

**REGULATING HEDGE FUNDS, PRIVATE EQUITY
AND OTHER ALTERNATIVE INVESTMENT VEHICLES**

**ASSESSMENT OF THE PROPOSED AIFM DIRECTIVE
AND FURTHER PROPOSALS FOR A COMPREHENSIVE LEGAL FRAMEWORK
(September 4, 2009)**

This memorandum proceeds with an assessment of the proposed AIFM directive and lays down the ground of what should be an appropriate regulatory framework for hedge funds (“**HF**s”), private equity (“**PE**”) and other alternative vehicles. It is divided into three sections: general comments, detailed analysis and a list of items that the directive fails to address. It presents a set of proposals summarizing what an appropriate framework should be, which is presented at the end of the document.

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PROPOSALS

I – AN INSUFFICIENT PROPOSAL WITH MAJOR LOOPHOLES

Stated objective of the directive. The stated objective of the proposed directive is to provide a regulatory framework for all funds, in particular hedge funds and private equity. In some areas, it makes steps forward. In particular:

- It has the comprehensive, “all encompassing”, approach that we have demanded in our Parliamentary Report.
- It proceeds with direct regulation (which is needed in addition to indirect regulation), as we had requested.
- It has abandoned self-regulation and codes of conduct, which are intrinsically unable to address the issues we are faced with, comforting our position that there is no such thing as “soft law”.

The proposal grants the industry a uniform private placement regime. The directive gives the industry what they have been asking for years: a uniform regime to market alternative funds to professionals. This is of course only acceptable if the proposed regime provides for appropriate safeguards to all stakeholders, who collectively form the economy: investors, companies and employees. *We are touching here the essence of our claim: a central entry point to the single market may only be granted to funds if they comply with a complete set of requirements.* The proposed directive, as it stands, clearly falls short of providing such requirements.

Major loopholes. The proposed directive leaves open too many loopholes to be really effective. In particular:

- Funds are left out. Only fund managers are addressed, not the funds themselves, which are left unregulated.
- Major gap in investor coverage. The territorial scope does not guarantee the protection of EU investors: only fund managers located in the EU are covered, not managers providing services to funds whose investors are in the EU.
- Dangerous exemptions. The so-called “de minimis” exemptions prevent appropriate monitoring of risks. It will also lead to regulatory arbitrage, through the multiplication of small funds. Such exemptions would thus make the directive essentially ineffective.
- Access for third countries. Third countries will have a very large access to the EU under conditions that will make it difficult to ensure the proper enforcement of the rules provided by the directive.

Significant progress still to be made. The details of the proposed directive show there is still a lot to amend and add if any substantial progress is to be achieved. In particular:

- Leverage. The proposed control of leverage is too weak and capital requirements are not addressed.
- Information. Information is not sufficiently detailed and periodicity is not frequent enough.
- Employee rights. Companies in which funds (such as PE funds) invest need to be informed and consulted (Directive 2001/23/EC of March 12, 2001 needs to be made applicable).
- Remuneration. Remuneration of fund managers needs to be addressed: it has to be based on long-term results, computed on the basis of cash actually received (and not potential accounting profits based on fair value accounting).

Other critical issues to be addressed. Whether in this proposed directive or in other instruments, some other critical issues need to be addressed:

- Improper conduct. A major gap in the proposed directive comes from the fact that hedge funds located outside of the EU will remain able to carry on with the type of conduct that has destabilized European markets. Such improper conduct needs to be curbed: this includes speculative short-

selling (and naked short-selling), empty voting (which allows short term activism at little cost) and stealth acquisitions (acquisitions of large stakes in companies without required notifications to the market and the company through the use of cash-settled derivatives).

- Public Interest Entities. EU banks, UCITS, pension funds, insurance companies or listed companies (“**Public Interest Entities**”), to the extent they have collected funds from EU retail investors, need to follow specific rules when investing in alternative investment funds (“**AIFs**”).
- Taxation. Taxation issues need to be addressed: taxation of leveraged acquisitions and taxation of fund managers (the carried interest is to be subject to income tax).
- Social cohesion. Promoting social cohesion should lead to sharing benefits of PE transactions with employees.

Keeping the focus right. Any reform should make sure that the focus is kept on the most important issues. Regulation should be made in view of long term sustainable growth and promote social cohesion. To this effect, it should address consumer protection, investor protection, market integrity, market stability (and prevention of systemic risk) and social externalities.

II – DETAILED ANALYSIS OF THE PROPOSED DIRECTIVE

A) SCOPE: WHO SHOULD BE REGULATED?

Proposed directive. The proposed directive introduces a legally binding authorisation and supervisory regime for alternative investment fund managers (“**AIFM**”) managing alternative investment fund in the EU. All EU domiciled AIFMs with assets under management above the threshold of 100 million EUR or, in case of AIFs with no leverage and lock-in period of 5 years or more, above the threshold of 500 million EUR are covered. The regime will apply irrespective of the legal domicile of the AIF managed.

Our analysis:

The “all encompassing” approach of the directive does not cover all issues. The directive uses an “*all encompassing*” approach: all collective investment vehicles are addressed to the extent they are not regulated under the UCITS directives. This is fine as it prohibits any attempt of regulatory arbitrage. Closed-end and open-ended funds are addressed. “In-house” funds are not addressed in this document: they should obviously be covered but, as they are not collective investment schemes, they should be covered in other directives, such as those regulating banks.

Funds should not be left out from the scope of the directive. The directive is based on the UK system, which provides for the registration of HF managers located in the UK.¹ Regulating managers addresses in part regulatory concerns. However:

- In general, regulating managers does not permit an easy “indirect” regulation of funds. For instance, in the UK, the FSA acknowledged that they do not review the exposure of funds as “*they are located offshore*”.² This is clearly insufficient.
- More specifically, as has been acknowledged by the Commission, “*the AIF may be located (...) in an off-shore jurisdiction for reasons of tax efficiency*”.³ Bringing the funds on shore would make it possible to address properly taxation issues.

