, UCITS may not directly invest in commodities. However, UCITS may indirectly invest through shares in commodity companies or derivatives.
Market size	**No**, no retail market for commodity funds yet.
Retail suitability	**No**, such funds are significantly more volatile and more difficult to value than retail funds.
Proven track record	**No**, this type of fund has only evolved recently.
Interest in cross border distribution	**No**, there is neither clear indication for sufficient retail demand nor for interest on the supply side for cross-border distribution to retail investors.
	Infrastructure fund
Business model	**No**, UCITS may not invest in infrastructure projects/real estate rights.
Market size	**N/A**
Retail suitability	**No**, these funds are very illiquid, difficult to value and less diversified than UCITS funds.
Proven track record	**No**, this type of fund has only evolved recently.
Interest in cross border distribution	**No**, there is neither clear indication for sufficient retail demand nor for interest on the supply side for cross-border distribution to retail investors.

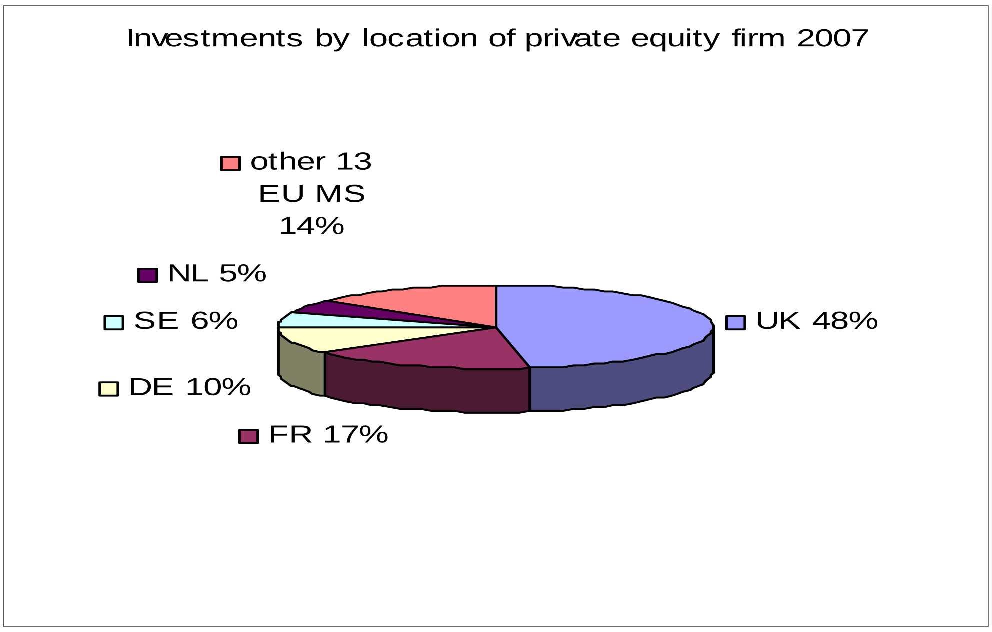
ANNEX III: European Private Equity activity in 2007

Table 1:



Source: EVCA

Table 2:



Source: EVCA

ANNEX IV: Key UCITS investor protection safeguards

The following table shows a summary of the key investor protection safeguards which are put in place for UCITS funds when offered to the public:

Criteria established in the UCITS Directive to ensure retail investor protection	
Authorisation and supervision of the fund • In order to be authorised the fund has to meet all requirements which ensure, inter alia, a high level of investor protection • Supervision ensures that the fund meets these requirements on a continual basis *Fund structure and redemption policy* • open-ended structure, i.e. investors may continually buy and sell units without being locked-up excessively • unlimited duration, i.e. investments in asset classes with long-term investment focus (e.g. real estate funds) is possible *The fund unit price* • corresponds with the net asset value of all underlying assets. This ensures that investors can buy and sell the fund at its fair value • the net asset value has to be calculated and published whenever investors buy and sell units. Only then can investors rely on buying or selling the fund at its current value *The assets the fund may invest in* have to be sufficiently liquid, i.e. the fund must be able to sell the assets within relatively short notice, notably in order to be able to satisfy redemption requests by investors can be valued at any time; this is indispensable in order to allow the fund to calculate its net asset value *High level of disclosure obligations* • to enable investors to make an informed investment decision the fund must offer them free of charge a disclosure document (usually a full prospectus and a simplified prospectus; the latter summarises the main characteristics of the fund) In addition the fund must publish on an ongoing basis an annual (and usually also a half-annual) report certified by an auditor which inter alia contains a statement of assets and liabilities as well as of income and costs	• Investment policy/risk management • diversification of the portfolio reduces the fund's exposure to risks inherent to each single underlying asset[56] • the fund may not exceed a threshold for investing in assed of the same issuer in order to reduce the issuer risk (e.g. the insolvency risk) • the fund does not have to invest all money into assets, but may hold ancillary liquidity which allows it to satisfy redemption requests by investors • the fund may only invest directly into assets to avoid in transparent structures • restricted use of derivatives to reduce the risk of losses • in principle no borrowing is allowed to reduce the risk of losses • no assets can be sold which the fund does not own to reduce the risk of losses • Depositary • Funds usually have to entrust their assets to a depositary (i.e. credit institution) in order to ensure that they are ring-fenced against the insolvency risk of the fund or its management company • the depositary checks whether the fund complies with the laws and the fund rules and protects the interests of investors • The fund's management company[57] • needs to be duly authorised • must have sound administrative and accounting procedures • conflicts of interest must be minimised • capital requirements ensure that it is financial sound and capable of performing its tasks • Specific rules for funds of funds (FoFs) • FoFs may only invest in target funds which are authorised and subject to ongoing supervision • FoFs must diversify their portfolio by investing in at least five target funds

Source: European Commission services own summary, not exhaustive, not legally binding.

56 For instance, if a real estate fund invested only in one property (e.g. a hotel), it would be completely dependent on the fate of that property and its tenant(s). In case the tenant terminates the lease contract or gets bankrupt and no new tenant willing to pay an adequate rental price can be found, the fund's value would significantly decrease. Such risks can be significantly reduced by investing in many properties having different tenants.

57 Except for self-managed investment companies.

ANNEX V: Qualified Investor vs Professional Client vs Eligible counterparty

Qualified Investor *(Prospectus Directive[58], Article 2(1)(e))*	**Professional Client** *(MiFID[59], Annex II, Section I)* Includes entities carrying out characteristic activities authorised or regulated by a non-Member State	**Eligible Counterparty** *(MiFID, Article 24(2))* May include third country entities equivalent to those mentioned
Credit institutions		
Investment firms		
Insurance companies		
Pension funds and their management companies		
Central banks		
National governments		
Other authorised or regulated financial institutions		
Regulated collective investment schemes and their management companies		UCITS and their management companies
	Commodity and commodity derivatives dealers	
	Locals	Undertakings exempted from MiFID under Article 2(1)(l)[60]
	Public bodies which deal with/manage debt	
Regional governments		
International and supranational institutions e.g. IMF, ECB, EIB		Supranational organisations
Large undertakings		
	Other regulated institutional investors	
Legal entities not authorised or regulated to operate in the financial markets whose corporate purpose is solely to invest in securities	Other institutional investors whose main activity is to invest in financial instruments, including entities dedicated to the securitisation of assets or other financing transactions	

58 Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003.

59 Directive 2004/39/EC of the European Parliament and of the Council of 21st April 2004.

60 Firms which provide investment services and/or perform investment activities consisting exclusively in dealing on own account on markets in financial futures or options or other derivatives and on cash markets for the sole purpose of hedging positions on derivatives markets or which deal for the accounts of other members of those markets or make prices for them and which are guaranteed by clearing members of the same markets, where responsibility for ensuring the performance of contracts entered into by such firms is assumed by clearing members of the same markets.

Opted-up qualified investors *(Prospectus Directive, Articles 2(1)(e)(iv) and (v)*	**Opted-up professional clients**[61] *(MiFID, Annex II, Section II)*	**Opted-up eligible counterparty** *(Implementing Directive MiFID*[62]*, Article 50)*
Small and medium-sized enterprises[63]	Clients other than the ones listed above (including public sector bodies and private individual investors) who meet specified criteria and have been assessed as possessing adequate expertise, experience and knowledge to make their own investment decisions and to understand the risks involved in relation to the transactions or services envisaged *Criteria*[64]*:* *- the client has carried transactions, in a significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters;* *- the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments, exceeds EUR 500 000;* *- the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or service envisaged.*	For professional investors only.
Natural persons[65] Investors who meet certain specified criteria relating to the possession of adequate expertise, experience and knowledge to make their own investment decisions and to understand the risks involved in relation to the transactions or services envisaged. *Criteria*[66]*:* *- the investor has carried out transactions of a significant size on securities markets at an average frequency of, at least, 10 per quarter over the previous four quarters;* *- the size of the investor's securities portfolio exceeds EUR 0.5 million;* *- the investor works or has worked at least one year in the financial sector in a professional position which requires knowledge of securities investment.*		

61 Client can opt-up in a general manner or in respect of a particular investment service or transaction, or type of transaction or product.
62 Commission Directive 2006/73/EC of 10th August 2006.
63 If provided for under national law (option left to Member States, subject to mutual recognition).
64 Two of these criteria should be satisfied to opt for the "professional investor" status.
65 If provided for under national law (option left to Member States, subject to mutual recognition).
66 Two of these criteria should be satisfied to opt for "qualified investor" status.

ANNEX VI: Risks related to activities of alternative investment fund managers (AIFM)

VI.1 Macro-prudential (systemic) risks

The experience of recent years requires reviewing the common understanding prior to the crisis that investment funds are traditionally not to be considered as systemically relevant. The lessons learnt from the LTCM collapse focused on prudential rules placed on prime brokers and sufficient collateralization of their lending to hedge funds. As a consequence, a failure of funds was supposed to be confined to investors and not to spill over to other financial institutions. However, there are two channels through which AIF/M can transmit systemic risks – the credit channel and the market channel.

Systemic risks of non-harmonised funds may crystallise through two broad channels:

'Credit channel': exposures to funds are an important source of counterparty risk for the providers of leverage, namely the prime brokers. These exposures are subject to prudential rules and are typically fully collateralised. However, risk management failures are possible, particularly if a fund borrows from multiple prime brokers and hence individual lenders may not have a global picture of a fund's leverage.

'Market channel': as large players in markets for many financial assets, leveraged funds have the potential to move markets, in particular in the event of the herding of positions in common trades. This is of particular concern in stressed conditions, where the disorderly unwinding of large, similar positions may fuel the collapse of asset prices and market illiquidity. This was seen in the recent financial crisis, where a vicious spiral was created: falling asset prices caused prime brokers to tighten lending conditions, forcing leveraged funds to sell assets, which in turn pushed prices down further.

In both cases, the risk is a function of the degree of leverage employed, since this will amplify the scale of both returns and losses. Within the universe of institutional funds, the use of leverage varies vary considerably and is on average considerably less than in some other financial sectors. Since the beginning of the crisis many funds that initially had a high leverage ratio have been forced by market conditions to reduce it in various ways.

Credit channel

Since many funds have recently employed leveraged investment strategies the systemic risk can materialize due to credit exposure ('credit channel') of the systemically important financial institutions. If these strategies fail, there is a risk that the fund will not be able to reimburse creditors/investors. To the extent that systemically relevant counterparties encounter difficulty because of large exposures to investment funds, failure of one or more investment funds could indirectly threaten financial stability. Close links between hedge funds and private equity funds and banks, insurance companies and pension funds combined with leverage can create systemic risks in the form of domino effects. This risk would seem to be greatest for the prime broker banks which have been heavily committed to supporting hedge funds (through lending of cash and securities), and banks which have extended credit lines to private equity owned companies.

The crisis has highlighted important parallels and similarities between the different types of investment funds (substitution effects between equity funds, money market funds, deposits etc), and their strong interdependencies with the wider financial system. These linkages need to be taken into account by macro-prudential policy if the latter is to be effective in achieving financial stability. Having said that, the different fund types can be broadly differentiated on the basis of their investment techniques and assets. With regard to systemic risk the use of leverage is of particular importance. As leverage is most extensively (but not exclusively) used by hedge funds, these funds are in the focus of this sub-section.

Hedge funds were particularly active in markets for innovative instruments – e.g. over 30% of credit default swaps (CDS) were bought by hedge funds. Hedge funds might have played a particularly pro-cyclical role: as such funds aggregate positions that are a multiple of underlying assets, they must close a larger number of positions when assets (whether equity capital or borrowing) decrease. Similar effects may have operated on other funds employing leveraged investment strategies. The pronounced tightening of credit by banks and prime brokers might have had an impact on the sector by forcing leveraged funds to sell assets to return cash.

Funds of funds have helped to propagate risk from one impacted fund to wider set of funds/investors. The capacity of funds of funds to spread financial damage across a wider segment of the market has been underlined by the Madoff scandal: a much larger number of funds were affected indirectly than directly (through their investments in the four directly impacted funds whose assets were entrusted to Madoff).

Leverage

One of the key features of many AIF strategies is worth highlighting at this stage. A common feature of many types of AIFs is the **use of leverage**. This typically occurs when investments are partly financed by credits from banks or other financial institutions in addition to the equity of the fund. Leverage can also be achieved in other ways, for example through the use of derivative products. Such products contain embedded leverage, which means that the exposure of the investor to profits and losses is greater than the variation in the value of the underlying asset. The use of derivatives can thus increase volatility considerably and result in very complex effects on the value of an asset.

The use of leverage increases the volatility of an investment and is used in the hope of amplifying investment returns. However, it also increases the risk of major losses for AIFs and of counterparty default for the providers of leverage. Leverage also introduces an additional systemic vulnerability, namely the impact of involuntary deleveraging. Under pressure from lenders and investors, leveraged AIFs may be forced to sell off assets rapidly, with a consequent impact on asset prices and market liquidity. The impact of deleveraging is likely to be greater if AIFs are forced to exit from similar positions (‘crowded trades’) simultaneously.

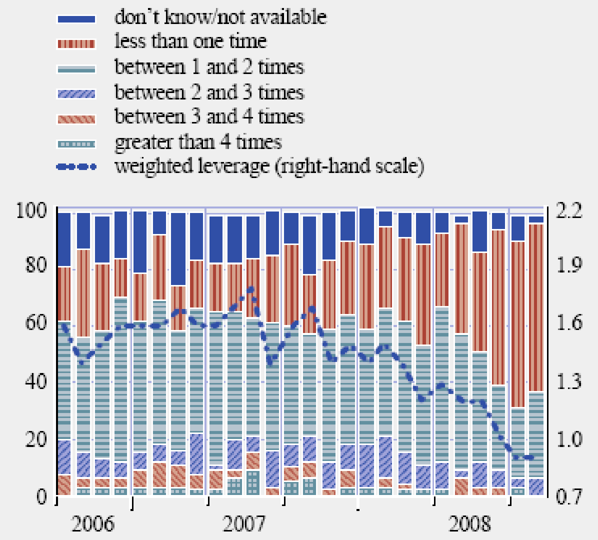
Observed levels of leverage in the AIF sector increased dramatically in stressed conditions as a result of the collapse in the value of an AIF's assets. This was the case at the time of the near-collapse of LTCM in 1998. Steady-state leverage levels in the AIF sector are however much lower and have fallen in recent months as a result of tighter credit conditions.

However, leverage remains an integral part of the investment strategies of certain types of AIF, in particular hedge funds. The use of extensive leverage is typically associated with the hedge fund sector, particularly those employing arbitrage strategies. However, most AIFs have access to leverage and as such the risk concerns are not limited to the hedge fund sector. An risk assessment limited to the hedge fund sector – however defined – would be too narrow.

The use of leverage is by no means confined to the AIF sector; in recent times, observed levels of leverage in other parts of the financial system have been much higher.

Chart VI.1: Hedge fund leverage

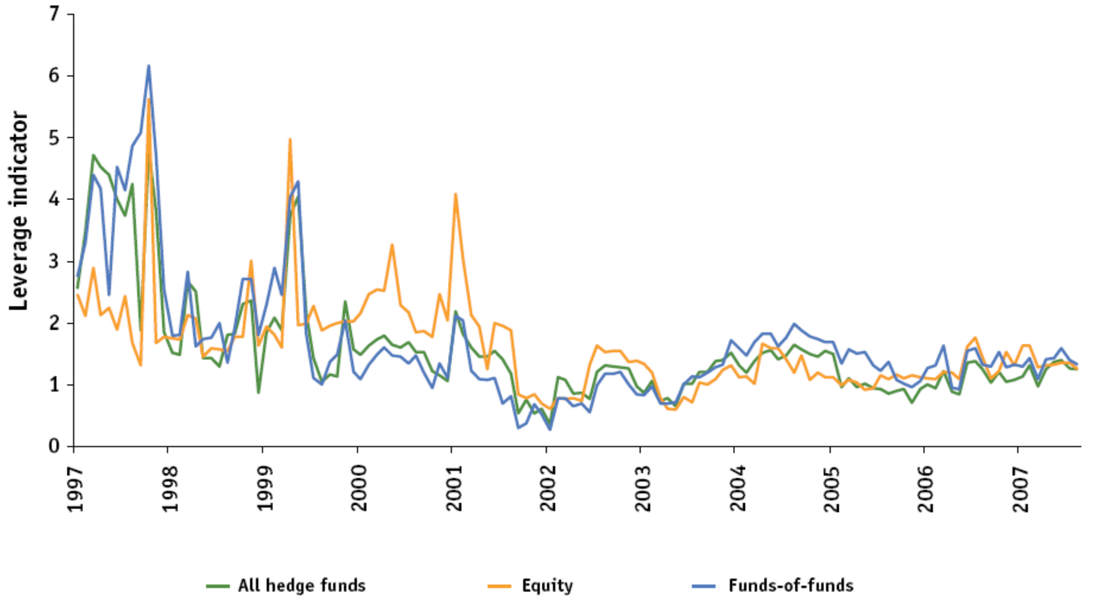
(Sep. 2006 – Oct. 2008; percentage of responses and weighted average leverage)



Sources: Merrill Lynch, *Global Fund Manager Survey*.
Notes: Leverage is defined as a ratio of gross assets to capital. The number of responses varied from 32 to 45.

ECB, Financial Stability Review, December 2008

Chart VI.2: Estimated hedge fund leverage measures



The leverage indicator is estimated using a rolling (24-month window fixed effects) regression of hedge fund returns on a variety of market-based risk factors. It is the sum of the coefficients on these risk factors and is thus a measure of the aggregate sensitivity of hedge fund returns to movements in underlying prices.
'All hedge funds' includes market neutral (excluding equity hedged), directional, equity (including equity hedged), fixed income and fund-of-funds style families of active funds reporting to HFR database; weighted by assets under management in each style family.

