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COMMISSION OF THE EUROPEAN COMMUNITIES

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**COMMISSION STAFF WORKING DOCUMENT**

*Accompanying the*

Proposal for a

**DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL**

**on Alternative Investment Fund Managers and amending Directives 2004/39/EC and  
2009/.../EC**

**EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT**

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## EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT

The financial crisis has exposed a series of vulnerabilities in the financial system. These necessitate a comprehensive review of regulatory and supervisory frameworks for all significant actors in European financial markets. As described in the Commission's Communication for the Spring European Council and in accordance with the conclusions of the G20, the Commission is committed to ensuring that '*all relevant actors ... are subject to appropriate regulation and oversight*'. This requires filling gaps in areas where European and national provisions are incomplete.

One such area concerns the activities of the managers of Alternative Investment Funds (AIF), defined as all funds that are not harmonised under the UCITS Directive<sup>1</sup>. The AIF sector is large – managing around €2 trillion in assets at the end of 2008 – and diverse. AIF managers (AIFM) employ a wide range of investment strategies and techniques and invest in an array of financial and physical assets. Hedge funds, private equity funds, commodity funds, real estate funds and infrastructure funds, among others, fall within this category. In view of the risks that these investments entail, investment in AIF is restricted primarily to professional investors.

The activities of AIFM pose a series of risks for their investors and counterparties and for the efficiency and stability of financial markets (see Table 1). The nature and intensity of these risks varies between business models. For example, macro-prudential risks associated with the use of leverage relate primarily to the activities of hedge funds and commodity funds; whereas risks associated with the governance of portfolio companies are most closely associated with private equity. However, other risks are common to all types of AIFM.

**Table 1: Overview of key risk areas**

<b>Macro-prudential (systemic) risks, relating in particular to the use of leverage</b>	<ul style="list-style-type: none"> <li>• Direct exposure of systemically important banks (as the providers of leverage) to the AIFM sector</li> <li>• Pro-cyclical impact of herding behaviour, risk concentrations in particular market segments and ('forced') deleveraging which are transmitted to the counterparties through asset prices and market liquidity</li> </ul>
<b>Micro-prudential risks</b>	<ul style="list-style-type: none"> <li>• Possible weaknesses in internal risk management systems with respect to liquidity risks, market risk, counterparty risks (credit and settlement risks, especially in the case of short selling) and operational risks</li> </ul>
<b>Investor protection</b>	<ul style="list-style-type: none"> <li>• Gaps in investor disclosure on investment policy, risk management, internal processes etc as barrier to effective due diligence</li> <li>• Conflicts of interest and failures in fund governance, in particular with respect to remuneration, valuation and administration</li> </ul>
<b>Market efficiency and integrity</b>	<ul style="list-style-type: none"> <li>• Impact of dynamic trading and short selling techniques on market functioning</li> <li>• Potential for market abuse in connection with certain techniques, for example short-selling.</li> </ul>
<b>Impact on market for corporate control</b>	<ul style="list-style-type: none"> <li>• Lack of transparency when building stakes in listed companies (e.g. through use of stock borrowing, contracts for difference), or concerted action in 'activist' strategies</li> </ul>
<b>Acquisition of control of companies by AIFM</b>	<ul style="list-style-type: none"> <li>• Potential for misalignment of incentives in management of portfolio companies, in particular in relation to use of debt financing</li> </ul>

<sup>1</sup> Directive 85/611/EEC on Undertakings for Collective Investment in Transferable Securities (UCITS).

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| <ul style="list-style-type: none"><li>• Lack of transparency and public scrutiny of companies subject to buy-outs</li></ul> |
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The financial crisis has shed further light on the role that AIFM play in financial markets. While AIFM were not the cause of the crisis, recent events have placed severe stress on the sector. Many AIFM have experienced liquidity problems as they struggle to manage the mismatch between the degree of liquidity promised to investors and the illiquidity of their investments. In some cases, adverse impacts have been felt by the wider market. For example, the abrupt unwinding of large, leveraged positions by hedge funds in response to tightening credit conditions and investor redemption requests has had a procyclical impact on declining markets and may have impaired market liquidity.

### ***Problem definition***

The core concern of this impact assessment is whether current regulatory and supervisory arrangements for the AIFM sector in the EU represent a sound basis for monitoring and controlling these risks. In particular, the report considers whether the cross-border dimension is taken into account adequately, given the international nature of AIFM investors and counterparties and their active role in financial markets throughout Europe.