¹ 80% of EU hedge funds are managed from the UK and 40% of all the equity investments made during 2007 were by PE funds managed from the UK.

² IOSCO, Technical Committee, March 2009, p.63

- Direct regulation of the funds would also permit to introduce effective capital and liquidity requirements.

Both fund managers and funds must thus be covered. Most countries require registration of both funds and fund managers.

The proposed territorial scope of the directive would leave open some loopholes. The directive covers only managers “established” in the EU, i.e. where it has its registered office (and its head office, as the directive provides that both need to be in the same MS). This is coming from the UK rules. It is wrong as it will push managers to operate from outside the EU, in which case no protection will be available for EU investors buying funds from non regulated AIFMs. The general rule should thus be that managers must register if they provide services to funds whose investors include EU investors.

The proposed de minimis exemptions would exempt most managers. The proposed regulation includes a broad *de minimis* exemption. A threshold of €100 million implies that roughly 70% of hedge fund managers more than 50% of managers of other non-UCITS funds would not be covered by the directive. This approach is wrong, as it leaves out a majority of funds and will lead to a multiplication of small funds with dedicated managers who will delegate management to third parties to the fullest possible extent – this may jeopardize the quality and accountability of management. There should be no blanket *de minimis* exemption. An exemption should only be considered after some time, when the monitoring system is effectively applied, and for amounts that would allow the capture of most managers and funds.

B) REGISTRATION PROCESS: SINGLE ENTRY POINT SYSTEM

Content of proposed directive. To operate in the EU, all AIFMs will be required to obtain authorisation from the competent authority (CA) of their home Member State. They will be required to demonstrate that they are suitably qualified to provide AIF management services and will be required to provide detailed information on the planned activity of the AIFM, the identity and characteristics of the AIF managed, the governance of the AIFM (including arrangements for the delegation of management services), arrangements for the valuation and safe-keeping of assets, audit arrangements, and the systems of regulatory reporting, where required. The AIFM will also be required to hold and retain a minimum level of capital.

Our analysis:

The single entry point system is fine as long as it does not lead to regulatory arbitrage. The directive has adopted the single entry point system. Each MS remains competent to register the managers. This will lead to arbitrage in favour of more relaxed registration authorities, especially as registration in a MS will give the right to market the fund with all EU professional investors in the EU. However, the directive provides that the “head office” must be in the same MS as the registered office: if this provision is read as imposing the “real seat” to be in the same MS as the registered office, arbitrage potential will be more limited. This provision will need however to be strictly enforced to be efficient.

The registration procedure is not complete. The description of information provided to obtain registration is not complete:

³ Impact Assessment, p.5. In the UK, the Investment Manager Exemption provides that managing an offshore fund from the UK will not bring it onshore for tax purposes.

- It addresses registration of managers but not funds.
- More information, such as information related to the precise track record of would be managers, should be asked.
- The registration procedure also needs to provide for notification to other MS and for ready access to collected information, post registration, for all supervisory authorities, through a database that could be run by CESR.
- It does not require fund managers to commit some of their own money in the funds they manage.

The minimum level of capital required from funds is not consistent with the objectives set by the directive. Managers are required to hold and retain a minimum level of capital of at least €125,000, plus 0.02 percent of the amount by which the value of the portfolios exceeds €250 million. According to the directive, “*the ongoing capital requirements should cover the potential exposure of AIFM to professional liability in respect of all their activities, including management services provided under delegation or on the basis of a mandate* » (whereas n°11). Obviously, the proposed amounts are too low to cover professional liability of the managers. More substantial amounts should be proposed.

C) TRANSPARENCY REQUIREMENTS

Content of proposed directive.

Investors. The proposed directive requires AIFMs to provide to their investors a description of the investment policy, including descriptions of the type of assets and the use of leverage; redemption policy in normal and exceptional circumstances; valuation, custody, administration and risk management procedures; and fees, charges and expenses associated with the investment. Annual reports will have to be made available to investors. AIFMs will be required to treat their investors fairly and, if investors are not treated equally, to disclose any such preferential treatment to all investors.

Regulators. To support the effective macro-prudential oversight of AIFM activities, AIFMs will be required to report to the CA on a regular basis on the principal markets and instruments in which it trades, its principal exposures, performance data and concentrations of risk.

Our analysis:

Minimum requirements regarding the content of the annual report should be included in the directive. While it makes sense to leave the details of the report to level 2 legislation, minimum standards and requirements should be included in the directive itself, which is not the case in the proposed draft.

Disclosure to investors should be standardized. Information disclosed to investors should be standardized (to any reasonable extent) and filed in a public register. Investors should receive periodic information on items such as:

- (1) investment strategy, objectives and techniques (including on assets in which the fund can invest in, techniques it may use, planned leverage) and past performance,
- (2) identity of the depositary, valuator, auditor and any other service providers and a related agreed conditions, conditions of delegated management (if applicable),
- (3) valuation procedure and pricing models, liquidity risk management,
- (4) redemption rights, gates, side pockets, fair treatment of investors and beneficiaries of preferential treatment,
- (5) fees, charges and expenses due and paid;

- (6) percentage, amount and description of assets which are hard-to-value, illiquid or placed in side pockets,
- (7) current risk profile, including valuation of assets, use of leverage,
- (8) detailed description of the investment by the managers in the funds,
- (9) source, maturity and amount of funds raised including share of the fund contributed by the management company and its staff.

The requirements regarding reporting to regulators are vague. The core of the issue is referred to Commission implementing measures. The periodicity of disclosure should be addressed. Among information to be addressed to regulators, there should be a list of investors. Regulators should be provided with aggregated information on items such as:

- (1) trading, exposures, valuation of assets, concentrations of risks, percentage, amount and description of assets which are hard-to-value, illiquid or placed in side pockets, current risk profile, performance data,
- (2) use of short selling,
- (3) structure of fees and amounts paid,
- (4) list of investors,
- (5) short and long positions,
- (6) level of leverage, its rate of change; funding and its maturity.

