House of Lords European Union Committee Call for Evidence on the Directive on Alternative Investment Fund Managers

Response by the Hedge Fund Standards Board (HFSB)

Introduction

The Hedge Fund Standards Board (HFSB) was set up to act as custodian of the Best Practice Standards published by the Hedge Fund Working Group in 2008 and to promote conformity to the Standards. It is also responsible for ensuring that they are updated and refined as appropriate. Over 50 managers from the UK and abroad – totalling approximately USD 200BN in assets under management, have already committed to the process of the HFSB, and more are expected to sign up to the Standards over coming months. The HFSB expects its Hedge Fund Standards to be widely adopted and an increasing number of investors to use the Standards in their due diligence. This market based regime was developed in close cooperation with the FSA, and is designed to provide a framework of discipline for the Hedge Fund industry which is more effective than traditional prescriptive regulation, while being fully integrated into the UK's regulatory regime for Hedge Funds.

The HFSB is pleased to have the opportunity to respond to the House of Lords European Union Committee Call for Evidence on the Directive on Alternative Investment Fund Managers (AIFM).

Consultation responses

1. **What economic benefits arise from Alternative Investment Funds? What risks to financial markets arise from Alternative Investment Funds? Will the Directive help reduce these risks?**

Hedge Funds provide many benefits to investors and the economy as a whole. They are almost irrelevant in quantitative terms, representing only 1 to 2% of the total financial system, but their qualitative impact is very important. They are driven by investor demand and they only exist and develop if they provide investors with superior returns. But in doing so they also contribute to more complete financial markets, provide opportunities for risk management and, in general, contribute to financial innovation which is of benefit to the whole economy.

To investors, they provide additional choice of investment opportunities along the risk return spectrum, helping investors to optimise their portfolios. Hedge Funds in particular seek to provide return opportunities in economic environments in which traditional investments such as stocks and bonds offer limited returns. Today, most investment in Hedge Funds is done by Institutional Investors – in particular, pension funds, insurance companies and endowments. These sophisticated investors have complex asset management requirements, want and appreciate a broad spectrum of choices and allocate more and more to Hedge Funds because this is the best way of adapting their portfolios to their investment preferences.

The economic benefits of Hedge Funds are related to financial market efficiency and innovation, as well as more comprehensive risk management.

In the financial markets:

- Hedge Funds contribute significantly to market liquidity, thereby reducing spreads (=the transaction cost to all market participants).
- The activity of Hedge Funds lead to more efficient price discovery: Hedge Funds often invest heavily in information acquisition (research) to spot valuation anomalies early on and trade accordingly. Thereby, markets incorporate new information more quickly. This results in more robust prices. In this context, short sellers can be seen as "market detectives" who spot excessive valuations early on and provide a corrective force, thereby preventing misallocation of capital in the economy.
- Some hedge funds engage in short selling, and this activity can help dampen price bubbles, by smoothing out excessive peaks in market prices and accelerating price corrections, while at the same time buying at times when prices are falling (i.e., to cover the short position). This also reduces price volatility in markets, thereby ultimately reducing the cost to companies of raising capital in the markets.
- More generally, Hedge Funds are extremely innovative, by constantly developing new strategies and products, bringing them to investors and testing their viability in the marketplace. Whenever new products or strategies are successful, they are often adopted by others and disseminated throughout the financial system, with substantial benefits for all concerned. Hedge Funds can be considered the leading edge of the markets, the laboratory where innovation is tested, and the source of competitive advantage for the financial sector. The long term competitive survival of the financial industry cannot be based on routine processes executed on a large scale; it has to be reaffirmed by constant adaptation to a market which is frequently changing and demanding new solutions. This is, perhaps, the most important reason why Hedge Funds are of crucial value to the development and prosperity of the financial industry, in Britain and in Europe.

