

CISX – Guernsey International Business Summit
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**Response to the EU directive on Alternative Investment Fund Managers
(AIFM)**

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Status of Jersey and Guernsey under EU law – “third countries” for financial services

1. The Crown Dependencies (CDs)’ status under EU is dealt with in Protocol 3 to the UK Act of Accession (1972), covering – essentially – the customs union and trade in goods.
2. For financial services, the CDs are “third countries”.
3. Recently all CDs have begun a process of “constructive engagement” with the EU (as well as other international organisations) notably on fiscal issues but, increasingly, on financial services and related areas with the aim of preserving and enhancing market access in the EU.
4. Recognition of the “equivalence” of Insular regulation and supervision with EU law and practice is fundamental to this new approach.
5. Given the formal responsibility of the UK for the international relations of the CDs, the Islands’ “constructive engagement” with the EU requires cooperation with the UK and, ultimately, UK support.

Comprehensive EU regulation of financial services in the wake of the economic and financial crisis – the “old approach” restored?

6. The AIFMD is one piece of a comprehensive jigsaw puzzle on financial services and related matters (auditing, accounting, company law, money laundering, taxation etc.).
7. The FSAPs of 1999 and 2005 (almost 100 measures implemented in only 10 years) laid the basis for comprehensive rules (and an embryonic EU supervisory system) at EU level on financial services.

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8. Between 1985 and 2005, the EU followed a “new” approach to legislation, based on minimum harmonisation, mutual recognition of equivalent national rules and practices, with all matters not regulated at EU level being left to national regulators. Until the inauguration of the “Lamfalussy” system in 2005, supervision was on an entirely national basis.
9. The economic crisis has led to a new surge of regulatory measures from the EU aimed at:
 - a. more comprehensive and binding rules (including directly-applicable Commission implementing regulations), reinforcing risk-management;
 - b. better enforcement procedures at EU and national level;
 - c. EU-wide supervision of cross-border business, the de Larosière system, building on and succeeding the Lamfalussy system;
 - d. enhanced investor and consumer protection.
 - e. corporate governance (including executive remuneration and bonuses).
10. Measures so far enacted this year or in the pipeline include: a credit rating agencies Regulation (CRAs), a strengthened capital requirements directive (CRD), a consolidated and strengthened package on insurance (Solvency II) as well as a new focus on derivatives. Following the de Larosière report earlier this year, the Commission will publish later this month plans to revise the supervisory architecture. The AIFMD is of particular concern to third countries for its extra-territorial effects.
11. All these new measures reflect a reversion to the “old approach” of total harmonisation, with the Commission openly admitting in the case of banking, insurance and securities that the aim has been to produce “European Rulebooks”, excluding national rules (“gold-plating”).
12. The supervision and enforcement of these “European Rulebooks” will be by national supervisors backed up in future by a European Systemic Risk Board (ESRB), a European Banking Authority (EBA), a European insurance and occupational pensions authority (EIOPA) and a European Securities and Markets Authority (ESMA).

Key issues raised by the AIFMD

13. Since the Commission published its proposals in May, the Directive has been subject to intense negotiation between Member States in Council. Attachés have met fortnightly and the Swedish Presidency has produced an “issues”

note (“condensing Member States’ positions”) which is now the basis for discussions in the Council Working Group. Controversial issues have been grouped together by the Swedish Presidency to facilitate discussion, together with “options” for how to proceed. These issues cover scope, definitions, capital, valuation, depository, delegation, leverage, obligations for managers managing funds which acquire controlling influence in companies, third-country issues and supervision.

14. The EU proposal derives from the G20 conclusions of 2 April 2009 as well as the de Larosière report approved unanimously by the Council:

to extend regulation to all systemically important financial institutions, instruments and markets... including systemically important hedge funds”.

Current evidence tends to show contrasting (not “equivalent”) approaches in the EU and the US, at least on hedge funds.

15. Stepping back, the key issues seem to be articulated as follows:

- a. The diversity of funds covered: the fact that the draft directive covers a multitude of heterogeneous funds² which present different features as regards risk, investor protection etc. as well as (sometimes) different national regulatory regimes.
- b. Extension delegated law-making comitology: the need to reserve many areas to delegated legislation or decision-making by the Commission in comitology (especially, but not exclusively in the third country section);
- c. Legal consistency: the need to ensure consistency with related measures such as UCITS IV, MiFID, the prospectus directive etc.
- d. Market access for third countries: the extent to which third-country managers and funds should be covered by the directive and permitted access to the EU market, both during a transitional period following the adoption of the directive and thereafter (including the question of whether “passporting” should be permitted at all and, whether the default option should be for the status quo to remain in place, i.e. current national private placement arrangements;
- e. Pan-European supervision: the supervisory regime under ESMA which has still not formally been published by the Commission;

² Real estate, commodity funds, infrastructure funds, hedge funds, private equity and “other infrastructure funds”.

- f. The possibly unintentional consequences of the proposals, such as the provisions regarding custody and delegation which cut across current practices and group business models. The fear is that in an attempt to protect investors, EU is in fact not only a fortress but also a prison – preventing EU investors from accessing third country markets. Industry and MEPs for different reasons are concerned about the effects this would have on investor choice, and risk management.

