



## Hedge funds: MEPs call for less speculation and more transparency

The EP Economic and Monetary Affairs Committee on Monday adopted its position on the draft EU law regulating managers of alternative investment funds, including hedge funds. MEPs voted for new ways to deal with managers and funds located outside the EU, a proportionality system to regulate less risky funds more lightly, and rules on remuneration policies and short selling. They also made improvements to the directive's transparency and risk reduction rules.

"This position will ensure better transparency and better investor protection while at the same time being on the side of the financial industry when it is working for the real economy", rapporteur Jean-Paul Gauzès (EPP, FR) said minutes after the vote.

Under the legislation as amended by the committee, alternative investment fund managers (AIFMs) in third countries would have to comply with the directive in order to market funds around the EU. Funds such as private equity and investment trusts would be more lightly regulated than hedge funds and some other types of alternative investment funds (AIFs) would be completely exempted.

The main changes put forward by MEPs to the Commission's initial draft are intended to increase investor protection and transparency while at the same time reducing the potentially protectionist dimension of the rules on access to the EU market from the outside.

Negotiations are now expected to take place between MEPs and the Council of Ministers ahead of the first-reading vote by the full Parliament, scheduled for July.

### More transparency

The adopted text increases the disclosure requirements to investors by AIFMs in some fields and also proposes some new reporting requirements for to the competent authorities.

Most notably, new rules would require AIFMs to inform investors about maximum levels of leverage (borrowing) and the total amount of leverage used by an AIF, and to provide information on the domicile of underlying funds in case of "fund of funds" AIFs and the domicile of any master fund. Managers would also be required to provide a description of the past performance of the AIF, changes in liability if there is a contractual agreement between the AIFM and the depositary, and information about the role of sub-depositaries if these are being used.

The authorities would need to be informed about the overall leverage used for each AIF, the ways fees are paid and the amounts paid to the AIFM, and performance data of the AIF including the valuation of assets. The authorities may ask for additional information from managers which they consider may pose important risks. The European Securities and Markets Authority (ESMA) may also require additional reporting in exceptional circumstances or in order to protect the stability of the financial system.

### Less risk

The committee suggests new features designed to reduce risk in the financial system. These include new rules on remuneration, selling of borrowed securities (short-selling) and marketing to retail investors.

On remuneration, the text requires that AIFMs adopt sound policies and practices that do not encourage excessive risk. More specifically it demands that remuneration policies for AIFMs be closely similar to those to be applied to banks.

The text bans "naked short-selling", a process of selling a security which is neither owned nor borrowed. It also requires managers regularly to disclose information on important short positions to national authorities. It also provides that ESMA may decide to restrict short-selling activities in exceptional circumstances or to protect the financial system's stability.

On marketing to retail investors, Member States would have to ban the marketing of an AIF to retail investors on their territory if that AIF invests more than 30% of its funds in other AIFs which are prohibited from being marketed within the EU.

## **Third country issues**

The European Commission had proposed a system based on equivalence. If the Commission considered the legal system of a third country equivalent to that of the system set out in the AIFM directive, then the funds and fund managers of that country would have access to the EU.

In view of the implementation problems this method could cause, the EP text adopted on Monday puts forward a different approach. In the case of access of AIFMs to the EU markets it provides that a non-EU AIFM would have to voluntarily subject itself to the directive's requirements. In such cases the financial supervisors of that third country would have to act as agents to ESMA in the supervision of that manager.

In the case of a fund outside the EU, this fund would be allowed to be marketed in the EU if the country where it is located has high enough standards to combat money laundering and terrorist financing, grants reciprocal access to marketing of EU funds on its territory and has agreements in place with the Member States where marketing is intended on exchange of information related to taxation and monitoring matters.

## **Different treatment for different AIFs**

The Commission proposed that only AIFMs with a portfolio of less than EUR 100 million with use of leverage (borrowing) or EUR 500 million with no leverage would be exempted from the directive.

The adopted text puts forward a system which applies different levels of regulation according to the type of fund rather than a one-size-fits-all break-off limit. It will be the Member State authorities which will establish who qualifies for lighter treatment on the basis of the directive's rules.

