**IML CONFERENCE**
**INVESTMENT MANAGEMENT**

**A EUROPEAN PERSPECTIVE**

Jay Baris: ...distribution review, fundamental overhaul of the FSAs rules for the distribution of investment products and services in the U.K.[1] He's best described, maybe not, this may not be to his liking, but as kind of a counterpart to what Buddy does over in the U.K. That is to say, he plays a very important role in the regulation of investment management and Ben is here today, in from London and he is going to share with us his views on the European perspective of issues related to investment management.

Daniel: Thank you very much Jay. I was, I had to restrain myself from throwing in comments in that last panel. There were so many read across common issues between ourselves, it's really quite interesting. So I want to talk a little bit about what's happening in Europe in respect of post-crisis what to do about fund management issues and what the Commission, the Parliament and the Member of States are thinking about. There's a lot going on. I'm not going to talk about capital and the issues all in that respect except in passing. I'll focus on two major initiatives on the fund management side. The first is the alternative investment fund managers directive—the AIFMD.[2] And that is a quite controversial piece of legislation, as has already been mentioned. Secondly, the reforms of the UCITS regime.[3] The UCITS – Undertakings in Collective Investment Schemes In Transferable Securities – lovely name.[4] Better known as mutual funds. These are the authorized passporting cross boarder EU funds, that basically retail mutual funds across the border in Europe. And I'll say a little if I have time – I may not

[1] Financial Services Authority Rules, *available at* http://fsahandbook.info/FSA/html/handbook/ [hereinafter FSA Rules].
[2] Alternative Investment Fund Managers Directive, Eur. Parl. Doc. (SEC 576-577) (2009) [hereinafter AIFMD].
[3] Directive 2001/107/EC of the European Parliament and of the Council of 21 January 2002 amending Council Directive 85/611/EEC On the Coordination of Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable securities (UCITS), 2001 O.J. (L 041) [hereinafter UCITS].
[4] Proposal for a Directive of the European Parliament and of the Council on the Coordination of Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities (UCITS), Eur. Parl. Doc. (SEC 2263-2264) (2004) [hereinafter UCITS IV].

given that we're running behind a little bit – I might say I little bit toward the end about the overall work on European regulatory architecture which is quite important. The first thing to say, of course, is that the asset management industry is a global one and one of the things that the G20 wants us to do is find a global solution to the problems that the crisis has revealed and inflicted upon us.

So it's extremely important in our view that the solutions that are developed in Europe are recognizing that fundamental fact. We don't want to end up in a world with a fortress Europe or in a world with a prison Europe. And there are some features of what's happening now that make us is in the U.K. quite nervous about that. But there is a huge momentum for change, for regulatory change, for raising of standards, for capturing of certain vehicles that have not been captured before. The alternative investment fund managers directive is the first case in point.[5] That was put on the table by the European commission last April. They had done a earlier white paper some months before which set out at very high level what it might look like to have a cross-border passporting regime for private funds, which was a very attractive thought, as you can imagine. Particularly from the UK's point of view where 60% of the large private equity operations are located in the U.K. and 80% of hedge funds managed in Europe are managed from the U.K. So the idea that these services could be passported and marketed across Europe and with a common regime is a very attractive one because at the moment you've got this very complex collection of 27 member states and their requirements. So that sounded good. The Commission then produced a directive which didn't quite deliver what we were hoping for. And, unusually, the commission delivered that directive without the usual consultation. The UCITS IV process or the revision of the UCITS process has been going on for more than four years.[6] A very transparent, too slow, but very transparent collaborative process, taking comments, evidence in public in Brussels, all around Europe on the detail of that proposed directive. This draft directive has gone straight into the European Counsel for discussion, that is behind closed doors with the

[5] AIFMD, *supra* note 2.
[6] UCITS IV, *supra* note 4.

Ministries of Finance, assisted by their regulators. They'll be a new draft directive, we hope, quite soon. It's not even clear that it's going to be published. At the same time the parliament is working on the draft directive and will feed amendments in to the counsel. So its not the kind of process we believe is a credible one for running public policy.

The Commission has taken a lot of heat on this as you can imagine but it's been an extraordinary time and extraordinary times make for sometimes extraordinary developments, including in the law. Right, so the first thing to say before I talk about some of the issues is in the directive is that the U.K. has been regulating these private firms, private investment companies from the beginning. We regulate them all as fund managers, but they have very different regimes as are tailored their business models which are very different. I was interested in Jeff's remarks earlier about trying to distinguish between hedge funds and private equity funds. It's really very difficult. What does the draft directive do? It says everything that isn't a UCITS is covered.[7] That's what is says. So if you're a nationally authorized, but not passporting retail fund, you're covered. If you're private equity, you're covered. If you're a hedge fund, you're covered. If you are a listed, closed-end investment company, you're covered. If you're a real estate firm – you're covered. And every one of those vehicles has different governing arrangements, different boards and different structures around them. And this directive has got a one-size-fits-all solution based on UCITS.[8] Well guess what, it doesn't work and that has been a fundamental problem with this directive. The game now is to try to find solutions that will tailor the directive to these different subcategories of funds. Because the truth is these funds should have nothing to fear from sensible and proportionate regulation and in the U.K. we have not had a problem with that. We haven't had, as someone said before, we haven't bailed out any hedge funds or any private equity funds or any real estate funds so it's and we have a regime that is tailored to those. And that's what we think the model should be in Europe. And that would bring benefits.

