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Commissioner Charlie McCreevy
European Commissioner for Internal Market and Services
The European Commission
200 Rue de la Loi, Brussels 1049, Belgium

21 October 2009

Dear Commissioner McCreevy,

ISDA comment on Proposal for a Directive on Alternative Investment Fund Managers (AIFMD)¹

The International Swaps and Derivatives Association (ISDA)² welcomes the European Commission's (EC) Proposal for a Directive on Alternative Investment Fund Managers as published on 30 April 2009. ISDA believes benefits will accrue from many of the provisions in the proposal. We are concerned, however, about the problems that it creates in several areas.

Passporting, governance, transparency

The proposal provides the right for home country authorised Alternative Investment Fund Managers (AIFMs) to market to professional investors within the European Union (EU) on a cross-border basis. ISDA **welcomes** this European passport aiming at the creation of a Single Market for AIFMs. This increases liquidity, diversification, performance and efficiency for all market participants. The provisions on governance and transparency create a level playing field for different types of AIFMs. The disclosure rules allow an AIFM to make sure that investors understand the products offered to them and that their expectations are met. Both disclosure to investors and regulators enable more efficient monitoring of systemic risk. Cooperation between regulators provides for efficient information sharing and an exchange of best practices.

Exemption for credit institutions and investment firms

The AIFMD proposal (Article 2, Paragraph 2d) exempts credit institutions from its scope. We support also exempting MiFID³ investment firms as they are subject to an equivalent regulatory framework to that for credit institutions, for instance, under the Capital Requirements Directive (CRD).⁴

¹ Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2004/39/EC and 2009/.../EC, Commission of the European Communities, Brussels, 30.4.2009, COM(2009) 207 final, 2009/0064 (COD)

² ISDA © (International Swaps and Derivatives Association) represents participants in the privately negotiated derivatives industry. ISDA was chartered in 1985 and today has over 800 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the risks inherent in their core economic activities.

³ Directive of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC

⁴ Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast)

Non-European Union funds, managers and investors

As an international organisation, ISDA is in principle opposed to proposals implying an extra-territorial implication or geographical limitation.

Under the terms of the draft Directive, non-European Union funds and managers seeking to access the European Union market will need to get a passport. However, such a passport will not be available until three years after the Directive is introduced. Even then, they will only be able to obtain it if they can demonstrate regulatory equivalence to the EU in their jurisdiction (on prudential legislation, access to markets and tax-sharing), which will make it difficult to acquire in practice. Permanent exclusion of third country funds and managers seems the most likely outcome.

We believe that once the Directive addresses and ensures the key investor protections within the investment vehicle through the requirements binding on the service providers to it, the actual domicile of the fund (the investment shell to which the services are provided) is of no importance. There is therefore no reason to favour any one fund centre over another.

If the Directive is implemented as currently drafted, EU investors will face a potentially significant loss of choice, less efficient asset allocation and portfolio diversification, and consequently increasing costs and diminishing returns as a result of this limitation. It is estimated by the Alternative Investment Management Association (AIMA) that around 95% of funds globally are either not domiciled in the EU or do not have EU managers.

International investors investing in EU funds or served by EU managers will also face increasing expense in relation to provision of this service. EU funds and managers will simply pass on to investors the compliance costs the Directive imposes. This decrease in global competitiveness of these funds will inhibit investment in the European economy.

Delegation of portfolio management

Under the terms of the draft Directive, European Alternative Investment Funds (AIFs) can delegate the management of their portfolio only to a firm that holds an AIFM license. However, as the AIFMD only allows EU-established firms to be authorised, no management functions could be delegated to non-EU-based firms.

Such a proposal has clear and important extra-territorial implications and has not been proven justified on risk grounds. It would also not be in the interest of investors: portfolio management could not be provided by the person/entity best placed to do it, i.e. person/entity familiar with the local market, local law and any other relevant circumstances. For instance, an EU fund investing in assets in emerging markets such as China, India or Brazil would normally use a local manager in these countries to manage the assets.

Delegation to any type of company should be possible provided that this company is authorised by law to do so and subject to prudential supervision. If the mandate refers to the delegation of management to a third-country firm, cooperation between the relevant supervisory authorities should be ensured.

ISDA does not believe there is any risk-based justification for prohibiting delegation of AIF portfolio management to MiFID firms in Europe.

Depositaries

We appreciate that the provisions in the proposal concerning co-operation between AIFMs and depositaries are intended to protect investors. We believe they need further consideration, however.

1. The AIFMD requires that depositaries and sub-custodians are EU credit institutions. These provisions would hinder non-'EU credit institutions' from acting as depositaries and/or sub-custodians to AIFs. Moreover, such restrictions may make it more difficult for an AIF to appoint multiple prime brokers, potentially leading to concentration of risk;

- a. AIFMD should provide for some form of equivalency recognition of third country depositaries;

b. MiFID investment firms are subject to capital requirements equivalent to those imposed on credit institutions in CRD. We believe that investment firms should be allowed to perform depositary functions under AIFMD as well.

2. The AIFMD also proposes strict liability on depositaries for AIFs' losses resulting from depositaries' failure to perform their obligations. This liability is not affected by any delegation of responsibilities to sub-custodians. We are concerned that this provision could lead depositaries to withdraw their services or increase fees. ISDA's view is that AIFMD should not impose new, unclear and unprecedented strict standards of liability on depositaries.

Leverage

We are concerned that restrictions in the proposal on leverage and liquidity could prevent many strategies from operating and may result in diminished returns for investors. Unnecessary compliance costs will be passed on to investors. This will make non-UCITS EU funds less attractive. In particular, we would recommend reviewing the provisions on the EC's role in setting leverage limits, the level of these limits and the definition of leverage.

Master-feeder structure

We are concerned that the Directive does not seem to acknowledge the role of master-feeder structures, which have important functions in the hedge fund industry. The master-feeder structure accommodates the different tax needs of US taxable and US tax-exempt investors and minimises costs. It is unclear how this structure would be treated under the AIFMD – despite the fact it is recognised under UCITS IV.⁵ Master-feeder structures could face substantial costs in complying with the AIFMD or would avoid being within its scope.

Threshold: authorisation versus disclosure

The AIFMD proposal includes in its scope AIFMs which manage portfolios with total assets of more than €100m, or €500m if AIFs are not leveraged and with no redemption rights for 5 years from their creation. The covered AIFMs are required to seek an authorisation under this Directive to be able to provide management services. This authorisation gives them a passport to market AIFs across borders within the EU. ISDA supports removal of this threshold in order to allow all AIFMs to benefit from the passport under equal terms. We note that AIMA also recommends the removal of this threshold.

We support, however, a threshold for disclosure of systemically relevant data for hedge funds managers with assets of €1 billion or greater. We would strongly recommend specifying the distinction between authorisation and disclosure thresholds in the Directive. We note that AIMA is working with the UK Financial Services Authority and other key regulators to develop an appropriate disclosure regime.

Conclusion

ISDA welcomes the opportunity to comment on the European Commission's proposal, and will be pleased to engage in any further discussions. We would be happy to assist the EC and other EU decision-makers in finding workable solutions where they believe it to be appropriate in relation to the aforementioned aspects of the Directive. Finally, we would urge the Commission to take account of discussions taking place at the international level (i.e. IOSCO, regulatory review in the US) so as to avoid creating an unlevel playing field that could affect the competitiveness of the EU fund industry and lead to regulatory arbitrage.

Yours sincerely,



Robert Pickel, Executive Director and CEO
International Swaps and Derivatives Association, Inc.

⁵ Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (as amended)