

CD/SJ - n° 2620/Div.

Mr Robert Whiteway
Clerk of EU Sub Committee A
Committee Office
House of Lords
London SW1A 0PW

Paris, 9th September 2009

**AFG response to the House of Lords' Call for Evidence regarding
the proposal for a Directive on Alternative Investment Fund Managers**

Dear Mr Whiteway,

The Association Française de la Gestion financière (AFG) welcomes the House of Lords' call for evidence regarding the proposal for a Directive on Alternative Investment Fund Managers.

For your information, the Association Française de la Gestion financière (AFG) represents the France-based investment management industry, both for collective and discretionary individual portfolio managements.

Our members include 409 management companies. They are entrepreneurial or belong to French or foreign banking or insurance groups.

AFG members are managing 2500 billion euros in the field of investment management, making in particular the French industry *the leader in Europe in terms of financial management centers for EU collective investment funds* (with nearly 1500 billion euros managed from France, i.e. 22% of all EU investment fund assets under management), wherever the funds are domiciled in the EU, *and second at worldwide level after the US*. Taking into account global asset management (i.e. funds and mandates), France ranks second in Europe after the UK.

In the field of collective investment, AFG represents – besides UCITS – the employee savings schemes and products such as regulated hedge funds, regulated funds of hedge funds as well as a significant part of private equity funds and real estate funds.

AFG is of course an active member of the European Fund and Asset Management Association (EFAMA) and of the European Federation for Retirement Provision (EFRP). AFG is also an active member of the International Investment Funds Association (IIFA).

We wish to express the following views on the AIFM proposal released by the European Commission.

1. [What economic benefits arise from AIF? What risks to financial markets arise from AIF? Will the Directive help reduce these risks?](#)

AFG regrets that the Commission proposal was not properly submitted to public consultation beforehand, contrary to the usual practice. We are also concerned that this proposal was launched in a very highly political context (G20 plus European Parliament requests), while a smoother way of preparing the proposal would have avoid too intense and unnecessary debates once the proposal was released.

We were advocating for a directive in this field (“alter-UCITS”) for a very long time. If we had been heard – but we were not, as many players from other countries (including in the UK) were against any text – there should have been enough time for in-depth consultations.

From a pragmatic perspective, now that a Directive is going to be adopted sooner or later because of this political context and because we think a directive is necessary anyway, we consider that if rightly amended, the AIFM Directive will bring two main advantages from a European point of view – which is the natural point of view to take into account when assessing a European piece of legislation.

First, through a so called ‘European passport’, it will make the Single Market a reality for those European AIF funds who will choose to follow the Directive’s requirements, while today such a Single Market does not exist. Currently, only so-called ‘UCITS’ funds covered by the UCITS Directive are allowed to be passported throughout the EU. The new, complementary, passport for AIFs would bring both additional business opportunities for European management companies promoting such funds and a widening of investment choices for European investors as they will see a wider range of funds actively marketed to them.

Second, this new piece of legislation will facilitate the development of a worldwide brand for European AIFs, as for instance the UCITS Directive helped developing a worldwide brand for EU UCITS.

Regarding the risks to financial markets that you mention, we don’t see how or why this Directive could/would bring additional risks. But we regret that systemic issues are officially mentioned as a reason for proposing such a Directive, as we don’t consider that most AIFs imply systemic risks that are not already caught. We think that to a large extent this systemic dimension “pollutes” the real issue for AIFs from a European perspective, which is to set up both a Single Market and a worldwide brand for them.

2. To what extent is there a need to create a single regulatory regime for AIFM in the EU? Does the Directive achieve its objectives? Should the objectives of the Directive be modified?

AFG has been calling for the creation of an AIF passport for years (“alter-UCITS”). Indeed, most European management companies wish not to limit their activities to national boundaries; therefore the ability to passport their funds within the Community will help them reduce their costs, which will in turn benefit consumers. Competition will increase and investors will have a broader choice. Besides, the creation of a single regulatory regime at EU level will reduce regulatory arbitrages and decrease legal uncertainty, and thus will directly enhance investor protection. Finally, we believe that, like the UCITS passport, the passport for European AIFs will encourage the development of the AIF industry in the EU and the creation of a recognised brand that will be more easily exported to third countries.

However, like the UCITS passport, the AIF passport should be limited to EU-domiciled funds and managers. There is a crucial need to restore confidence in investors’ minds. If the AIF passport should be extended to non-EU funds and managers, it would imply that a fund domiciled anywhere in the world could be actively marketed throughout the EU. One tricky point is that in case of blowing out of a non-EU AIF, the European investor would have to go before a non-European judge – where the fund is domiciled – to try getting its money back. There is a high risk of non-recovery, and therefore any scandal could harm the whole investment fund industry at large, without making the difference between the European industry and the others.

