

Evidence on the Alternative Investment Fund Managers Directive (AIFMD) **By Dr Syed Kamall, MEP for London (Conservative)**

This Submission

This submission is the personal evidence of Syed Kamall MEP, the Shadow Rapporteur on the Alternative Investment Fund Managers Directive (AIFMD). It does not seek to describe the Directive in detail but to contextualise the background and the potential impacts of the Directive.

Summary

The principal point made in this submission is that this is an unnecessary Directive which will only serve to limit the growth of the financial services industry in London and across Europe. Furthermore, the draft directive was drafted in a hurry and there has been no thorough economic impact assessment. Although this Directive now looks inevitable, the Council of the European Union and the European Parliament may be able to amend the Directive significantly in order to limit its regulatory scope.

Political Background

There has always been a degree of antipathy on the Continent of Europe towards the way in which the Anglo-Saxon economies buy and sell large numbers of shares in companies and the consequent frequency in the change of control of companies. Takeovers by private equity vehicles, because they often result in restructuring of companies are sometimes portrayed as undermining the European concept of “social solidarity”, even though such takeovers may save jobs and even create new ones, especially where the company that was taken over had been performing badly.

It has emerged in the media this summer that as far back as April 2007, before the credit crunch was widely understood or predicted by most economists, the German Government favoured coordinated action to regulate hedge funds.¹ Germany was enjoying a current account surplus and there were significant money flows out of the country so it had an interest in ensuring that German money was not flowing into risky financial instruments. At the time they regarded the unregulated hedge funds as risk-takers; it subsequently turned out that the regulated commercial banks were far higher leveraged and invested in generally much riskier derivative instruments (often mortgage-backed).

In 2007, socialist Members of the European Parliament, former Danish Prime Minister Poul Nyrup Rasmussen and Ieke Van den Burg from the Netherlands published a report reproving hedge funds, *Hedge Funds and Private Equity: A Critical Analysis*.² The following year the same MEPs pushed for regulation in an own-initiative report³. Although own-initiative reports from the European Parliament are not legally binding, they are often foreshadow draft Directives such as the one we now have before us.

¹ <http://waugh.standard.co.uk/2009/08/brown-ignored-warnings-re-toxic-loans-and-financial-crisis.html>

² http://www.pes.org/downloads/Hedge_Funds.pdf

³ <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+COMPARL+PE-404.764+01+DOC+PDF+V0//EN&language=EN>

For its part, the European Commission resisted regulating hedge funds for two years. But politicians in the European Parliament have seized on the credit crunch as reason to look again at regulating hedge funds and private equity. This is despite there being scant evidence that either forms of alternative investment were the cause of the credit crunch. (The commercial banks were far more highly geared than most investment funds and it was their failure to run themselves properly and the regulatory authorities' failure to oversee their risks that resulted in them running into trouble.)

It has proved convenient for elected politicians to play to their electorates by trying to blame the credit crunch on a few "greedy" individuals investing in hedge funds. The blame should in fact lie with the politicians, regulators and bankers who were complicit in allowing credit to be overextended to people who could not afford the homes they were buying, and who allowed bankers to buy securities the underlying value of which they knew very little. To its credit, the European Commission has stated in the preamble to the Directive that "AIFM were not the cause of the crisis"⁴.

80% of Europe's hedge funds managers and 60% of Europe's private equity managers are located in London. Both the German and French governments, during their Presidencies of the EU from January - July 2007 and July - December 2008 respectively, encouraged the Commission to work up a draft Directive. The new Swedish Presidency has been more conciliatory in tone, and there may be significant amendments made to the text of the Directive before it is passed into law.

Now the draft Directive will pass to the Council and the European Parliament for consideration under the co-decision procedure. The Commission has indicated that it hopes the Directive can be adopted by the end of the current year with implementation by Member States required by the end of 2011.

Scope of the Directive

The Directive on Alternative Investment Fund Managers covers a number of "alternative" investment funds such as hedge funds, private equity, commodity funds, real estate and venture capital funds.