Despite this interconnectedness, the regulatory environment for AIFM is currently highly fragmented. While AIFM are subject to certain cross-cutting provisions of Community law, there is no Community regulation targeted directly at AIFM. This does not mean that AIFM are unregulated: many are subject to regulation and supervision in the Member States in which they are established. However, the scope and content of national regimes vary significantly, for example with regard to the requirements for the registration and authorisation of AIFM, regulatory reporting and standards for investor disclosure and risk management.

The report considers two related problems associated with this regulatory fragmentation:

- First, regulatory fragmentation may **inhibit the effective regulation, supervision and macro-prudential oversight of AIFM** by failing to take account of the cross-border dimension of their activities. This may result in incomplete or inconsistent monitoring and control of the macro-prudential, micro-prudential and market efficiency risks and weaknesses in frameworks for ensuring investor protection.
- Second, it may also **impede market integration and the development of the single market** by creating barriers to the efficient cross-border distribution of AIFM products. This may prevent AIFM from achieving the available economies of scale and investors from diversifying their portfolios optimally.

The report concludes that, when judged from an EU perspective, the current regulatory environment does not represent a comprehensive or effective basis for monitoring and responding to risks posed by AIFM to their counterparties and the financial system. The European dimension of the public good to be protected by regulation and supervision is not sufficiently taken into account.

In particular, the absence of a consistent approach to the collection of relevant macro-prudential data from AIFM (for example on leverage and risk concentrations) and of an effective mechanism for macro-prudential authorities to share this information at the European or global level is a significant barrier to effective macro-prudential oversight. Moreover, the absence of a consistent standard of supervision and regulatory protection across the EU is a source of uncertainty for investors and counterparties.

#### ***Objectives:***

In response to these problems, the report defines as an over-arching objective the achievement of a comprehensive and effective regulatory and supervisory framework for AIFM in the EU.

The report recognises that some of the risks described are not unique to the AIFM sector and hence are better addressed by cross-cutting initiatives. These include measures to address concerns in relation to short-selling and to the transparency of certain techniques for the acquisition of voting rights in listed companies. In addition, the report notes that other elements of the broad reform agenda announced in the Communication to the Spring European Council will impact on the AIFM sector.

However, many other risks relate directly to the activities of AIFM and as such warrant a targeted response. The specific objectives of this response would be to:

- Ensure that all AIFM are subject to appropriate authorisation and registration requirements
- Provide a framework for the proper monitoring of macro-prudential risks
- Ensure the proper monitoring and limitation of micro-prudential risks
- Provide a common approach to the protection of professional investors in AIF
- Enhance public accountability of AIFM holding controlling stakes in companies
- Develop the single market in AIF

- Ensure that actions are proportionate to the risks posed and appropriately differentiated to take account of differences in AIFM business models.

***What type of action is needed to achieve these objectives?***

In assessing the appropriate form of a response to the problems identified, the impact assessment addresses a series of key questions as to the target and scope of that action, before proceeding to consider the level at which such action should be taken.

*Which parts of the value chain should be targeted?*

The report finds that the objectives could best be achieved by an approach targeted at the level of the AIFM. While the AIF is merely a legal structure for the pooling of assets and has no economic life of its own, the AIFM is responsible for all key decisions in relation to the management of the fund. These include decisions on investment; the use of leverage; the governance structure and internal systems for risk management and the avoidance of conflicts of interest; the management of relationships with investors, counterparties and regulators, including the provision of information; the organisation of administrative functions (including valuation), safekeeping of assets and audit, even if these functions are delegated to third parties. The risks therefore lie almost exclusively at the level of the AIFM.

The report notes, however, that an approach targeted at the AIFM would need to be supplemented by appropriate controls on third party service providers (such as valuers and depositaries). Moreover, robust counterparty risk management by lenders plays a vital role in mitigating the risks posed by AIFM to the banking sector.

*What is the appropriate scope for action: should specific AIFM business models be targeted, or is a more horizontal approach preferable?*

The report then considers the case for targeting specific business models or for developing a horizontal approach to the AIFM sector. It concludes that a horizontal approach would be the preferred option, provided that it is designed so as to be proportionate and sensitive to the differences between business models. Individual business models would be difficult to define in a precise and legally robust way and any such definitions would create opportunities for regulatory circumvention. In addition, many of the risks to which these actions respond are not limited to individual business models but are found to a greater or lesser extent throughout the AIFM universe. Wider coverage would thus ensure that risks were controlled in a comprehensive way.

The preference for an 'all-encompassing' measure does not imply that a 'one-size-fits-all' approach is appropriate. An appropriately designed measure would be sensitive to the differences in business models, with provisions targeted at the risks posed by particular activities.