State of play and next procedural steps

16. The AIFMD is subject to the co-decision procedure under Article 251 and gives equal power to the Council and the Parliament in the legislative process with the Commission continuing to act as “honest broker”.
17. The Swedish Presidency have maintained a brisk pace, with four meetings since taking on the presidency in July. Another meeting will take place on 22 September. Despite the hype in the press, work is proceeding on a business-like basis, led by the low-key pragmatic Swedish Presidency, with technical assistance from the Commission. Ten Member States participate actively in the Council Working Group – especially the UK, France, Italy, the Benelux and Germany. There is therefore a “silent majority” in Member States, which nonetheless will have to vote one way or the other in a measure adopted by qualified majority (QMV).
18. The European Parliament agreed to leave substantive discussions on this dossier until after the elections in June. Work began in the lead committee in the Parliament, the Economic Affairs Committee (ECON), chaired by Sharon Bowles (UK Liberal-Democrat) on 2 September. A French centre-right Rapporteur has been appointed – Jean-Paul Gauzès with close links to President Sarkozy. He will be assisted by a drafting team from his own party and “shadow” rapporteurs from 4-5 other political groups, including a German Liberal representing Frankfurt, Wolf Klinz, a French Green, Pascal Canfin and a London Tory, Syed Kamall. The debate so far has been dominated by the British and French but we can expect more input from the Germans after their elections. The first priority for the Parliament is to receive Mr. Gauzès report probably by November, to which MEPs will table amendments in committee. The Legal Affairs Committee (JURI), chaired by Klaus – Heiner Lehne (DE EPP) will also play an active role in shaping the Parliament’s contribution to the process.
19. Throughout the co-decision process, close contact is maintained between the Council and the Parliament, with the aim (probably optimistically) of securing adoption of the directive in one reading. Were this approach

successful, we may see adoption by the first-half of 2010 under the Spanish Presidency.

Third country dimension

20. It has been said that the AIFMD is one of the most protectionist measures to have been put forward by the Commission, and if emulated by the EU's partners around the world (notably the US) global capital markets would be fragmented to the detriment of funds, their clients and the global economy (including emerging or developing markets). More subtly, the Commission's proposal aims to retain EU supervisory control over all significant management functions and, to the extent that any of these functions are delegated outside the EU, to ensure that maximum investor protection is ensured through the adoption of EU rules (or their equivalent) by third countries complemented by cooperation and information exchange agreements between third countries and EU Member States.

21. Other key points in the third-country provisions include:

- a. a lack of clarity on the situation following the three-year transitional period during which national private placement regimes will remain in place, although it seems that new authorisations will have to be sought by all fund managers on the basis of the new EU rules, whether these are for activities limited to one Member State (e.g. the UK) or for pan-European passporting;
- b. why "depositories" may only be EU authorised "credit institutions"
- c. why the directive which purports to provide for recognition of "equivalent" third-country rules and procedures, but in practice in certain cases requires the adoption of EU (AIFMD) rules per se by third countries;
- d. the delegation, under comitology procedures, to the Commission of legislative authority on the criteria for equivalence and executive authority on decision-making for individual cases of "equivalence".

The future for the Crown Dependencies

22. The good news is that the doors of the European institutions are relatively open to representations by all economic operators from inside and outside the EU. The AIFMD has been a steep learning curve for all EU institutions, which continue to need technical and business input from all affected by the measure.

23. The less good news is that, at least at this stage, and notwithstanding the fact that “there seems to be an overwhelming majority of Member States which are against imposing undue restrictions on investment opportunities for especially institutional investors, as well as creating other barriers to global capital flows” (according to the Swedish issues paper), a number of powerful Continental Member States seem to be in favour of retaining a maximum of economic, regulatory and supervisory control in EU hands, subjecting third-country market access to rigorous conditions, based on the acquis, questioning whether “classical” passporting should be allowed at all and limiting current activities on national markets to a three-year time period, without the possibility for extended “grand-fathering”.
24. It is not clear, at this stage, to what extent the United States is prepared to fight the EU on this measure, despite the radically different approach followed in Washington. Indications are that there is growing awareness of the potential this measure will have for US industry and investors. Industry, primarily based in London, is playing an active role in Brussels. Senators and Congressmen have already been to Brussels to discuss the matter. Sharon Bowles, Chair of ECON in the EP is keen to ensure that the outcome does not harm the transatlantic financial market. On their first meeting in Brussels after the election, the ECON committee welcomed leading Congressmen to a debate on the matter. Fragmentation of markets (both in the EU and globally) remains a real threat however.
25. Given the limited resources available to the Commission now and in the future, it is not clear how quickly the “third-country” dimension can be implemented in practice, with the definition of equivalence criteria and the approval of individual cases. The Commission will start work as soon as the directive is adopted, which will give 18 months for this exercise to be completed. There must at least be a risk that, in this process, the Crown Dependencies would come well down the list of priorities for the Commission, even assuming substantive recognition of equivalence and the absence of politically-motivated opposition.
26. It is not even clear at this stage whether the equivalence provisions will remain in the proposal (although, to me at least, this seems unlikely). The French are sceptical about passporting. The French are a powerful and persuasive voice in Council, but other Member States may not necessarily share their views. This could be particularly true for the “silent majority” in Council who have yet to speak up, and whose future survival will depend on continued access to significant levels of inward investment, although it has to be remembered that:

- a. the aim of this measure is to create a genuine Single Market for all alternative funds, but also
- b. enhanced investor protection and avoidance of systemic risk particularly at the professional level; and
- c. an overwhelming majority of Member States apparently support open international capital markets, which points to a third-country regime in the AIFMD which keeps open the possibility of out-bound and in-bound business, both for funds and managers.

27. In conclusion, the high reputation of Jersey and Guernsey in the funds business should facilitate constructive discussions with the EU on this new measure, contributing to the development of the external personality of the Islands and a relationship with the EU which preserves and enhances market access in financial services.

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