Source: HFR, BIS calculations

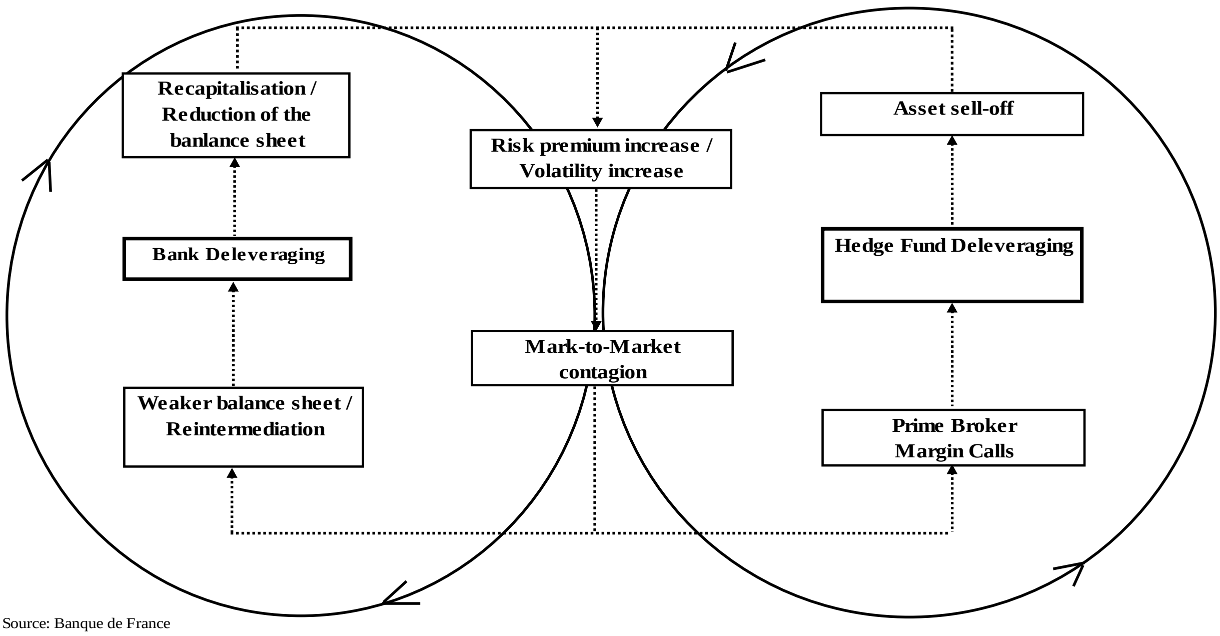
Market channel

The systemic impact of investment funds – especially alternative investments – need increasingly to be viewed from another angle: their contribution to driving market momentum or fuelling asset bubbles/deflation. During the bubble phase, the increasing asset prices increase the value of collateral and allow AIF to obtain more leverage. The new credit fuels demand for assets which pushes asset prices further up. There has been some tendency towards crowding of investment fund trading in certain markets and instruments. Coupled with a market sentiment, this can create a situation where price momentum is self-fuelling, until sentiment turns in which case funds can lead a 'stampede for the exit'. The mechanics works in reverse during the phase of deflation as illustrated in the chart below. This amplifies the pro-cyclical behaviour of the financial system.

In addition, the burst of the asset price bubble is usually accompanied by tightening of the credit conditions which reinforce the process of deleveraging. The abrupt unwinding of positions can cause market disruptions - the asset prices collapse and market liquidity disappears suddenly. This has serious impacts on other market participants.

Turmoil in credit markets deepened in early March [2008], setting the stage for the pronounced shift in market sentiment later during the period. Pressures on bank balance sheets had been accumulating throughout the crisis, but further intensified early in the month. As banks continued to cut their exposures across business lines, tightening repo haircuts (Chart VI.1-A.3) caused a number of hedge funds and other leveraged investors to unwind existing positions. As a result, concerns about a cascade of margin calls and forced asset sales accelerated the ongoing investor withdrawal from various financial markets. In the process, spreads on even the most highly rated assets reached unusually wide levels, with market liquidity disappearing across most fixed income markets. This included assets, such as certain US student loan securitisations, whose underlying exposures are almost entirely protected by federal guarantees, as well as mortgage-backed securities underwritten by US government-sponsored enterprises. *(BIS Quarterly Review, June 2008)*

Mutual contagion through the market channel: banks and hedge funds



Source: Banque de France

Chart VI3: Tightening of repo 'haircuts' is illustrated in the following table:

Typical "Haircut" or Initial Margin
(In percent)

	April 2007	August 2008
U.S. treasuries	0.25	3
Investment-grade bonds	0–3	8–12
High-yield bonds	10–15	25–40
Equities	15	20
Investment grade corporate CDS	1	5
Senior leveraged loans	10–12	15–20
Mezzanine leveraged loans	18–25	35+
ABS CDOs: AAA	2–4	95[1]
AA	4–7	95[1]
A	8–15	95[1]
BBB	10–20	95[1]
Equity	50	100[1]
AAA CLO	4	10–20
Prime MBS	2–4	10–20
ABS	3–5	50–60

Sources: Citigroup; Morgan Stanley Prime Brokerage; and IMF staff estimates.
Note: ABS = asset-backed security; CDO = collateralized debt obligation; CDS = credit default swap; CLO = collateralized loan obligation; MBS = mortgage-backed security; RMBS = residential mortgage-backed security.
[1]Theoretical haircuts as CDOs are no longer accepted as collateral.

Source: IMF Global Financial Stability Report (October 2008)

It has been very hard to put together a complete picture of fund positions in key markets over recent years. However, there are reasons to believe that funds – and hedge funds in particular – have been an important contributor to asset prices dynamics in a number of financial (and possibly even non-financial)[67] asset markets. AIF may play a greater role in this respect due to their specific investment techniques (e.g. intensive use of leverage; trading size, short-selling), their dominant role in many financial markets (complex products) and their role as (one of) active traders.[68] Hedge funds have been leading traders in complex products, notably sub-prime mortgages, and structured instruments (CDOs, CDS) that were arguably the root of the crisis.

Herding behaviour

Many investors, including fund managers seem to have bought funds and other investment products (that might have used funds as underlying) that they did not understand properly. Institutional investors, in particular, seem to have neglected due diligence and followed general trends instead - **"herding".** Trust in counterparties, products and external ratings had replaced proper own assessments. A lack of understanding of the complexity of structured financial products and market developments may have hindered an early detection of the developments that led to the crisis and a better protection of the EU markets from the consequences of the crisis.

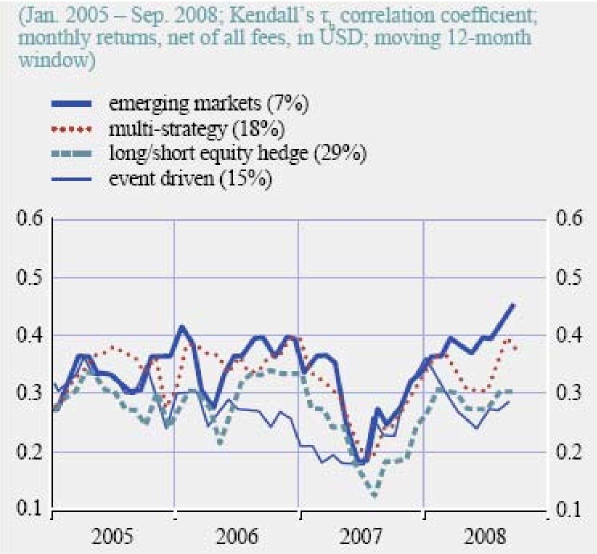
The similarity of hedge fund investment exposures and the associated risk of an abrupt collective exit from **crowded trades** can be estimated by using correlations across individual hedge fund returns within various hedge fund investment strategies. The moving median pair-

67 In commodity markets, the role of financial arbitrageurs or traders cannot lead to a fundamental deviation from the equilibrium price derived from supply and demand. However, it can lead to short-term price spikes.

68 Hedge funds are frequent traders accounting for half of the trading volume.

wise correlation coefficients of some of the more popular investment strategies shown in Chart VI.1-A.4 increased, not least because of funding liquidity pressures resulting from cuts in bank financing and investors' withdrawals and the fact that broad-based and often correlated changes in various asset prices made differences across hedge funds' investment portfolios less relevant.[69]

Chart VI.4: Medians of pair-wise correlation coefficients of monthly global hedge fund returns within strategies[70]



Sources: Lipper TASS database, Lipper TASS and ECB calculations.
Notes: Numbers in brackets after strategy names indicate the share of total capital under management (excluding funds of hedge funds) at the end of June 2008, as reported by Lipper TASS. If, instead of one fund or sub-fund, several sub-fund structures were listed in the database, their weighted average monthly return in US dollars was used. Sub-fund structures typically represent onshore and offshore versions or different classes of shares (usually differing in currency denomination) that basically correspond to the same pool of money managed in a highly correlated or nearly identical way.

However, problems were not confined to hedge funds or leveraged funds: some money market funds – traditionally a fail-safe and ultra-liquid asset class became over-exposed to asset backed securities and encountered liquidity and valuation problems when these markets dried up. Their systemic relevance also deserves some particular consideration. Money market funds play an important role in maturity transformation in financial markets – buying bank and corporate debt or securities with slightly longer maturities (up to one year) in return for cash. Money market funds have grown to become an important alternative source of liquidity for financial and corporate borrowers and a mainstay of commercial paper and short term bank paper markets. They are also widely regarded as a liquid investment vehicle for corporate treasury management. The sudden contraction of liquidity in markets for commercial and bank paper meant that these funds could no longer sell their assets to meet cash demands from their investors. Money market funds could no longer play their role of liquidity provider and even struggled to meet redemption demands from investors. This exacerbated the existing liquidity tensions in money markets.

[69] ECB, Financial stability review, December 2008
[70] ibid

Failure of some big money market funds could have triggered very serious effects for many parts of the economy that make heavy use of these funds: many companies of the 'real economy' as well as financial institutions such as banks, insurances or pension funds. There is a considerable risk that failure of the money market fund sector could result in illiquidity of many of these investors.

Box: Oil markets and role of speculators and financial investors

Gilbert (2007) observes that "when markets become tight, inelastic supply and demand make prices somewhat arbitrary, at least in the short term. There will always be a market clearing price but its level may depend on incidental and not fundamental features of the market"[71]

Till (2008) tries to assert that there were plausible incidental factors behind the 2008 rally in oil prices: spike in diesel imports by China in advance of the Beijing Olympics, purchases of light sweet crude by the US Department of Energy for the Strategic Petroleum Reserve, instability in Nigeria, and tightening environmental standards in Europe.[72] However, the author acknowledges that in the short term it is very plausible for the actions of traders to influence the price of a commodity, especially one that is exhibiting scarcity. The author also provides several examples of periods of financial de-risking and deleveraging where both the equity market and the commodities (except gold) behaved as one market. The theme of commodity investment as a store-of-value is also elaborated.

IMF Global Financial Stability Report, October 2008, addresses the possible causal relationships between increased financial market participation and commodity prices. The analysis finds there is correlation between prices and positions in some commodities markets. However, the analysis was unable to detect causality from financial positions to prices for major commodities used in the study.

Chart VI.5: NYMEX Crude Oil Front Month

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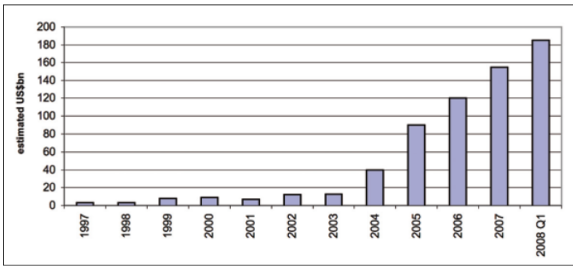
[71] Gilbert, C., 2007, "Commodity Speculation and Commodity Investments", University of Trento and Birkbeck College.

[72] Till, H., October 2008, The Oil Markets: Let the Data Speak for Itself, EHDEC Business School

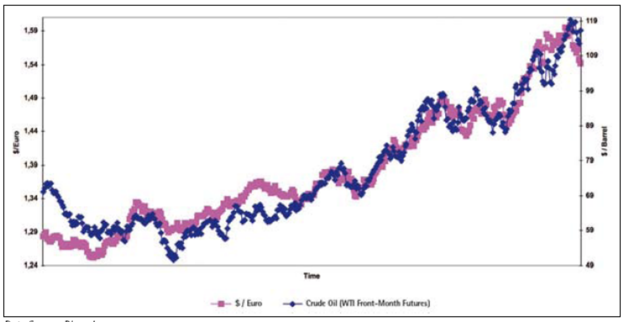
Chart VI.6: Investment in commodity indexes: store of value and inflationary hedge

Investment into commodity indexes[73]



Source: Heap and Tonks (2008), "Great Bulks of Fire IV", Citigroup Global Markets Equity Research, April 7.

E/$ vs. Crude Oil (in $) (17/8//06 to 2/5//08)[74]



Data Source: Bloomberg.

VI. 2 Micro-prudential risks

Market risks - the risk of adverse movement in interest rates, exchange rates, and the prices of equities and commodities.

Credit risks - the risk of loss caused by a counterparty or debtor's failure to make a promised payment (default risk); settlement risk – risk of payment to a counterparty to settle a transaction (eg. while the counterparty is declaring bankruptcy or loss of assets posted as collateral and then re-used (re-hypothecated) by broker who then declares bankruptcy).

Liquidity risks -

- funding liquidity risk: the risk that liabilities funding long asset positions cannot be rolled over at reasonable costs (i.e. the issue is the liquidity (maturity) mismatches between assets and liabilities and availability of cash)

- market liquidity risk: risk that a financial instrument cannot be purchased or sold without a significant concession in price because of the market's potential inability to efficiently accommodate the desired trading size.

Operational risks – risk of loss from failures in a company's systems and procedures or from external events.

The financial crisis has exposed weaknesses in risk management and control throughout the financial system, in particular with regard to the management of funding liquidity risks. The institutional fund sector is no exception. The quality of the internal risk management processes of institutional funds is of concern both to their investors and – to the extent that they grow to become of systemic relevance – to the financial system at large. It is vital that the robustness of internal risk controls is commensurate with the role that (in particular, leveraged) funds play in the financial system and the complexity of the investment strategies they employ. Institutional fund management companies typically hold capital to allow for an orderly winding down of the company in the event of bankruptcy. However, investor funds are not retained as capital against losses in the investment portfolio. A proper risk management is also crucial for the timeliness and reliability of reporting to supervisors and investors. Both need reliable information on the risks the fund and the management company are taking to be able to get a complete picture of the risks and the risk-adjusted return profile of the fund.

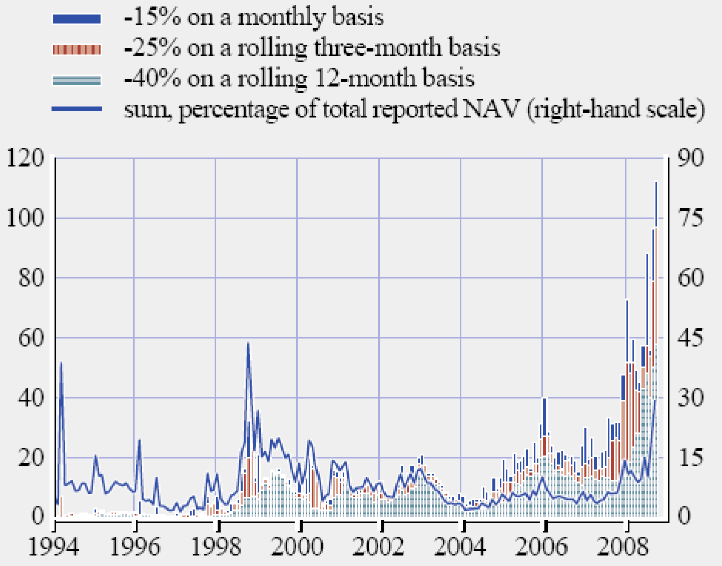
[73] ibid

[74] ibid

The curtailed availability of leverage may not always have implied lower counterparty credit risk for banks since net flows from investors and the investment performance of many hedge funds continued to suffer amid turbulent conditions in the global financial markets and is likely to lead to a higher liquidation rate in the period ahead. As shown in Chart VI.2-A.1, the estimated total net asset value (NAV) and the proportion of single-manager hedge funds breaching typical triggers of total cumulative NAV decline have increased markedly. Triggers of total NAV cumulative decline represent contractual termination events which allow banks to terminate transactions with a hedge fund and seize the collateral held.[75]

Chart VI.7: Estimated total net asset value (NAV) and proportion of hedge funds breaching triggers of cumulative total NAV decline[76]

(Jan. 1994 – Oct. 2008; USD billions and percentage of total reported NAV)



Sources: Lipper TASS database and ECB calculations.
Note: Excluding funds of hedge funds. The net asset value (NAV) is the total value of a fund's investments less liabilities; also referred to as capital under management. If several typical total NAV decline triggers were breached, then the fund in question was only included in the group with the longest rolling period. If, instead of one fund or sub-fund, several sub-fund structures were listed in the database, each of them was analysed independently. The most recent data are subject to incomplete reporting.

After the problems encountered by several large US prime brokers, hedge funds and other institutional investors, particularly the larger ones, are reportedly paying increasing attention to the safety of the funds and securities kept with prime brokers, and are thus asking for the segregation of those assets. This reduces the ability of banks to recycle hedge funds' assets for their own purposes. Moreover, in the wake of recent events, more hedge funds are likely to establish additional dealing relationships, possibly favouring banks with stronger balance sheets. More generally, this highlights another dimension of counterparty risk, which is related to the willingness of counterparties to transact and can prove crucial for the destiny of a strained financial institution. As highlighted by recent events, even good collateral may not be sufficient

[75] ECB, Financial stability review, December 2008
[76] ibid

to obtain funding if the counterparty is concerned that it will need to liquidate posted collateral in potentially far less liquid markets.[77]

Settlement risk associated with short selling transactions

Uncovered (naked) short selling[78], where an investor has not confirmed the availability of a stock to borrow, may lead the investor to fail to deliver the stock on its settlement date. Short-selling may be accompanied by a parallel stock-borrowing transaction. This provides the short-seller with some additional assurance that he/she can source the asset needed to meet its settlement obligation at the agreed date, on the agreed terms.

Fails to deliver are disruptive to a fund's trading program because they interfere with a fund's risk management calculation and introduce another layer of uncertainty—the risk of a trade being cancelled by the clearing broker. In addition, a fund is likely to face significant operational difficulties when there is a failure to deliver a security, including a potentially lengthy trade reconciliation process, the task of updating its books and records, the impairment of voting rights, friction with its prime broker and the uncertainty and risk of a costly buy-in. Funds that conduct algorithmic trading strategies may place thousands of orders to buy and sell various stocks. It would be very costly and operationally burdensome for such a fund to reconcile its trades and update its books and records, among other things, if its clearing broker cancels trades, so these firms have a strong incentive to locate the stocks they intend to borrow in advance of any short sale. (MFA, Response to Commission consultation on hedge funds)

For example in the United States, under Reg SHO of the SEC, a broker-dealer, prior to accepting a short sale order, must "locate" securities available for borrowing. Rule 203(b) of Reg SHO prohibits a broker-dealer from accepting a short sale order in any equity security from another person, or effecting a short sale order for the broker-dealer's own account unless the broker-dealer has: (1) borrowed the security, or entered into an arrangement to borrow the security; or (2) has reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due.

VI. 3 Investor protection and fund governance

Institutional funds are marketed predominantly to sophisticated, professional investors. This investor base has grown in recent times, as so-called 'alternative' investments have become more mainstream. Exposures to hedge funds and private equity, for instance, are now commonplace in the investment portfolios of pension funds, insurance companies and some public authorities.

It is commonly assumed that these investors have the capacity to understand and to bear the risks that their investments entail. The experience of the financial crisis is a challenge to this assumption. The manifest failure of due diligence in some cases has fuelled doubt over the transparency of some investment vehicles vis-à-vis their investors, as well as the capacity and willingness of investors to process the information and to react accordingly.

Disclosure

Regardless of their market standing, all investors require information on the nature and the risks of the investment into which they are entering. The appropriate content and form of this

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[77] ECB, Financial stability review, December 2008

[78] The IOSCO Technical Committee on short selling describes "naked" short selling as broadly referring to situations where the seller does not own the stock he is selling and has made no provision, [at the point of sale], to borrow or otherwise for delivery of stock to the purchaser by settlement date.

information will vary according to the degree of sophistication of the investor. In the case of public offerings, pre-contractual disclosures are typically highly regulated.[79]

When banks, investment firms or other intermediaries distribute funds, they are subject to the existing MiFID rules concerning the provision of investment services (such as information requirements and, where required, appropriateness or suitability assessment depending on the service provided). However, these disciplines apply primarily to distribution to less sophisticated investors.

When funds are distributed directly to professional investors, disclosure practice is driven largely by contractual arrangements between the funds and their investors. Investors request information to serve as the basis for their due diligence and to ensure compliance with their own investment constraints.[80] However, in the course of the current crisis concerns mounted that professional investors did not apply sufficient due diligence and did have sufficient information to properly assess and manage their investments but either relied on external ratings or trusted and followed the trend.[81] A potential reason for this might be that investors did not get sufficient information from the fund managers and did not have sufficient bargaining power to force them to provide it. The logical consequence, namely to exit the fund, however, might be understood as a sign of weakness or incompetence while staying in the fund did not raise any doubt and seemed to be of low risk – other investors would certainly apply due diligence and thereby ensure proper management of the fund.

