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Response to the House of Lords EU Committee's Call for Evidence on the Draft EU Directive on Alternative Investment Fund Managers

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In response to the G20 pledge to regulate unregulated financial markets, including hedge funds and private equity funds the European Commission has produced a draft proposal for a Directive on Alternative Investment Fund Managers which establishes an authorisation and supervisory regime for alternative investment fund managers in the European Union in relation to their management of their funds domiciled both inside and outside of the EU.

As part of an inquiry into the proposed directive the UK Government, acting through the House of Lords Economic and Financial Affairs and International Trade Committee, invited interested parties to submit their opinions on the proposed Directive.

Dechert partners Gus Black, Jennifer O. Wood, and Adam Levin submitted their opinions on the proposed Directive to the House of Lords of committee and the substance of their response is reproduced in the following pages.

Questions 2 and 6

To what extent is there a need to create a single regulatory regime for Alternative Investment Fund Managers in the European Union?

There is already a (recently implemented) pan-EU regulatory regime covering alternative investment fund managers (AIFM) in Europe in the form of the Markets in Financial Instruments Directive (2004/39/EC).

Whilst we appreciate the drivers behind further regulation in the financial services industry following recent events, we do not consider that a case has been made to single out AIFMs for special regulatory attention. It is widely acknowledged that the alternative investment fund (AIF) industry was not the cause of the recent financial crisis. Further, many of the risks that are perceived to be associated with AIFs as regards their activities are simply not applicable to many AIFs, or are also found in other quarters of the investing community that undertake those activities and which are ignored by the Directive.

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* Susan Lark and Vanessa Giadom provided assistance with the preparation of the submission.

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Financial services regulation generally seeks to regulate behaviour or outcomes that are thought to be problematic. If certain behaviour—be it directional shorting, 'excessive' leverage or opacity—is thought to present, for example, a systemic risk (an argument which is far from conclusively made out by the Directive's explanatory notes), there seems to us to be no logical basis to single out only one specific group of market participants that could engage in such behaviour—i.e., AIFMs—for regulation.

To the extent that further regulation in the sector is found to be necessary (following proper consideration and consultation), as a general matter we would agree that it makes sense to have common standards across the EU as far as possible.

Does the Directive achieve its objectives? Should the objectives of the Directive be modified?

The Directive appears to go well beyond financial regulatory objectives, muddling these with a political agenda. We comment on certain objectives—as we understand them from the Impact Assessment to the Directive (SEC (2009) 576) and the text of the draft Directive—below.

Risk monitoring and management

We do not see how the Directive's objectives of monitoring and/or managing macro and micro prudential risks in financial markets can be achieved by requirements that apply in respect of AIFMs and AIFs but which do not apply to other large sections of the investing community such as banks, insurance companies and occupational pension funds—which nevertheless engage in exactly the same types of activity, often to a greater degree.

Consumer protection?

The Directive states at point 29 of the preamble that its objective is to ensure a high level of consumer and investor protection by laying down a common framework for the authorisation and supervision of AIFMs. We are surprised at the focus on consumers: AIFs are neither intended for, nor generally available to, "consumers" as the word is generally used in the industry: i.e., retail customers.

Consumers do ultimately benefit from AIFMs indirectly (for example, through investment of their pension funds or other investment products). Crucially, however, in such cases there is an interposed professional manager, who is best placed to take a view on the risks involved and will often only invest in AIFs following sophisticated legal and operational due diligence processes.

In our view, the Directive as currently drafted will restrict not only the choice of investment opportunities available to such professional managers, but also competition within the industry (see, for example, our comments to the following question). These are not outcomes usually associated with a pro-consumer agenda. Further, to the extent that these outcomes diminish AIF returns, they will ultimately be felt by consumers via their individual pension plans and savings products. Accordingly, we consider that the Directive as it stands fails consumers rather than protects them.

Accountability of AIFM, etc.

We understand them from the Impact Assessment to the Directive that one of the Directive's objectives is the greater public accountability of AIFMs investing in and managing companies.

Again, it is not clear why AIFMs should be singled out. Why, for example, should investors who join together to make private investments be required to disclose onerous levels of information to regulators, shareholders, etc.—when investors acting alone, or other types of investors, are not?

Will the passport system help create a single market in investments funds within the EU? How will the passport system established affect the EU and the UK industry and particularly their position in the global market?

In principle, a passport system would help to create a single market. Its potential to open up capital markets and to simplify what can be a significant and costly compliance burden, dealing with the existing patchwork of regulatory approaches is, in theory, to be welcomed.

