



International Centre for
Financial Regulation

Annual International Regulatory Summit

Regulation without Borders - G20 Ideals and National Interests

The Hilton, Amsterdam, Netherlands 8 – 9 November 2010

Session Bibliographies

Working Group II: Investments and Investors

9 November 2010**14:15 – 15:30****Working Group II: Investments and Investors**

“Far more needs to be done to protect consumers, depositors, and investors against abusive market practices, promote high quality standards, and help ensure the world does not face a crisis of the scope we have seen.” – G20 Pittsburgh, September 2009

With so much focus on financial institutions, the end investor is sometimes neglected. This working group will focus on two key issues: the trade-offs between protecting domestic investors and an open, international operating environment, and the impact of new regulations on investor decision-making. It will consider the extent to which the end investor wants or needs protecting, how that protection might or should vary between retail and institutional investors, and whether such protections are the business of legislation, regulation or the market. It will also ask if some of these efforts at consumer protection are effectively protectionism by another name. Secondly, the abundance of new regulation affects all investors. The working group will consider, among other issues, the impact of the AIFM Directive, governance reforms, Solvency II, restructurings and the projected changes of the MiFID review on institutional funds management, more investors' interest, bank and equity, debt under new bank regulation.

Questions which this session may consider include:

- To what extent did institutional investor behaviour contribute to the crisis?
 - Was differential access to information an issue in the financial crisis? Is it an issue that can or should be addressed with regulation?
 - Would more active involvement by investors as shareholders have helped to prevent or lessen the crisis?
 - Did investors delegate too much of their research to credit rating agencies? Were their investment criteria too driven by ratings? What is likely to change?
- What changes are currently being made by the industry in the wake of the crisis? What is the impact of changing regulations on investors?
 - What is the outlook for the hedge fund industry in light of the increased regulation?
 - Are investors taking ever shorter time horizons? Why? What is the impact on demand for certain products?
 - Will the regulatory demands and behaviour changes favour large institutional Investors?
- The impact of the Alternative Investments Funds (AIF) regulation on the industry and its clients
 - In order to avoid being directly touched by the Directive, hedge funds may choose to market their funds under the EU's UCITS regime. What are the costs and constraints of doing this relative to their current structures: liquidity and leverage, increased disclosure and taxation if funds may choose to move onshore? What are the pros and cons of moving onshore? Which types of funds are most likely to choose this route?
 - Restrictions placed on leverage limits could cause some hedge funds to wind down or leave the EU. A compromise proposal could mean that the Commission does not place “blanket” leverage limits and leaves it to the discretion of the manager and monitoring by a regulator. What impact could this have on institutional investors?

Working Group II: Investments and Investors

November 2010

- According to a study by Open Europe¹, 8 out of 10 hedge fund managers are based in non-EU countries. If these funds choose not to ‘passport’ what does this mean for EU investors? Will the increased levels of protection offered by the AIFM justify less diversity of investment choice?

- Questions relating to MiFID
 - If the deadlines on post-trade activities were changed, how will this affect firms and investors?
 - What could be the effects of classifying public debt bodies as professional, disregarding their ability to be sophisticated? Should local authorities that manage public debt not be included?
 - Should investment firms be given autonomy to assess whether a professional client possesses the required knowledge and experience?

¹ Open Europe, “The EU’s AIFM Directive: Likely Impact and Best Way Forward”

Bibliography:

The ICFR has prepared a core bibliography on works relating to reform of financial regulation. Many of the works in that bibliography have sections relevant to this topic.

Basel Committee on Banking Supervision (BSBS) (2007): *Institutional Investors, Global Savings and Asset Allocation*

- **Link to the publication:** <http://www.bis.org/publ/cgfs27.htm>

This document discusses the increasing importance of institutional investors in global financial institutions. Some of the observed trends amongst this category of investors include their contribution to tackling the decrease of household saving ratios related to ageing populations. One issue that affects the development of institutional investors and the strategies they adopt when investing, is the impact of new regulations. Regulatory reform should aim to reduce investors' risk profile and involves the transfer of investment risk to households or the adoption of strategies that include liabilities in decisions affecting asset allocation. The paper argues that in assessing what influences investors to make decisions on asset allocation and market dynamics, it is impossible to separate the effect of regulatory and accounting changes from other factors. Evidence from the UK suggests that long-term yields have been affected by changes in institutions' asset allocation strategies, which shows the importance of regulatory policy changes that affect institutional investors. In conclusion, emphasis was placed on policy implications that require the need for better risk management by institutional investors, the diversification of investment risk among a broader investor base and enhanced transparency in corporate accounts.