*How much of the AIF value chain should be required to be located in the EU for action to be effective?*

For the regulation and oversight of AIFM activity in the EU to be effective, the AIFM would need to be located in the EU. However, the report recognises that important parts of the AIF value-chain often reside in off-shore jurisdictions, in particular the AIF itself and key third-party service providers.

The report recalls that since the risks lie almost exclusively at the level of the AIFM, the domicile of the AIF does not jeopardise the achievement of the objectives. However, certain third-party services, for example valuation and asset safe-keeping, are critical to the protection of investors yet are often conducted off-shore for certain types of AIFM. In these instances, an effective response to the risks would require effective controls to be put in place for these activities.

#### *What is the appropriate level for action?*

The report assesses five options: 'do nothing', self-regulatory approaches, and legislative action at Member State, European or international level. It concludes that the effective monitoring and mitigation of AIFM-related risks requires legally binding and enforceable measures to ensure a high standard of regulation and oversight throughout the EU. Industry-developed standards may have a role to play in informing these provisions and in providing additional guidance to industry.

Member States could in principle upgrade their own regulatory and supervisory arrangements and seek to improve cooperation between jurisdictions. However, an uncoordinated approach would risk failing to take account of the cross-border nature of risks and binding cooperation and information-sharing agreements may prove elusive. Moreover, it could not be guaranteed that single market freedoms would be achieved.

It is therefore considered that legislative action at the EU level offers clear advantages, both in terms of risk monitoring and control at a pan-European level, and in providing a secure framework for pan-European AIF distribution. Given the potential for international risk spillovers, action in the EU would ideally be coordinated with international action in this area. The development of a robust framework in Europe could provide a useful starting point for global discussion and sharing of information.

#### *Subsidiarity*

The report argues that European action in this area would respect the principle of subsidiarity by virtue of the inherently transnational nature of the risks and the need for a high degree of consistency in the requirements placed on AIFM and in the information collected from them. Article 47(2) of the EC Treaty would provide the legal basis for such action.

With regard to the choice of instrument, a Directive would provide for the appropriate balance between harmonising key risk control measures and allowing Member States the flexibility to incorporate these provisions in national law. A European regime could also provide sufficient flexibility for Member States to implement additional requirements to AIFM operating in a purely domestic environment; and if appropriate to provide a regime for the distribution of certain types of AIF to retail investors.

#### *Provisions of a potential proposal and expected impacts*

The final section discusses how action in this area could be structured so as to be proportionate to the risks posed and to avoid creating excessive administrative burdens.

#### *General provisions*

The report describes a set of general provisions to be applied to all AIFM. These would include authorisation requirements designed to provide the competent authority with

sufficient assurance that the AIFM is fit and proper, holds sufficient capital, and has the appropriate arrangements in place for *inter alia* risk management, valuation, asset safe-keeping, audit and the management of conflicts of interest. Additional provisions would seek to ensure that AIFM provide appropriate and timely information to investors on their investment policy, fees and internal systems; and to regulators on the nature of the AIF managed and on major positions and risk concentrations. Subject to these requirements, AIFM would be granted the right to provide their services in all Member States (subject to notification) and to market the AIF they manage to professional investors throughout the EU.

In order to be proportionate, these requirements would apply only to AIFM managing a total of €250mn or more. For smaller AIFM, the additional administrative burden and the burden for supervisors would outweigh the marginal benefit in terms of the mitigation of the risks associated with their activities.

#### *Activity-based provisions*

In addition to the general provisions, a number of provisions would apply if and only if the AIFM engaged in particular activities. These would be sensitive to the differences in AIFM business models and calibrated to the risks posed. In particular:

- **AIFM using leverage systematically** and at a relevant scale would be required to provide additional disclosure to investors and would have to report to competent authorities on the use of leverage; and
- For **AIFM acquiring stakes in companies**, additional information and disclosure requirements would be triggered once an AIF reached a controlling stake in a (non-SME) company; and if an AIFM delists a company, reporting obligations as required for listed companies would continue to apply for a temporary period.

#### *Administrative burdens*

The requirements of the proposed measure would create some administrative burden on AIFM. The additional cost would depend primarily on the national requirements already in place in the home country. These additional costs to AIFM (and their supervisors) would be justified by the enhanced supervision and the benefits to AIFM in terms of cross-border provision of AIFM services and AIF marketing to professional investors upon a simple notification procedure.

Due to uncertainties about costs, it is not possible to assess or to quantify precisely the impact of the proposal on the competitiveness of EU-domiciled AIFM.