The alternative fund industry, however, is a global industry. Provided there is "equivalent" regulation in other non-EU states it ought to be possible for managers in such states to access the EU market and vice-versa. Unfortunately, as the Directive currently stands it is not clear that any third country, including the United States, would meet the proposed standards for equivalence (please refer to the comparison appended hereto). Ultimately, the passport system will help neither the interests of the UK nor EU market if it effectively serves to deprive the market of access to third country managers and funds. Mutual market access should be negotiated at an EU level based on a minimum best practice acceptable to both the EU and elsewhere.

Question 3

What risks arise from Alternative Investment Funds? Is the Directive proportionate given the role of AIF in the financial crisis? Will the Directive introduce over-stringent regulations or does it not go far enough?

The lack of causation between AIFs and the recent financial crisis is well documented by the major reports (see, for example The High-Level Group on Financial Supervision in the EU Report (chaired by Jacques de Larosière) etc.) and we will not dwell on this. Similarly, a number of industry representatives and trade bodies have highlighted some of the costs likely to arise from the Directive, which go to proportionality (or lack thereof).

We believe it is important to distinguish the perceived risks associated with AIFs and the real risks. In our view AIFs pose little systemic risk when compared with other industry players, specifically banks. For example, evidence points to the fact that in overall terms neither hedge funds' nor private equity funds' levels of leverage have been excessive:

- Dan Waters, FSA Asset Manager Sector Leader, said in a speech to the International Fund Forum on 24 June 2009, "Some four years ago we set up a specialist supervision team to focus explicitly on hedge fund managers, and began gathering comprehensive data from the prime brokerage community that lends to them, giving us a good grip on their levels of leverage – which in recent years – including the run up to the crisis – have very typically been modest, especially in comparison to banks."

- Insofar as private equity is concerned, the World Economic Forum on the Global Economic Impact of Private Equity found, in 2008, that private equity-backed companies had a default rate of 1.2% per year, compared to an average default rate of 1.6% for US corporate bond issuers.

The policy contained in the Directive does not appear to acknowledge that the real roots of the financial crisis lay in the ready availability of debt across the board. The use of leverage by certain AIFs was a small part of the overall picture. It would seem more logical for the focus of the regulatory attention to be the debt markets or banking institutions rather than investment structures that are primarily equity-driven.

Turning to micro rather than macro risks: in our view, those best placed to assess such risks are the investment professionals. At the underlying AIFM level, in most cases managers' personal fortunes are tied to their investment performance. Further, as noted earlier, AIF investors such as pension funds often have highly developed portfolio risk and due diligence functions that carefully scrutinise AIFs both pre-investment and on an ongoing basis. The AIF industry on both sides of the Atlantic has been developing best practice standards for quite some time, with close involvement from such investors. The Directive goes considerably further than such standards. This suggests that investors themselves do not see the net benefit in such additional restrictions and indeed this is borne out by much of the feedback on the Directive from investor representatives to date.

Question 4

Is it appropriate to regulate Investment Fund Managers, rather than the Fund itself?

We believe that, in general, it is appropriate that the Directive should seek to regulate the manager rather than the funds. After all, as noted above in our response to Q.2, there is already an effective system of manager regulation in place.

The Directive is, however, overly influenced by continental European fund structures, whereby the manager frequently has a greater degree of control over the fund than is the case with certain other structures common in the marketplace. With a corporate fund, for example, strategic management and control (including, for example, the appointment of key service providers) rests with the board of directors, not the management company. Likewise, a limited partnership fund acts through its general partner.

Accordingly, to make sense and to be workable in practice, regulation of AIFMs should be confined to matters that the AIFMs can actually control in the context of the fund structure.

Does the Directive contain appropriate provisions to distinguish between different types of alternative investment?

Although the Directive distinguishes between different sorts of funds to some degree, ultimately it applies concepts that appear to be motivated by systemic risk concerns indiscriminately to all kinds of AIFs. For example:

- the concept of a depositary in the context of a private equity fund is a wholly unnecessary concept that will serve only to add an additional layer of fees, limit structuring opportunities and ultimately lead to competitive disadvantage for EU AIFs; and

- leverage limits may be aimed primarily at hedge funds, but could equally apply to other fund types, such as private equity funds, property funds or commodity funds.

It seems to us that better focused regulation that is more sensitive to the particular needs of managers of different types of investment strategies pursued by AIFs would better achieve the objectives.

Does the scope of the Directive create a danger of unintended consequences?

There has been wider commentary on potentially significant unintended consequences for the industry (which extends far beyond AIFMs themselves) and the consequential impact on the wider UK economy, which we will not rehearse here.

Here are some specific points:

- The Directive excludes non-EU managers who are nonetheless properly regulated in and by another jurisdiction (for example Australia, Hong Kong and the United States) from providing management services to AIFs. We do not believe that this restriction is in the interests of EU investors or the operation of an EU export market for the provision of fund vehicles.

