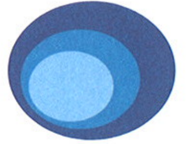

NAPF
Securing the future of pensions

14 September 2009

Mr Charlie McCreevy,
European Commissioner for Internal Market and Services,
European Commission,
B-1049 Brussels,
Belgium.

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Dear Mr McCreevy,

Proposed Alternative Investment Fund Managers Directive

I enclose a representation on behalf of our pension scheme members, setting out our concerns about the proposed Alternative Investment Fund Managers Directive.

We welcome certain aspects of the proposed directive, in particular the proposal that all alternative investment fund managers should be authorised and the provision of a European passport for marketing alternative investment funds to professional investors. We believe that in other respects the directive is misguided. Its wide scope fails to differentiate between the different types of institution in the alternative investment management space and their differing business models, and it fails to take into account existing regulatory protections and the due diligence that is undertaken by sophisticated investors and their agents in professional markets. Our main worries about the directive concern the reduction of investment choice, increased costs and the model of regulation that the directive proposes.

We are convinced that the directive as currently drafted will reduce the investment options available to investors. This will both reduce investment returns and increase risk. For long term investors like pension schemes, even a relatively small reduction in investment returns, compounded over a number of years, will have a dramatic impact on the affordability of pensions. A reduction in the investment opportunities available to investors will also reduce the opportunities for diversification, which is perhaps the most important element in investors' risk management strategies.

The directive will also increase fund providers' costs. These will inevitably be passed back, in whole or in part, to end-investors. As with reduced investment returns, even a relatively small increase in costs, compounded over a number of years, will have a dramatic impact on the affordability of pensions.

The directive represents a flawed model of regulation. It appears to be based on a model of retail regulation (the UCITS Directives). Pension schemes, like other wholesale investors, undertake their own due diligence or demand that their agents undertake it on their behalf. Industry practice is based on a model whereby bespoke information is drawn from investment managers, in contrast to the one envisaged by the directive which would require managers to provide generic information to investors. We believe that the due diligence undertaken by market participants is vital to market integrity. We would oppose anything that discouraged due diligence by allowing professional investors to place an unjustified reliance on the supervisory and regulatory authorities.

I am copying this letter to select Commission officials and to staff at the Swedish Permanent Representation and Finance Ministry, as well as to the relevant UK authorities.

Yours sincerely

Joanne Segars
Chief Executive

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NAPF Representation
on the proposed Alternative Investment Fund Managers Directive

1 About the NAPF

1.1 The National Association of Pension Funds (NAPF) is the leading voice of workplace pensions in the UK. We speak for 1,200 pension schemes with some 15 million members and assets of around £800 billion. NAPF members also include over 400 businesses providing essential services to the pensions sector.

1.2 Disappointing and volatile investment returns, combined with the imposition by government of additional obligations, have led to the closure over the past decade of many defined benefit pension schemes, first to new entrants and then to accruals. One of our main objectives as a trade association is to encourage government to reduce the burden on pension schemes so that employers can feel confident to continue to offer their employees good quality pensions.

2 General Considerations

2.1 While we support some aspects of the proposed Alternative Investment Fund Managers Directive, we believe that in other respects it is misguided. In particular:

- its wide scope fails to differentiate between the different types of institution in the alternative investment management space and their differing business and operating models and fund structures;

- it fails to take into account existing regulatory protections at both fund level (for example, through the Prospectus and Listing Directives as well as through a range of qualified investor and non-UCITS requirements) and at investment manager level (for example, through MiFID);

- it seeks to prohibit any form of private placement of non-EU / non-equivalent funds even to the most sophisticated investors, and even where the placement activity has been initiated by the investor;

- it fails to take into account the due diligence that is undertaken by sophisticated investors and their agents in professional markets, effectively overlaying existing industry practice in which bespoke information is drawn *from* investment managers with one in which managers are required to provide generic information *to* them – at a cost; and

- it creates an unlevel competitive playing field by requiring information disclosure from AIFs that is not required from equivalent but non-AIF entities. For example, there will be a requirement for private equity funds to disclose their plans for target companies that will not apply to private or Sovereign Wealth Fund investors, effectively introducing a cost to AIF investors without introducing any attendant benefit in terms of mitigating systemic risk or protecting national 'real economies'.