Periodicity. Detailed periodicity of disclosure should be left to level 2 legislation, with:

- (1) Minimum requirements included in the level 1 directive:
 - Compulsory comprehensive annual report for each fund and fund manager.
 - Disclosure every three months for specific subsets of information (such as leverage or valuation), as specified by regulators on the basis of risk assessment.
 - Disclosure on valuation at the time of each redemption.
- (2) Right for supervisors to require enhanced disclosure under certain conditions and to adapt disclosure to evolving financial techniques.

D) OPERATING CONDITIONS

Content of proposed directive. The AIFM will be required to satisfy the competent supervisor of the robustness of internal arrangements with respect to risk management, in particular liquidity risks and additional operational and counterparty risks associated with short selling; the management and disclosure of conflicts of interest; the fair valuation of assets; and the security of depository/custodial arrangements. When managed AIFs are domiciled in a third country and the assets of those AIF are also deposited in a third country, CA will be required to pay particular attention to the robustness of these depository arrangements. The proposed directive foresees that the precise requirements, in particular with regard to disclosure requirements, will be tailored to the particular investment strategy employed.

Our analysis is presented in sections D1 and D2 below.

D1) CREATING A SAFETY NET: VALUATION, DEPOSITARY, DELEGATION, CONDUCT OF BUSINESS

Proposed valuation rules are clearly not sufficient. The directive provides for yearly valuation (or each time there is a redemption, if this is more frequent) made by a valuator legally or functionally independent, which may be offshore. The valuation standards will be that which are included in the

funds' rules or instruments of incorporation – i.e. the fund managers will decide on the valuation rules. This is not satisfactory:

- Valuations should take place more often if risks are to be correctly monitored at a macro level (this is in particular true for PE, where there are no interim redemptions and thus the yearly valuation would be the rule).
- Valuation principles and guidelines should not be entirely left to managers – there should be some guidelines set by competent authorities.
- Valuers should be legally *and* functionally independent (Chinese walls are not sufficient), have their head office (i.e. their real seat) within the EU (not just a letter box) and they should not be authorized to delegate the valuation to a third party (otherwise, this obligation is pointless).
- In addition, independent valuation is necessary for the assessment of management fees and for a correct evaluation of risks.

If this had been done before, we would now be in a better economic situation.

Rules regarding depositaries are not sufficient. The directive provides for the liability of the depositary unless it can prove that “*it could not have avoided the loss which has occurred*” – which is an awkward formulation. Depositaries should follow a strict liability rule: they must be able at all times to give the shares back to the investors, unless they can prove a case of *force majeure* (which would be a stricter and better defined standard than the one which is proposed in the directive). Investors should also be entitled to have a direct claim against failing depositaries in all cases. In addition, whereas the directive provides that depositaries must be onshore, delegation of their tasks is authorized. As proposed in the De Larosière report, the depositary should not be allowed to delegate its functions.

Rules regarding conduct of business are vague. Managers must “*act honestly*” – no comment. Preferential treatment of some investors remains authorized provided it is disclosed. The treatment of conflicts of interest is odd: they are permitted as long as they are disclosed; however, when the funds of an investor are locked in, disclosure is not particularly helpful. Conflict of interest should be prohibited unless specifically approved by the investors.

D2) RISK REDUCTION: CAPITAL REQUIREMENTS, LIQUIDITY MANAGEMENT, REMUNERATION

Rules regarding liquidity management and risk management are not sufficiently detailed. The wording of the proposed directive is light and most of this issue is delegated to Commission implementing measures. Liquidity must be consistent with redemption rights and with the amount of leverage. This needs to be monitored closely.

The directive does not provide for capital requirements for funds. Among the ways to address risk management for funds, there is the requirement to have minimum capital requirement. This mechanism should be added to the directive.

The issue of managers' remuneration is not addressed in the directive. As has been correctly highlighted by the De Larosière report, the wrong incentives that induced excessive risk taking, in particular in connection with remunerations, must be rectified. Remuneration policies should be based on long-term profit and firm-wide profitability, based on actual performance. If these measures are not complied with, financial institutions should be required to provide additional capital under pillar 2 of the Basel framework.

E) SPECIFIC PROVISIONS

Regulating specific conducts. The proposed directive does not make any *direct* reference to “hedge funds” or “private equity”, but addresses some of their most typical conducts: leveraging for the former, acquisition of controlling interest for the latter. This approach, based on objective criteria, is acceptable to the extent it is complete (which is not yet the case) and if specific regulation addresses certain types of funds and of conduct.

E1) SPECIFIC PROVISIONS FOR HEDGE FUNDS: LEVERAGE, IMPROPER CONDUCT

1) Regulating leverage

Content of proposed directive. An AIFM employing leverage on a systematic basis above a defined threshold will be required to disclose to the competent authorities the aggregate leverage, the form of leverage (cash borrowing, securities borrowing, leverage embedded in derivatives), and the main sources of leverage (lending institutions such as prime brokers, banks etc) to the home authority of the AIFM. Information on the level of leverage must be disclosed on a quarterly basis to investors. The proposal includes the introduction of limits to leveraging by the Commission and recognises emergency powers for authorities of the home MS to restrict the use of leverage in respect of individual managers and funds, if the stability and integrity of financial markets so requires. The proposed directive requires that this information be shared between competent authorities and transmitted on quarterly basis to the Economic and Financial Committee and without delay in the event of threat of imminent instability or counterparty failure.

Our analysis:

The proposed exemptions leave some investors without protection. The specific disclosure requirements regarding leveraging are subject to two conditions. First, it applies only to funds “*employing high levels of leverage on a systematic basis*”, defined as a leverage exceeding the value of the equity capital on two out of the past four quarters. Whether this test makes sense will depend on how it will be applied. Second, the requirement applies only if the assets under management of the manager exceed 500 million euros, which leaves investors in smaller funds without protection.

Rules regarding the reporting to supervisors are vague. The wording is short and frequency of disclosure is left to implementing measures. The relevant information should be disclosed to supervisors on a periodicity which is sufficient to provide a close monitoring (for instance, basic information providing early warnings may be disclosed on a weekly basis and more extensive information on a quarterly basis).