- In particular, the Directive will most likely exclude EU investors from participating in anything except EU AIFs as the "equivalency" test for the approval of marketing of other regimes is not likely to be met in practice. It will hamper the ability of EU investors to access third country management talent, and will also effectively prevent EU AIFs from pursuing certain strategies that will not be compatible with the practical effect of the Directive, such as emerging market funds.

- AIFs provide valuable capital which can be deployed in all manner of situations: venture capital, private equity, real estate development, etc. The Directive will restrict the flow of this capital, in turn affecting jobs, local economies, etc. This consequence is exacerbated by the current dearth of capital available from other quarters.

- See our other responses for detail on some other unintended consequences. For example, see responses to questions 4 and 7.

Question 7

Does the Directive contain appropriate rules on leverage?

We believe that the rules on leverage in the proposed Directive are commercially unworkable. If one fund in a group of funds managed by the same AIFM uses leverage up to a certain point, the terms of the Directive may prevent any other fund managed by that AIFM from using leverage. However, in general, funds managed by the same AIFM are not affiliated and so the use of a high level of leverage by one will not affect the others. AIFMs may have different objectives for different funds and the rules on leverage in the Directive could actually harm an AIFM's ability to manage separate funds.

Private equity funds are generally leveraged on an investment-by-investment basis so that, absent any bridging loan, the failure of one investment due to excessive levels of leverage will not even present a failure risk to the fund overall, let alone the market.
See also our comments at question 3 above.

Is the requirement for independent valuation agents and depositaries for Alternative Investment Funds adequate?

See question 4 for our comments on the inappropriateness of depositaries for private equity funds (which apply equally to certain types of real estate funds and others whose assets are not held in custody in the same way that securities are). The same might be said of valuation agents for closed-ended private funds that are not traded. The Directive also fails to strike an appropriate balance between the advantages of independent valuation (where appropriate) and the fact that the manager may actually be best placed to value assets in many circumstances—meaning that the Directive could result in less accurate valuations than would otherwise be the case.

The Directive effectively states that no custodian (depositary) outside the European Union is suitable to act as custodian for funds. It is worth noting that the UCITS Directive does not impose similar geographic restrictions on the use of sub-custodians for UCITS funds, reflecting the needs of the market: and this is in a retail context. The Directive also creates a situation where the depositary could be subject to semi-strict liability for the potential frauds of other parties and other matters. It is also worth noting that a lot of valuable asset servicing expertise, in the form of fund administrators and other parties, does not reside in institutions who would be eligible to become "depositaries".

These requirements, especially the high standard of liability and the requirement that depositaries be EU-authorised credit institutions, will in all likelihood reduce the number of institutions willing or able to carry out this service (potentially leading to concentration risk and increasing the impact of institutional failure) and will also lead to a significant increase in the costs that AIFs will have to bear. Moreover, the level of liability to which depositaries would be subject would no doubt force a change in the service level arrangements under which the depositary is willing to operate, thereby potentially limiting the ability of some AIFs to engage in transactions in some countries or engage in transactions with certain counterparties. Again, the end effects of these restrictions will be felt by those who ultimately invest in AIFs—primarily EU individual investors.

For example, limitations on sub-depositaries would make it difficult or even impossible for an EU-domiciled AIFM to manage an AIF with a global or emerging markets strategy and for any AIF with such an objective to be established in the EU, since sub-depositaries around the world are typically used by AIFs not investing solely in the EU and are often required in order to operate such a strategy. Why should EU investors be deprived of the chance to participate in such strategies?

Question 8

Will the provisions strengthening disclosure requirements help to create a more transparent market or do they go too far?

As the Directive only applies to EU based AIFs, the disclosure requirements regarding controlling influence in companies will not ultimately achieve a more transparent market across the board, as non-EU based AIFMs and other industry players that are not categorised as AIFMs will not need to

adhere to the same rules. This will create an uneven playing field for EU AIFs against all other market participants.

In addition, there are dangers in disclosing too much. For example, disclosure of information relating to strategy, development and any other 'forward-looking' information may be abused by third parties or serve to fetter management discretion in reacting to future developments. Given that some of the proposed disclosure requirements in relation to private companies go beyond that which is required in relation to listed companies, the case for requiring such disclosure needs to be better made.

Question 10

How does the Directive compare to existing or proposed regulation of Alternative Investment Funds outside of the European Union, particular that of the United States? How will the Directive affect the position of EU Alternative Investment Funds in the global market?

Please see the table attached as Appendix which compares requirements under the Directive to current and proposed US requirements.