Conflict of interest and fund governance: Valuation, administration and delegation

The relative opacity of many institutional fund structures and the absence of a prescriptive regulatory framework raise concerns over the oversight of internal processes. Fair treatment of the investor requires that processes such as valuation and administration are conducted prudently and fairly; and that any conflicts of interest are managed effectively. Investors also rely on fund managers to ensure that their assets are held safely in custody.

The valuation of complex assets has proved to be problematic in stressed conditions when many asset markets become illiquid. However, even in benign market conditions, the valuation process can be beset by conflicts of interest, in particular when the remuneration of the fund manager is driven by the performance of the fund. This may create an incentive to inflate the value of the fund's assets. This is a particular risk when assets are hard-to-value and/or infrequently traded, since the valuations are then difficult to verify. An element of independence in the valuation function is therefore desirable.

Non-harmonised funds are often by their nature less liquid than retail funds. Investor funds are locked in for relatively long periods to allow the fund to take advantage of the premium on less liquid investments, such as property and lightly (or non-) traded financial assets. The financial crisis has seen many hedge funds but also real estate and money market funds suspending redemptions. Surprising fund closures or adjustments to valuation can produce dramatic effects not only for the fund concerned but also for other funds in that category if investors start to mistrust them and try to withdraw their money on short notice.

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79 At EU level, the Prospectus Directive 2001/34/EC applies.

80 In some jurisdictions, certain information obligations have been codified through self-regulatory standards, such as those overseen by the Hedge Fund Standards Board in the United Kingdom.

81 A recent study by EDHEC finds that there are 'great differences between hedge fund managers' perceptions of relevant information disclosure and their investors' needs suggest that the industry should rethink its overall disclosure practices.' Hedge Fund Reporting Survey, November 2008

VI. 4 Market efficiency and integrity

It is commonly held that, in normal market conditions, rapid trading and the diversity and relatively unconstrained nature of hedge fund strategies help to boost market liquidity; and the recourse by many hedge funds to short-selling techniques may help to correct the prices of over-valued securities.

However, experience in the recent stressed market conditions has raised a number of concerns about the impact of funds, particularly hedge funds, on the efficiency and integrity of financial markets.

Some of these concerns have crystallised around the issue of short-selling, an investment technique heavily, but not exclusively, used by hedge funds. Short-selling is widely recognised as a legitimate hedging or trading technique and is central to the risk management processes of many market participants. However, recent fears that short-selling could drive the stock price of systemically relevant financial institutions to exaggeratedly low levels and thereby undermine their viability prompted the introduction of temporary curbs on the practice in many jurisdictions around the world. In addition, concerns have been voiced that short-selling was sometimes being used in conjunction with abusive practices, such as the spreading of false adverse rumours or manipulative actions.

Abusive practices and market manipulation are illegal. However, it seems that current rules did not provide sufficient basis for effective legislative action. To the extent that there is substance to these allegations, this is primarily a matter of improving monitoring and enforcement. More fundamental concerns with short-selling warrant further analysis and may necessitate greater transparency in stock borrowing and short positions. It is important to note that institutional funds are by no means the only financial market participants to make use of these practices.

VI. 5 Impact on market for corporate control

The business models of so-called ‘activist’ hedge funds and of some private equity funds entail the acquisition of minority equity stakes in listed companies. These funds represent a relatively small proportion of the hedge fund and private equity funds universe, respectively.[82] Yet their activities have, in some cases, attracted adverse publicity as a result of the perceived disproportionate and aggressive nature of the tactics used to re-orient corporate strategy.

In common with all shareholders in listed companies, these funds are entitled to exercise the voting rights on their shareholdings. It can also be presumed that changes in corporate strategy or management advocated by activist funds will benefit other shareholders and possibly improve the performance of the company to the ultimate benefit of all stakeholders. It is alleged, however, that the exercise of these rights may be used to influence company management with a view to maximising short-term return on the holding, but possibly at the expense of the long-term health of the company.

Further, practices such as the use of derivatives, securities lending or voting agreements could be used to exercise disproportionate influence over the company, in relation to the voting rights attached to the shares which hedge funds own. Moreover, the use of derivative positions or securities lending allow investors to increase their stake in a public company in a way which may not be sufficiently transparent, or which confers a voting right without a long-term economic interest in the company. This is potentially a source of conflict of interest and renders it difficult for management and market participants to identify the 'owners' of the company.

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[82] Source: OECD.

While these techniques may be deployed by hedge funds, they are available to all market participants.

To the extent that these concerns in relation to transparency towards issuers derive from widely-available techniques, the possible failures described are not specific to the activities of certain categories of institutional fund. [Evidence from IOSCO, OECD]

VI. 6 Acquisition of control of companies by AIFM

Some forms of institutional fund, most notably private equity, acquire majority stakes in companies and seek to deliver returns to investors by enhancing the profitability of the company and at a later stage disposing of the company. In this way, institutional investment can have a very direct impact on the real economy and on employment.

Provided that the interests of the private equity firm, the companies' management and other relevant stakeholders (employees, other stakeholders) are well-aligned, no failure is apparent. However, a common accusation is that there is a fundamental misalignment between the interests of the private equity investors and the long-term health of the portfolio companies. In particular, the pressure to deliver returns to investors may induce short-termism, where decisions are taken to maximise short-term profits but which are not consistent with the long-term health of the company.

Examples of such practice might include the disposal of assets (so-called 'asset stripping') and heavy recourse to debt financing. The ability for portfolio companies to finance this debt has been severely tested by the prevailing credit conditions.

VI.7 General overview of the principles of the present regulatory status quo

The following table provides general overview of principles underpinning the present regulatory status quo and their current critique which highlights the need for comprehensive review of the financial system.[83] The specific risks related to the activities of AIFM that were illuminated during the financial crisis are described in more detail in the preceding sections.

[83] Adapted from the Turner Review: A regulatory response to the global banking crisis, FSA, March 2009

Table: General overview of principles

Principles of present regulatory status quo	***Need for review:***
Market prices are good indicators of rationally evaluated economic value.	**Efficient markets can be irrational:** - Market efficiency does not imply market rationality. The fact that prices move as random walks and cannot be predicted from prior movements in no way denies the possibility of self-reinforcing herd effects and of prices overshooting rational equilibrium levels. - Individual rationality does not ensure collective rationality. If determined in conditions of imperfect information and/or determined by particular relationships between end investors and their asset manager agents, result in market price movements characterised by self-reinforcing momentum. - Individual behaviour is not entirely rational. - Allocative efficiency benefits have limits. - Empirical evidence illustrates large scale herd effects and market overshoots
The development of securitised credit, since based on the creation of new and more liquid markets, has improved both allocative efficiency and financial stability.	**Securitization has increased systemic risk:** - all liquid traded markets are capable of acting irrationally, and can be susceptible to self-reinforcing herd and momentum effects. - increased reliance on 'liquidity through marketability'. Simultaneous liquidation of positions dries up market liquidity. - swings in prices of credit securities have larger impact on the stability of financial system and real economy than swings in prices of equity securities.
The risk characteristics of financial markets can be inferred from mathematical analysis, delivering robust quantitative measures of trading risk.	**Undue reliance on (faulty) mathematical models:** - short observation period introduced pro-cyclicality - non-normal distributions: underestimation of chances of small probability high impact events; need for stress tests - systemic risk (network effects) not considered: the models implicitly assume that the actions of the individual firm, reacting to market price movements, are both sufficiently small in scale as not themselves to affect the market equilibriums, and independent of the actions of other firms. But this is deeply misleading: herding effects and feedback loops present in markets; According to VAR measures, risk was low in spring 2007: in fact the system was fraught with huge systemic risk: need for stress tests - non-independence of future events: underlying methodological assumption is insecure: the analysis of past price movement patterns may not deliver statistically robust inferences relating to the probability of price movements in future.
Market discipline can be used as an effective tool in constraining harmful risk taking	**The failure of market discipline:** - conflicts of interest of investors can lead to slack in due diligence - conflicts of interests of prime brokers can lead to insufficient 'indirect' supervision - market prices (CDS, equities) did not signal problems ahead.
Financial innovation can be assumed to be beneficial since market competition would winnow out any innovations which did not deliver value added.	- Illusory mark-to-market profits in a rising market create incentives to take further risks through the bonus structure. - Extraction of economic rents was made possible by opacity of margins, the asymmetry of information and principal-agent problems. Financial services grew to a size unjustified by the value of its service to the real economy.

ANNEX VII: Executive Summary of the Impact Assessment on Private Placement

What is private placement?

Private placement is an officially recognised distribution method through which designated market participants can buy and sell financial instruments to each other without having to comply with rules that would usually apply when the same instruments are offered to the public/retail investors. It provides participants with a flexible cost-effective tool to sell and buy tailor-made financial instruments. Participation in private placements is usually reserved to appropriately qualified market participants; typically these are authorised financial intermediaries, including placement agents, banks or investment funds/firms, pension funds, life insurance companies, in some cases also high net wealth individuals and corporate investors.

Private placement is particularly suitable for the distribution and marketing of investment propositions which may be considered less suitable for wider public offer. This could include distribution of new types of investment strategy, such as single hedge funds, private equity funds or some commodity funds, whose risk-reward profile may make them less appropriate for retail investors.

Problems and objectives

Within Europe, Member States have developed different arrangements to support private placement between local buy-side and sell-side participants. Differences between national private placement regimes mean that it is often not possible to extend private offerings across EU Member States without adjusting the marketing material or even the offer itself. Offerors also have to be careful in determining the potential investors they can approach. This legal uncertainty is aggravated by frequent changes to national rules and conditions as reported. Offerors therefore have to bear substantial costs in order to identify and comply with the relevant rules. These may lead to self-imposed restrictions on the Member States where investments are privately placed. This means lost business opportunities for placement intermediaries. It restricts investment choices or increases costs for potential qualified investors in other Member States. Investors may be deprived of important portfolio diversification opportunities. Financial markets in smaller Member States might suffer from reduced liquidity in relevant financial instruments.

Problems with cross-border private placements result primarily from inconsistencies between and insufficient transparency of, national regimes with respect to the boundaries of the regime: Who can participate? Which products can be placed? Which rules have still to be complied with? These shortcomings prevent potential participants from profiting from the benefits of private placement, with the adverse consequences for financial markets and the wider economy as described above. An EU private placement regime[84] should help to overcome these problems.

Options and assessment

Options for developing such a regime feature in the substance or coverage of such a regime and the appropriate instrument or technique to be used to give effect to it. The former set of options focuses on the eligibility of investors, offerors and products. The latter includes both legislative and non-legislative forms at industry, national and EU level. The analysis of the potential impacts of the options has revealed that, at this stage, there are not sufficient available data and information to come to a substantiated assessment and recommendation of the best way forward. Instead, the impact assessment work should be continued, with this report serving as a stocktaking and information document for all stakeholders and interested partners.

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[84] The term 'EU private placement regime' is used in a very broad sense here. A regime does not necessarily have to be a legal framework but could as well consist of a common understanding of the concept only.

ANNEX VIII: Summary of responses to Commission consultation on hedge funds

GENERAL REMARKS ON CONSULTATION PROCEDURE AND FEEDBACK:

The financial crisis has led to renewed debate about the impact of hedge funds on the functioning of financial markets. The de Larosière High Level Group has summarised the situation as follows: 'Concerning hedge funds, the Group considers they did not play a major role in the emergence of the crisis. Their role has largely been limited to a transmission function, notably through massive selling of shares and short-selling transactions. We should also recognise that in the EU, unlike the US, the great bulk of hedge fund managers are registered and subject to information requirements. This is the case in particular in the UK, where all hedge funds managers are subject to registration and regulation, as all fund managers are, and where the largest 30 are subject to direct information requirements often obtained on a global basis as well as to indirect monitoring via the banks and prime brokers.'[85]

Notwithstanding this, there is a desire to provide a common regulatory and supervisory framework to underpin the oversight of, inter alia, hedge funds. The European Parliament has clearly expressed this view in its reports of September 2008 (Rasmussen & Lehne reports). The move towards closer regulatory engagement with hedge funds has also been evident in international discussions concerning the regulatory response to the financial crisis. The G20 (November 2008) summit issued a call to extend regulatory oversight to all financial markets, institutions and products – including private pools of capital. This has been followed quickly by the creation of an IOSCO task force on hedge funds.

It was against this backdrop that the Commission published a consultation paper on hedge funds on December 18th 2008. This consultation document sought views and evidence on a range of hedge fund related issues so as to inform the preparation of an appropriate regulatory initiative. The issues on which the Commission invited views included:

- **Systemic risks.** The consultation asked whether existing systems of macro-prudential oversight were sufficient to allow regulators to monitor and react to risks originating in the hedge fund sector and subsequently transmitted to the wider market through counterparties, including prime brokers, and through the impact on asset prices.
- **Market integrity and efficiency.** The consultation asked whether and under what circumstances the activities of hedge funds posed a threat to the efficiency and integrity of financial markets.
- **Risk management.** The consultation asked whether public authorities should concern themselves more with the way in which hedge funds manage the risks to which they and their investors are exposed, value their asset portfolios and manage any potential conflicts of interest.
- **Transparency towards investors and investor protection.** The consultation invited views on whether hedge fund investors are adequately protected and receive the information required for sound investment decisions.

[85] Point 86, p. 24, Report of High-level Group on financial supervision in the EU, published 25.02.09.

The deadline for responses to this consultation paper was January 31st 2009. One hundred and four answers to the consultation have been received: 71 % from private sector organisations and representative bodies, 8% from citizens and 21% from public authorities.

The principal messages and issues highlighted by the respondents are:

- *Hedge funds are complex products best reserved for sophisticated investors;*
- *Hedge funds represent a very heterogeneous class of asset and investment strategies so there are inherent difficulties to be overcome in designing an operational regulatory response that avoids a 'one size fits all' solution. Most respondents believed that an international or global response would be superior to an EU response. However, a small majority of respondents believe that it is nevertheless appropriate to come forward with EU level action;*
- *A considerable number of respondents see concerns ranging from the need for more effective monitoring of hedge fund impacts on financial stability and market efficiency, through risk management systems, organisational arrangements and use of particular investment techniques (e.g. short selling);*
- *Much comment centred on the impact of hedge funds on financial stability. Currently, the potential systemic impact of hedge funds is addressed primarily through oversight of systemically important hedge fund counterparties (investment banks, prime brokers). This approach was widely seen as important – but only part of the solution. Various respondents observed that supervision of hedge fund counterparties does not protect financial markets from cyclical impacts of herding behaviour by hedge funds, hedge fund trading concentrations in particular market segments and deleveraging. Recent developments have revealed the capacity for hedge funds to impact overall market functioning through the market channel, i.e. through impacts on market prices and liquidity. 62% of respondents (to this question) believe that supervisors and macro-prudential authorities should be provided with more information on hedge funds to monitor the systemic effect their activities may have on EU/global markets.*

The issues raised by the consultation were discussed at a high-level conference in Brussels on 27th February 2009.[86] Those discussions and responses to the consultation will contribute to the preparation of a regulatory proposal on hedge funds and private equity funds which the Commission will present before the end of April 2009.

Responses to this consultation will also serve as the basis for European input into the parallel reflections on hedge funds at international level by the G20.

I. OVERVIEW OF RESPONSES TO THE CONSULTATION

The consultation was launched on 18th December 2008 and closed on 31st January 2009. Responses were invited from all interested parties on the questions relating to the activities of hedge funds, their impact on financial markets, and their interactions with investors and other market participants.

One hundred and four answers to the consultation were received from a wide range of organisations and professional representatives, citizens and national and European public authorities. Figure 1 provides a more detailed presentation of the status of responses received

[86] The conference proceedings are published on Commission web-site. http://ec.europa.eu/internal_market/investment/index_en.htm.

broken-down into the following categories: fund administrators, asset managers, asset manager associations, banking associations, trade unions and trade union groupings, consultants, insurance companies, insurance associations, investor associations, lawyers, pension fund associations, prime brokers, professional associations, and stock exchanges. Responses were received from a large number of EU Member States (15) and 4 non-Member States (figure 2).

Figure 1:

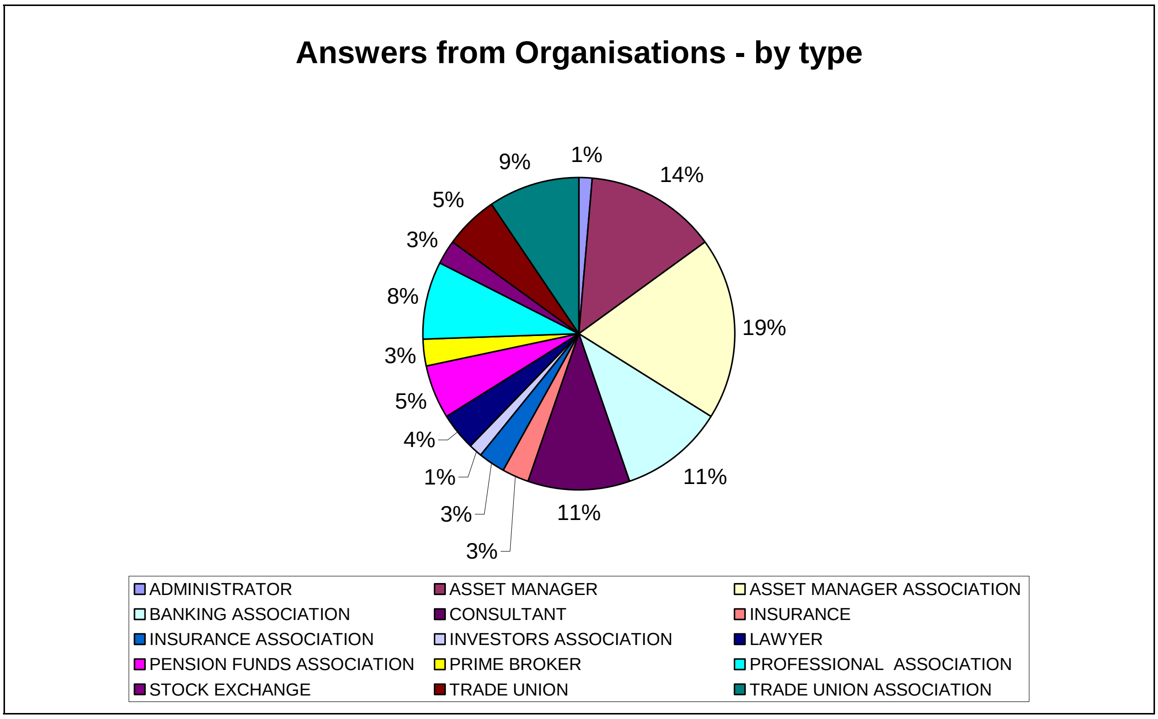
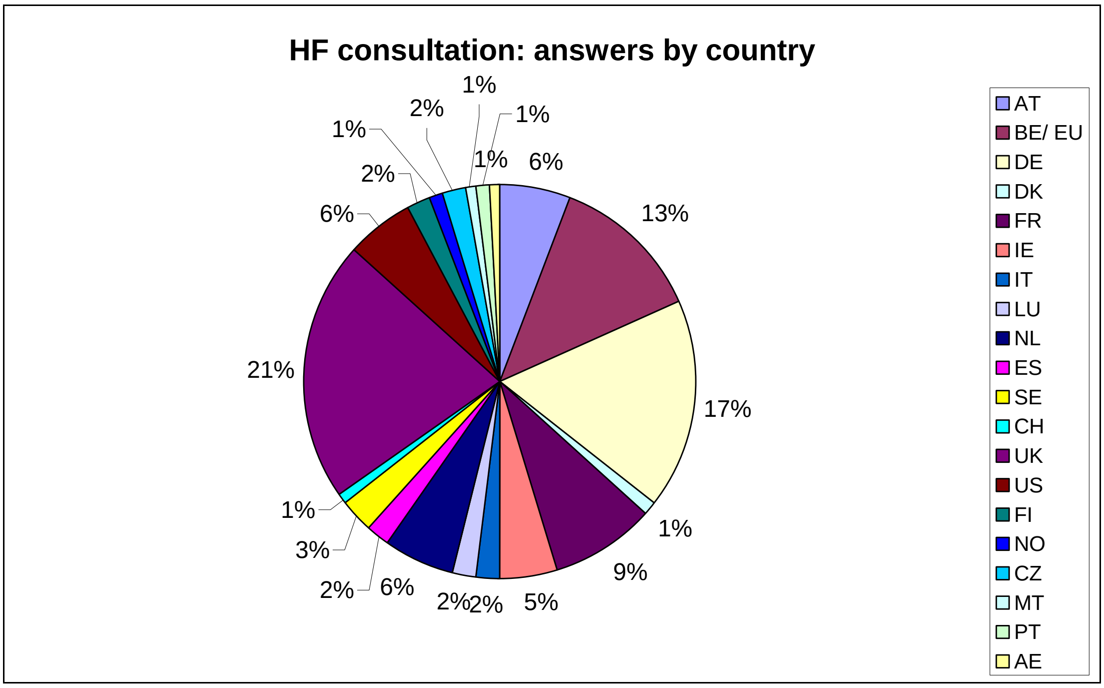


Figure 2:



For the purposes of this feedback statement, answers from respondents have been classified in four sub-groups:

(1) **Public authorities:** 22 public authorities responded to the consultation. This includes market regulators, prudential supervisors, ministries of finance, Member States' parliamentary groups or individual MEPs, European parliamentary groups and the European Central Bank (Eurosystem). Some Member States' public authorities have provided a single collective answer.