Hedge funds and private equity are very different investment vehicles. That they are clumped together under this draft regulation is odd. Private equity investments tend to be longer term investments in which the investor takes ownership of all or part of a company with a plan to sell this share at a profit (usually) within a few years. Hedge funds, on the other hand, invest in a range of instruments on behalf of people and organisations such as high net worth individuals, insurance companies and pension funds.

The risks in these types of investments are much the same as those of any other type of investment. In investment there is always a risk of failure, this is intrinsically how markets function. Hedge funds may be risky in that often they are managed by individuals and deal with large sums of money. Most hedge fund managers earn their profit through management fees which are, in most cases, a percentage of the total value of the fund. Therefore, hedge fund managers have an incentive to act prudently in their investments as failure will result in a loss for them as well as the investor.

⁴ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2009:0207:FIN:EN:PDF> (p. 3)

Although performance fees may create the incentive for managers to take unnecessary risks with investors' assets, high-water marks are often used to discourage this sort of volatile trading. People who invest in such funds should (and in most cases do) act prudently when investing and are often looking to "riskier" investments as potentially producing higher returns for their overall investment portfolio.

Impacts of the Directive

Capital adequacy - The draft Directive's rules on capital requirements are intended as an insurance that funds can meet investor claims. For AIFMs with significant funds under management, the 0.02% capital add-on will place severe pressure on their capital resources. It represents a significant jump from current rules in the UK where AIFs require enough capital to meet basic payrolls, this frees up capital for more investment. The new requirements are unnecessary for many funds that use lockup periods to limit investor withdrawals and this jump in requirements can also cause barrier to entry to markets for new managers and therefore may hinder competition. Many Member States of the EU do not currently have capital requirements at all; so the UK is already ahead of many other Member States in this respect and our capital requirements have proven sufficient for us in the past.

Leverage - The draft Directive intends to impose limits on the amount of leverage that managers of alternative investments can employ. I do not believe that the investment strategies of fund managers should be restricted in this way or that government should be the judge of risk. Investors know the risks and should pay the consequences and lose their money if these funds do poorly. (Taxpayer bailouts for failed ventures should not be an option.)

Disclosure - Managers should not be made to make information about borrowing and leveraging public. This would discourage competition in the industry. It may be prudent to see that alternative investment fund managers disclose information on their assets and risk to relevant authorities in their Member States, and that this information is not disclosed to the market. Potential investors should research information on risk before investing.

Custody - The draft Directive, if implemented in its current form, would make it very difficult for investment managers to invest in funds that are not domiciled inside the EU. This would apply to the majority of hedge funds and other investment funds managed in the UK, as the portfolios themselves are often located in other countries.

We could well face a scenario where hedge funds do not relocate their portfolios into European credit institutions. My conversations have revealed that fund managers could instead relocate to Switzerland, Shanghai, Delaware or Dubai. Far from increasing tax revenue in EU member states, this Directive could reduce it by pushing fund managers out of the EU altogether.

Unemployment would follow and exodus of the hedge fund industry from London. The City has already incurred many job losses. The lost jobs in the hedge fund industry would not return.

It is crucial to remember that investors and fund managers are not the only beneficiaries of AIFs. Pensioners in Europe could also be affected. Many private

pensions invest with hedge funds. One study⁵ shows that this Directive could cost the European private pension industry €25 million and limit options for pensioners. Some European Member States' pension industries rely very heavily on AIFs, the Dutch pension industry for example would be extremely jeopardised under the current regulatory framework.

It is also important that such funds retain the ability to takeover and turn around failing companies in order to save jobs and local communities.

It is also vital that a thorough investigation into other beneficiaries and groups that depend on AIFs, such as homeowners, charities, and consumers, is prepared before implementation of the Directive is completed.

Conclusion

We need to be sure that this legislation will not drive investment out of Europe. It would be wise to study the legislation being considered in other countries, such as the more measured approach of the Obama administration. The Financial Services Authority has announced that it will publish a cost analysis of the EU Directive later this year. The City is only just waking up to the implications of the Directive but I expect the clamour for it to be amended to grow in the coming months.

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⁵http://www.aima.org/en/media_centre/press-releases.cfm/id/7B789862-0DD2-40C9-A0547A7687F4C51D