A crucial point is to take into account the new profile of European professional investors – which are the investors to which AIFs could be actively marketed. According to a recent FSA study¹, more than 80% of investors in Hedge Funds are institutional investors – for instance pension funds - and not high net worth individuals. Through pension funds or municipality funds, the risks are spread indirectly to final investors which may be retirees or local tax-payers. As AFG is very concerned about keeping investor confidence in the long run, we want to avoid taking such a legal risk (which may ultimately

¹ See Annex 5 of the International Organization of Securities Commissions (IOSCO) Consultation Report on Hedge Funds Oversight, March 2009, page 63

lead to a political risk in some cases) and therefore we think that the EU passport should be limited to EU-domiciled funds and managers.

As a complementary element to this EU passport limited to EU funds, we suggest keeping the existing national private placement regimes in place, in order to keep national flexibilities in active marketing of non-European funds to local investors. Said more clearly, EU countries should remain free to grant a “national visa” (which is different from a passport) to non-EU funds that they thought could be authorised to be sold to or bought by their national investors. The only caveat is that it could, if it is felt necessary, be decided that the possibility to grant these “visas” will in the future be restricted to non-EU AIFs registered in jurisdictions applying IOSCO rules and principles.

Thus, we think that European professional investors (if, of course, their own sectorial regulations make it allowed) should be kept free to invest in non-EU funds if their wish to do so, but on their own initiative and under their own responsibility.

Last but not least, in terms of legislative approach, we think crucial that as far as possible the AIFM Directive provisions be similar to the UCITS Directive ones, in order to ensure a level playing field between UCITS funds and AIFs. Our aim is to avoid any circumvention of the UCITS Directive, i.e. the risk to see some providers changing slightly the characteristics of a UCITS fund in order to make it non-compliant anymore with the UCITS Directive and to make it benefit from the AIF passport which could be less onerous.

3. What risks arise from AIF? 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?

As a complement to what we mentioned in our answer to Question 1, AFG would like to highlight the fact that alternative funds do not necessarily imply excessive or speculative risks, even though some alternative funds may use speculative techniques. Many strategies for Hedge Funds for instance – such as Long/Short strategies – do not necessarily entail higher volatilities than direct investment by investors in equities.

In addition, in the context of the recent financial crisis, hedge funds have been pointed at; however, it has been shown that they were not responsible for the crisis.

As we mentioned in our answer to Question 1, the Directive was hastily drafted in times of strong political pressure. It was designed with two specific types of funds in mind (i.e. hedge funds and private equity funds) but structured in such a way as to encompass all management companies managing all types of funds apart from UCITS funds. Hence, some inconsistencies it resulted in particular in inconsistent rules for the different types of funds potentially covered.

A way to amend the Directive on this point could be to let purely national AIFs out of the scope of the Directive, making it mandatory nonetheless that all national funds and asset managers are subject to the oversight of a national regulator.

4. Is it appropriate to regulate Investment Fund Managers, rather than the Fund itself? Does the Directive contain appropriate provisions to distinguish between different types of alternatives investment? Does the scope of the Directive create a danger of unintended consequences?

We are not opposed to the fact that regulation concentrates on Managers rather than on Funds. To a large extent such an approach makes sense as an over-rigid regulation of the Funds themselves would not fit with the ‘raison-d’être’ of hedge funds or private equity funds for instance, which require a high degree of flexibility by nature.

However, we believe that for some specific provisions the Directive should contain appropriate provisions to distinguish between different types of AIF and allow for particular considerations regarding specific AIF (for instance real estate funds and private equity funds). For example, we think that the provisions on leverage are not appropriate to be applied to private equity funds.

5. What is your evaluation of the Commission's consultation in the preparation of the Directive?

As already said in our answer to Question 1, AFG can only regret that stakeholders were not publicly consulted by the Commission beforehand on a draft proposal for a Directive – contrary to what is usually done. At the same time it should be recognised that many of those who are now complaining about this situation were, not so long ago, completely opposed to any EU regulation and thus not very open to debates or consultations – although the Commission did organise workshops and hearings on the subject in the past few years.

6. 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?

We are fully convinced that the passport system will help to develop a truly single market in investments funds within the EU as long it is limited to EU funds and managers. It will increase cross border business and reduce costs. It will also widen the choice of investments for European investors. In addition, we strongly believe that it will facilitate the growth of the European AIF industry out of Europe by creating a recognised brand (in the same way the UCITS Directive encouraged the development of the UCITS industry). Conversely, if the benefit of the AIF passport were extended to non-EU AIFs and non-EU managers (but it does not make sense to grant a European passport to non-European entities or funds), the active marketing of non-EU funds to European investors, such as European pension funds and municipality funds, would create legal risks and potentially political risks as well in case of blow out.