(2) **Citizens:** 8 answers from this group comprise contributions from citizens, authors, researchers or research centres or universities.

(3) **Asset management and financial sector organisations:** 51 answers from this group representing fund administrators, asset managers and their associations, prime broker and banking associations, consultants, lawyers, and other professional associations (such as associations of lenders or derivatives practitioners).

(4) **Other stakeholders** comprising investor representative bodies (both institutional and retail), labour and listed company representatives (23 answers): organisations such as pension funds and their associations, insurance companies and their associations, investors and their associations, trade union and trade union associations, one consultant and an issuers' association.

2. Detailed analysis of responses:

The feedback statement presents a broad summary of responses to each of the eleven questions raised in the consultation paper. The tables provide a quick overview of the balance of respondent opinions. These opinions have been categorized into 'yes/no' categories of answers wherever possible. Some respondents have also provided qualitative commentary to supplement or nuance their 'yes /no' answers. In this case, the explanations have been grouped under a number of sub-headings ("*For one or more of the following reasons*:") to enable a more detailed analysis of the respondents' views.

Please note that some respondents have sometimes expressed more than one opinion in answer to a question. Therefore the cumulative total of answers to a question may sometimes exceed 100% of answers received.

QUESTION 1

Are the above considerations[87] sufficient to distinguish hedge funds from other actors in financial markets (especially other leveraged institutions or funds)? If not, what other/additional elements should be taken into account? Do their distinct features justify a targeted assessment of their activities?

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[87] For information, criteria identified in the consultation paper were: Hedge funds focus on delivery of absolute returns; Hedge funds have a relatively high and systematic use of leverage; Hedge funds are confined to institutional or other sophisticated investors; Hedge funds are exempt from direct regulatory requirements.

Opinions expressed:	Number of opinions expressed on question n°1	% over the total number of contributions received to the consultation	Public authorities	Citizens	Organisations		
					Total	Industry organisations	Other organisations
Yes, these criteria are sufficient	**5**	5%	**1**	**0**	**4**	**1**	**3**
No, these criteria are not sufficient because the hedge funds class of asset is too heterogeneous	**82**	79%	**22**	**1**	**59**	**45**	**14**
Additional detailed views : ▪ *Criteria identified also apply to other entities which are not considered as hedge funds*	*22*	*21%*	***3***	***0***	***19***	*18*	*1*
▪ *Other criteria are relevant*	*45*	*43%*	***14***	***1***	***30***	*24*	*6*
▪ *Hedge funds are not "Unregulated". This criteria is not relevant*	*7*	*7%*	***2***	***0***	***5***	*5*	*0*
▪ *Hedge funds are not necessarily highly leveraged. This criteria is not relevant*	*15*	*14%*	***4***	***0***	***11***	*11*	*0*

A majority of respondents, including most regulators and organisations from the financial industry, did not consider the criteria identified in the consultation paper as sufficient to distinguish hedge funds from other actors in financial markets:

(1) The criteria identified in the consultation paper also apply to other entities which are not' hedge funds', such as (retail) collective investment schemes (130/30, market-neutral and long/short mutual funds). Proprietary trading desks of investment banks *or* institutions (SPV) should also be taken into account when supervising leverage. These entities engage in similar behaviours and give rise to the same risk for underlying investors and financial system;

(2) Other criteria should also be taken into consideration in defining hedge funds, such as structured performance fees, use of 'alternative strategies', engagement in 'short selling activities', 'Absolute return', use of specific liquidity & redemption rights, etc… It is worth recalling that hedge fund managers also use a wide range of legal structures (collective investment schemes, managed account, feeder/master structures etc.);

(3) Leverage criteria were seen as not necessarily the most relevant criteria. Some respondents perceived hedge funds as being highly leveraged entities. However, some respondents have provided data showing that the average leverage of hedge funds lies in a range of 1.3-1.8 times capital. They observe that this leverage is significantly less than that witnessed in some investment banks. However, it is difficult to be precise about the level of leverage used by hedge funds. Figures supplied by respondents do not include leverage embedded in financial instruments;

(4) Some respondents contest the perception of hedge funds as unregulated. Even at EU level, aspects of hedge fund business and hedge funds themselves are subject to MiFID, the Transparency Obligations Directive and the Market Abuse Directive. When they become members of trading systems (Regulated Markets or Multilateral Trading Facilities) they are also subject to the rules of that platform including all relevant transaction reporting rules

(5) Hedge funds do not form a homogeneous group. A large majority of participants consider that the hedge fund industry is fast moving. A rigid definition of the "Hedge fund" class of asset would therefore become quickly obsolete.

QUESTION 2

Given the international dimension of hedge fund activity, will a purely European response be effective?

Opinions expressed:	Number of opinions expressed on question n°2	% over the total number of contributions received to the consultation	Public authorities	Citizens	Organisations		
					Total	Industry organisations	Other organisations
No, a 'pure' EU action won't be effective.	**71**	68%	**17**	**2**	**52**	39	13
For one or more of the following reasons : ▪ *EU action in isolation will have adverse effects, and/or*	*43*	*41%*	*13*	*1*	*29*	*23*	*6*
▪ *International work (IOSCO, G20) should be taken into consideration*	*46*	*44%*	*9*	*1*	*36*	*26*	*10*
but **Yes**, EU should act	**53**	51%	**14**	**3**	**36**	22	14
For one or more of the following reasons : ▪ *EU should take the leadership, and /or*	*19*	*18%*	*6*	*0*	*13*	*7*	*6*
▪ *EU action will enhance international cooperation*	*15*	*14%*	*7*	*2*	*6*	*5*	*1*

A majority of respondents are not convinced that a "purely" European response is likely to be successful. They feel that it may even have adverse effects on the European asset management industry, exposing it to regulatory arbitrage. Initiatives taken by the G20, FSF and IOSCO should also be integrated into ongoing reflections at the European level. A heavy-handed EU response which would not be matched by action elsewhere could simply drive business away and reduce the competitiveness of the EU asset management industry. Given the interconnectedness of global financial markets and the international dimension of hedge funds, any effective answer must be taken at international/global level.

However, the argument that only globally-harmonized regulation works is regarded by other respondents as too simplistic. Over 50% of respondents insist that superiority of international action must not be an excuse for European passivity. Europe is home to a major alternative investment management industry and represents a substantial client base for this industry. It is perceived as a big player in the world economy and offers a vast market for all financial actors including hedge funds. Therefore, many respondents believe that Europe can play an instrumental role in shaping a global regulatory regime for hedge funds through the creation of a "European label". An EU framework could serve as a reference for global regulation of alternative investment management activity. It would help to enhance the attractiveness of the European asset management industry and to foster the spread of standards of best practice. It could also ensure the effectiveness and competitiveness of the single financial market. Some respondents call on the European Commission to establish an adequate and proportionate EU framework. European Single Market for hedge funds would abolish regulatory fragmentation and strengthen Europe's position in negotiations of international standards. Some respondents perceive a European initiative as a first step towards international consensus on hedge fund regulation.

QUESTION 3

Does recent experience require a reassessment of the systemic relevance of hedge funds?

Opinions expressed:	Number of opinions expressed on question n°3	% over the total number of contributions received to the consultation	Public authorities	Citizens	Organisations		
					Total	Industry organisations	Other organisations
Yes, recent experience requires a reassessment of the systemic relevant of hedge funds.	**35**	34%	**8**	**2**	**25**	16	9
▪ *But systemic relevance should also be reassessed for all other leveraged market participants.*	*23*	*22%*	*7*	*1*	*15*	*13*	*2*
No, reassessment is not necessary	**31**	30%	**9**	**0**	**22**	17	5

Respondents generally acknowledge that hedge fund activities are an integral and valued part of the financial market due to their contribution to market liquidity and market efficiency. A number of industry and public sector respondents feel that there is insufficient empirical evidence to support the view that hedge funds have a particular systemic relevance. However, a slightly larger number of respondents consider that the recent financial crisis has raised new questions about the effects of hedge fund activity, in times of general market distress which call for consideration. In support of this view, these respondents argue that the process of hedge fund deleveraging has added to downward pressure on already falling asset prices in recent months and caused distress to other market participants. Hedge funds may constitute a source of counterparty risk to core financial institutions and the broader financial system as a consequence of sudden and large scale liquidation of hedge fund positions.

Hence, for most respondents the analysis of the systemic risks of hedge funds should focus more on leverage. This work should not focus on hedge funds exclusively, but also on the banking sector and other market participants making extensive use of leverage.

In assessing possible stability impacts, this perspective should take account of assets under management, number of counterparties, level of leverage, and volume of trading.

QUESTION 4

Is the 'indirect regulation' of hedge fund leverage through prudential requirements on prime brokers still sufficient to insulate the banking system from the risks of hedge fund failure? Do we need alternative approaches?

Opinions expressed:	Number of opinions expressed on question n°4	% over the total number of contributions received to the consultation	Public authorities	Citizens	Organisations		
					Total	Industry organisations	Other organisations
Yes, indirect regulation insulates the banking system from the risk	**51**	49%	**13**	**0**	**38**	31	7
But, **No** it also can be improved	**46**	44%	**10**	**2**	**34**	20	14
▪ *Prime brokerage regulation needs to be reviewed.*	*28*	27%	***8***	***0***	***20***	*17*	*3*
▪ *Indirect prudential regulation is insufficient to isolate financial system from hedge funds' failure. Additional direct prudential requirement (such as a minimum capital requirement for the asset manager) should apply.*	*26*	25%	***7***	***2***	***17***	*4*	*13*

To date, regulatory attention has been focussed on ensuring that hedge fund bankruptcy does not jeopardise the viability of systemically relevant credit institutions. A significant number of respondents expressed the view that the banking industry seems sufficiently well capitalized to withstand a hedge fund failure. A number of respondents, including public authorities, noted that some hedge funds have been liquidated without destabilizing the banking system.

Respondents feel that prime brokers are subject to strict prudential requirements and have their own risk management tools to protect themselves from counterparty risks. Banks are required to make robust assessments of credit risk and to set aside sufficient capital to absorb reasonably foreseeable counterparty losses. In the view of many respondents, bank risk assessment systems have recently undergone severe stress test and so far, they have proved robust with respect to counterparty risks. However, some respondents also perceive that this remains only a preliminary assessment, based on the initial phases of the crisis. Since credit, counterparty and market risks can materialize quickly, some respondents believe that it may be necessary to further strengthen the prime broker management of hedge fund related risk in order to limit the potential for failure of a very large fund to trigger a systemic impact.

Some respondents expressed concerns regarding the need for more specific and targeted regulatory requirements for prime brokerage business. Concerns related to practices such as re-use by prime brokers of hedge fund collateral, and sometimes the assets of the fund they hold in custody. Other respondents also pointed to the conflicts of interest faced by prime brokers when dealing with hedge funds. Prime brokers may not have the incentives to impose constraints on their exposure to hedge funds given that hedge funds contribute substantially to the revenues of prime brokers. The effectiveness of indirect (prime broker) regulation may also be limited by the fact that most large hedge funds use multiple prime brokers. Consequently no single broker has all the information necessary to assess creditworthiness and soundness of its hedge fund client. A similar problem derives from the fact that banks conduct stress-testing of exposures with individual hedge funds. However, this stress-testing does not sufficiently take account of the fact that many hedge funds implement similar or highly correlated investment strategies. These respondents therefore conclude that the 'indirect' regulation approach is inherently limited in its effectiveness. It does not sufficiently protect the financial system, since it does not take into account the fact that different hedge funds sometimes imitate each other's strategies and can generally be affected by common market developments.

Some respondents have also expressed their concern that the prime broker's prudential requirements only mitigate risk transmitted via the banking system. This neglects the potential impact of the collective impact of hedge funds on market conditions. Reference was made to the fact that hedge funds account for 50% of trading on financial markets and can play a determining role in price formation. The indirect prudential approach needs to be strengthened and be supplemented by direct surveillance measures to take account of these wider market effects. Some respondents suggested that minimum capital reserves should be part of the regulatory "tool-box".

QUESTION 5

Do prudential authorities have the tools to monitor effectively exposures of the core financial system to hedge funds, or the contribution of hedge funds to asset price movements? If not, what types of information about hedge funds do prudential authorities need and how can it be provided?

Opinions expressed:	Number of opinions expressed on question n°5	% over the total number of contributions received to the consultation	Public authorities	Citizens	Organisations		
					Total	Industry organisations	Other organisations
Yes, supervisors do have enough information to monitor effectively exposures	**19**	18%	**4**	**0**	**15**	13	2
No, supervisors do not have enough information to monitor effectively exposures	**64**	62%	**18**	**3**	**43**	26	17
Additional comment: ▪ *Even with the information, supervisors may not have sufficient tools to adequately monitor the risk*	*11*	*11%*	***5***	***0***	***6***	*4*	*2*

Although some prudential reporting to prudential supervisors is currently required[88], a large majority of respondents, including most public authorities, financial organisations and investors, feel that supervisors do not have enough information to monitor hedge fund trading activities. To that extent, transparency and disclosure by hedge funds to the supervisory authorities could be improved and harmonized. A single, global registration procedure for hedge funds and their managers is proposed by some respondents as a starting point for improved transparency towards authorities. Hedge funds could also be required to deliver periodic regulatory reports of appropriate information on, for example, size, investment style, exposures, leverage and performance. It is suggested that the information collection process could involve hedge fund managers as well as prime brokers, the valuator, the clearing broker or other central counterparties. Some respondents also feel that prudential authorities may not

[88] Regulation (EC) No 958/2007 of the European Central Bank (ECB) of 27 July 2007 concerning statistics on the assets and liabilities of investment funds (ECB/2007/8), all investment funds including hedge funds in the European Union have to notify important information to the National Central Banks (NCB) as of December 2008.

be sufficiently equipped to monitor effectively exposures of the core financial system to hedge funds, or the contribution of hedge funds to asset price movements.

QUESTION 6

Has the recent reduction in hedge fund trading (due to reduced assets and leverage, and short-selling restrictions), affected the efficiency of financial markets? (…)

Opinions expressed:	Number of opinions expressed on question n°6	% over the total number of contributions received to the consultation	Public authorities	Citizens	Organisations		
					Total	Industry organisations	Other organisations
No, the reduction of the hedge funds activity had a negative impact on the markets.	**18**	17%	**5**	**2**	**11**	3	8
Yes, the reduction of the hedge funds activity has affected trading efficiency.	**59**	57%	**15**	**1**	**43**	33	10

Most respondents, including most public authorities, believe that markets function less efficiently since hedge funds have scaled back their trading. Against this, many respondents believed that 'forced selling' by hedge funds, triggered by a swift tightening of credit conditions by prime brokers and redemption requests from investors, has tended to amplify downward pressure on the price of assets. This outcome could be exacerbated when different hedge funds are pursuing the same or correlated strategies.

Most financial organisations argue that hedge funds were not the immediate cause of the current financial crisis. They observe that all market participants facing liquidity pressures have been going through the process of deleveraging. For most respondents (public authorities, organisation, investors, pension funds), there is no clear evidence that hedge fund activity impairs markets. The market is perceived to have suffered from the decline in hedge fund trading, because hedge funds have not been able to act as liquidity providers to the same extent.

European equity market trading volume (measured in number of shares traded) has decreased substantially during the fourth quarter of 2008. This reduction has continued in early 2009; as a result of this reduced trading and liquidity, markets are less able to absorb buying and selling pressure. There is anecdotal evidence showing that primary liquidity at the touch (i.e. the amount of shares available at the best bid and offer) in European financial stocks has decreased since the short selling restrictions were introduced and average spreads (i.e. the difference between best bid and offer) have increased.

QUESTIONS 7 & 8

Are there situations where short-selling can lead to distorted price signals? Are there situations where restrictions on short-selling might be warranted?

Are there circumstances in which short-selling can threaten the integrity or stability of financial markets?

Opinions expressed:	Number of opinions expressed on question n°7	% over the total number of contributions received to the consultation	Public authorities	Citizens	Organisations		
					Total	Industry organisations	Other organisations
No, short selling is normal market tool under normal market situation.	**59**	*57%*	**12**	**0**	**47**	33	14

57% of all respondents to the consultation generally expressed broad support for short selling as a legitimate investment technique under normal market conditions. Many respondents regard it as being generally beneficial to the efficient operation of the market. 17 respondents believe that there is no evidence that short selling has distorted prices against just 3 expressing the view that short selling can distort prices.

Opinions expressed:	Number of opinions expressed on question n°7	% over the total number of contributions received to the consultation	Public authorities	Citizens	Organisations		
					Total	Industry organisations	Other organisations
No, they are no situations were short selling may be restricted: short selling bans had negative impact on the market.	**9**	*9%*	**0**	**0**	**9**	8	1
Yes, there are situations where short selling ban may be warranted under exceptional cicumstances.	**15**	*14%*	**8**	**0**	**7**	3	4
Yes, there are situations where short selling ban may be warranted: when short selling transactions can be used as part of abusive strategy	**48**	*46%*	**10**	**0**	**38**	24	14
Yes, short selling may be restricted; short selling positions should be disclosed.	**8**	*8%*	**1**	**0**	**7**	6	1
Yes, short selling should be restricted; all short selling transactions should be regulated or limited	**8**	*8%*	**0**	**2**	**6**	2	4
Naked short selling should be regulated or limited.	**15**	*14%*	**5**	**1**	**9**	7	2

However, a large number of respondents consider that there are a range of circumstances in which short selling restrictions could be justified. This compares to just 9 respondents who believe that restrictions would never be justified.

46% of respondents to the consultation consider that short selling could potentially be used as a part of an abusive strategy. Respondents argued that where this is the case, the focus of regulatory attention should be on the abuse, not on short-selling itself. 15 respondents observed that short-selling may also be problematic in the midst of a loss in market confidence. For example, some respondents mentioned that in a context of a credit crisis where some entities face liquidity challenges, but are otherwise solvent, a decrease in their share price induced by short-selling may lead to further credit tightening for these entities. In a worst case scenario this could result in bankruptcy. When such entities are systemically relevant, there may be a case for shielding them from short selling, leading to further downward pressure on price and erosion of confidence.

15 respondents were of the view that naked short selling is a practice that could be detrimental to market integrity and efficiency. It was suggested that this issue could be addressed through appropriate regulation of clearing and settlement.