[7] AIFMD, *supra* note 2.
[8] *Id.*

We don't disagree with the Commission at all that the idea of a, of a pan-European private placement regime is a desirable one, as I've said. We so see that as a desirable end, but what we think now has to happen is that the directive must be differentiated to address the peculiarities and the unique features of these various subsectors of the market.

So what are some of the key areas of the directive that are worth commenting on in the context of this international audience? The first is information gathering – this has already been commented on in the last panel, and this is an important one.[9] We do not believe at the FSA that the hedge funds themselves should be regulated. People who have tried to regulate hedge funds don't have any. That's the way that goes. And several European jurisdictions have set up regimes for hedge funds and if you build it, they did not come. That's how that went. So, and there's an obvious reason for that – the complexities, the flexibility, the uniqueness of these investment strategies are not readily captured in statutes. They just aren't. No one's been able to do it so far. So we just don't think that's the right way to go. We think the way to go, is to go through the manager or as you would call them the advisor to the fund. Those are the people that we regulate and we get the information we want – why? Because they set up the funds. These funds are located in tax havens for reasons that are obvious and they are set up by the fund managers. We get the information that we need, both from the hedge fund managers and from those who lend to them, the primary fund brokers. We've been doing that for the last five years. We've been gathering information from the prime brokers about their leverages, about their positions, about their overall impact in the market and have a pretty good sense of where the hedge funds were during the crisis. And I can tell you they were not levered 35-to-1, as some heavily regulated institutions were. So it's important to keep a perspective on who's really doing what in these markets. We don't think, and the evidence is very clear, that hedge funds caused the crisis or triggered the crisis anymore than private equity funds or these other alternative vehicles did. It

[9] *Id.*

is probably right that in de-levering there was some contribution to the overall movements in the markets at the time, but in terms of the build up of leverage in the system, that really lies elsewhere as I'm sure you know.

So gathering information – important. We've done what we're calling a hedge fund survey at the moment gathering quite detailed information from the hedge funds about their positions or exposure, their borrowing, and that we are aiming to provide to the Commission as an approach to include in the directive because the language that's in the directive now about information sharing we don't think is very helpful. It isn't asking for the right information and its not information that the regulators need. We're working very closely with the SEC as was announced a couple of weeks ago that we're going to work jointly on this, which makes perfect sense. If you have the SEC and the FSA working together you have accounted for the regulation of 80% of hedge funds assets globally. So if we can come up with a solution that we think is sensible, that we think will meet the requirements of regulators. Which are genuine requirements in respect of understanding what system effects could be, that kind of solution can be delivered to the Commission and can indeed form the basis of a sensible approach to the regulation of potential systemic effects of these funds.

Let me say something about leverage now. I've already indicated that we don't think that the leveraging in hedge funds was a significant contribution to the crisis and the leveraging on average as from the data we've got is about 3.5 to 1 on average across the sector during the height of the crisis. In some cases, far less then that. That said, it is conceivable and LTCM is probably the most obvious example, and no one's forgotten about that, and for the good reason, it is conceivable that a particular fund could become either systemic or more likely a collection of funds might themselves end up having a significant enough position in a vulnerable subsector of the market that they could have a disruptive effect and that's something that we would want to know about. And we'd want people to deal with. So the question is what to do about that and to what extent is leverage a problem and could it be a problem and if it were a problem what

would you do about it? Well the first thing you have to do is have information to know about it which you've already talked about. The second thing is to do something.

The directive proposes an ex ante across the board cap on leverage,[10] which we don't think is the right answer. We think the better answer is to have a reserve power for the national regulators to be able to address a leverage position in a fund if that is becoming or is already a problem. I'm reminded, it's an analogy in my CFTC days of many, many years ago of the kind of markets surveillance that the CFTC used to carry out and monitored some of the larger positions of traders in the market and was able in real time to intervene and to understand better the trading intentions of firms and what they might be planning to do with their positions in terms of rolling them forward or liquidation or whatever. That's not a perfect example because this market is not nearly as transparent as that, but in principle you can see that the idea of having information in the right hands at the right time would be something that would be valuable to the supervisors in the respect of ameliorating the possibility of systemic effects. So that's where we'd like to see the directive land, in a power that looks like that and I would say my assessment is that there area many other member states that agree with us on that and we'll see where the directive ends up.

