Investment Management Association

ima

10 July 2009

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Dear David

Alternative Investment Fund Managers Directive

Thank you very much for your time last Thursday. I thought it might be helpful to set out the key points that I raised with you.

IMA is very comfortable with the proposition that alternative investment fund managers should be subject to regulation, and we welcome the concept of a passport for alternative investment funds marketed to professional investors. The directive has however been drafted in a relatively short space of time, which – as I think you acknowledged – did not allow for the usual consultation before it was issued. As a result there are several points that need to be addressed, including who or what is the "manager". We will be feeding in detailed comments as the legislative process goes forward. But I would like to set out our key high level concerns.

1. Allow the continuation of national private placement regimes

Although the directive is cast as one about managers, in practice it introduces a large measure of product regulation. It does so by setting out a number of requirements that an alternative investment fund must satisfy in order to secure a passport, but does not allow national authorities to authorise other types of fund for professional investors within their own jurisdictions. The UK at present has a private placement regime that allows a wide variety of funds to be marketed to professional investors; as the directive stands, this would be prohibited after the three-year transition period.

In effect it would then be illegal for an EU citizen to invest in a hedge fund, private equity fund or any other vehicle that does not comply with the directive. This seems excessively onerous.

While it is of course reasonable for the directive to set down criteria for funds which will receive a pan-European passport, we can see no reason why European legislation should impose similar restrictions on non-passported funds that are operating perfectly well under existing national regimes. Fund managers would then have a choice: continue to operate as now within national frameworks, or change the business model to conform to the directive and gain a passport.

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2. Provide a reasonable level of depositary liability and powers of delegation

As drafted, the "depositary" role is solely concerned with the safe custody of the fund's assets, and has none of the oversight functions normally associated with a depositary. This potentially creates confusion between the roles of depositary and custodian. For example, the depositary of a UCITS (under the existing rules) must be located in the same domicile as the fund. But custody sometimes has to be delegated, since certain assets have to be held within the given jurisdiction: in such cases, custody is subject to local law and regulation, which is part and parcel of investing in that region. Since the draft is talking about a custody function, rather than a depositary as currently understood, the provisions about delegation are quite simply unworkable for any fund investing in international instruments. Moreover a custodian is unnecessary for certain asset classes (for example, OTC derivatives, real estate and private equity).

We have other concerns with the treatment of depositaries, notably depositary liability. Let me say at once that safekeeping of investor assets is of immense importance. The Directive however applies a "no fault" standard of liability on the depositary, so that it is liable even if it has shown reasonable skill and care. The depositary can escape liability only if "it could not have avoided" the relevant loss, which is an extraordinarily difficult test, since it makes no allowance for whether it would be reasonable to have expected the depositary to have taken whatever steps might, with hindsight, have avoided the loss.

The problem is most acute when it comes to sub-delegation. This standard continues to apply when custody is delegated, regardless of the fact that the standards applied by sub-custodians in less developed jurisdictions may be very different from those in the home state of the depositary.

This creates a real problem for depositaries. Depositary fees are typically a very low number of basis points – so the need to make good a loss would consume several thousand years' worth of associated revenues. Depositories are giving something approaching an insurance policy in the event of any loss.

This in turn is very likely to have consequences for investors. Depositaries will have to hold significantly more capital which will increase costs and reduce returns. And they may be no longer willing to accept assets from emerging economies, making it impossible to offer emerging market funds in future - and probably needing to wind up existing funds.

We are considering alternative wording and will look to feed in to the process in due course.

3. Allow wider powers of delegation

The draft directive is very restrictive in the powers to delegate portfolio management (perhaps because of the confusion about who is the manager). In particular, by allowing delegation only to other AIFMs, it prevents a manger appointing, for example, its subsidiary in a local jurisdiction to manage part of the portfolio. This

may in many cases be completely contrary to the interests of investors, by preventing appointment of the person able to provide the best service. It also restricts competition by conferring an advantage on global firms, who may have portfolio managers around the world, over boutiques and other specialist managers.

This issue was extensively debated during the passage of MiFID. We regard the present provisions as protectionist and ask for wider powers of delegation.

4. Exclude closed-ended investment companies traded on a regulated market

UK investment trust companies are the longest standing collective investment vehicles in the UK. It is impossible to see how they can fit within the framework in the directive: they have no depositary because the responsibility for oversight rests with the board of the company. They are not regulated entities because they are incorporated under UK company law, but are subject to the Transparency and Prospectus Directives. And the portfolio manager is hired and fired by the board, a concept which the directive simply does not recognise.

The simplest solution would be to exclude closed-ended investment companies listed on a regulated market, in the same way as we propose for national private placement regimes. In so doing, however, it would need to be ensured that the passport enjoyed by these vehicles under the Prospectus Directive is not affected. I am sure you are also receiving representations from the Association of Investment Companies on this point.

5. Exclude nationally regulated retail funds

The UK has a class of retail funds that do not comply with the UCITS directive but can still be sold to the public in the UK. We see no reason why they should be covered by a directive aimed at the provision of services to professional investors.

This is really a particular case of the ability we seek (1. above) to continue national regimes for funds that do not comply with the terms of the directive. In this way they could choose whether to stay as they are or opt into either the UCITS or AIFM regimes to gain an EU passport.

6. Remove the three-year period during which third country funds may not have a pan EU passport

The directive allows third country fund access to the passport provided the Commission is satisfied that an equivalent regime is in place there. But a transitional period of three years must be completed before that can be granted. For this period, third country funds will be placed at a competitive disadvantage to EU-domiciled funds as regards the ability to market around Europe, but will, ironically, be in a better position than nationally authorised non-UCITS that do not comply with the directive.

We do not believe this is consistent with the principles of free trade and open markets. The three year period has no justification. It is quite conceivable that some types of fund – Channel Islands real estate funds, for example – could be ready a lot sooner than that. We think this arbitrary constraint on competition is protectionist in its effect and should be removed.

Yours sincerely

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