Appendix

Category	Requirement under Proposed Directive	Corresponding Current or Proposed US Requirement
Authorisation/Registration required for EU-based manager required to:		
Manage EU-based funds?	Yes	No
Manage non-EU based funds?	Yes	Maybe. **Current:** Yes if fund is US-based and the fund is one of 15 or more US-based clients the EU-based manager has had during the preceding 12 months or the EU-based manager holds itself out as an investment adviser in the United States **Proposed:** Yes if (i) fund is US-based and the fund is one of 15 or more US-based clients the EU-based manager has had during the preceding 12 months or (ii) fund (directly or in combination with other similar funds managed by the EU-based manager) has assets under management of at least $25 million attributable to US investors, or the EU-based manager holds itself out as an investment adviser in the United States
Market EU-based funds in EU?	Yes	No
Market non-EU based funds in EU?	Yes	No
Market EU-based funds in US?	No	Maybe **Current:** No requirement for registration as an investment adviser but registration as a broker dealer may be required depending on the facts and circumstances
Market non-EU based funds in US?	No	Maybe **Current:** No requirement for registration as an investment adviser but registration as a broker dealer may be required depending on the facts and circumstances
Authorisation/Registration required for US-based manager required to:		
Manage EU-based funds?	Yes, but not permitted	Maybe. **Current:** Yes if fund is one of 15 or more clients the US-based manager has had during the preceding 12 months or the US-based manager

Category	Requirement under Proposed Directive	Corresponding Current or Proposed US Requirement
		holds itself out as an investment adviser in the United States **Proposed:** Yes if the US-based manager has AUM of $30 million or more
Manage non-EU based funds?	No	Maybe. **Current:** Yes if fund is one of 15 or more clients the US-based manager has had during the preceding 12 months or the US-based manager holds itself out as an investment adviser in the United States **Proposed:** Yes if the US-based manager has AUM of $30 million or more
Market EU-based funds in EU?	Yes, but not permitted for 3 years after adoption	No
Market non-EU based funds in EU?	Yes, but not permitted for 3 years after adoption	No
Market EU-based funds in US?	No	Maybe **Current:** No requirement for registration as an investment adviser but registration as a broker dealer may be required depending on the facts and circumstances
Market non-EU based funds in US?	No	Maybe **Current:** No requirement for registration as an investment adviser but registration as a broker dealer may be required depending on the facts and circumstances
Are there de minimis exemptions to requirements for authorisation?	Yes, for managers with AUM less than €100 million	Yes. **Current**: Yes, for managers with fewer than 15 clients during the preceding 12 months and who do not hold themselves out in the United States as investment advisers **Proposed**: Yes, for US managers with AUM less than $30 million.
May a manager opt into authorisation to manage funds?	Yes	Yes
Permitted to delegate to other managers in the EU?	Yes	Yes

Category	Requirement under Proposed Directive	Corresponding Current or Proposed US Requirement
Permitted to delegate to other managers in the US?	No	Yes
Does the manager need to seek further authorisation prior to managing or marketing new funds?	Yes	No
Is the manager required to identify and disclose conflicts of interests?	Yes	Yes
Is the manager required to separate risk management and portfolio management functions?	Yes	No
Is the manager required to adopt risk management procedures and review them annually?	Yes	Yes if required to be registered (see above)
Is the manager obligated to ensure that the fund implements a redemption policy appropriate to the liquidity profile of fund investments?	Yes	No
Is the manager required to adopt liquidity management procedures?	Yes	Yes if required to be registered (see above)
Is the manager required to maintain own funds capital?	Yes	No
Is the manager obligated to ensure an independent valuator has been appointed in respect of the fund?	Yes	No
May a third country valuator be appointed?	Yes, subject to limitations	Yes
May a third country administrator be appointed?	Yes, subject to limitations	Yes
Limitations regarding depositories	Yes, must be an EU credit institution	Yes, must be either: (i) a US bank or FDIC insured savings association; (ii) a US registered broker-dealer holding client assets in customer accounts; (iii) a US registered futures commission merchant holding client assets in customer accounts, but only with respect to clients' funds and security futures, or other securities incidental to transactions for the purchase or sale of a commodity for future delivery and options thereon; or (iv) a non-US financial institution that customarily holds financial assets for its customers, provided that the non-US financial institution keeps the advisory clients' assets in customer accounts segregated from its proprietary assets.
Are there limitations on delegation to third country depositories?	Yes, only permitted in very limited circumstances.	Yes, must be a non-US financial institution that customarily holds financial assets for its customers, provided that the non-US financial

Category	Requirement under Proposed Directive	Corresponding Current or Proposed US Requirement
		institution keeps the advisory clients' assets in customer accounts segregated from its proprietary assets.
Are there specific mandatory disclosures that must be made to investors regarding the terms of the fund?	Yes	No, but anti-fraud rules apply
Are there mandatory leverage limitations?	Yes	No
Are managers required to make reports to the regulator regarding the use of leverage?	Yes	Maybe **Current:** No **Proposed:** Yes