7. Is the threshold for defining "systemically relevant" AIF appropriate? Should the Directive include provisions on capital requirement? Does the Directive contain appropriate rules on leverage? Is the requirement for independent valuation agents and depositaries for AIF adequate?

- Definition of systemically relevant AIF

AFG agrees with introduction of thresholds. We feel that the thresholds are low enough to encompass the vast majority of AIF while leaving small entities that do not present systemic risk out of the scope of the Directive (these entities may nonetheless choose to opt-in), but we are not against further discussion on their level and scope.

- Provisions on capital requirement

The provisions set by the Directive on capital requirement are generally aligned on those set by the UCITS Directive. However, the maximum amount of capital required in the UCITS Directive should also apply to AIFM. Besides, we are of the opinion that the inclusion of delegated portfolios in the portfolio of an AIFM is not justified, as these portfolios are already taken into account in the portfolio of the delegating AIFM. The legal risk relating to the delegated portfolio lies with the AIFM that delegated its management. This is the approach taken by the UCITS Directive and it should be adopted by the AIFM Directive.

- Rules on leverage

The provisions on leverage contained in the Directive are not appropriate.

First and foremost, we believe that these provisions on leverage should not apply to Private Equity funds.

In addition, the Directive does not give a sufficient definition of leverage and how it should be calculated. Indeed, the definition of leverage is complex and should perhaps be described in further detail in level 2 measures.

For instance, AFG feels that a threshold of 2 is arbitrary and too low. In any case, we believe that the level of leverage can only be appreciated with regards to the liquidity of the assets in the portfolio. Also, the limits imposed to AIF should not be more stringent than limits imposed on banks (there is a risk of creating an unlevel playing field if this is not the case).

More importantly, these limits should anyway not be set by the Commission, as it is not a regulator. Rather, limits - if they were finally considered as necessary - should be decided by Member States' regulators, but only in exceptional and temporary circumstances and in collaboration with CESR in order to ensure a similar application for the whole EU. Conversely, on a permanent basis, there is no reason to limit leverage: the flexibility of the leverage is frequently a major characteristic of AIFs.

Finally, AFG believes that the disclosed information regarding systemic risk needs to be centralised at a European level, as the scope of vision regarding systemic risk will not be wide enough if it remains at national level. We therefore suggest that CESR should be the co-recipient of information on leverage, along with the home Member State regulator, or receives automatically this information from the home Member State regulator.

- Requirement for independent valuation agents

We strongly contest the requirement of an independent valuator set by the Directive.

Indeed, the notion of 'independent valuator' is contrary both to the existing regime of the UCITS Directive and to many national regimes regarding non-UCITS funds. No market failure would justify a change from the current regime. According to the UCITS Directive and such national regimes, the Management Company is the single entity responsible for this valuation, even though it may outsource the valuation function.

For instance, the competence of real estate or private equity fund managers resides in their professional skills to value real estate or private equity or to confirm the valuation done by an external valuator. In many cases, the establishment of the value of the assets acquired by the AIF relies on the knowledge of the AIFM and this exercise cannot be done without the involvement of the AIFM.

In addition, the use of an independent valuator could increase the final risk for investors as it will legally imply an additional player in the value chain and will reinforce the uncertainty for the respective responsibilities of all these players.

Moreover, the notion of 'independence' is ambiguous. Does the Directive refer to legal or capitalistic independence? The Directive explains that implementation measures will be taken but this leaves room for interpretation and at this stage we can not be assured of the final result.

Finally, if the Management Company were not responsible for the valuation, there would be a risk that it might care less about the valuation's accuracy, which would be prejudicial to investors.

As a conclusion, we firmly believe that valuation should be a function, not an entity, and part of the management function (in the same way Annex II of the UCITS Directive includes valuation as part of administration and in turn management services). It could be carried out by the AIFM itself or outsourced under the responsibility of the AIFM. If carried out internally, the valuation should be made by a function autonomous from the investment management function. However, the principle of proportionality should apply depending on the size / nature of the AIFM. If needed, level 2 measures could provide for relevant conduct of business rules.

- Requirement for depositaries

First and foremost, AFG believes that there is an urgent need to take into account the Commission's consultation on UCITS depositaries, in order to ensure consistency between the two regimes, if not identical regimes. The provisions of the Directive should definitely incorporate the findings of the Commission's consultation on the UCITS depositary function, in particular the definition of safekeeping and the need for a unique depositary.