CFA Institute Centre for Financial Market Integrity and Council of Institutional Investors (2009): *U.S. Financial Regulatory Reform: The Investors' Prospective*

- **Link to the publication:** http://www.cfainstitute.org/ethics/Documents/us_investors_working_group_report.pdf

The report by the Investors' Working Group (IWG) focuses its attention on making the U.S. system of regulation more comprehensive, effective and responsive to the needs of investors, consumers and the broader financial system. The main discussion topics covered are: (i) strengthening and reinvigorating existing federal agencies responsible for policing financial institutions and markets and protecting investors and consumers; (ii) filling the gaps in the regulatory architecture and in authority over certain investment firms, institutions and products; (iii) improving corporate governance. Overall this report is intended to ensure that policymakers fully consider and reflect on making regulatory changes that serve investors, consumers and the broader financial system.

Charles River Associates (2009): *Impact of the Proposed AIFM Directive across Europe*

- **Link to the publication:** http://www.fsa.gov.uk/pubs/other/Impact_of_AIFM_Directive.pdf

Charles River Associates (CRA) was commissioned by the FSA to assess the impact of the proposed Alternative Investment Fund Manager Directive (AIFMD) on investors and financial markets across the EU. This paper produces the findings of the assessment, highlighting that investors feel they will no longer have access to "best in class" funds from around the world, which will reduce the variety and quality of funds. The EU Passport allows investors to accrue benefits which result in the availability of funds not previously marketed in certain member countries. Changes to legal structures will however bring about huge one-off compliance costs of up to 3.2 billion Euros on AIFMs. The biggest casualties of the AIFM Directive are hedge fund managers/investors, who will experience a restricted number of assets to invest in. In order to reduce systemic risks, additional rules will be imposed on hedge funds to limit their use of leverage. This will reduce the extent to which risk transmission arises by an accumulation of leverage. Other investors such as those of private

Working Group II: Investments and Investors**November 2010**

equity, venture capital funds and investment trusts are also concerned. Investors of real estate funds will be less affected by the Directive. In conclusion, there is the concern that investor choice will be hugely limited by the new Directive whilst there will be a substantial rise of compliance costs.

Daniélsson J, Taylor A and Zigrand JP (2005): *Highwaymen or Heroes: Should Hedge Funds be regulated?*

- **Link to the publication:** [http://eprints.lse.ac.uk/24782/1/dp518\(revised\).pdf](http://eprints.lse.ac.uk/24782/1/dp518(revised).pdf)

In this paper the authors argue that the “consumer protection arguments for direct regulation are not convincing, but find that the systemic concerns are sufficiently serious to warrant some forms of regulation.”² The objective of the paper is to identify the key economic reasons for and against regulating hedge funds, and identify the optimal form of regulation. The four main viewpoints are: (i) regulate hedge funds in the same manner as all other financial institutions are regulated, (ii) do not regulate hedge funds due to the efficiency they provide to the financial system, (iii) micro-prudential regulation of hedge funds for investor protection and, (iv) macro-prudential regulation of hedge funds due to their capacity to worsen liquidity crises. The paper then proceeds to evaluate each of these suggestions in more detail.

European Parliament (2009): *Ex-ante Evaluation of the Proposed AIFM Directive*

- **Link to the publication:** <http://www.eer.co.uk/download/2009shortAIFMdirective.pdf>

This Short Impact Assessment provides a quantitative assessment of the costs and benefits associated with the AIFM Directive. It considers the rationale for intervention in the AIFM sector, as well as alternative approaches for regulation. This study was commissioned by the European Parliament in order to build on the Impact Assessment (IA) carried out by the European Commission on the proposed Directive on AIFM to conduct a quantitative assessment of the costs and benefits. The questions this report tries to answer are: (i) what would be the costs and benefits of the changes proposed by the draft Directive, including impacts on the real economy, competitiveness and employment?, (ii) what would be the result of “one size fits all” regulation for alternative investment fund managers upon the level playing field after the Directive had been applied?, (iii) what would be the impact on sectors covered by UCITS and MiFID?, (iv) what is the assessment of the risk of capital flow from the EU to non EU countries because of regulatory arbitrage?, (v) what are the justifications for the suggested de minimis thresholds and the impact on alternative investment fund managers domiciled in third countries?, (vi) what are the risks posed by off-shore provision of valuation? And, (vii) what alternative options might there be to the measures in the draft Directive?