In combating these practices, does it make sense to tighten controls on hedge funds, in particular, as opposed to general tightening of market abuse disciplines?

Opinions expressed:	Number of opinions expressed on question n°8	% over the total number of contributions received to the consultation	Public authorities	Citizens	Organisations		
					Total	Industry organisations	Other organisations
No, short selling is not a HF specific issue	**40**	*38%*	**12**	**0**	**28**	24	4

Those who answered this question took the view that short selling is used by a wide rage of market participants – and that therefore it made little sense to address the use of this technique by hedge funds in isolation.

A number of respondents noted that overnight introduction of short-selling restrictions created significant operations and compliance problems for market participants. This was especially the case as actions across different jurisdictions were not coordinated. Some respondents called for a unified, global regime for short selling; the IOSCO task force on short selling was referred to as a promising development in this respect.

QUESTION 9

Should the internal processes of hedge funds be improved, particularly with respect to risk management?

Opinions expressed:	Number of opinions expressed on question n°8	% over the total number of contributions received to the consultation	Public authorities	Citizens	Organisations		
					Total	Industry organisations	Other organisations
No, short selling is not a HF specific issue	**0**	*0%*	**0**	**0**	**0**	0	0
▪ *It can be achieved through codes of conduct, and/ or*	***19***	*18%*	*4*	*0*	*15*	*12*	*3*
▪ *There is a need for additional direct regulatory initiatives*	***29***	*28%*	*8*	*0*	*21*	*10*	*11*
Risk management can be improved in 1 or more of the following ways : ▪ *Measurement & portfolio risk management*	***15***	*14%*	*3*	*0*	*12*	*10*	*2*
▪ *Liquidity risk management should be more clearly disclosed and explained to investors*	***5***	*5%*	*3*	*0*	*2*	*2*	*0*
▪ *There is a strong need for hedge fund corporate governance regulation*	***37***	*36%*	*12*	*2*	*23*	*21*	*2*
▪ *There is a strong need for hedge fund valuation regulation*	***30***	*29%*	*6*	*2*	*22*	*21*	*1*
▪ *Voting policy of the fund should be made public, and more clearly explained*	***5***	*5%*	*3*	*0*	*2*	*0*	*2*

There was considerable discussion relating to risk management by hedge funds. Most respondents saw the need for enhancing risk management standards employed by hedge funds. Respondents differed as to whether this could best be achieved through self-regulatory codes of conduct or statutory regulation.

A minority of respondents (19 out of 48) answering this question believe that best practice initiatives, led by market participants, are viewed as a good starting-point for effective regulation.

29 (out of 48) respondents believe that there is a need for some regulatory intervention in respect of hedge fund risk management. In support of this it is argued that experience with self-regulatory codes has raised questions relating to compliance and enforcement which undermine their effectiveness. The existence of these codes has not been sufficient to prevent the emergence of concerns relating to this industry. Indirect supervision (through prime brokers) cannot fully substitute for the required direct regulation and supervision of hedge fund – and that this regulation should extend to some aspects of hedge fund risk management.

Respondents also provided many suggestions as to how hedge fund risk management could be improved. Some respondents underlined that some hedge funds already implement high standards and processes of risk management. However, a number of respondents remain concerned that there has been excessive reliance on theoretical models for assessing risk. Other respondents consider that initiatives on hedge fund risk management should be directed at the internal governance and organisation of hedge funds. Managers should be required to have adequate resources to support their trading strategies and to demonstrate that they have the appropriate risk management systems and reporting mechanisms.

Responses highlight concerns relating to the risk management process. Respondents call for more transparent and independent valuation controls, liquidity management and corporate governance. Separation of functions is viewed as a way to reduce operational risk and the possibility of fraud, and misappropriation of assets. Thus valuator, administrator, auditors and custodian functions should be separated in order to avoid possible conflicts of interest. In addition, some respondents insist that the assets of the fund should be segregated from those of the prime broker. If not, the interests of the former are exposed to the risk of the bankruptcy of the latter.

QUESTION 10

Do investors receive sufficient information from hedge funds on a pre-contractual and ongoing basis to make sound investment decisions? If not, where do the deficiencies lie? What regulatory response if any is needed to complement industry codes to make a significant contribution to the transparency of hedge fund activities to their investors?

Opinions expressed:	Number of opinions expressed on question n°10	% over the number of total contributions received to the consultation	Public authorities	Citizens	Organisations		
					Total	Industry organisations	Other organisations
Yes	**32**	*31%*	**5**	**0**	**27**	21	6
No	**37**	*36%*	**15**	**0**	**22**	16	6

A significant proportion of the respondents from industry organisations believe that the hedge fund business is responsive to investor needs. If an investor is not satisfied, he/she should not invest. The client/investor remains responsible for its decision and should undertake its own due diligence. Hedge funds were originally targeted towards institutional investors able to assess complex risk profiles and absorb occasional large losses.

However, a majority of respondents underline that the level and the quality of information available to investors often depends on the targeted investors and is quite unbalanced. Some report deficiencies in the information provided which are either incomplete or not available on an on-going basis. Most information transparency concerns relate to transparency of the fund liquidity management[89], redemption policy and on the equal treatment of shareholders (e.g. side letter practice).

QUESTION 11

In light of recent developments, do you consider it a positive development to facilitate the access of retail investors, subject to appropriate controls, to hedge fund exposures?

[89] e.g. disclosing information on the proportion of the portfolio invested in non-marketable securities and hard-to-value assets

Opinions expressed:	Number of opinions expressed on question n°11	% over the total number of contributions received to the	Public authorities	Citizens	Organisations		
					Total	Industry organisations	Other organisations
Yes	**33**	*32%*	**6**	**0**	**27**	**23**	**4**
▪ *but with strong regulatory safeguards*	27	*26%*	3	0	24	21	3
No	**40**	*38%*	**12**	**2**	**26**	15	11

Most respondents do not view retail investor access to hedge fund exposures as a positive development. Several respondents also expressed some concerns about exposure of pension funds and individuals' investors to hedge funds – given that the assets of individual pension-holders or retail investors are at stake.

Those respondents in favour of access to retail investors recognise that any such access should be accompanied by strong regulatory safeguards.

* * *

ANNEX IX: Outline of relevant measures proposed in the Commission communication on Driving European Recovery of 4 March 2009

To deliver responsible and reliable financial markets for the future, the Commission will propose an ambitious new reform programme, with five key objectives:

(1) To provide the EU with a **supervisory framework** that detects potential risks early, deals with them effectively before they have an impact, and meets the challenge of complex international financial markets. The Commission will present a **European financial supervision package** before the end of May 2009, for decision at the June European Council. The legislative changes to give effect to these proposals will follow in the autumn and should be adopted in time for the renewed supervisory arrangements to be up and running in the course of 2010. The package will include two elements:

- Regarding macro-prudential supervision, measures to establish a **European body** to oversee the stability of the **financial system as a whole**
- Regarding micro-prudential supervision, proposals on the architecture of a **European financial supervision system**

(2) To fill gaps where European or national **regulation** is insufficient or incomplete, based on a 'safety first' approach. The Commission will propose:

- A comprehensive legislative instrument establishing regulatory and supervisory standards for **hedge funds, private equity** and other systemically important market players(April 2009)
- A White Paper on **tools for early intervention** to prevent a crisis (June 2009)
- On the basis of a report on **derivatives** and other complex structured products (June 2009), appropriate initiatives to increase transparency and ensure financial stability
- Legislative proposals to increase the quality and quantity of **prudential capital** for trading book activities and tackle complex securitisation (June 2009) and to address liquidity risk and excessive leverage (Autumn 2009)
- A rolling programme of actions to establish a far **more consistent set of supervisory rules** (to be launched in 2009)

(3) To ensure that European **investors, consumers and SMEs can be confident** about their savings, access to credit and their rights as concerns financial products, the Commission will come forward with:

- A Communication on **retail investment products** to strengthen the effectiveness of marketing safeguards (April 2009)
- Further measures to reinforce **bank depositor, investor and insurance policy holder protection** (Autumn 2009)
- Measures on **responsible lending** and borrowing (Autumn 2009)

(4) To **improve risk management** in financial firms and align **pay incentives** with sustainable performance. To this end, the Commission will:

- Strengthen its 2004 Recommendation on **remuneration of directors** (April 2009)
- Bring forward a new Recommendation on **remuneration in the financial services sector** (April 2009) followed by legislative proposals to include remuneration schemes within the scope of prudential oversight (Autumn 2009)

(5) To ensure **more effective sanctions** against market wrongdoing. To this end, the Commission intends to:

- Review the **Market Abuse Directive** (Autumn 2009)
- Make proposals on how **sanctions** could be strengthened in a harmonised manner and better enforced (Autumn 2009)

ANNEX X: Effectiveness of existing industry codes and best practice guidelines for private equity and hedge funds

1. Private equity – role in economy

Private equity business model

Private equity provides risk capital to unlisted companies including those that are de-listed as part of a public to private transaction. Private equity incorporates wide variety of investment strategies ranging from buy-out deals (acquisition of majority of shares in a company) to early stage investments (i.e. seed, start-up), also known as venture capital. The proportion of buy-out investments to venture capital in Europe has for the last five years fluctuated around 70%-80% to 30%-20% divide. As such, private equity expands the range of financing options available to European businesses and creates new portfolio diversification opportunities for investors. Private equity funds represent alternative asset allocation possibility for investors who are looking for investment diversification with enhanced returns and usually medium to long term investment holdings. Investors are usually tied into their investments until the end of the life of the fund. This usually spans to 10 years, after which all investments are exited and total fund profits calculated and distributed among investors and the fund manager.

Most private equity funds take a form of limited partnerships to raise capital and target predominantly sophisticated and institutional investors. Private equity funds differ from other types of investment funds in that where their fund managers often play a direct role in the decision making and management of their portfolio companies. Private equity funds themselves are not leveraged but the investments done by private equity managers deploy considerable levels of leverage. The debt financing is provided by credit institutions and has played a key role for majority of buy-out transactions up until 2007 in which an average buy-out deal consisted of 30% equity and 70% debt financing. Venture capital deals rely less on debt financing in this respect.

Private equity funds make only a few investments each year, due to the time it takes to complete due diligence and general assessment of the potential target company before making an investment. It can take up to three years for a fund to fully invest its capital raised from investors - Limited Partners. Once a suitable portfolio company is selected the investment takes on average 4-5 years. Additional 2-3 years are then needed for realising an appropriate exist strategy for the portfolio company, be it via initial public offering (IPO), a secondary buy-out by another private equity investor or a strategic corporate merger. Assets of private equity funds' are therefore illiquid and they can not be easily traded or sold. To align the interests, fund managers invest their own money into the fund (usually 1% - 5% of total commitments raised from investors) and they receive their share back together with the proportion of the profit only once an exit of portfolio company is realised and only after investors profit share is paid out.

The constrained credit market had a considerable impact on private equity business model in particular in the area of large buyouts, since these can not be effectively realised without leverage. However, the bulk of companies concerned by buyout transactions are actually small and medium size enterprises – the mid market - and here, despite the difficulties to access new credit this business segment continued to work. The only problem common to all types of transactions at the moment is the lack of any feasible exist strategy. For this reason, private equity is for the time being undertaking very few if any new deals as it will need to stay longer in current portfolio companies and focus more on their sustainability. What recent events shown as well, is that private equity firms are willing to put in higher amounts of equity, and deals that emerge as a result have an equal equity-debt ratio or have no debt at all. However the potential of defaults remains high and its full scale is yet to be seen in the coming years. Inevitably, we will see decreased levels of funds being raised, the number of private equity companies will also be driven down and so will the returns of this particular asset class to their investors.

The growth of private equity

The highest concentration of private equity activity, measured either by private equity firms or portfolio companies, is in the United Kingdom, France, Germany and Sweden who represent more than 50% of the market in either category – private equity firm or the portfolio company. The remainder of the top ten countries includes Spain, Italy, The Netherlands and Finland.

The asset class grew four-fold in the space of a decade. The great deal of private equity transactions (leveraged buyouts, secondary buyouts etc.) took place at the peak period of 2006 and first quarter of 2007, the buyout funds being the best performers in 2007. The assets under management of private equity and venture capital funds in 2007 reached €222 billion compared to €180 billion in 2006[90]. Having the prospect of strong and stable returns private equity investments attracted even more sophisticated professional investors. In 2006, private equity represented globally less than 1.5% of GDP (including leverage)[91].

Between 2003 and 2007 European private equity firms raised €317bn. The considerable jump in raising funds occurred in 2005 when €72bn was raised compared to €27bn in 2003 and 2004. The fundraising peaked in 2006 with €112bn and scaled down in 2007 to €79bn. The share of expected allocation of funds between venture capital and buy-out transactions remained stable, 25%-75%. Capital raised with view to be allocated to a buy-out deal tripled, from €20bn in 2003 to €60bn in 2007, whereas the capital raised for venture deals less than doubled. Insurance companies and especially pension funds formed more than 30% of the investor base in this period, after banks (15%) and fund of funds (14%). As at the end of 2007, the retail exposure based to private equity and venture capital funds was approximately 2%, of sales volumes.[92]

In the same five-year period, European private equity firms invested domestically about €258bn. Out of the amount that European private equity firms invested in 2006 (€71bn) and 2007 (€74bn) more than 86% were investments in companies with fewer than 500 employees however the share of the total amount invested in such companies was just about 30%. From the perspective of European portfolio companies, about 5200 of them received private equity investments in 2007. On the buy-out side, about 1300 companies were targeted in 2007, representing only 26% of the total number of companies receiving private equity financing, but 79% of amounts invested. UK companies received 29 per cent of the total amount invested, followed by France (16.4 per cent) and Germany (14.7 per cent).

Given that about two thirds of total equity investments are devoted to buy-outs, and that buy-outs are themselves leveraged significantly whereby the leverage represents two thirds in the capital structure of a buy-out investment, it can be estimated that between 2003 and 2007 European private equity firms invested more than €600bn (see also Annex X.A-6)

Private equity in focus

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90 The retailisation of non-harmonised investment funds in the European Union, October 2008, http://ec.europa.eu/internal_market/investment/docs/other_docs/study_non-harmonized_funds.pdf

91 Based on EVCA/Thomson Financial/PriceWaterhouseCoopers

92 The retailisation of non-harmonised investment funds in the European Union, October 2008, http://ec.europa.eu/internal_market/investment/docs/other_docs/study_non-harmonized_funds.pdf

As a result of its considerable growth, private equity became and important market player. Many stakeholders and governments question the impact of private equity activities on the well-being of companies, their employees and society as whole. The exponential growth of private equity activity in the leveraged buyout (LBO) sector and the 'public to private' buy-outs in particular has focused stakeholder attention on these issues. Indeed, having completed public to private takeover, the pressure on maintaining the same level of socially responsible business practices (generally known as corporate social responsibility – CSR) by de-listed companies disappears.

There is nothing inherent to the private equity model that should mean that privately owned businesses must be less sustainable or less responsible than public companies. However, there has been growing coverage of the negative impact of LBOs resulting from their perceived short-term interest, their use of financial engineering, the excessive debt burden that private equity puts on its portfolio companies, while having limited positive impact on companies' future performance and employment.

Governments in the European Union provide individual national frameworks under which private equity business operates. Private equity is subject to general company law and civil law that applies at the Member State level and in some areas also EU level regulatory framework applies. In addition, some issues are addressed directly through European regulatory frameworks, i.e. EU legislation on market abuse or provision of investment services. However, the behaviour and actions of many alternative investors, to which private equity belongs, and their impact on the rest of the financial system and economy as a whole, are tackled in different ways, and to varying degrees in different Member States.

Historically, private equity investments were of a local character focusing in principle on creation of profit and returns for their shareholders. In the past 20 years, the development of information technologies and increased international character of private equity activities contributed to a greater awareness of private equity as well as its scrutiny by variety of stakeholders. As noted only few years ago "the private equity firms themselves are starting to realise that greater transparency and disclosure – over important issues such as performance, fees, and even compensation – might be in their own self interest"[93].

To some extent number of issues is addressed by the industry in the voluntary codes and best practice guidelines developed at national, European or international level. Their ultimate aim is to codify behaviour or agree on best practices in order to increase the awareness and acceptance of private equity business in the society. It has been argued that, it is in the interest of the companies to adopt and promote responsible behaviour since it is one of the key assets that effectively help to build reputation and trust, an essential element for success of private equity firms as well.

The key question today remains whether the current combination of national rules, tax treatments and industry codes and standards developed creates a sound environment for further development of private equity. Does this set of overlaps respond to the growing key concerns relating to the impact of private equity on the economy and financial system overall? This document aims to provide additional input to steer the discussion on the above questions by assessing the effectiveness of existing legislative frameworks and industry codes against the concerns raised recently in relation to activities of private equity.

93 http://www.finance.ox.ac.uk/file_links/finecon_papers/2008fe17.pdf

Currently a number of European and national codes governing private equity behaviour exist in parallel, all covering a wide range of issues (e.g. ethics, valuation, transparency and reporting to investors, portfolio companies and the public). This section aims to provide a qualitative analysis to determine the level of compliance, the scope and effectiveness of the various codes and best practice guidelines that have been developed at European or national level. It will address the various risks posed by the private equity business model and evaluate to the extent possible, whether the professional standards and codes of conduct as they stand today, provide for an effective mechanisms through which the risks are enforced and mitigated, i.e. to what extent they can be expected to make a difference on the ground for stakeholders (investors, portfolio companies, supervisors, and the public). This analysis will employ criteria to assess whether specific risks are effectively addressed by the codes and applied by those who engage in private equity business.

2. How are concerns relating to private equity addressed by national and European regulatory frameworks?

Number of issues was raised in the past couple of months in relation to the impact of unregulated entities and other actors in the financial markets. There is no private equity specific regulatory framework either at national or European level to gauge the behaviour and impact of these entities under a common regulatory oversight. However private equity is subject to general national legislation and in some areas also European level regulatory framework governs directly or indirectly some areas of private equity activities.

This section will map the relevant regulatory frameworks in place and match them against the concerns and risks mostly linked to the activities of private equity.

2.1 Financial stability

It has been acknowledged that private equity has not been among the drivers exacerbating the financial crisis and as such it does not pose any macro-prudential concerns to the economy. Leverage is an integral part of private equity transactions and it has become a common place for any buy-out transaction to employ a considerable level of leverage. And as a result of favourable economic environment we have seen on the markets in the past couple of years, leverage levels increased exponentially along with the number and size of large and mega buy-outs. However the leverage of this part of the corporate sector did not reach the size nor does it have the characteristics of creating negative spill-over to the financial system and economy as a whole. In 2007, it was reported that banks with exposure to leverage buyout loans had less than 1% of their total assets invested in these instruments[94].

Leverage employed by private equity firms and the risks linked to it are rather isolated and limited the lending institution, the portfolio company and the private equity fund investing in it. The risks are limited to the quality of the buy-out transaction in which both private equity and lending institutions play their part. If a leveraged buy-out transaction does not work out, private equity investors incur decreased returns on their overall investments, private equity managers can also loose part of their own money and it is the portfolio company that will suffer the biggest consequences – loosing the prospects of restructuring, re-energising, exploring new market possibilities, etc.. The level of debt is a function of the portfolio company's ability to repay it. Lending institutions have at their disposal monitoring tools to inform them about an on-going performance of the company and the prospects of the debt being serviced according to the plan. The instrument that serves this purpose is the so called 'covenant'. It sets out performance thresholds of portfolio companies that if breached, the

[94] ECB, Monthly Bulletin, August 2007

lending institutions can ultimately force such company into foreclosure. Lightly negotiated covenants were a common practice in recent years, which ultimately loosened the power of lenders to act when portfolio companies did not perform according to the covenant.

Given the diverse nature of private equity investments in various sectors and in companies with varying strategies there are no systemic consequences for the economy and other market players other than those involved in a particular transaction since it would take a large number of portfolio companies to default at the same time. In addition, the risks stemming from a failed buy-out transactions can not be solely assigned to the role of leverage as it is in addition the quality of the business strategy and development plan employed by the private equity firm that play a key role in a private equity investment to be successful.