Let me say something about custody. This has been a very, very controversial part of the directive. The Madoff scandals have driven a lot of concern in Europe. As you probably know, there were some UCITS funds which lost money, quite a lot of money in that there was serious concern about the delegation of custody to a related entity of Madoff, questions about whether due diligence had been done properly by the delegating European institutions, etc. At the moment the UCITS directive governs that kind of delegation and says that unjustifiable failure will cause liability to accrue to the delegating depositary of that custody function.[11] The proposition in the directive is strict liability for the

[10] *Id.*
[11] UCITS, *supra* note 3.

depositary delegating custody anywhere in the world.[12] So any failure of a subcustodian in Thailand or Russia or anywhere for any reason is the responsibility of the depositary. You may imagine the cost of that proposition. It is eye-wateringly high. Especially in kind of a low interest rate environment in which returns are not particularly brilliant. This would make a major hit. So we don't think that's a sensible solution and many of our European counterparts agree with us. But some do not. So that is very much up for debate. There is another problem in respect of custody. And that is limits on who can be a custodian. At the moment the directive says you have to be a European credit institution.[13] That is, guess what, a bank or what we would call in the U.K. a building society, we'd call here a savings and loan. So basically a banking-type institution. Well needless to say that would completely disrupt the custodian arrangements and similar lending arrangements of most of the alternative investments funds world who don't use depositaries in the way that USCITS do. We don't think that that is a sensible solution. We don't see the case being made for it. In fact, it's counter-intuitive to, at this particular time, concentrate risk in a small number of large institutions. So you see, its just the opposite of what we ought to be doing, so we're not very pleased about that.

There was also a restriction on delegation in the directive.[14] You can only delegate to another E.U. credit institution which would prevent alternative investment funds of all types from investing in non-E.U. markets where there are local custody requirements, so good-bye Brazil, good-bye Russia. In terms of European investments, this to us does not seem very sensible. So, lots of issues around depositaries and custody that needs to be fixed. Is it going to be fixed? I don't know. It's a lively debate. There was very, very strong political reaction when retail investors lost money in Madoff and we shouldn't underestimate how powerful that driver is. But as sometimes is the case, significant events cause people to act quickly and sometimes you get unintended consequences that may

[12] AIFMD, *supra* note 2.
[13] *Id.*
[14] *Id.*

be worse than the thing that you're trying to fix. So we do hope that a more sensible line can be taken in respect of custody.

The third country aspects is another area that's probably of interest to this audience and this has been touched upon already. I suppose, I'm encouraged to hear that people are aware of it because I think that frankly when we began to understand the scale of it, there was frankly disbelief that this could have actually have been written in this way. But it has been written in this way and we think it needs to be changed.

One of the most significant changes is that the proposed requirement that jurisdictions of alternative investment firm managers based outside the E.U. would have to meet an equivalence test to be determined by the commission which is giving power to them that they don't currently have in respect of prudential regulation and supervision.[15] Before the managers in those jurisdictions would be allowed to market their funds to anyone in Europe. Similarly, there's an equivalence test in respect of tax agreements for any domiciled funds in the Caymans, Bermuda and, indeed, in the U.S.,[16] so basically tax equivalence arrangements have to be in place between the jurisdiction of the fund and every European member state in which they intend to market. And this would not only apply to marketing, but also to investor initiated contact. So if I'm a pension fund in London, I cannot buy a U.S. hedge fund unless these requirements are met and there's an equivalence determined by the SEC. Well, you may imagine that we don't think that this is a very sensible place to land.

We have been operating in the U.K. – a national-based regime for the marketing of hedge funds and alternative investment funds for years. We think it works quite well. We do not allow the marketing of hedge funds to the retail market.[17] It is a private placement regime and it seems to work reasonably well. There's a lot of pushback on some of these provision I would say at the moment, so we'll see where we land. But just to be as clear as I can be, as an example. If an

[15] *Id.*
[16] *Id.*
[17] FSA Rules, *supra* note 1.

investor in London approached a New York hedge fund manager and wanted to invest in the Cayman islands, right, in a domiciled fund there, three conditions would need to be met.[18] I hope that's been cleared up, but I'll say it again.