Open Europe (2009): *The EU’s AIFM Directive: Likely Impact and Best Way Forward*

- **Link to the publication:** <http://www.openeurope.org.uk/research/aifmd.pdf>

The findings and recommendations in this report are based on two separate surveys of the alternative investment industry that Open Europe carried out during August 2009. One of the surveys covered members of the Alternative Investment Management Association (AIMA), representing hedge fund managers from all over the world. The second survey covered members of the British Private Equity and Venture Capital Association (BVCA). The report assesses the costs to the economy, investors and the AIF industry. It also details areas that are wrongly conceived in the original AIFM proposal and in the end; the report provides recommendations to improve the Directive.

Hanlon T (2010): *How developments in regulation may affect investment companies*

² Quotations in all the summaries are from the works summarized

- **Link to the Publication:**

http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2010/0420_th.shtml

Until recently, institutional investors were able to negotiate the terms and conditions governing their funds while the attention of the UK Financial Services Authority (FSA) used to be on retail investors. The four main issues this speech addresses are i) client money, ii) valuations, iii) design and marketing of investment funds and iv) challenge to fund managers. To promote investor protection, detailed rules have been written in FSA's Client Assets Sourcebook (CASS). This is to make sure that customers' money and assets are safe, and remain safe even if an asset manager becomes insolvent. Directors have to show that they have taken measures to prevent clients' money from being misused or embezzled. The speech also highlights the need for robust and reliable valuation of assets in managing clients' portfolios. The tendency for valuations for complex instruments such as OTC derivatives, to be unreliable, warrants the need to safeguard investors' assets. Steps have been taken to ensure that independent advisors will provide unbiased advice on all retail investment products. To engender a level playing field between all products that are suitable for retail clients, product providers cannot offer commission. If assets are not adequately valued and investors are not protected, this could result in litigation or reputational damage. The speech concludes with the proposals for equivalence tests to be carried out for funds or fund managers in the case of depositories outside of the EU. This would ensure that supervisors for the jurisdiction where the fund or fund manager is based, have signed agreements of cooperation and exchange of information.

European Fund and Asset Management Association (EFAMA) (2004): *Asset Management Expert Group – Final Report*

- **Link to publication:**

http://www.efama.org/index2.php?option=com_docman&task=doc_view&gid=108&Itemid=-99

This report outlines the asset management industry's views on the future direction of regulation of the asset management sector. The group acknowledged that maintaining high standards of investor protection was essential to the future health of the industry and that commitments to investor protection are a condition for cross-border access. The paper called for the industry to develop coordinated principles on: (i) identification and management of possible conflicts of interest; (ii) high level principles of corporate governance for the industry; (iii) adequate disclosure of all information material to investors' decisions; (iv) improvements to investor education; and (v) develop an adequate resolution mechanism for cross-border disputes. . The paper argues that self-regulation by the industry was the ideal way forward but, if this failed to materialise, that regulatory intervention would be inevitable.

EFAMA (2010): *A New Report on Asset Management*

- **Link to Publication:**

http://www.efama.org/index.php?option=com_docman&task=doc_download&Itemid=&gid=405

This report published by EFAMA highlights their main findings from their research on the European asset management industry "across the investment funds and discretionary mandates landscape." The key areas highlighted in the report showed 13.5 trillion Euros under management as of the end of 2006, with investment funds and discretionary mandates representing an average 53% of the total in which the U.K, France and Germany together accounted for more than 65% of the European total assets under management, followed by Italy and Belgium. The additional key facts and figures provided in the report show the important role the European asset management industry plays, showing consideration is needed for adverse effects with any regulatory policy proposed.

Speeches:

- **Link to publication:**

http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0311_hs.shtml

Hector Sants, FSA Chief Executive, addresses the influence investors have over the UK economy and the importance that this influence is used effectively, and for the betterment of the financial industry. He addresses the fundamental causes of the crisis as an introduction to what the investment industry can expect next particularly in respect to regulatory reforms. While he encourages these reforms and insists that they as investors to a certain extent need to carry the role of regulation upon themselves, he also concedes that “without risks there will be no innovation or competition which are the basis for economic prosperity.” Showing that a relationship between the ‘regulators and the regulated’ will be necessary in order to reach a state of financial stability and equilibrium.

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