Information to be provided to investors is not sufficient. Information such as the aggregate leverage, the form of leverage (cash borrowing, securities borrowing, leverage embedded in derivatives), and the main sources of leverage (lending institutions such as prime brokers, banks etc) should be regularly disclosed to investors. The exact periodicity may be left to contractual provisions above minimum requirements.

The proposed rules do not include a Global Credit Register. The European Central Bank and now the High-Level Group on Financial Supervision chaired by Jacques De Larosière have proposed the setting up of a global credit register. There have been additional proposals for the creation of a global directory of all trading positions to help identify systemic risk arising from credit and counterparty

exposures and from herding and contagion in the financial markets. This register should be set up and all information that is collected should be filed with it.

Powers of supervisors (not sufficient). The power of supervisors to restrict the level of debt is possible if the “*stability and integrity of financial markets so require*”. The condition should be “*if the stability or integrity of financial markets so require*”.

Ex ante limits on leverage should be more clearly specified and there should be rules regulating the division of risks and providing for capital adequacy requirement. Ex ante limits to leverage are left to implementing measures and rules on division of risk should be added. Specific limits should depend on the type of activity, the risk profile of the fund and the maturity of their funding. Margin capital requirements could also be required when positions become large in a particular market or grow quickly. This means that meaningful capital adequacy requirements must be introduced. These limits should be set up ex ante and take into account the stability or integrity of financial markets or the general situation of the economy.

2) Regulating improper conduct

The following items are not addressed in the proposed directive and should be covered by appropriate regulation:

Regulating activist HFs. Activist hedge funds have specific features that warrant specific regulations – even, if, in the end, such regulations should be extended to all market players. These features are the following:

- Leverage can amplify the position taking ability of a hedge fund manifold. Compared to pension funds and other institutional investors which normally hold well-diversified equity portfolios, hedge funds can and often do hold concentrated positions which means that they many have a significantly large equity stake in a particular company. They are able to move quickly in and out of positions and thus can have disproportionate influence on share prices and through this mechanism on corporate governance and management decisions.
- Hedge funds are often considered to be “leading edge” investors so others often follow suit and sell when they sell and buy when they buy so their influence extends beyond their own share of investments.
- They can sell short and pursue other strategies that other institutional investors cannot – this gives them more influence over the management of a company than other more traditional fund managers.
- They can, using derivatives and short selling, build up big positions in the shares of a company at relatively little expense.
- It is common for hedge funds to buy the shares of a company that is likely to be acquired and shell short the shares of the company that is likely to acquire. This means that they have different financial incentives from the shareholders of either the firm being acquired or doing the acquiring and a full disclosure of this interest is essential for good corporate governance and is in the interest of all other shareholders.
- Hedge funds often act aggressively and are the leaders in the use of techniques that are in grey areas from a legal standpoint.
- It has been suggested by the FSA in the UK that as many as a third of all M&A transactions suffer from insider trading, sometimes linked to hedge funds.

Stealth purchases. An appropriate disclosure regime should include both direct voting interest in terms of an outright ownership of shares as well as indirect interest acquired through derivative transactions (including cash settled transactions, as has now been decided in the UK) or financial instruments giving rights to newly issued shares.

Empty voting. Voting in general meeting without the corresponding economic exposure is a technique that activists funds have developed over the years to influence companies' management at little cost, in view of making short term profits. This conduct is detrimental to companies and to the markets, which are not aware of this type of manipulative practices (as there are no requirements to disclose them). Such practices are well documented and should be banned (as proposed by the Hedge Fund Working Group itself).

Short selling. The crisis has shown the destabilizing effect of short selling when used in troubled circumstances. Naked short selling should be banned and speculative short selling should be restricted. These rules should be applicable to all investors.

E2) SPECIFIC PROVISIONS FOR PRIVATE EQUITY: TAKING SIGNIFICANT STAKES IN COMPANIES

1) Assessing the proposed directive

Content of proposed directive. Particular requirements apply to AIFMs managing AIFs which are in a position to exercise controlling influence over a listed or non-listed company, in particular to notify the existence of this position and to disclose information to the company and all its other shareholders about the intentions of the AIFM with regard to the future business development and other planned changes of the controlled company. In order to ensure transparency regarding the controlled company, enhanced reporting requirements should apply. The proposal does not extend these requirements to acquisitions of control in SMEs.

Our analysis:

The proposed directive does not address properly the lack of reliable information. Private equity has so far disclosed very little information, mostly unverifiable and not provided on a consistent basis. As this type of ownership leads to significant changes in the management style of companies, it is of the utmost importance to have a complete and consistent picture of companies under LBOs. This information is important for investors, supervisors, employees and the public. There should be no exemption from information requirements, be it on the basis of the fund size or the managed company size.

Investments in SMEs should be covered. Investments in SMEs are exempted from the disclosure requirements. This is wrong as employees in SMEs as well as the public in general are interested in PE investments in all segments of the economy.

Triggering of disclosure requirements is ill-defined. Disclosure is required only when a 30% threshold is reached, which is too high. Regarding listed companies, the directive assumes (wrongly) that the 30% threshold triggers in all MS a mandatory tender offer and then refers to the takeover bid directive for information to be provided! In other words, no specific disclosure is required from managers. In addition, the concept that all managers "acting in concert" should be aggregated is missing. The following principles should be applied:

- When participations of 10%, 20%, 30% and 50% are acquired by funds or fund managers acting alone or in concert, in public or private companies, specific disclosures should be made.
- The level of disclosure should be adapted to the level of participation – the information should be most significant when a controlling influence is taken. Information should also be substantial when several funds (even not related) take a controlling influence, as the management style will also be substantially affected in this case.

- This information must also be updated in annual reports.

Disclosure requirements are extremely limited. Very little information is required to be disclosed, and less information is required when acquisitions relate to private companies. For instance, information on the acquirer's intentions with regard to the future business of the target company, the safeguarding of the jobs of its employees and management, including any material change in the conditions of employment, and in particular the acquirer's strategic plans for the two companies and the likely repercussions on employment and the locations of the companies' places of business" is only asked in connection with public companies (and this requirement already exists in connection with tender offers).