First the Commission would determine whether the SEC standards on prudential regulation and supervision were equivalent to those in the European directive.[19] Secondly, the Caymans would have to enter into a tax treaty with the U.K. and third the New York manager would need to ensure that the fund met all the requirements of the directive.[20] The fund met all the requirements of the directive with respect to independent valuation, custody arrangements, etc. So you can see that this is really quite onerous and in our view completely unacceptable. What is held out is the possibility of a passport for these funds that would meet these requirements. My personal view is that that is an illusory promise. We know that the French will die in a ditch to oppose it. The French chairman spoke at our asset management conference in September and while we have many areas of agreement with our French colleagues and work very closely with them in Europe, in this we disagree quite strongly. So I think there is hope to hope for sensible change here. I think there's hope for allowing investor-led investment. As I said at the outset, we don't want to be a fortress or a prison in respect of asset management. So, I think to conclude, it's kind of a gloomy picture, I'm afraid. It's a directive that has a lot of things about it that are fine, but probably more things about it that need to be fixed. We're working very hard.

Let me turn to a happier topic and that's the USCITS IV, that's the fourth version of the European mutual funds regulation since it was started in the mid-80s.[21] It's a very successful global brand actually, these funds are sold all, not in the U.S., of course – that's another issues – but they're sold just about every place else. Cause one day Buddy we'll have mutual recognition, won't we. Right, yeah. And other dreams. Let's see. That's it, that's it. So the changes there have been

[18] AIFMD, *supra* note 2.
[19] *Id.*
[20] *Id.*
[21] UCITS IV, *supra* note 4.

a long time coming, but I'd say were, have been good. Of particular relevance is the work on disclosure, the fund disclosure document.[22] We've landed on this thing call the key information document, the KIDD. We're going to mandate a two page disclosure document. There was a big battle about that as you may imagine. People were very, very worried about liability issues, people who believed that consumers actually read things were concerned about having only two pages. Our experience tells us we'll happy if they did read the two pages because frankly people just often don't. This, the Commission has behaved in an exemplary manner on this one including conducting consumer research on different variations of this document to test not only whether consumers would engage with it, but also whether they could understand the information that was in it. So there's a lot of research and care that's gone into this and we expect to land in a reasonable place there.

There's also a number of other important reform elements and given the time I won't go into all of them, but there's master feeder structures are being created, fund mergers is being much simplified.[23] One of Europe's problems is there are lots and lots of very small funds that are just kind of being run on because it's too difficult to merge them and consolidate and you have a lot of fragmentation, which is not in anyone's interest really. And probably the most important, one of the most important elements is this management company passport which will allow for example, a hedge fund, a USCITS fund manager sitting in London to manage funds that are set-up in Luxembourg or France or Italy.[24] And this was a very, very controversial provision, as you can imagine and what it yielded in the end was quite interesting was that those countries which were worried about it were not prepared to agree to it unless we reversed into harmonization of fund management oversight standards because people were very concerned about authorizing a fund in their jurisdiction being managed by somebody else in another jurisdiction who wasn't being properly supervised. So that's happened is

[22] *Id.*
[23] *Id.*
[24] *Id.*

and we've kind of back into harmonization of supervisory requirements on the fund management companies in a way that is surprising but I think probably a good thing overall and certainly does create potential efficiencies of scale and scope in Europe through that element. That's been a hard fought one, that was a most difficult element of the directive.

So I think that's probably enough to say. I'd say a little bit about European institutional reform but it's probably just too complicated to get into in two or three minutes. I think I'll just leave on that, but I would be very happy to take questions if anyone wants to ask me anything about what I talked about or anything else, I'd more than happy to respond.

CLAPPING

Question: [Inaudible]

Daniel Yeah, that's what happens now and the director would have to be changed to allow that to happen, to sort of revert to the status quo but that's certainly something we're looking to achieve. I mean, it's one, my own assessment of this is that I think we will certainly end up with a European passport. I'll be surprised if we end up with a third country passport. That would be a desirable thing to achieve. This is a global market. We would like that. We are supportive of that. There's a lot of heat on the other side on that one, but what we don't want to do is disrupt the sensible national arrangement that exists today. That's an important thing to fix.

Jay Baris: Daniel you mentioned that there's a one size fits all system of regulation and that everything that is not a USCIT, the managers have then regulated. What about two guys and a dog in a garage enter into a partnership, is that?

Daniel: There's no, there are thresholds in the directive at the moment that would carve out some of those things of varying sizes for different sizes, parts of the market.[25] It's a very curious thing that a directive who's life began in "what should we do about potential systemic threats arising from hedge funds" turned into something

[25] AIFMD, *supra* note 2.

really quite different which is full of all kinds of consumer protection kinds of issues and things like that. And as a result of which we think, if you are talking about trying to achieve something in respect of systemic oversight, the thresholds here are just too low and will capture far too many people. Some quite small private-equity firms will be captured, some insignificant hedge funds, so there's an active debate about what are we trying to achieve and what bits of the directive are doing that and what bits of the directive are sort of working contrary to that.

Jay Baris: Okay, I want to thank Dan Waters for flying all the way over here from London to join with us today and talk about the European prospective. Thank you very much.

Daniel: You're very welcome.

Jay Baris: We're going to have about a 60 second break and move into the next panel.