Second, we think that the provisions of the Directive should be aligned on those of the UCITS Directive as far as possible. The differences between the Directive and the UCITS Directive related to depositaries should be solved if they do not appear justified. An identical treatment is necessary in order to ensure a level playing field between the regulation applicable for UCITS and AIF.

- AFG notes that, contrary to the UCITS Directive, the Directive does not include any control function in the list of tasks performed by depositaries. We therefore suggest assigning control functions, in addition to safekeeping, to depositaries of AIF.
- Furthermore, the Directive establishes de facto a depositary passport which currently does not exist for UCITS: in practice, the AIFM Directive would allow for EU AIFs to get a depositary domiciled in another Member State than the fund domicile. We are not opposed to the principle of such a depositary passport, but it should be introduced only when a similar depositary passport is offered to UCITS funds in the UCITS Directive (which is not the case today).

Third, the Directive should tackle the subject of the role and responsibilities of prime brokers. The role and responsibility of the depositary can only be examined in light of the activity of prime brokers. Indeed, the Directive does not take their role into account at all. But it is crucial that it clarifies how the roles of the AIFM, the depositary and the prime brokers will articulate, especially if prime brokers are located outside the Community.

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

AFG believes that some of the information disclosure requirements imposed to AIFM managing AIF which acquire controlling influence on companies are disproportionate. The Management Company should not be required to provide information to employee's representatives, but rather to Management, who may then pass it on to employees' representatives.

In particular, the obligation to disclose the development plan to shareholders and representatives of employees does not make sense. This is confidential information and it should be kept within the company and not publicly disclosed (this might distort competition). This is not required in other areas of the industry so why should it apply to AIF? We need a level playing field between AIFs' and other shareholders' disclosures.

9. What effect will the Directive have upon the position of the City of London and the EU as a whole as a leading location for Investment Fund Managers? Could it cause many hedge funds to relocate outside of the EU? What impact would the Directive have upon professional investors and institutions?

We strongly think that the AIFM Directive will enhance the position of the EU – including the UK – at global level, both by facilitating the passporting of AIFs throughout Europe and by setting a brand complementary to the UCITS one for worldwide distribution. Of course it will not prevent competition to continue between the different current financial management places (London, Paris, Frankfurt, etc) but we are not afraid by such a continuing competition, as in any case we will all of us take benefit from a developing AIF market both at EU level – thanks to the passport and a wider offer for EU investors – and at global level – thanks to the new worldwide brand given by the Directive to European AIFs.

But it implies obviously that the benefit of the passport is limited to EU funds, as otherwise it could create legal risks for European investors (see our answers to Questions 2 and 6 above) and no EU brand could be set up (national entry visas to non-EU funds obeying IOSCO rules and principles should anyway still be granted by countries who wish to do so).

10. How does the Directive compare to existing or proposed regulation of AIF outside of the EU, particularly that of the US? How will the Directive affect the position of EU AIF in the global market?

Currently the US is preparing a regulation of Hedge Funds managers, with a higher degree of requirements than today. Although the details of this forthcoming regulation are not known yet, it shows that both sides of the Atlantic are taking to some extent the same orientation.

From a competition perspective, the crucial issue for the EU is to make sure that the EU Directive will find the best mix between light touch regulation and investor protection (especially taking into account the growing part of EU investors composed of retirees through pension funds and taxpayers through municipality funds). But the ultimate aim of the Directive must be to set up a framework for EU AIFs which is able to compete in the best way with non-EU ones – as it was successfully found with the UCITS Directive, which facilitated the worldwide selling of European mutual funds.

11. What effect will the Directive have on flows of capital and financial innovation?

It is clear that EU financial innovation will be stimulated by the Directive, if it is properly drafted of course, as there will be new business opportunities at stake for EU AIFs, both within the Single Market (thanks to the EU passport) and at global level. But conversely, if the passport were extended to non-EU funds and managers, the Directive would have a negative impact on the development of the EU AIFs, as non-EU AIFs as easily as EU AIFs to European investors: sooner or later a blow out from non-EU AIFs would harm EU investors and ultimately create prejudice to the whole investment fund industry, without differentiating EU funds and non-EU funds.

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We thank you in advance for your attention to the views expressed above.

If you wish to discuss the contents of this letter with us, please do not hesitate to contact myself at +33 1 44 94 94 14 (e-mail: p.bollon@afg.asso.fr) or Stéphane Janin, Head of International Affairs Division at +33 1 44 94 94 04 (e-mail: s.janin@afg.asso.fr): as it is a very touchy and controversial matter, we firmly believe that constructive interaction between all stakeholders is very much in need.

Sincerely,

Pierre BOLLON