Information should include, in relation to past and planned conduct (as appropriate):

- (1) operational and financial developments: presentation of revenue and earnings by business segment, statement on the progress of company's activities and financial affairs, assessment of expected progress on activities and financial affairs, report on significant events in the financial year, R&D effort,
- (2) financial and other risks, including financial risks associated with capital structure,
- (3) impact on environment,
- (4) employee matters: turnover, terminations, recruitment,
- (5) statement on realized or planned significant divestment of assets,
- (6) information on capitalisation,
- (7) financing of the acquisition, plan for refinancing post acquisition,
- (8) management package,
- (9) acquisition and resale price.

Information regarding delisted companies. Companies undergoing public to private transactions will continue to provide the same level of information for two years. This seems reasonable.

2) Going further: leverage, asset stripping, value extraction, employee rights,

The following items are not addressed in the proposed directive and should be covered by appropriate regulation:

Keeping the focus right. Private equity firms, just as hedge funds or asset managers, tend to see privately held companies as a "*class of assets*" – just as gold bullions, stamp collections or mansions on the Riviera. Under this theory, allocation of private wealth between the various "classes of assets" should be as easy as possible. This is wrong. *Companies are much more than a "class of assets" – this is a narrow finance standpoint on the world.* Companies are made of people, working on projects, with appropriate equipment and finance, within a legal and social organization which is rooted in a local culture and immersed in history. All regulation relating to companies should take this into account. In addition, the specificity of funds, and in particular PE funds, should be taken into account: *Private equity funds hold companies with a view to resell them.* Thus, just as strategic shareholders, they have a strong control on management, but, similar to the situation of dispersed shareholding, they have in reality a low commitment to the company's project and prospects. This warrants a specific regulatory approach, because it raises concerns regarding negative externalities, social issues (including allocation of resources) and regulatory concerns.

Limit to leverage. Funds acquiring companies with intent to resell should be constrained in their ability to leverage acquisitions.⁴ This may be achieved either through a limit on the leverage multiple (which may vary according to the industry where the target company operates) or, in a simpler and more flexible way, through a limit on the deductibility of interests paid by the target and the acquisition vehicle when such interests exceed a certain percentage – for instance 30% - of the target company's EBITDA. Generally speaking, *ex ante* capital adequacy requirements and limits to leverage requirements should be based on a top down approach (general situation of the economy) and bottom up approach (financial condition and long term sustainability and growth of target companies, in particular assessed through business plan and projected EBITDA).

Limit to asset stripping. When asset stripping is motivated by the need to repay a portion of the acquisition debt, it should be appropriately controlled. To this effect, in the event a company under private equity control wishes to sell company assets in any material respect, the management of both the target company and the acquisition vehicles should issue a statement as to why the sale is implemented and certifying that the proposed sale is in the best interest of the target company. Second, in the event the proposed sale is connected to a repayment of the acquisition debt, the employees of the target company should be informed and consulted, through the workers' council when there is one. Third, in the event the company becomes insolvent after the asset stripping, the private equity firm should be held liable. More generally, management of companies under LBO should be required to issue a statement that capital outflows (including fees paid) is in the long term interest of the company, including its long term growth and R&D needs.

Limit to value extraction. Excessive value extraction within the first years following an acquisition provides a wrong incentive to address risk in a proper manner. Examples of such value extraction are compelling: Warner music was bought for \$1.25 bn in 2003 by a private equity consortium including Bain capital and, within months of being acquired, it made payments including dividends and advisory fees of \$1.43 bn on behalf of its owners; just six months after the buyout of Hertz, a trio of private equity companies collected a \$1 bn dividend which was financed by a new loan taken out by Hertz and earned back half their initial equity investment while keeping the amount intact; the Blackstone group put \$650 million for Celanese, a US chemicals company in 2004 and within nine months had paid itself \$500 million in dividends and an additional \$45 million in advisory fees. This type of conduct should be addressed through proper restrictions.

Employee rights. As employees are the ultimate source of any profit made by private equity firms and funds, they should be informed and consulted on the detailed structure of the acquisition of the company they work in, including fee arrangements, management packages, debt repayment plans, etc. If private equity transactions are good for employees, there should be no fear to communicate such information. Such acquisitions should thus be subject to the employee information and consultation rights provided by directive 2001/23/EC relating to the safeguarding of employee's rights in the event of transfers of undertaking, businesses or parts of understanding or businesses.

Employee participation. When a target company is resold, appropriate incentives should be set up to provide that its employees receive a fair portion of the sale price – for instance, 20% could be an appropriate figure.

⁴ *"It is estimated that, at the global level, more than USD 500 billion of leveraged loans and high-yield bonds will have to be refinanced between 2008 and 2010."* (ECB, Financial Stability Review, December 2008). Although these figures do not relate to private equity only, it is likely that tightened credit conditions will lead to stresses in corporate credit and CDS markets. The resulting difficulties for portfolio companies of private equity funds might backfire on the returns of the funds and might lead to detrimental effects in the real economy, at least at local or regional level.

F) PRIVATE PLACEMENT: THE PP PASSPORT

Content of proposed directive. In order to facilitate the development of the single market, an AIFM authorised in its home Member State will be entitled to market its funds to professional investors in Member State. Member States will not be permitted to impose additional requirements on AIFM domiciled in another Member State insofar as marketing to professional investors is concerned. The cross-border marketing of AIF would be subject only to a notification procedure, under which relevant information is provided to the host Member State and transmitted to the host.

The proposed directive does not provide rights in relation to marketing AIF to retail investors. Member States may allow for marketing to retail investors within their territory and may apply additional regulatory safeguards for this purpose. Such requirements shall not discriminate according to the domicile of the AIFM.

AIFM shall also be entitled to freely provide management services in Member States other than their Member State of domicile, subject to a notification procedure.