The economic benefits of Hedge Funds are especially related to risk management. By providing risk taking opportunities for investors Hedge Funds create more complete markets, where all contingencies can be appropriately price and traded. Investors have access to higher return opportunities, by accepting these risks within their larger portfolios. And firms and even policy makers benefit by finding investors prepared to take these risks, defining a price for them and managing them in a process that creates no systemic consequences. Since risk taking and risk management is such a vital part of a developed, innovative and sophisticated economy, it is of crucial value that systems exist to handle risk in a controlled fashion, by finding those who are prepared to invest and face the potential losses, while preserving overall systemic stability. As we have painfully learned over the last two years, it is much better that risks be taken by knowledgeable and sophisticated investors, operating through Hedge Funds, than by large scale banks, investing money that belongs to unsuspecting depositors.

2. **To what extent is there a need to create a single regulatory regime for Alternative Investment Fund Managers in the European Union? Does the Directive achieve its objectives? Should the objectives of the Directive be modified?**

While there is significant benefit in creating a harmonised European market place for alternative investment management, the approach taken in Directive is questionable:

- The Directive seeks to cover a very wide and diverse spectrum of asset management activities in significant detail. The expert feedback to the draft Directive has highlighted that many aspects are not workable. A one size fits all approach might not be appropriate at the level of detail the Directive is currently targeting.

- The Directive is protectionist, preventing European investors from investing abroad. In particular, funds managed in the US - which form the bulk of the industry - will not be allowed to sell to European investors. Investors have voiced strong concerns about this type of "investor protection". The development of European financial markets will never be healthy and competitive, if the market is not open and firms are protected from competition from abroad.

- The Directive proposes centralising a lot of powers in Brussels, ignoring the subsidiarity principle, a key pillar of European policy making. Local regulators should be empowered in areas where they are better capable of setting out detailed requirements in dealing with their industries. Clearly, this has to be in line with the higher level requirements as set at the European Union level.

The objectives of the Directive seem to be appropriate, but the chosen response is not proportionate. It is questionable if the Directive achieves its objectives in an efficient and effective manner in its current form.

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?**

In the area of hedge fund activity, concerns have been voiced in relation to systemic issues, investor protection, and market integrity.

The HFSB does not see evidence of the systemic nature of hedge funds.[1] In addition, there is widespread agreement that the activity of hedge funds has not been the cause of the financial crisis. However, the HFSB agrees that systemic risk regulators should have confidential access to relevant

[1] Also see HFSB consultation response to FSA DP09/2: A regulatory response to the global banking crisis, p.3/Q8: http://www.hfsb.org/sites/10109/files/hedge_fund_standards_board_response_to_fsa_dp_09-2.pdf

information from all types of financial market participants (including alternative investment fund managers) allowing them to assess the potential build up of systemic risks.

In relation to investor protection issues, it is important to note that Hedge Funds are usually not sold to retail investors, which require a higher level of protection than institutional and other sophisticated investors. However, sophisticated investors have not asked for more protection (and are now concerned about the implications of the Directive). Indeed, in some areas, the requirements of the Directive go beyond what is currently required in the UCITS regime, which is meant to cater for retail investors. This is for example the case in the area of depository liabilities. This and other examples demonstrate that the Directive is not proportionate.

There is a serious concern that the Directive creates over regulation, leading to misallocation of regulatory resources, thereby preventing the supervisor from focussing on more relevant issues. One example to highlight this is the need for globally integrated alternative investment fund managers to seek authorisation for delegation of fund management activities. Also, changes to investment strategy and policy for individual AIFs will need to be notified to authorities with approval/rejection/restrictions to be granted within a month. It is very doubtful that regulators are in a position to assess the viability of investment strategies. The overarching concern is that the Directive creates significant bureaucracy, with no obvious benefit.

Issues in relation to market integrity should not be dealt with in a manager directive, but rather in the appropriate market abuse legislation – which is already in place -, thereby applicable to all market participants, not just alternative investment fund managers.

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 alternative investment? Does the scope of the Directive create a danger of unintended consequences?**

The HFSB believes it is appropriate to regulate the fund manager, rather than the fund itself as long as the fund is sold to sophisticated investors only, who have not asked for more investor protection (via product/fund regulation).