2.2 A number of the directive's measures are unduly restrictive and would limit investor choice. We believe that it is important that fund providers should feel confident that they can safely place units in their funds with willing professional investors and that professional investors can seek out such investments. Other measures may either serve to increase costs or lead to sub-optimal fund performance without bringing additional protection to the markets, to nation-state economies or to investors. In particular, we think that key parts of the directive need to be rethought in order to find the right balance between protection for investors and the attendant costs that it will impose on them. More generally, we are surprised at the lack of consultation with investors, whose interests the proposed directive is intended to protect, in drawing up the directive.

2.3 We would like to emphasise that we are not opposed to regulation per se, but to inappropriate regulation. Investors welcome good regulation that provides robust, well-functioning markets and protection from abuse. Indeed, we believe that UK's regulatory framework for the professional market - involving a strong authorisation framework (including a requirement for alternative investment fund managers to be authorised), sound conduct of business rules, the prohibition of abuse, and supervisory oversight – could be looked to as an effective working model for Europe as a whole, as the de Larosière Group on Financial Supervision in the EU itself acknowledged in its report to the Commission in February[1].

2.4 We welcome certain aspects of the proposed directive. In particular, we welcome:

- the proposal that all alternative investment fund managers should be authorised; and

- the provision of a European passport for marketing alternative investment funds to professional investors and the granting of access

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[1] "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."

to the market of third country funds subject to appropriate regulatory and supervisory standards – provided, of course, that this does not in practice become a pretext for excluding third country funds.

3 Specific Considerations

3.1 Fund providers and their trade associations will by now have provided you with evidence of how the directive in its current form is incompatible with some of their business models and of the additional costs to which it would give rise, even where they could continue to offer the same or similar types of fund. We would, however, like to draw your attention to a number of areas where investors' interests are likely to be damaged.

3.2 Our main worries concern the reduction of investment choice, negative implications for fund performance, increased costs for investors, and the model of regulation that the directive proposes.

3.2.1 **Reduction of investment choice**. We believe that the directive as currently drafted will reduce the investment options available to investors by its restrictions on sub-delegation, by denying AIFMs access to passporting rights or by granting access unevenly (and anti-competitively)[2], and by prohibiting the existing private placement regime via the directive's definition of 'marketing'[3]. This will:

- reduce investment returns. For long term investors like pension schemes, even a relatively small reduction in investment returns, compounded over a number of years, will have a dramatic impact on the affordability of pensions.

- increase risk. A reduction in the investment opportunities available to investors will reduce the opportunities for diversification, which is perhaps the most important element in investors' risk management strategies.

3.2.2 **Increased costs for investors**. The proposed directive will increase fund providers' costs in a number of areas:

- the provision of unnecessary (and unlooked for) disclosure to investors[4] will inevitably be borne by investors, and would appear to fall most heavily on investors in private equity funds[5];

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[2] Articles 31-35 & 39
[3] Article 3. We would support a retention of the existing private placement safe harbours for alternative investment funds.
[4] Articles 5 & 20
[5] Articles 27-30

- burdensome disclosure to competent authorities[6] will increase costs for both the industry and its regulators, and ignores the combined proposals of the de Larosière and G20 Reports and the Turner Review that regulators should monitor systemic risk in 'leveraged' AIFs via prime brokers; and

- there will be clear costs in appointing an independent 'valuator' entity[7], when what is actually required is functional as distinct from entity-level separation. Functional separation could be ensured via a range of different means from adherence to existing codes of practice[8] to a requirement for an independent audit of valuation methodology.

We are particularly concerned about the significant re-insurance costs that will be generated by depositaries being required to assume complete liability for AIF assets[9]. It strikes us that mandatory re-insurance against damaging but highly unlikely ('catastrophe') events is not the correct way to protect investors and could in fact exacerbate the risks inherent in the custody of assets at the same time as having negative implications for fund performance. Should the directive's requirements force depositaries out of the market, the spectrum of investible assets available to AIFs and their investors would shrink (as the scope of available local custody is reduced) at the same time that 'concentration risk' would grow as the same amount of assets are held by fewer custodians.