Private equity funds and non-systemically important AIFMs will be able to avoid full implementation of the directive. Other types of funds will be completely excluded from the scope of the directive such as holding companies, and banks and pension funds only investing their own money.

## **Rules on private equity**

According to the text adopted by MEPs, when an AIFM has more than 10, 20, 30, and 50% of the voting rights of a non-listed company it must notify the relevant authorities and the investors in the AIF in question. The manager must provide information on the communication policy with employees, plans for conflict-resolution and indicate which persons are responsible for deciding on business strategy and employment policy. Finally, AIFMs must give notice of any planned divestment of assets.

The draft directive also deals with asset-stripping practices, by requiring that the company owned by private equity must have capital which is in line with the requirements on capital adequacy established in already existing legislation on EU company law.

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The private equity provisions will not apply to companies employing less than 50 persons. In this sense investment by private equity in micro-companies will be excluded from the directive's scope. Moreover, the directive calls on the Commission to review existing company law legislation to ensure that companies owned by private equity are not at a disadvantage in comparison to companies owned by other means, especially regarding reporting requirements and information which needs to be divulged to employees.

## **Leverage levels up to AIFMs**

The Commission proposal stated that it was for the Commission to decide the maximum levels of borrowing that a specific AIFM could use to increase the returns of an AIF. The text adopted on Monday states that it should be the AIFMs themselves who set their own leverage limits in respect of each AIF they manage. The national authorities would then monitor the suitability of these limits. ESMA would also have the power to require these limits to be corrected if it considered them inappropriate.

## **Valuators**

The Commission proposal prohibited an AIFM from being its own valuator of the worth of its AIF. The Economics Committee text allows this provided there are safeguards in place allowing the valuation function to be carried out independently (Chinese walls). The text also provides that if there is no external valuator the Member State may ask for the system in place guaranteeing independence to be checked by outside bodies such as an audit firm.

The text also specifies that the delegation of valuation tasks will not shift liability from the AIFM to the external valuator.

## **Depositories**

The main innovation here is that the depositary will be able delegate its tasks to a certain extent, provided that it keeps a watchful eye on the actions of the sub-depositary it has delegated these tasks to. A depositary will also be able to delegate some of its tasks to a sub-depositary outside the EU provided it remains liable for the sub-depositary's actions, retains control over it, and the third country fulfils similar conditions required from non-EU countries wishing to have their AIF marketed in the EU.

Regarding liability, a depositary will be able to avoid liability for any loss of financial instruments if this is a result of force majeure or it can be proven that the cause of the loss was an unforeseeable external event. In the event of delegation, the main depositary remains liable for the actions of the sub-depositaries unless the depositary is legally prevented from exercising its role in the country where its AIFM is investing or could not due to unforeseeable external events. Finally, in the event of the sub-depositary being contractually able to reuse or transfer the assets, the depositary can then relieve itself of liability.

## **Capital requirements**

The text proposes to align this directive with the directive on UCITS. In this connection, self-managed AIFs would need to have initial capital of at least EUR 300 000. The Commission's proposals on capital requirements for external AIFMs managing an AIF are maintained. In the case of large value portfolios (over EUR 250 million) the text caps the extra capital needed at EUR 10 million. The Commission had not proposed any such cap. Moreover the text also provides that AIFMs can be exempt from up to 50% of the extra capital required if they have guarantees by a bank or an insurance company matching the amount of which they are to be exempt.

## **Further work after the directive enters into force**

The new points in the directive as approved on Monday would - if incorporated in the final text of the legislation - need to be elaborated by the European Commission through implementing rules called delegated acts. For example, the Commission would come up with rules specifying the details on requirements regarding remuneration, third countries aspiring to have their AIFs marketed in the EU, and the content of agreements between ESMA and

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national supervisors in third countries, which need to be in place for non-EU AIFMs to obtain EU marketing access. Although they are to be decided by the Commission, the EP and the Council would retain oversight over these rules.

ESMA would also be involved in a number of the most important novel aspects introduced by the EP text. For example, it would be responsible for periodically reviewing the criteria to be fulfilled by an AIF in order to benefit from the proportionality principle regulating which funds are covered by the directive and to what extent. According to the text, ESMA would also be empowered to issue guidelines to the national supervisory authorities on how to monitor conformity with the directive and also to settle conflicts between these national authorities.

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