The Directive does not differentiate sufficiently between types of alternative investments. Even within the hedge fund sector, there is great diversity of activities, and some requirements might in the future limit certain hedge fund strategies or even make them impossible to pursue. This relates in particular to the leverage limits that the Directive seeks to impose on the industry.

There is significant scope for unintended consequences. The leverage limits suggested in the Directive could have a pro-cyclical effect, forcing managers to unwind positions in times of increased market volatility or distress, thereby causing forced selling in already tumbling markets. This is exactly the opposite of what is actually desirable in times of distress.

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

While the Commission consulted publicly on Hedge Funds in February 2009 prior to issuing its Draft Directive, it is unclear whether and how the consultation feedback has fed into the process to develop the Directive. On the Directive itself, no consultation has taken place.

The HFSB believes that the European Commission should have consulted in a much more proactive manner on the regulatory objectives and the actual draft.

Regulatory aspects

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?**

A European passport will be a major step forward in the development of Europe´s financial markets. It will contribute to a much larger and efficient internal market, will enable the most competitive fund managers to expand and will create conditions more comparable to those in the US.

7. **Is the threshold for defining "systemically relevant" Alternative Investment Funds 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 Alternative Investment Funds adequate?**

From a systemic risk perspective, it is very unlikely that small firms that fall under the Directive have any stand alone relevance at all. However, in a systemic risk context, it makes much more sense to allow regulators to collect the data they deem relevant. In most instances, they might focus on the largest funds, but there might also be instance where a regulator wishes to collect data from all managers, irrespective of size.

A capital requirement for the manager is already imposed via other pieces of legislation, notably Mifid. A capital requirement for the actual fund is not needed. This is where investors and creditors determine the appropriate and desired level of "leverage", which is a function of the riskiness of the fund strategy as well as the risk appetite of investors and creditors.

While HFSB is promoting independence in the valuation process via its Standards, we acknowledge that there can be instances where independent valuation might not be suitable or even possible. This is why HFSB does not prescribe one single way of doing things, but rather provides leeway under the condition that managers explain and disclose their approach to investors. It is then investors who can decide for themselves, whether they like the approach or not. This is superior to prescriptive and rigid rules. HFSB agrees that there needs to be independent custody of assets.

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

HFSB is in general in favour of disclosure to investors. Therefore, we welcome meaningful requirements to enhance transparency to investors.

Impact

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?**

The Directive will weaken Europe and the City of London as a leading location for investment management. The protectionist element might reduce foreign competition, resulting in the European investment management industries losing their current competitive edge. Protectionist measures could also lead to retaliation by trade partners, either in the area of asset management, or elsewhere. Also, the Directive makes it much more difficult to manage a globally integrated asset management company from Europe, given the bureaucratic requirements the Directive will establish in the area of delegation of functions.

European professional investors, and in particular European pensioners will suffer, given the reduction in choice of investment opportunities and the incremental cost the Directive will cause, which will ultimately be borne by investors in the form of reduced returns.

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

The regulatory framework in the US is currently in the making, starting with the requirement that Hedge Funds be registered with the Securities and Exchange Commission and with some oversight powers for the SEC. But it is very unlikely that the US will impose similarly damaging requirements on its own alternative investment management industries.

This will indeed weaken the position of European and in particular UK alternative investment fund managers. In the past, being a UK-based, FSA-regulated manager has been a quality mark, given the sophistication and appropriateness of the FSA regulatory regime, in particular in relation to hedge funds.

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

Capital flows will be restricted given the investment restrictions imposed on EU investors to invest with non-EU managers. The depository requirements and the restrictions on the delegation of functions will certainly reduce flows to emerging markets.

Financial innovation will be slowed down, in particular where the Directive interferes with investment strategies or imposes restrictions (leverage limits, approval of investment strategies).

Ultimately, all this will be detrimental to efficient global capital allocation and global economic growth.