Our analysis:

Marketing to professional investors (subject to improvement of the proposed directive). The directive proposed a “professional investor marketing passport” (the “**PP Passport**”). Authorizing managers to market funds when they comply with the directive may be fine, but not with such a directive. In addition, the category of “professional advisors” is not relevant: a distinction should be made between, on the one hand, high net worth individuals and private companies, and on the other, entities using funds collected from the public.

No leakage (vague). The directive provides that measures should be adopted to avoid leakage of funds to retail investors. No details are given as to how this is to be achieved.

G) SPECIFIC RULES REGARDING THIRD COUNTRIES

Content of proposed directive. Specific rules regarding relationships with third countries will apply from 2014 onward (or three years after the directive becomes law in Europe). In particular, the directive proposes that:

- AIFs domiciled in a "third country" may be marketed in the EU after this date, provided that such third country has entered into an agreement based on the OECD Model Tax Convention (Art. 26).
- AIFMs established in a third country may market AIFs in the EU if the following conditions are met: signature of an OECD Model Tax Convention, equivalence of rules regarding prudential supervision and on-going supervision, reciprocity, signature of a cooperation agreement.
- Delegation of tasks to third parties by an AIFM is permitted if the beneficiary of the delegation is subject to prudential supervision and a cooperation treaty has been signed.
- An AIFM shall be entitled to use a valuator established in a third country if valuation standards in the relevant third countries are equivalent to those applicable in the EU.
- With respect to AIFs domiciled in a third country, the depositor used by such AIF shall be entitled to delegate its functions to a sub-depositary established in the same third country, provided that there is an equivalent legislation, such sub-depositary is subject to prudential regulation and supervision and co-operation is sufficiently ensured.

Our analysis:

The rules regarding third parties weaken considerably the effect of the directive. Although some precautions are taken to control third party access to the EU market, it is clear that the proposed rules would considerably weaken the whole directive and in particular the ability to design and enforce appropriate rules. Investor protection would be significantly affected as a result.

III – ITEMS MISSING IN THE PROPOSED DIRECTIVE

The proposed directive does not address, in any significant manner, many items, including indirect regulation and taxation. These issues call for regulation, although the appropriate instrument may be other, new or existing, directives.

All items addressed below in this section III are not addressed in the proposed directive and should be covered by appropriate regulation.

1) Indirect regulation: Public Interest Entities and Prime Brokers

Public Interest Entities. Protection of EU investors requires that all entities funded by EU investors be subject to a specific regime. Investments by PIEs in funds should therefore be regulated in light of the specific characteristics of each category and the type of funds. Generally speaking, strong due diligence requirements should also be imposed when investing in funds.

Prime brokers. Prime brokers are a key partners of funds. However, considering the risk they incur, additional capital requirements should be imposed under Basel 2 rules. These requirements should be based on the type of fund and could be increased if the level of disclosure does not comply with applicable rules.

2) Taxation

Tax issue. The vast majority of hedge fund and private equity vehicles were incorporated in offshore jurisdictions with the Cayman Islands being the most popular. The Cayman Islands has 63% of HF assets, BVI 13%, Bermudas 11% with Luxembourg, Liechtenstein and Monaco being the three big mainland centres. The reason behind this is that these offshore centres offer a combination of zero tax regimes for non-citizens and privacy. For example, a US or EU citizen putting money into these offshore vehicles would not have to pay any tax till the profits were remitted home. There is no withholding tax or any independent reporting by the source. It has been shown by the US IRS that in such cases voluntary compliance with the tax code falls to below 50%. Hence it is likely that billions of dollars of taxes were avoided (evaded) on income earned through offshore hedge fund and private equity investments. Addressing the tax issue is thus critical.

Tax subsidy. Acquisition by PE funds is subsidized through the deductibility of interests. This massive cost is only justified if PE activity is good for the economy. This should then be reviewed regularly and tax deductibility of interests should be limited.

Taxing managers. The tax affairs of hedge fund managers and private equity partners, who have earned billions of dollars in the boom and through their actions have contributed to the bust, have been problematic. For instance, in the UK, several managers/partners have been using the ‘non-domicile’ status to avoid paying tax. “Dual contracts” for offshore and onshore work has also been used. The

treatment of private equity “carried interest” as capital gains, where private equity partners ended up paying lower rates of taxes than cleaners despite earning hundreds of millions, is not acceptable. It is time to end the non-domicile regime and legislate for the treatment of ‘carried interest’ as income for tax purposes.

PROPOSALS FOR A COMPREHENSIVE LEGAL FRAMEWORK

I – GENERAL RULES

A) DIRECT REGULATION

Who should be regulated? (Scope of direct regulation)	
General scope	Regulation must be general and address all forms of collective investments vehicles that are not otherwise regulated pursuant to UCITS directives, such as hedge funds, private equity funds or real estate funds. This includes open-ended and closed-ended funds, whether listed or not, irrespective of legal form Within this broad category, specific regulation may target specific conducts or risks.
Fund managers and funds	Fund managers and funds must be registered.
Territorial scope	Funds and fund managers must be registered in a MS if: <ul style="list-style-type: none"> - They are located within the EU. - Final investors are located in the EU.
De minimis exemptions	In principle, no de minimis exemptions should be applicable. After two years of implementation of the directive, based on experience, level 2 legislation may provide for exemptions applicable to small funds, provided that exemptions are granted for renewable one year periods and do not apply to data collection.
<p>Explanation: Regulation needs to avoid the creation of any loophole: it thus needs to be “all encompassing” and, as a principle, to have no de minimis exemptions. Both fund managers and funds need to be covered, in particular as offshore funds are most often used for tax and regulatory arbitrage reasons. The right territorial criterion to use when determining which fund manager or fund should be registered is not only the location of the entity (as it may easily be relocated offshore) but the location of the final investors – EU regulation should provide protection to EU investors irrespective of the location of the fund or the fund manager.</p>	