We feel that the provisions on sub-delegation of custody are divorced from the reality of custody provision. We are convinced that the imposition of strict liability on custodians for sub-delegation of custody will significantly increase costs and could make investment in some developing markets virtually impossible. We strongly support the legal principle that while delegatees may sub-delegate functions that have been delegated to them, they may not delegate the responsibility. But this is not the same as the imposition of strict liability. Acceptance (or imposition) of strict liability increases custodians' costs by increasing the risks that they bear – and in some cases custodians may be unwilling to take on the risk at all. We also see no reason why custody services should be restricted to EU banks.

Costs will inevitably be passed back, in whole or in part, to end-investors. As with reduced investment returns, even a relatively small increase in costs, compounded over a number of years, will have a dramatic impact on the affordability of pensions.

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[6] Article 21
[7] Article 16
[8] Existing codes include AIMA's *Guide to Sound Practices for Hedge Fund Valuation*, FHSB's *Standards* and IOSCO's *Principles for the Valuation of Hedge Fund Portfolios*.
[9] Article 17

3.2.3 Negative implications for fund performance. Besides the more general consideration that we have already outlined in paragraph 3.2.1 that reduced investment choice will reduce investment returns, we believe that the directive will have a negative impact on fund performance in a number of specific areas:

- imposition of leverage limits has clear implications for fund performance and, as an example of product regulation, is out of place in a manager-level directive. The directive should not seek to impose inflexible caps on something as fluid as the AIF industry, which offers a range of products that are constantly changing in response to investor demand[10]. In view of the wide range of business models of the funds covered by the directive, we feel that leverage caps are inappropriate. Leverage caps are also likely to lead to forced sales in falling markets, further destabilising them.

- independent 'valuator' entities, when isolated from the expertise of the AIFM, may be prone to valuation mistakes, while favouring pessimistic valuations at a default level in order to mitigate their own liability. While in an ideal world our preference would be for independent valuations, the reality is that independent valuators have neither the capacity nor the immediate access to data that would be required if independent valuations were mandatory. Valuations must be a matter for investors themselves and not for regulatory prescription.

- the directive requires 'duplicate' capital amounts to be set aside by both delegating and 'delegated to' AIFMs[11]. In terms of capital adequacy requirements, it is worth noting that a number of standard fund structures have more than one 'manager' (as defined by the Directive)[12] implicit in their infrastructure. For example, a Luxembourg SICAV or Irish or UK OEIC will often have a fund 'operator' who then appoints an 'investment manager' (under appropriate legal terms subject to review and approval by a competent authority). Under the current definition of 'manager' in the directive both entities would count as AIFMs resulting in a number of regulatory duplications – not least a duplication of capital amounts. We would not wish to have the directive force AIFMs to make investment decisions about delegation on the basis of the economies of their internal structures, rather than with the object of increasing investment returns or mitigating risk.

[10] Article 25
[11] Article 14
[12] Article 3(b)

In a similar vein, we feel that there will be negative implications for fund performance of the directive's requirements relating to the delegation of portfolio and risk management functions by an AIFM[13] and of sub-custodial responsibility by an appointed depositary[14]. Both provisions would seem to work against the very benefits that investors seek out when investing via a global rather than country- or region-specific asset manager. Funds and the investment managers to whom they delegate need to be able to sub-delegate investment management to non-EU managers so as to able to access local expertise.

3.2.4 **A flawed model of regulation**. The proposed directive appears to be based on a model of retail regulation (the UCITS Directives). Pension schemes, like other wholesale investors, undertake their own due diligence or demand that their agents undertake it on their behalf. We believe that the due diligence undertaken by market participants is vital to market integrity. We would oppose anything that discouraged due diligence by allowing professional investors to place an unjustified reliance on the supervisory and regulatory authorities, who we doubt would wish this themselves.

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[13] Article 18
[14] Articles 17 & 36