However from the perspective of the portfolio company, the use of leverage has been challenged recently and belongs to one of the key policy concerns relating primarily to the sustainability of debt assumed by private equity portfolio companies and its use to amplify short term returns to private equity funds. This concern will then further be discussed below under the *'acquisition of control of companies by Private Equity fund managers'* chapter.

Applicable legislative framework

From the perspective of the fund managers, existing national legislation requires managers to put down a minimum of own capital to set up a company depending on the legal form of the vehicle. In addition, in some Member States[95] management companies need to maintain a certain level of regulatory capital to cover operational risk that is proportionate to the value of portfolio under management. There are no other direct risk based capital requirements imposed at national level neither at the level of a management company nor at the level of a fund. No legislation poses a specific cap as to how much leverage (debt) can private equity use in the acquisition of a portfolio company.

At European level, Existing Capital Requirements Directive 2006/48/EC and Capital Adequacy Directive 2006/49/EC already require risk based capital for investment firms and credit institutions. Private equity is therefore exposed to these regulations indirectly via requirements imposed on the lending institutions for the purposes of private equity leveraged acquisitions.

2.2 Market Integrity and Market Efficiency

Market integrity

A further set of issues relate to the integrity of financial markets and the potential threat posed by the activities of private equity. This might be the case in particular where a public to private buy-out transactions are in play. Since these transactions involve a considerable exchange of price sensitive information a potential for market abuse exists. These concerns were fuelled in particular given the steep rise of the European LBO market along with the complexity and size of the transactions.

Applicable legislative framework

Private equity firms are subject to existing market abuse and market conduct rules. At European level the Market Abuse Directive applies directly to any participant in a private equity transaction. In addition private equity is also directly covered by existing EU anti-money laundering regulation.

Market efficiency

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[95] France, Italy, Spain, The United Kingdom

There are number of concerns that question the impact of increased private equity activity on the efficiency of public markets. The key aim of private equity transactions is to target companies that are undervalued but who carry the highest potential to create substantial gains in relatively short period of time. Given the substantial growth of private equity takeovers where predominantly large public companies were targeted number of concerns is being raised:

- The scale of public to private buy-outs substantially decreases proportion of public markets in given Member State. As a result new public markets' structure emerges and includes only particular types of firms that are either too risky or too mature and shareholders are loosing out their dividends' share in companies when they experience highest growth, i.e. under private equity ownership.
- Other concerns relate to the distortion of managers' behaviour as a result of the large scale of private equity public to private LBOs that we have experienced recently. Being afraid to become a target of a buy-out, managers of public companies start focusing their strategies on short term maintenance of relatively high and stable share prices at the expense of long-term growth and strategic perspective of the company.

Applicable legislative framework

There is no regulatory framework that would define the right proportion of private to public markets in the economy. It is the market forces that determine the situation at a point in time and it is constantly changing. The benign economic environment allowed for transactions where number of big public companies has gone private. Nowadays, the time of highly leveraged deals is the past and we see that new market forces are moving towards different equilibrium, ultimately reflecting current economic environment.

2.3 Corporate Governance

Another set of concerns arise from stake-building and empty voting by minority shareholders. Although private equity investors typically take controlling stakes in companies and aim to enhance their performance in order to earn a return on their investment they also invest in minority stakes in listed companies. The criticism of activist shareholders is that they may seek disproportionate influence over company management with a view to maximising short-term gains at the expense of the target company's long term health and prosperity. At the heart of this concern is the use of derivatives and borrowed stock that effectively allows minority shareholder to exert disproportionate influence on company's management. However, these concerns are not limited to the activities of private equity, in fact are more typically used by activist minority shareholders.

The genuine concern in this respect are techniques that allow private equity managers to build stakes that are not sufficiently transparent to the company's management and may potentially give rise to abusive behaviour and cause harm to a company's key stakeholders (employees, customers, suppliers, etc). Examples of these techniques include (1) the use of derivatives that impacts shareholder notification/disclosure, (2) securities lending and borrowing to influence voting rights and (3) shareholders' information obligations towards portfolio companies.

From the perspective of the portfolio company there are also concerns as to the behaviour of their managers and executives in particular before the take-over by private equity occurs. Examples of current practice include directors and executives accepting various incentives in the form of bonuses, share option plans or other benefits from private equity managers. The opaqueness of executives incentive pay raises questions as to the loyalty of the portfolio company's managers towards its shareholders before the take-over by private equity is finalised.

Applicable legislative framework

A review of some Member States legislation reveals that the provisions of corporate law apply, in particular fiduciary duties of directors in portfolio companies and provisions dealing with the misuse of their power are the most relevant reference provisions in this case.

At European level, the Transparency Directive requires notification of all positions that confer the entitlement to vote, independently of the ownership of the shares and the existence of an economic interest. Certain derivatives and borrowed stock are therefore covered by the disclosure duties set out in the directive. However, the directive's basic threshold of 5% is relatively high and the notification duty, for practical reasons, only becomes effective a few days after the acquisition.

A review of Member States' implementation of the threshold reveals that in some Member States (Germany, Spain, Ireland or the United Kingdom) a stricter threshold of 3% is already applied. In Italy and Portugal, it is even lower, at 2%. In addition, some Member States have acted to impose additional disclosure requirements, for example the UK FSA's recent decision to require disclosure of positions obtained through contracts for difference. However, there is at present no consensus among Member States on the appropriate response to these issues.

It is important to note that the legitimate concerns that exist in the area, while relevant to some types of AIFM, are not limited to the activities of AIFM. The techniques and instruments that may require greater scrutiny in future are widely available and thus, to the extent that there is a regulatory failure in this area, an appropriate response would focus on the technique rather than any particular category of actor.

The Commission plans to review the Transparency Directive in 2009. This review will cover issues including shareholder identification, registration and requirements of shareholders to notify issuers of the proportion of their voting rights. In addition, the Shareholders' Rights Directive is due to be transposed by August 2009.

2.4 Transparency, Disclosure and Investor Protection

The investment landscape changed considerably in the past couple of years. Private equity established its position as an important market player and became a standard source of investors' portfolio diversification.

Although private equity remains the domain of professional and sophisticated investors, the number of investors has increased and so have their requirements to receive appropriate information on time. This is marked in particular by the sharp rise of pension funds and insurance companies as investors in private equity funds, forming together more than 30% of investors' base in the past five years in Europe. There is a need to ensure that members of the pension scheme are appropriately informed about the way in which pensions are invested and the associated risks.

Private equity investors receive already substantial level of information from private equity managers before and after investments are made and the level and detail of the reporting and disclosure to investors has also increased in time. However the quality and content varies considerably, depending in particular on the manager providing this information. Today, the new investors are seeking to have the same or comparable level of information and therefore assurance about associated risks and processes and other related indicators as they get from traditional asset managers.

Significant areas of dissatisfaction among investors can be observed across a range of issues associated in particular with reporting, risk management and disclosure.[96] Investors complain that lack of transparency makes it difficult to compare or benchmark performance between various funds, understand the investment risks and strategies, others voice their concerns as regards standardised valuation reporting and reliability and consistency of valuations for ongoing investments. The latter became topical during the financial crisis.

Applicable regulatory framework

In many national frameworks disclosure to investors is governed by provisions of company law. The disclosure requirements are usually specified in the fund rules and subject to contractual obligations and enforcement between the fund and its investors. The same company law applies in cases of disclosure of information to supervisors which in many instances takes a form of filing audited annual or semi-annual reports with the relevant national authority.

At European level, securities legislation already provides for a mandatory information and disclosure requirements which apply to different financial instruments (funds, securities issued by listed entities) and intermediaries selling/recommending these instruments, i.e. Directive 2004/39/EC (MiFID). Also Prospectus Directive provides for harmonised disclosure document when securities are offered to the public or admitted to trading on a regulated market.

In general, information requirements to members of pension schemes are governed by Member States' social and labour law. The Occupational Pension arrangements that are under the remit of the European IORP Directive 2003/41/EC have fairly advance regime as far as investment rules and information obligations are concerned. As regards the investment rules, they are to a large extent based on the "Prudent Person Rule". As to the information requirements, the Directive provides for obligations to the occupational pension institution to provide certain information to the members of the scheme/employees.

Transparency relates not only to the features of the investment (e.g. the investment policy and the risks that entails) but also to the internal processes of the private equity fund managers. Many aspects of their activity and the way in which they are organised impact directly on the interests of their investors. For example, the processes for valuing the fund's assets, ensuring that these assets are secure, and for ensuring that conflicts of interest do not drive a wedge between the interests of the managers and their investors (or between categories of investor) are also of direct interest to the investor. Effective and well-governed internal processes are thus necessary if an appropriate level of investor protection is to be achieved.

At present, national regulatory regimes do not provide a consistent and effective regulatory baseline for the protection of investors. In some Member States, requirements that exist have been supplemented with industry-developed disclosure standards. However, such standards have not been applied consistently throughout the EU (see chapter 3). Variation in disclosure standards is thus an additional source of concern for investors operating cross-border.

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96 PricewaterhouseCoopers – March 2008, Transparency versus returns: The institutional investor view of alternative assets: This survey of institutional investors points to a number of areas of dissatisfaction among investors across a range of issues associated in particular with reporting, risk management and disclosure. Investors complain that a lack of transparency makes it difficult to compare or benchmark performance between various AIF, understand the investment risks and strategies; others voice their concerns as regards standardised valuation reporting and reliability and consistency of valuations for ongoing investments

2.5 Acquisition of control of companies by Private Equity

One of the key policy concerns relate primarily to the sustainability of debt assumed by private equity portfolio companies. Some evidence suggests that leverage levels have indeed been increasing especially in buy-out transactions above certain size[97]. If the pressure is than too high on the portfolio company to service its debt it can lead it to financial distress which ultimately negatively affects its employees and the society as a whole. And as reported in mid 2008 there were about 75% of portfolio companies behind schedule in their earnings plans to decrease the debt burden, which clearly reflects the difficulty of accessing credit to re-finance the debt, as was common practice prior to the financial crisis. As a result some irregularities in behaviour by those involved in such transactions were brought to public attention and criticism.

From the perspective of employees, concerns arise that in cases where company is acquired by private equity employees do not enjoy the same protection and rights as is the case when a transfer of undertaking occurs. Underlying this concern is the legitimate desire to ensure that labour forces are treated sensitively and carefully about major changes in the life of their company – especially those concerning their own job tenure and employment conditions.

Applicable regulatory framework

At national level, general provisions of corporate law apply in all Member States, in particular fiduciary duties of directors and provisions dealing with the misuse of their power.

However, existing national and European regulatory provisions providing general safeguards accommodate these concerns only partially. The most relevant is the Second Company Law Directive (77/91/EEC), as recently amended by Directive (2006/68/EC) that provides a framework for capital formation, maintenance and alteration of a company. The Directive on Transfer of Undertakings (2001/23/EC) and the framework Directive for consulting and informing employees (2002/14/EC) provides a framework for employee protection. As regards the Directive 2001/23/EC, it applies only in cases where legal transfer of the company or a merger takes place. The Take-over Bid Directive has also limited applicability from the perspective of portfolio companies that are not listed.

The existing regulatory framework and industry codes governing disclosure and information provisions of AIFM do not sufficiently address **the cross-border character of private equity transactions**, both in terms of the geographical location of investors and of the investee companies. About 30% of private equity funds are invested in portfolio companies in Member States other than that of the AIFM and about 24% of funds are raised from investors located in Member States other than that of the AIFM.[98]

However, there is no consistent standard for the level of transparency required in relation to such deals. Consequently, key stakeholders (existing shareholders of target companies and their employees as well as investors of AIF) of these transactions may not receive comparable and consistent information about the intentions of the acquiring AIFM and the strategic implications of such acquisition either at the time of the transaction or on a continuous basis.

In the absence of relevant legislative provisions, national trade associations in some Member States have acted to introduce additional disclosure requirements on their home AIFM with

[97] 2006 ECB survey of leveraged buyout activity demonstrated that leverage levels were rising steadily in larger transactions in Europe (typically > €1bn).

[98] EVCA Yearbook 2008: in 2006 and 2007, 23% and 24% of funds raised by European AIFM originated from investors in other Member States, 38% and 42% were raised in 2006 and 2007 from domestic investors and the remainder 40% and 34% from investors outside EU.

regard to companies subject to buy-outs in their jurisdictions. However, despite recent efforts to deliver a more harmonised approach, these standards are not applied on a consistent basis across Member States and hence the level of transparency towards key stakeholders and public accountability associated with private equity deals varies.

3. Analysis of private equity codes of conduct and other applicable guidelines

Currently a number of European and national codes governing private equity behaviour exist in parallel, all covering a wide range of issues (e.g. ethics, valuation, transparency and reporting to investors, portfolio companies and the public). The Commission has indicated on several occasions that effective self-regulation is a possible avenue to be exploited.

This chapter will therefore engage in a qualitative analysis to determine the level of compliance, the scope and effectiveness of the various codes of conduct that have been developed at European or national level. It will address the various risks posed by the private equity business model and evaluate to the extent possible, whether the professional standards and codes of conduct as they stand today, provide for an effective mechanisms through which the risks are enforced and mitigated, i.e. to what extent they can be expected to make a difference on the ground for stakeholders (investors, portfolio companies, supervisors, and the public). This analysis will employ criteria to assess whether specific risks are effectively addressed by the codes and applied by those who engage in private equity business.

3.1 Criteria for assessing the effectiveness of private equity codes and best practice guidelines

Before going into a more detailed discussion as to how effective current professional codes and guidelines applicable to private equity are, it is essential to set out clearly criteria that should allow us to draw such conclusions. Experience shows that voluntary codes can work only effectively if there is a strong enforcement and oversight mechanism built in the codes. In assessing the effectiveness of industry codes and best practice guidelines, we applied the following criteria that help to guide our analysis as regards the overall credibility of existing self-regulatory framework in the EU.

<u>1/ Content/Focus:</u>

Currently there are six different codes of conduct and industry guidelines developed at European or national level that apply to private equity businesses and those who are directly impacted by their activities. For the purpose of this analysis the issues covered by all of these codes will be looked at.

The following codes and best practice guidelines are therefore considered: EVCA Code of Conduct, EVCA Corporate Governance Guidelines, EVCA Governing Principles, EVCA Reporting Guidelines, International Private Equity and Venture Capital Valuation Guidelines and other Transparency and Disclosure Guidelines that so far have been developed only at national level and we will consider the following EU Member States – the United Kingdom, Denmark, Germany and Sweden.

Benchmark for purpose of this analysis: What issues are covered and what is the level of detail – prescriptive or rather principle-based content? Are the codes sufficiently well specified to provide clear basis for influence in behaviour? Is the content of the particular code/guidelines focused enough to address concerns raised in relation to the impact of private equity on society and economy as a whole?

<u>2/ Scope/Coverage:</u>

When assessing the effectiveness of the existing codes and guidelines one of the key criteria is the extent to which the number of entities that comply with the guidelines and codes is representative of the industry and the market where such code applies. For the purpose of this analysis, coverage will be assessed taking into account: (1) number of private equity companies that are full members of EVCA[99], (2) number of private equity firms in existence in given Member State, (3) of which number of private equity firms with headquarter in given Member State, (4) number of private equity companies as full members of national private equity and venture capital association (see Table 1). The number of private equity firms in each category (1-4) can not be summed up since one company and its subsidiaries are members of more national associations. Coverage can therefore to a limited degree be assessed at the level of each Member State[100].

Benchmark for purpose of this analysis: the extent to which all possible private equity firms are covered by the codes or guidelines.

<u>3/ Compliance</u>: There are three main categories of compliance that can be distinguished: voluntary, comply or explain and mandatory.

Benchmark for purpose of this analysis: level of compliance

<u>4/ Monitoring:</u>

How is the compliance with existing codes monitored? Companies that subscribe to compliance with any code should establish within their internal organisational structures functions that engage in regular monitoring of compliance with the code, such monitoring would be internal. Additional or alternative level of monitoring - external - could also be established at the level of the supervisory authority, industry umbrella organisation or any other relevant body.

Benchmark for purpose of this analysis: how is monitoring of compliance with the code organised, is it active or passive type of monitoring and who is responsible for compliance monitoring.

<u>5/ Enforcement and Sanctions:</u>

Although the compliance with codes is in general on voluntary basis, this should not decrease the responsibility of an actor who violates principles and rules to which he/she subscribes. Therefore it is an indispensable for any voluntary code's credibility, to contain clauses that deal with the way how violation of code's principles and rules is to be dealt with.

Benchmark for purpose of this analysis: existence of effective enforcement mechanism and sanctions in the body of the code or guidelines

3.2 Analysis of existing professional codes applicable to private equity

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99 Industry data indicate national trade associations' memberships in EVCA captures approximately 80% of assets under management in the European Union.

100 Example: the UK private equity and venture capital association contains about 210 full members (associate members usually do not engage in private equity business but provide some support services etc.). The industry data report that in 2008 there were more than 400 private equity firms headquartered on UK the market. At EU level, 115 private equity firms from the UK register as full members of EVCA. Neither of these numbers can provide a definitive view of the gap that might exist on this market for the reasons mentioned above. However this picture is typical for many Member States where private equity is active. Although it is not possible to quantify the gaps, these figures reveal issues that are nevertheless essential for this analysis.

This analysis looks at codes developed by the European private equity industry and also at codes that were put in place in some Member States at national level. Those codes that exist at European level draw their compliance through the membership in the European Private Equity and Venture Capital Association (EVCA). In 2008 its membership comprised of 1,297 members of which 693 were full members, 572 associate members and 32 national associations of which 19 refers to EU national association Similarly, codes developed at national level also to some extent draw on their compliance through membership of the national private equity and venture capital association but their scope and coverage vary to some degree.

EVCA has been at the forefront of developing industry standards as we know them today and as such has a key role to play in the management and development of the self-regulatory framework in the EU[101].

3.2.1 EVCA Code of Conduct

Content and Objectives

This code sets out six high-level guiding principles that should offer a framework for the resolution of ethical dilemmas. As of 2009 a new Code of Conduct was adopted by EVCA based on the IOSCO Model Code of Ethics. Its objectives are:

1. To state the principles of ethical behaviour that members of EVCA abide by,
2. To assert on behalf of the membership the collective view that high standards of commercial honour and just and equitable principles of trade and investment shall be observed, and
3. To provide the basis for consideration of an dealing with lapses in professional conduct within EVCA

The following guiding principles form the body of this code:

1. Act with integrity
2. Keep your promises
3. Disclose conflicts of interest
4. Act in fairness
5. Maintain confidentiality
6. Do no harm to the industry

Assessment

EVCA does no actively monitor compliance with the code. EVCA acts upon receipt of complaints that are then dealt with but the code contains reference to enforcement and sanction mechanisms. As regards transparency, the code is well publicised at the level of EVCA (website), however a random check of about 40 private equity firms websites (full members of EVCA) reveals that very few post a reference or link to this code and provide any statement about their compliance with the code. It is therefore not possible to assess the extent to which individual firms integrate the code into their business practices. Compliance with the code is mandatory for all members of EVCA and according to them its members account for

[101] EVCA Code of Conduct, October 2008: "*As part of its longstanding objective to provide an appropriate self-regulatory framework for the industry, EVCA has published several documents that present principles that should govern the professional relationship between the three key groups of participants in the industry: the General Partner, the Limited Partner, and the investee company. These documents outline the key elements of governance, transparency and accountability that are expected of the main industry participants towards one another*".

over 80% of assets under management by private equity firms in the EU. From a different angle, we can say that most of the private equity companies in the EU are covered through the membership of EVCA or their national trade association that developed their own codes of conduct. However to what extent are all private equity firms active on the EU market captured remains questionable since it is not possible to fully quantify the gap as regards entities that are active in the EU but are not members of EVCA or other national association (see Table 1).