Registration process for funds and managers: single entry point system	
Competent authority	Freedom for funds and managers to chose MS where registration is requested, subject to: <ul style="list-style-type: none"> - “real seat” doctrine: registered office and head office must both be in the selected MS, - the measure should be strictly enforced.
Procedure	Review of registration application should include a notification by the selected “home” MS competent authority to competent authorities of other MS and a one month cooling-off period to allow for opposition by such authorities.
CESR database	Information collected during the review of the application and on an on-going basis is posted on a database run by CESR and available to all supervisors.
Information required	Detailed information on all relevant issues, such as (1) information on the identity and personal track record of the managers, management company shareholders, whether direct or indirect, known or targeted investors, and the amounts of their respective holdings, (2) a programme of activity (including compliance, risk management, valuation, etc.), (3) detailed information about each fund (including fund rules and by-laws), (4) information on delegation to third parties of management services functions, (5) agreements with depositaries, administrators and prime brokers, (vi) information on

	marketing and distribution and (6) any additional information to be provided to investors pursuant to the directive (see “Transparency requirements” below).
Manager involvement	The managers should be required to hold and retain a minimum level of capital, in order to make sure that they are properly incentivised.
<u>Explanation:</u> A single entry point system for registration is proposed, which is the counterpart of the implementation of appropriate measures taken to avoid regulatory arbitrage and inappropriate dissemination of unregulated products. Appropriate preliminary checking should be done in cooperation between home and host MS. Information should freely circulate between regulators both before and after registration.	

PP passport	
Principle	When registration in a MS is granted pursuant to the “single entry point” system, it is immediately valid in all other MS.
Scope	The passport may be used in connection with: <ul style="list-style-type: none"> - Professional investors only, in principle. - However, limited exemptions for certain categories of retail investors may be granted on a case by case basis, depending on existing national laws (provided such laws do not apply lower standards than the directive).
No leakage	Prohibition to sell to investors not covered by the passport, even if investors were not solicited.
<u>Explanations:</u> A single entry point for funds, giving them access to a passport, is a powerful mechanism that can only be set up if strong guarantees are given. Strong anti-leakage provisions should be adopted.	

Transparency requirements	
Periodicity	Detailed periodicity of disclosure should be left to level 2 legislation, with: <ol style="list-style-type: none"> (1) Minimum requirements included in the level 1 directive: <ul style="list-style-type: none"> - Compulsory comprehensive annual report for each fund and fund manager. - Disclosure every three months for specific subsets of information (such as leverage or valuation), as specified by regulators on the basis of risk assessment. - Disclosure on valuation at the time of each redemption. (2) Right for supervisors to require enhanced disclosure under certain conditions and to adapt disclosure to evolving financial techniques.
Disclosure to investors	Periodic information on items such as (1) investment strategy, objectives and techniques (including on assets in which the fund can invest in, techniques it may use, planned leverage) and past performance, (2) identity of the depositary, valuator, auditor and any other service providers and a related agreed conditions, conditions of delegated management (if applicable), (3) valuation procedure and pricing models, liquidity risk management, (4) redemption rights, gates, side pockets, fair treatment of investors and beneficiaries of preferential treatment, (5) fees, charges and expenses due and paid; (6) percentage, amount and description of assets which are hard-to-value, illiquid or placed in side pockets, (7) current risk profile, including valuation of assets, use of leverage, (8) detailed description of the investment by the managers in the funds, (9) source and amount of funds raised including share of the fund contributed by the management company and its staff.
Disclosure to regulators	Aggregated information on items such as (1) trading, exposures, valuation of assets, concentrations of risks, percentage, amount and description of assets which are hard-to-value, illiquid or placed in side pockets, current risk profile, performance data, (2) use of short selling, (3) structure of fees and amounts paid, and (4) list of investors.
Disclosure to the public	Most important information to be made available to the public through web site publication.

Standardization and filing	Information disclosed to be standardized and filed for registration at the EU level.
<u>Explanations:</u> Lack of transparency was one of the causes of the financial crisis and has led to a number of frauds. Full transparency should thus be required. Minimum standards should be set and regulators should be granted the possibility to require more information as appropriate.	

General operating conditions	
Valuation	Regular valuation (every quarter and at the time of each redemption), based on principles and guidelines set by competent authorities. The valuation should in particular cover management fees and the evaluation of risks. Legally independent valuers having their head office (i.e. their real seat) within the EU (not just a letter box). They should not be authorized to delegate the valuation to a third party.
Depository	Legally independent depository, subject to prudential regulation and on-going supervision, with a strict liability duty to return deposited assets. No delegation should be permitted. Depositories must be located in the EU. Investors should be entitled to have a direct claim against failing depositories in all cases.
Conduct of business	Fund managers to apply duties of care and diligence and rules relating to the prevention and management of conflicts of interest..
Risk management	Identification, assessment and monitoring of risk at all times.
<u>Explanations:</u> Investor protection and prudential rules require regular and independent valuation and appropriate risk management, with the conduct of regular stress tests. Independent, onshore and fully liable depositories are necessary to guarantee at all times the return of deposited assets.	

B) INDIRECT REGULATION

Indirect regulation	
Public Interest Entities	Specific rules should be applied to Public Interest Entities (i.e. entities soliciting or holding public funds, such as EU banks, regulated funds, pension funds, insurance companies or listed companies) investing in funds, based on: nature of Public Interest Entities, nature of activity of the fund and related risk profile, quality of disclosure by the fund and the fund managers. The rules should relate to additional capital requirements for banks, technical reserves for insurances, etc. All Public Interest Entities must also comply with due diligence requirements upon investing and on an on-going basis.
Prime brokers	Additional capital requirements for prime brokers investing in hedge funds and private equity. Conflicts of interests must be addressed.
<u>Explanations:</u> Indirect regulation is needed on top of direct regulation, to address properly the issues created by funds. Public Interest Entities and prime brokers should thus be regulated.	

C) TAXATION

Taxation	
Tax subsidy	A limit should be set on tax subsidy (limit to deductibility on debt in LBOs)
Taxing managers	Carried interest should be taxed as income tax. Dual contracts issue to be addressed
<u>Explanations:</u> Taxation is a normal way to regulate the economy. It should be used to provide the right incentives to the various players.	