In addition, this code of conduct and its principle number six 'Do no harm to the industry' is one possible reference in the plethora of existing codes that should have the potential to effectively discourage private equity to engage in taking excessive leverage and capital depletion of their portfolio companies. It can be asked whether a high level principle such as the one contained in the code of conduct is focused enough to discourage private equity firms to burden their portfolio companies with excessive debt, to prohibit disproportionate disposal of portfolio companies' assets and other similar practices. Overall, there are some positive aspects of the code that refer in particular to the compliance, enforcement and monitoring of the code of conduct. Whether coverage via EVCA membership is sufficient enough can be subject to discussion as well. However, it is evident that the content of this code is not focused enough to mitigate concerns raised in relation to the use of leverage in private equity buy-out transactions and the overall economic and social sustainability of portfolio companies.

3.2.2 EVCA Governing Principles

Content and Objectives

This document is a set of best practice guidelines that are based on principles that should govern the interactions between private equity fund managers and investors. The following principles are concerned:

1. The Law	4. Skill, care and diligence	7. Transparency
2. The Contract	5. Adequacy of resources	8. Conflicts of interest
3. Integrity	6. Investors' interest	9. Investors' assets

On basis of examples, the document goes through all stages of the life cycle of a fund - ranging from fund raising and structuring of the investment offers, due diligence and investment structuring, investment management and monitoring, disposal of investments and proceeds distribution and reporting to investors etc. - provides illustrative explanations with the aim to be a useful reference for fund managers as well as to investors as to the application of the guiding principles in practice.

Assessment

The examples of best practice behaviour in the various stages of investment is relatively well described and documented, although number of exceptions are possible since one size does not fit all managers and the funds they manage. The compliance with these guidelines is voluntary for members of EVCA. As of today only four national associations subscribe to these principles. No other Member State trade association developed its own standards so far. It is up to the investors to enforce their contractual rights and managers' compliance since the limited partnership agreements constitute the legal framework for the investment into the fund.

The guidelines require managers to ensure that all investors receive the same information (stipulating minimum content) and should be treated equally and informed about reasons if exceptional circumstances arise. Many of the guideline's provisions address issues of concern raised in relation to private equity activities ranging from the levels of leverage, to sustainability of portfolio companies, appropriate disclosure of relevant information to investors including risks or management and disclosure of conflicts of interest. Given the limited compliance with these guidelines and the private character of the limited partnership agreement it is to be questioned whether such a framework is sufficient for investors to receive appropriate information before and after investments are placed

3.2.3 EVCA Corporate Governance Guidelines

Content and Objectives

Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. This document is set of best practice guidelines that govern relationship between company's management, its board, its shareholders and other stakeholders. The guidelines should help managers of portfolio companies to understand the nature and behaviour and expectations that the private equity investment brings along. Examples of such behaviour are described taking into account the following principles:

Principles of Good Governance for Private Equity and Venture Capital Investing: law and regulations, integrity, partnership, the long term view, respect for stakeholders, transparency and confidentiality

Principles of Conduct as Shareholder: e.g. responsibilities in relation to strategy, performance information, the board and other shareholders and stakeholders including conflicts of interest

Principles of Conduct as Board Member: e.g. collective responsibility of board members for identification, assessment and management of risks, determination of remuneration of executives,

Principles of Conduct for Management: e.g. responsibilities of management for control activities, appropriate communication with employees (strategy, performance, risks assessment, etc.)

Assessment

Corporate governance issues are on top of the agenda in particular as regards the impact of private equity behaviour on various stakeholders. These guidelines therefore cover very important aspects of private equity behaviour. They also cover number of areas that were raised as key concerns in relation to the activities of private equity.

Similarly to the previous guidelines, the compliance is voluntary and only four EU Member States' national associations subscribe to these principles with one Member State applying its own. It is then a question how effectively can compliance be enforced either at the level of portfolio company or at the level of the fund manager given in addition to the voluntary compliance, the limited coverage and the lack of sanctioning mechanisms that one could resort to.

3.2.4 EVCA Reporting Guidelines

Content and Objectives

Reporting guidelines set out key requirements that must be applied by fund managers when reporting to their investors so that the latter can monitor their investments in an appropriate way. The guidelines are designed to complement and enhance the requirement of European laws regarding the format and content of statutory accounts. Requirements for reporting refer to some key principles to be observed by fund managers, like relevance, transparency and consistency. In addition, the main body of the guidelines lists in a detailed manner the content of what should be reported in relation to fund, portfolio, capital account, fees and carried interest. In order to illustrate practically the way in which such reporting could look like, the document also contains a template with examples. The reporting guidelines were introduced in 2000 and were updated in 2006 in order to take due account of the new valuation principles adopted in the International Private Equity and Venture Capital Valuation Guidelines.

Assessment

In general the requirements on what reporting towards investors should contain is relatively detailed and covers all important elements of information that investors should receive from their fund managers. Although compliance with the code is voluntary, there are as many as eleven Member States' national associations that subscribe to these guidelines. Non-compliance is not addressed in the document through sanctioning mechanisms as it is perceived that investors will place high expectations on managers who would then comply with the guidelines as it is in their best interest to sustain current investors also in the future. The question is whether investors are always aware of the fact that fund managers as members of one of the eleven national associations, subscribe to these guidelines. In relation to existing concerns in private equity relating in particular to reporting on investment strategy, risks, valuation of assets or management fees, these issues are in principle covered by the guidelines. To what extend do investors receive information that would be comparable across the industry and various investments is however questionable given the still limited coverage which abides to diverging application of reporting to investors. Also whether the information provided to investors is always relevant, transparent and consistent can not be fully assessed given the lack of independent information or evaluation of such reporting from the perspective other than the investor. This situation invites to question the lack of some form of an external monitoring, enforcement and transparency mechanisms to assess the overall effectiveness of the reporting guidelines.

3.2.5 International Private Equity and Venture Capital Valuation Guidelines (IPEV)

Content and Objectives

The guidelines were put in place in 2005 in a need to foster greater comparability across the industry and to ensure consistency with international financial reporting standards (IFRS) and US Generally Accepted Accounting Principles (GAAP). Managers use IPEV to value investments for their financial statements and for reports they submit to investors. These valuations are used to monitor progress of investments. IPEV guidelines are based on the 'fair value' principle. The IPEV board was charged with the revision of the guidelines in the course of 2008. Along with the guidelines, IPEV board was created as an independent legal entity that takes the responsibility for maintaining, promoting, monitoring and updating the guidelines. The guidelines contain two parts, the first one outlines principles which represent the best practice for the valuation of investments and the second section provide for a guidance on how the principles and methodologies can be applied in specific cases.

IPEV were developed together by the British, French and European private equity and venture capital associations. These guidelines are of an international impact as number of associations active in private equity and venture capital outside of Europe subscribe to them. The guidelines comprise a set of best practices as regards valuation of private equity and venture capital investments. Valuation of investment is an important element in the reporting process to investors and so the guidelines are an essential element in helping investors to make the right decisions.

Towards the end of 2008, IPEV board re-confirmed its position that 'fair value' remains the best measure for valuing private equity portfolio companies. The challenges for managers today are to demonstrate to regulators and others the appropriateness of the process by which they consistently determine fair value. Fair value should in addition not to be the only sources of assessing general performance of fund managers.

Assessment

The international acceptance of the valuation guidelines achieved so far and the high subscription rate by 18 EU Member States' associations is an important achievement. Although widely used, the gaps in their consistent adoption across the industry persist. However the same concerns arise as in the case of the reporting guidelines in that it is difficult to assess their overall effectiveness directly since from the perspective other than of the investor (enforcement and monitoring should be covered in the fund agreements) no information exists as to how is compliance with the guidelines monitored and enforced.

3.2.6 National Disclosure and Transparency Guidelines

Content and Objectives

Introduced in November 2007, the UK Walker Guidelines were the first of its kind in Europe to require additional disclosure and communication by private equity firms and their portfolio companies using the *'comply or explain'* principle. Some other EU Member States national associations (DE, DK, SE) followed suit inspired by the UK approach and in the course of 2008 introduced similar enhanced disclosure requirements.

These guidelines were introduced in principle as a reaction to the criticism targeted at private equity activities in particular in the past 3 years, when European large buy-out activity reached its highest levels, both in terms of volume and number of deals. Governments and stakeholders started to call for more information as to what was happening to these companies. As the new disclosure guidelines emerged first in the UK and the way they inspired other countries represents an important acknowledgment by the industry that more openness and transparency was needed and that it does have its merit.

Assessment

Although all four transparency and disclosure guidelines developed at national level have the same overall objective, their scope, coverage and level of descriptiveness vary considerably.

The UK and German guidelines target only the top end of the buy-out market, thus only a small proportion of private equity companies are caught by the requirements and obligations. Danish approach is also limited and applies to members of DVCA with committed capital of at least DK500 million and those private equity companies who do not have their headquarters in Denmark fall outside of the full scope of the guidelines. On the other end is Sweden with the widest scope: all private equity companies who are members of SVCA must comply with the guidelines.

At the level of portfolio companies only Sweden applies again the widest thresholds and so all companies with their headquarters in Sweden shall comply. All the other three countries have more targeted approach and apply combination of thresholds (value of acquisition, number of employees, generation of minimum level of revenue in given country) that also wary among these countries, for example in the UK only portfolio companies with more than 1000 full time employees are subject to the guidelines whereas in Denmark it is applicable to companies with more than 250 full time employees.

As regards the reporting obligations for private equity companies and their portfolio companies, here the guidelines differ also considerably. This is in principle due to the fact that some countries, like the UK have less comprehensive company law than for example Sweden. To that extent, we can see that the UK approach is more prescriptive than the Swedish one, which in effect is limited to one page of recommendations. As an example, we can take the disclosure requirements of portfolio companies regarding employment issues. In Sweden, trade unions are by law given an extensive insight as to the management of portfolio companies regardless if these are public, private or controlled by private equity. On the contrary, Denmark and the UK do not have such stringent statutory reporting requirements and so their guidelines are more detailed as to the content and form of additional reporting. When compared the more detailed approach of Denmark and the UK, it is evident that in several aspects the Danish approach goes further. For example, the Danish guidelines require portfolio companies to disclose information about employee turnover, capital structure, identify company's primary stakeholders, report o the board's tasks and responsibilities or disclose remuneration of the management and board members. Portfolio companies in the UK do not have to disclose such information.

Overall, all of these codes compare better to those developed so far on European level. In particular, the stronger compliance mechanism linked with the active monitoring done by national associations and underpinned by the obligation to disclose and publish the requirements adds to the influence and real bite these guidelines have to address some of the concerns raised in relation to private equity and induce changes how private equity behaves and operates vis-à-vis its key stakeholders as well as the public in general.

Another positive aspect is the increased role and responsibilities the individual national associations are given. Among others, they collect and consolidate data with the aim to provide views as to the general trends in the industry. For the first time since the UK guidelines were introduced, BVCA together with Ernst & Young issued its first report based on the extensive obligation of companies to report to BVCA. Overall, the UK companies' performance under private equity ownership was encouraging. However, it did highlight that a significant proportion of private equity portfolio company performance was generated by cheap borrowing to finance activities rather than operational improvements. Since the other three Member States guidelines were put in place in principle a year later, it is yet to be seen how effective were they and what information will we get following the data gathering done by the national associations.

To conclude, these codes do play a very important role in the current environment the private equity industry finds itself today. So far, we have seen only one to conclude its full cycle of implementation, enforcement, monitoring and reporting. The fact that the other three guidelines did not produce yet results does not hinder to assess their potential effectiveness. One could find many other different ways in which to compare them than the selective comparison presented in this chapter. On the other hand, it does not take a much of a detailed approach to spot the gaps. Overall, all four guidelines appear to be rather effective and have the potential of bringing about desired changes. These guidelines were a result of the industry taking very first steps to actively respond to the wide-spread criticism. One year later, it is clear that although most welcome, this response is not sufficient, be it because of the limited coverage of Member States in which the guidelines apply or the varying approaches to what is eventually disclosed to the public, investors, national associations or supervisory authorities.

4. Conclusion

Private equity self-regulatory approach to comply and enforce existing professional codes has been subject to increased criticism and so has been the lack of direct regulatory oversight of private equity activities. Indeed, there is number of European, national or international codes and guidelines in place but strong doubts persist as to their ability to bring about changes in behaviour and working practices of private equity business on a wider scale.

The mapping of existing regulatory framework and professional codes applicable to private equity activities identifies clear gaps where concerns raised in relation to private equity are not subject to specific or appropriate regulation and the level of effectiveness of existing professional codes does not sufficiently complement current regulatory environment to address the concerns related to private equity activities and its subsequent impact on the economy and key stakeholders.

Overall there is a reasonable doubt stemming from this analysis as to the level of effectiveness through which existing codes and best practices address issues of concern expressed by various stakeholders. The same level of doubt persists about the effectiveness of the codes as regards issues they are designed to regulate. There is a considerable overlap whereby the same issues and concerns are addressed by different guidelines with different coverage, content and objectives. As a result it is difficult for various stakeholders to realise who is covered by what guidelines and how their application is or can be enforced. It is reasonable to conclude that criteria necessary to be fulfilled for a professional code to make a difference in behaviour of private equity actors are not complete for most of the codes in question.

Box 1: Summary analysis of effectiveness of industry codes and best practice guidelines in private equity

To assess the effectiveness of self regulatory framework we focused our analysis on the framework applicable to AIFM in private equity in which we consider the following codes: National Codes of Conduct, National Transparency and Disclosure Guidelines, European Private Equity and Venture Capital Association (EVCA) Code of Conduct, EVCA Corporate Governance Guidelines, EVCA Governing Principles, EVCA Reporting Guidelines, International Private Equity and Venture Capital Valuation Guidelines (IPEV).

Content: As can be derived from the titles of the codes in question, they have different focus and different level of ambition. Some of them are very generic and wide ranging. This is the case where codes contain mainly high-level principles (e.g. EVCA Code of Conduct or EVCA Corporate Governance Guidelines). Others are more targeting a particular business activity and accordingly are more specific and targeted (e.g. EVCA Reporting Guidelines, International Private Equity and Venture Capital Valuation Guidelines – IPEV).

Scope/Coverage: The key criteria for codes to have an impact, they should be applied as far as possible by all relevant actors from within the industry. Using the example of private equity and coverage of the codes and guidelines in question we can conclude that overall coverage is rather patchy. The strongest coverage refers to Codes of Conduct both, national and European. For other codes, only few Member States private equity associations subscribe, for others, large number of national associations sign up. Regardless whether the subscription through national associations is high or low, doubts persist as to the extent to which all managers are captured, since membership in national or European associations is not obligatory in majority of cases. This is based on industry data indicating that the number of management companies with their headquarters in a given Member State exceeds considerably the number of management companies that are members of national associations.

Enforcement: A set of three enforcement criteria help us to determine whether professional codes or guidelines have a real impact. Firstly it is the level of compliance (mandatory vs. 'comply of explain' vs. voluntary), secondly monitoring of compliance and lastly the existence of sanctioning mechanism. Analysis shows that a compliance mechanism has a considerable influence over how is monitoring of compliance organised and whether particular code or guidelines provide for a reference to sanctions. Here we can conclude that majority of European and international codes, although enjoying relatively high coverage via membership in national associations, can not be efficiently enforced. This is due to the fact, that their voluntary compliance mechanism makes organised monitoring or sanctioning mechanisms irrelevant. These codes in fact lack a reference as to how is monitoring of compliance organised and the same is valid for sanctions. This is the case in particular for EVCA Corporate Governance Guidelines, EVCA Governing principles, EVCA Reporting Guidelines and IPEV.

Concerns raised in relation to private equity activities	Concerns addressed by national legislation, 8 Member States: FI, FR, DE, IT, NL, ESP, SE, UK	Concerns addressed by European legislation
I. Private equity managers		
REGISTRATION AND AUTHORISATION OF FUND MANAGERS	Yes (5 MS)	No
II. Financial stability		
CAPITAL REQUIREMENTS (INITIAL CAPITAL)	Corporate/Company Law	The 2nd Company Law Directive, MiFID (only if subject to it)
RISK BASED CAPITAL	No	Capital Requirements Directive (lending institutions)
III. Market integrity and Market stability		
MARKET ABUSE	Corporate/Company Law	Market Abuse Directive
MONEY LAUNDERING	Corporate/Company Law	Money Laundering Directive
IV. Corporate Governance		
SHAREHOLDER IDENTIFICATION	Corporate/Company law	Transparency Directive (listed companies)
TRANSPARENCY OF MANAGERS' REMUNERATION	Dealt with in LPAs - contract law	Commission Recommendation on Directors' remuneration (listed companies)
V. Transparency, Disclosure to investors, authorities, public		
INVESTMENT STRATEGIES, RISK MANAGEMENT AND VALUATION	Investors: dealt with in LPAs - contract law. Authorities/Public: Company law	The 4th and 7th Company Law Directive (audited accounts - private & public companies, risk management and valuation - public companies), MiFID, Prospectus Directive, IORP Directive
MANAGEMENT AND DISCLOSURE OF CONFLICTS OF INTEREST	Dealt with in LPAs - contract law. (Directors' duties/liabilities)	Only if subject to MiFID
VI. Social Economy		
CAPITAL SUSTAINABILITY OF PORTFOLIO COMPANIES (asset stripping)	Corporate/Company law (Directors' duties/liabilities)	The 2nd Company Law Directive (formation, maintenance & alteration of company's capital)
EXCESSIVE LEVERAGE OF PORTFOLIO COMPANIES	Corporate/Company law (Directors' duties/liabilities)	No
EMPLOYEES CONSULTATION AND INFORMATION	Labour law	Transfer of Undertakings Directive, Framework directive for consulting and informing employees.