II – SPECIFIC RULES RELATING TO HEDGE FUNDS

Operating conditions for hedge funds	
Funding of fund managers	Fund managers should be appropriately funded to implement appropriate systems that are necessary to remain in compliance with all relevant systems.
Liquidity management	Liquidity profile must be consistent with redemption rights and with leverage. Stress tests to be conducted regularly.
Capital requirement	Minimum capital requirement should be imposed to funds, in view of the leverage they use, maturity of funding and their risk profile. Additional capital requirements should be imposed if the remuneration structure is not appropriate and induces excessive risk-taking.
Remuneration policy	1) Remuneration of fund managers and of their employees must be based on long-term profit, actually received (not just booked in accounts on the basis of net present value of expected future returns assessed at fair market value). No guaranteed bonuses. 2) Failure to comply should be addressed both directly (through requirements imposed to registered funds and managers) and indirectly (through increased capital requirements for financial institutions lending money to non compliant funds).
<u>Explanations:</u> Liquidity management and capital requirements will reduce systemic risks. Basing remuneration on long term returns actually received in cash will also reduce undue risk-taking.	

Use of leverage by hedge funds	
Scope	Leverage (including leverage embedded in derivatives) used by all funds should be monitored (no de minimis exemption).
Disclosure to investors	Disclosure of maximum amount of leverage (in exceptional conditions and in all conditions) and of actual use of leverage, on a weekly basis.
Disclosure to supervisors	Detailed disclosure of leverage, including information on 15 banks with the largest exposure. ⁵
Global Credit Register	A Global Credit Register should be set up and all relevant information should be aggregated at this level.
Limits: leverage, risks, capital	Ex ante limits on leverage and rules on division of risk should be set up, based on the type of activity, the risk profile of the fund. and maturity of funding. Margin capital requirements could also be required when positions become large in a particular market or grow quickly. Significant capital adequacy requirements must be introduced. These

⁵ UK system (see IOSCO, Technical Committee, March 2009, p. 64)

	limits should be set up ex ante and take into account the stability or integrity of financial markets or the general situation of the economy.
Powers of supervisors	Supervisors may restrict the use of leverage if required by the stability or integrity of financial markets or the general situation of the economy.
<u>Explanations:</u> Overleveraging has been one the key elements of the current crisis. Appropriate monitoring should be set up for all funds (not just some of them). In addition, ex ante limits should be determined and work as safety net. Supervisors should also have the power to restrict the use of leverage, when the economy, the financial markets or the underlying companies require so.	

Regulating improper conduct	
Scope	Hedge funds have often had a leading role in the use of improper conduct. Such conduct must be regulated for all market participants.
Short selling	Ban on naked short selling and restrictions on speculative short selling.
Stealth acquisitions	Full disclosure of all shareholdings and “long” positions, including cash settled derivatives and convertibles. (“Stealth acquisitions” refer to the growing practice of acquisitions structured in a way that avoids disclosure to the market, the regulator and the target company).
Empty voting	Empty voting should be banned. (“Empty voting” related to vote in listed companies with borrowed or hedged shares, i.e. with shares that do not carry the economic risk associated with the decision taken).
<u>Explanations:</u> Improper and damageable conduct such as “empty voting”, stealth acquisition (through hidden block-building), naked short selling or speculative short selling must be prohibited, first at the level of funds (who are frequent users of such legal and financial devices) and then for everyone.	

III - SPECIFIC RULES RELATING TO PRIVATE EQUITY

Acquisition of significant stakes in private companies	
Scope	When participations of 10%, 20%, 30% and 50% are acquired by funds or fund managers acting alone or in concert, in public or private companies, specific disclosures should be made. This information must also be updated in annual reports.
Disclosure to the company, the investors and the employees	Information should include, in relation to past and planned conduct (as appropriate): (1) operational and financial developments: presentation of revenue and earnings by business segment, statement on the progress of company's activities and financial affairs, assessment of expected progress on activities and financial affairs, report on significant events in the financial year, R&D effort, (2) financial and other risks, including financial risks associated with capital structure, (3) impact on environment, (4) employee matters: turnover, terminations, recruitment, (5) statement on realized or planned significant divestment of assets, (6) information regarding shareholding and investors, (7) financing of the acquisition, plan for refinancing post acquisition, (8) management package, (9) acquisition and resale price.
Disclosure to supervisors	Same as above, in a standardized format, in order to permit monitoring and on going assessment of private equity impact on the economy.
Delisting	For two years, provision of same information as when the company was listed.
<u>Explanations:</u> Private equity has so far disclosed very little information, mostly unverifiable and not provided on a consistent basis. As this type of ownership leads to significant changes in the management style of companies, it is of the utmost importance to have a complete and consistent picture of companies under LBOs.	

Operating conditions: leverage, capital adequacy requirements, value extraction and asset stripping	
Limits: leverage, capital	Ex ante limits on leverage and capital adequacy requirements based on: top down approach: general situation of the economy bottom up approach: financial condition and long term sustainability and growth of target companies (in particular assessed through business plan and projected EBITDA)
Limit to value extraction	No significant extraction of value from the Company within a reasonable period of time after the acquisition.
Limit to asset stripping	Statement by management that capital outflows (including fees paid) is in the long term interest of the company, including its long term growth and R&D needs. Employee representative information and consultation Liability of management company.
<u>Explanations:</u> It is critical to protect companies under LBOs from predatory conduct. While flexibility of management should be preserved, safety nets should be set up. In addition, when the disclosure system is set up, the rules to be applied will be adjusted to the true picture of the situation.	

Employee rights	
Employee rights	Employee representative information and consultation when 10%, 20%, 30% and 50% are crossed (Directive 2001/23/EC to be used as a starting point).
Employee participation	Right to participate in the re-sale price (an amount of 20% is proposed).
<u>Explanations:</u> Employees are the root of any process of wealth creation. They are entitled to be informed and consulted when private equity funds invest in their company. They should also receive a fair portion of the resale price when the fund exits the company.	