Concerns raised in relation to private equity activities	Are concerns addressed by existing industry codes or best practice guidelines?					
	Nnational/EVCA Code of Conduct	EVCA Corporate Governance Guidelines	EVCA Governing Principles	EVCA Reporting Guidelines	International Private Equity and Venture Capital Valuation Guidelines	National Transparency and Disclosure Guidelines
I. Private equity managers						
REGISTRATION AND AUTHORISATION OF FUND MANAGERS	enhance	enhance				
II. Financial stability						
CAPITAL REQUIREMENTS (INITIAL CAPITAL)			enhance			
RISK BASED CAPITAL						
III. Market integrity and Market stability						
MARKET ABUSE	enhance	enhance				
MONEY LAUNDERING	enhance	enhance	x			
IV. Corporate Governance						
SHAREHOLDER IDENTIFICATION		x				x
TRANSPARENCY OF MANAGERS' REMUNERATION		x		x		x
V. Transparency, Disclosure to investors, authorities, public						
INVESTMENT STRATEGIES, RISK MANAGEMENT AND VALUATION	x	x	x	complement	complement	x
MANAGEMENT AND DISCLOSURE OF CONFLICTS OF INTEREST	x	x	x			x
VI. Social Economy						
CAPITAL SUSTAINABILITY OF PORTFOLIO COMPANIES	x	x				x
EXCESSIVE LEVERAGE OF PORTFOLIO COMPANIES	x	x				x
EMPLOYEES CONSULTATION AND INFORMATION	x	x				x

ASSESSMENT CRITERIA	BENCHMARKS	National/EVCA Code of Conduct	EVCA Corporate Governance Guidelines	EVCA Governing Principles	EVCA Reporting Guidelines	International Private Equity and Venture Capital Valuation Guidelines	National Transparency and Disclosure Guidelines (DK, DE, NL, SE, UK + FI)
CONTENT/FOCUS							
CONTENT/FOCUS	Does the content (principles - prescriptive) provide a good basis to address the concern?	A set of 6 high-level principles	Behaviour of PE firms in investee company - as manager, board member and shareholder	Behaviour of PE during the life-cycle of the fund	Reporting of PE to investors	Principles and methodologies for valuation of PE investments	Stronger and additional disclosure to public, investors, authorities. Some very prescriptive / other brief
SCOPE/COVERAGE							
SCOPE/COVERAGE	Extent to which all private equity firms are covered.	15 MS - 6 MS apply EVCA, 9 MS apply own codes (EVCA members cover 80% of Assets under Management in the EU)	4 MS' national associations + 1 MS/FR own national standard	4 MS' national associations	11 MS' national associations	18 MS' national associations	coverage differs among MS (All vs. Qualified - by size/N° employees)
ENFORCEMENT							
COMPLIANCE	What compliance is required? (mandatory > comply or explain > voluntary)	Mandatory for members of national or EU association	Voluntary for EVCA members	Voluntary for EVCA members	Voluntary for EVCA members	Voluntary for EVCA members	"comply or explain"
MONITORING	How is monitoring of compliance organised? Who is responsible?	passive by EVCA, national authorities/association	limited to management of portfolio companies	limited to investors (LPAs)	limited to investors (LPAs)	limited to investors (LPAs)	independent body, MS' national association
SANCTIONS	Existence of enforcement and sanctions in the code or guidelines.	eviction from national/EU or withdrawal of authorisation	no reference	no reference	no reference	no reference,	"comply or explain", see above

EN

EN

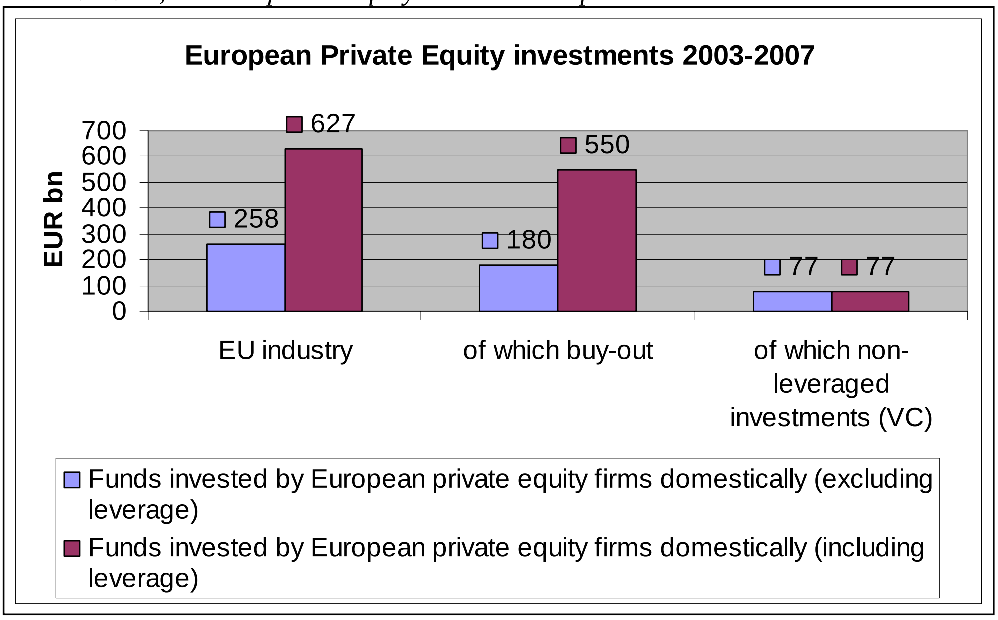
	Guidelines for Disclosure and Transparency in Private Equity (Walker Guidelines) (UK)	Guidelines for responsible ownership and good corporate governance (DK)	Recommendations regarding general disclosure of information regarding the private equity industry and the portfolio companies (SE)	Guidelines for Disclosure and Transparency issued by the Large Buy-Out Group, Regarding Disclosure Requirements of Private Equity Firms and Portfolio Companies (DE)
Guidelines issued:	November 2007	2008	June 2008	October 2008
Which private equity companies are covered?	UK based, authorised by FSA, and managing or advising funds that either own or control one (or more) UK companies that meet certain size criteria (see below) = **32 companies, 15% of BVCA members are covered**	**members of DVCA** with total commitment exceeding DK 500 million (coverage limited by commitment and firms whose parent companies not registered in DK fall outside of the full scope of the guidelines)	**Members of SVCA** that either invest companies in which they hold majority or minority shares or act as investment advisor to funds undertaking such investments = **100% of SVCA members**	Members of the BVK's Large Buy-Out Group that either act as a fund or advise funds and holding of interests in companies that meet certain size criteria **(coverage limited to 13 companies (6% of BVK members are covered), principle of coverage similar to that of UK)**
Which portfolio companies are covered?	acquired in public to private transactions (exceeding GBP300 million) or acquired in secondary transaction (exceeding value of GBP 500 million) and which have at least 50% revenues generated in the UK and at least 1,000 fulltime UK employees **(56 companies out over 1,300 receiving private equity investment, principle of coverage limited by size criteria)**	Danish companies: revenue exceeds €32 million, asset value exceeds €16 million and have more than 250 employees	Any company with its headquarters in Sweden	portfolio company registered under German law, enterprise value exceeding €750 million, must generate more than 30% of turnover in DE and employing more than 1,000 full time employees **(principle of coverage limited by size criteria - similar to that of UK)**
Requirements of private equity companies	**Publish annual review or on their website information about** (FSA authorisation details, history, investment strategy, executives and procedures dealing with conflicts of interest, description of portfolio companies, description of investors by type and geography), **supply relevant data to BVCA**, actively **communicate with stakeholders**	**Publish on their website information about** (the company, the funds and strategies and their investors and origins, provide a link to manco's accounts, description of programme used for carried interest if different than market standard, firm's policy and corporate responsibility, information on assets and companies under management), **supply relevant data to DVCA**	**Publish on their website information about** (investment strategy, funds information and their structure, information about each portfolio company, applicable guidelines for portfolio valuation and reporting to investors, policies dealing with conflicts of interest, policies regarding CSR and environmental issues), **participate in data gathering of SVCA**	**Publish on their website information about** (firm's history, investment principles, typical duration of investments - give examples, identify portfolio companies in which holding interest, composition of management including investment managers and advisors, basic and general information about investors by geography and investor type), **supply relevant data to BVK,** effectively **communicate with employees** of portfolio companies (ensure material information flow)
Requirements of portfolio companies	**Publish enhanced annual reports** and accounts on the website including (identity of private equity company that owns it and names of executives in management, composition of board and identity of names of the representatives of the private equity firm, business review including provisions relating to quoted companies), **publish a mid-year update, contribute data to the BVCA**	**Publish on the website annual report** including in addition to the statutory one the following data (operational and financial developments, corporate governance, financial and other risks and employee matters - terminations, recruitment, status at beginning and end of the year), **provide data to DVCA**	**Publish on website information about** (operations and turnover, ownership, board composition, financial reporting and data, information about significant events, ownership changes, changes in managements and board composition or other events of substantial financial importance, policies regarding CSR and environmental issues)	In addition to statutory requirement the **following information be readily accessible on website:** identity of funds controlling or advising company, composition of management board and disclose which of them are affiliated to private equity firm, summary of business segments, figures on sales revenues, figures on total number of employees and their share in Germany, dates of material recurring publications, **supply relevant data to BVK**
Compliance monitoring and reporting	**Comply or explain principle.** Independent monitoring group responsible to monitor and enforce compliance and report on it on a yearly basis	**Comply or explain principle.** DVCA responsible for the guidelines, monitors compliance (comply or explain) and in 2010 will evaluate if adjustments needed	not mentioned in the document	**Comply or explain principle**. Annually BVK, will issue report on overall compliance based on reports coming from private equity companies

ANNEX X.A-6: Supporting tables for the effectiveness analysis of Codes of Conduct in private equity

Table: Effectiveness criteria: coverage/scope: to what extent are all possible actors active on private equity markets covered?

National Association member of EVCA	N° of companies receiving PE investments in 2007	Number of individual companies members of EVCA	Number of private equity firms in existence in given Member State of which N° of those who have headquarter in Member State		Number of full members of national association
			Total number of PE firms in MS	Of which -Number of PE firms with headquarter in MS	Full members
UK	963	115	432	403	210
FR	661	81	266	230	240
SE	514	32	174	149	110
DE	1088	87	305	253	217
NL	393	41	99	13	85
IT	107	34	117	93	130
FI	235	18	54	48	37
ESP	300	32	139	120	90
DK	143	19	62	49	48
AT	70		62	58	20
BE	162		77	70	43
CZ	24	4	23	13	13
GR	10		15	14	na
HU	24	5	21	9	28
IRL	67		33	26	15
PL	58	14	52	34	34
PT	59		29	25	
SK			6	2	6
RO	30	10	23	7	

Source: EVCA, national private equity and venture capital associations



Source: EVCA, own calculation

Annex X.B. Effectiveness of industry codes and best practice guidelines for Hedge Funds

Existing codes and guidelines for hedge funds:

1. Alternative investment Management Association (AIMA): Guide to Business continuity Management for Hedge Fund Managers, Guide to Sound Practices for European hedge Fund Managers, Guide to Sound Practices for hedge Fund Valuation and Offshore Alternative Fund directors' Guide.
2. IOSCO: Principles for the valuation of Hedge Fund Portfolios
3. Managed Fund Association (MFA): Sound Practices for Hedge Fund Managers
4. The Hedge Fund Working Group (HFWG): Hedge Fund Standards
5. The Presidents Working Group (PWG) on financial Markets issues report called "Asset Managers Committee Report

Table X.B.-1: Coverage of industry guidelines for hedge fund disclosures

	AIMA	HFSB	MFA	PWG	IOSCO
Reporting style	+	+	+	O	
Valuation framework	+	+	O	O	+
Past returns	O	O	+	O	
Extreme risks		O			
Factor exposure				O	
Portfolio composition					
Leverage risk	O	O		O	
Liquidity risk	O	+		O	
Hedge fund structure	O	+	+	+	
Operational risk	+	+		+	

+: detailed advice in the guideline; O: topic mentioned in the guideline
Source: EDHEC Hedge Fund Reporting Survey 2008

Recently, in its consultation report[102], IOSCO issued an overview and analysis of the effectiveness of existing codes and guidelines for hedge funds, providing further evidence of the weak applicability the existing codes have.

Summary analysis of effectiveness of industry codes and best practice guidelines for hedge funds

The key issues dealt with in the existing codes and guidelines:

– Improved disclosure practices: to make operations of hedge funds more transparent for investors, counterparties and governments
– Asset valuation: to implement valuation arrangements to address and mitigate conflicts of interest in relation to asset valuation
– Risk management: sound risk practices are essential to ensure market confidence
– Governance: to have an appropriate structure to mitigate the potential of conflicts of interest
– Shareholder conduct: to ensure a standardised best practice conduct as a minority shareholder
– Trading and business operations: given the complexity of operations, hedge funds should have appropriate infrastructures in place
– Compliance issues: commitment to highest standards of integrity and professionalism

Assessment of effectiveness of existing codes and guidelines:

– Areas covered are quite comprehensive. However they lack a clear regulatory status and consistent implementation.
– As to the regulatory status, none of the codes or guidelines has the force of law. They are a set of recommendations to be adopted on a voluntary basis. November 2008 survey of one hundred UK

102 IOSCO: Hedge Funds Oversight, Consultation Report, March 2009, http://www.iosco.org/library/pubdocs/pdf/IOSCOPD288.pdf.

hedge funds found that while over 60% supported the HFWG initiative in terms of establishing standards for industry, less than 10% signed up to these standards.[103]

– Some of the industry codes do not converge in the way as to promote the same standards and the individual organisations responsible for their development do not necessarily work together.

Source: IOSCO

Table: Summary of industry recommendations that are to be addressed by industry codes

Topics	HFWG	PWG	MFA	AIMA
Disclosure of material information to investors	Yes	Yes	Yes	Yes
Segregation of responsibilities for assets valuation/independence of valuation function	Yes	Yes	Yes (suggested, but not recommended)	Yes
Policies and procedures to calculate NAV	Yes	Yes	Yes (NAV should be marketed at fair value)	Yes (ultimate responsibilities on directors)
Valuation procedures for hard-to-value/illiquid assets	Yes	Yes	Yes	Yes
Hedge Funds should follow U.S. GAAP or IFRS	No	Yes	Yes	No
Investments in hedge funds are only appropriate for sophisticated investors after careful diligence	No	Yes	Yes	No
Hedge fund manager risk management recommendations	Yes	Yes	Yes	Yes
Anti-money laundering procedures	Yes	Yes	Yes	Yes
Business continuity/disaster recovery plans	Yes	Yes	Yes	Yes
Fund governance	Yes	No	Yes	Yes
Shareholder conduct and proxy vote policy	Yes	No	No	No
Trading and Business Operations	Yes (dealing with operational risks)	Yes	Yes	Yes
Compliance issues	Yes	Yes	Yes	Yes

Source: IOSCO: Hedge Funds Oversight, Consultation Report, March 2009

103 According to the latest report issues by the HFSB in March 2009 the number of Hedge Fund signatories increased to 45, including also international hedge fund managers. Compared to the situation in autumn 2008, the number of Hedge Funds accepting these standards has by now nearly doubled. http://www.hfsb.org/

ANNEX XI: The Lamfalussy process

The new regulatory structure of the so-called Lamfalussy process has been initiated by the Stockholm European Council Resolution of 23 March 2001 on "more effective securities market regulation". The Lamfalussy process is based around the four-level regulatory approach recommended by the Committee of Wise Men on the Regulation of European Securities Markets, chaired by Baron Alexandre Lamfalussy[104].

The Lamfalussy process was designed to make Community legislation on securities markets more flexible, so that it can be agreed and adapted more quickly in response to innovation and technological change in financial markets; to allow the Institutions to benefit from the technical and regulatory expertise of European securities regulators and from better involvement of external stakeholders; and to focus more on even implementation and enforcement of Community law in the Member States.

One of the key innovations of the Lamfalussy process is the creation of two Committees to advise the Commission on Level 2 implementing measures – the **European Securities Committee (ESC)** representing the Member States and functioning as a so-called 'regulatory committee' under the Comitology arrangements[105] – and the **Committee of European Securities Regulators (CESR)**. The two Committees were set up by Decisions of the Commission on 6 June 2001[106]. The ESC acts in its capacity as a regulatory committee, assisting the Commission in the exercise of its delegated executive powers, within the terms defined in the Directives adopted at Level 1.

Transparency is another important feature of the process. The Lamfalussy process has established a rigorous mechanism whereby the Commission seeks, *ex-ante*, the views of market participants and end-users (companies, investors and consumers) by way of early, broad and systematic consultation, with particular regard to Level 1 proposals, but also at Level 2.

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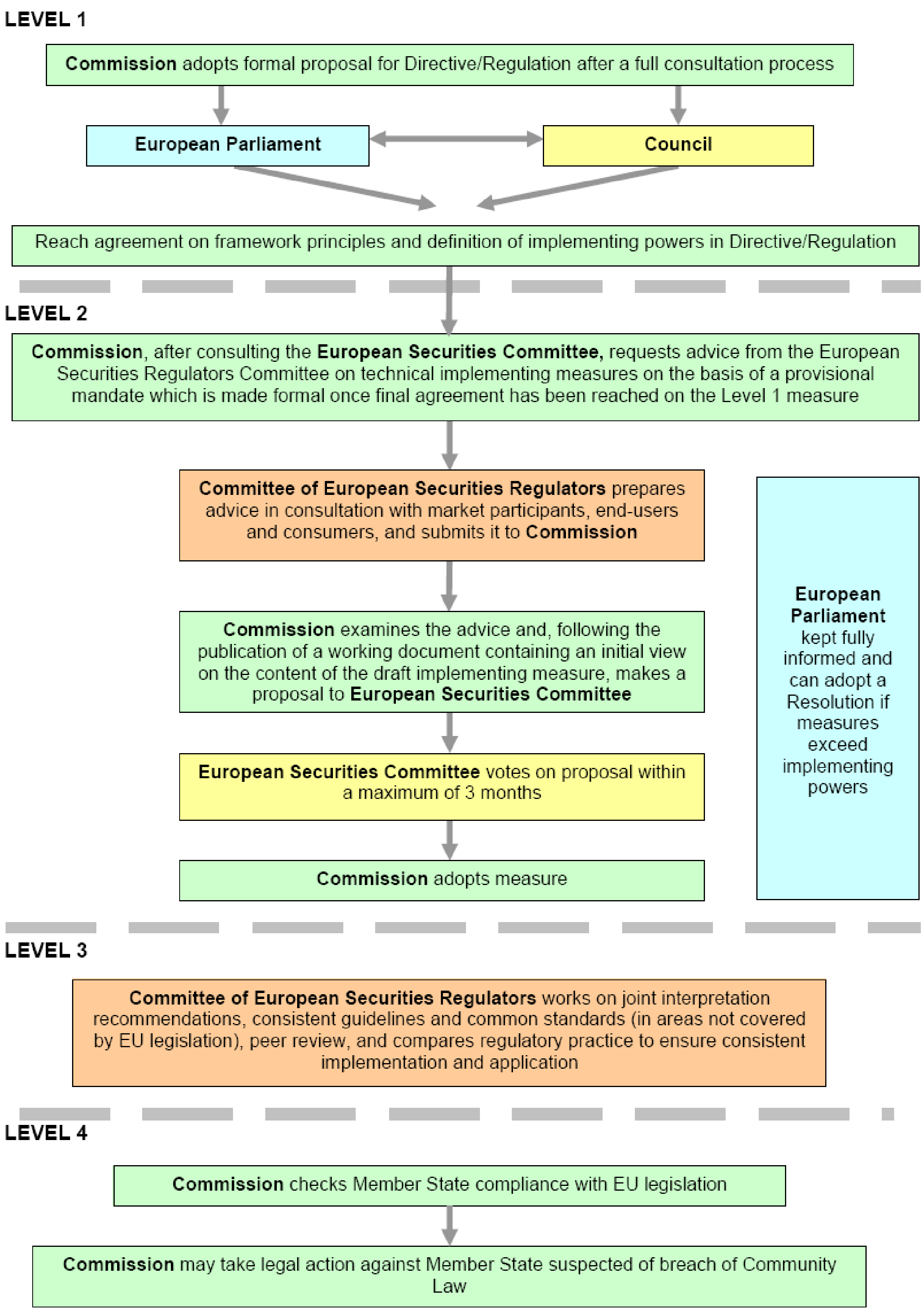
104 The Lamfalussy report, published on 15 February 2001, can be found on the Commission's website: http://europa.eu.int/comm/internal_market/securities/lamfalussy/index_en.htm

105 See Council Decision 1999/468/EC of 28 June 1999 laying down the procedures for the exercise of implementing powers conferred on the Commission, OJ L 184, 17.7.1999, p. 23.

106 See Commission Decision of 6 June 2001 establishing the Committee of European Securities Regulators (2001/527/EC), amended by Commission Decision of 5 November 2003 (2004/7/EC), and Commission Decision of 6 June 2001 establishing the European Securities Committee (2001/528/EC), amended by Commission Decision of 5 November 2003 (2004/8/EC).

- Table 1: The four-level regulatory approach under the Lamfalussy process[107]



[107] SEC(2004) 1459; the Level 2 phase will be modified following the entry into force of new comitology arrangements, anticipated for the end 2006/ beginning 2007.

ANNEX XII: References

- Consultation on hedge funds and Conference on hedge funds and private equity: http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm
- White Paper on Enhancing the Single Market Framework for Investment Funds 11/06 http://ec.europa.eu/internal_market/investment/asset_management_en.htm#white_paper
- previous AI EG (HF, PE: Reports of the Expert Groups 07/06; Public Consultation on Expert Group Reports feedback statement 10/06; http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm#alternative
- OEREF report March 08; Public consultation on report: feedback statement July 08) http://ec.europa.eu/internal_market/investment/real_estate_funds_en.htm
- previous conferences: Open Hearing on NHF April 08; http://ec.europa.eu/internal_market/investment/non_harmonised_funds_en.htm
- Private Placement Workshops Jan Feb 08; call for evidence on PP: summary doc September 07 http://ec.europa.eu/internal_market/investment/private_placement_en.htm
- IA on PP and NHF http://ec.europa.eu/internal_market/investment/private_placement_en.htm#report;
- PricewaterhouseCoopers (PWC) studies 2008: http://ec.europa.eu/internal_market/investment/studies_en.htm