



Investment Funds Team  
Financial Services Authority  
25 The North Colonnade  
Canary Wharf  
London E14 5HS

1st February 2013.

Dear Investment Funds Team,

The Chartered Financial Analyst Society of the United Kingdom (CFA UK) welcomes the opportunity to respond to the consultation Implementation of the Alternative Investment Fund Managers Directive (AIFMD) CP 12/32. This response has been prepared by CFA UK's Professional Standards and Market Practices Committee (PSMPC) and we have not surveyed our members.

### **About CFA UK and CFA Institute**

CFA UK serves society's best interests through the provision of education and training, the promotion of high professional and ethical standards and by informing policy-makers and the public about the investment profession.

Founded in 1955, CFA UK represents the interests of approximately 10,000 investment professionals. CFA UK is part of the worldwide network of member societies of CFA Institute and is the largest society outside North America.

CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behaviour in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has more than 110,000 members in 139 countries and territories, including 100,000 Chartered Financial Analyst® charterholders, and 136 member societies.

The aim of CFA UK's advocacy initiative is to work with policy-makers, regulators and standard-setters to promote fair and efficient-functioning markets, high standards in financial reporting and ethical standards across the investment profession. The society is committed to providing members with information regarding proposed regulatory and accounting standards changes and bases its responses on feedback direct from members or relevant committees.

Members of CFA UK abide by the CFA Institute Code of Ethics and Standards of Professional Conduct. Since their creation in the 1960s, the Code and Standards have served as a model for measuring the ethics of investment professionals globally, regardless of job function, cultural differences, or local laws and regulations. The Code and Standards are fundamental to the values of CFA Institute and its societies.

### **Response**

CFA UK understands the rationale for the AIFMD. Any measure that can promote higher standards, enhance market integrity and aims to protect client interests is to be welcome. The lessons from the crisis with respect to AIFMs are clear and appear to have been overlooked by the EU. The first is the ease of access to leverage; the second is funds can fail due to legitimate reasons; third, the AIFMD is unlikely to protect investors from fraudulent behaviour and inadequate due diligence. Just as we need to ensure non-EU funds that want to market themselves in the EU need to meet appropriate standards; the UK regulator should also ensure that the choice available to investors is not greatly reduced and result in sub-optimal portfolios.

The investment industry especially the AIFMs have no doubt made many representations to EU lawmakers to demonstrate why such a Directive may not have been deemed necessary. To some extent we would concur with this view; this segment of the investment community was not, after all, directly responsible for the crisis. However, while we appreciate that the scope to alter the form and content of the AIFMD is limited; we hope the Directive will be implemented in the UK so that it is consistent with existing regulations and aligned with the aims and objectives of the new regulatory authorities. Given the new UK regulators' approach aims to be more effective than before, this may differ from the approach adopted by other EU regulators. We would hope that the UK regulator is alert to any opportunities for regulatory arbitrage.

## Rationale and scope

Since the crisis the regulatory response in the UK and elsewhere has been characterised as being symptom led and on occasion designed to affect particular types of market participant (e.g short sellers); there is also little effort to enhance the demand side of the market. AIFMD is no exception. CFA UK has long been wary of these types of regulatory initiatives, more so when the evidence to support them is far from persuasive, overlooks root causes and insufficient consideration has been given to supervision and enforcement.

*“An AIF is a collective investment undertaking that raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors, and that does not require authorisation under the UCITS Directive.<sup>19</sup> This definition captures a very broad group of collective investment undertakings, apart from those authorised as UCITS schemes in the UK or other EEA Member States.” (para 3.3)*

CFA UK remains concerned and shares the CP's view (para 3.3) that the scope of AIFMD is likely to be wider than the headline intent of bringing hedge funds and private equity funds into the EU regulatory net. As the CP states, AIFMD may have emphasised hedge funds and private equity but will capture other asset managers involved with managing property and commodity portfolios. The CP also states in para 3.7 that that the regulator cannot make a definitive statement about which funds and managers will be in or out of scope and so CFA UK hopes the UK regulator is alert to unintended consequences. AIFMD may have been seen as affecting funds that only have professional investors but will also capture other funds (para 3.8-3.10) that impact non-professional investors.

We look forward to the next consultation that provides more information about what is in scope and what is not given the different regimes that exist in the UK.

## Lessons from failures of AIFs

Given AIFMs were not a cause of the crisis; it would be useful for the UK regulator to take note of three prominent examples of AIFMs that did attract attention. These examples also demonstrate that regulation can fail but it cannot and should not try to eliminate investment risk. Managing investment risk is down to the investor and their advisers/managers. Identifying robust investments requires verification, due diligence and professional judgement.

*Example 1 Bernard Madoff (2008) –*

"I thought it was the end game. Over. But SEC never followed up!" (Bernard Madoff)

The concerns raised by the collapse of the Madoff "Ponzi" scheme can be attributed to two main failures, firstly lack of due diligence by investors and their advisers; secondly regulatory failure. In fact, it was after the crisis broke that Madoff was exposed. Many years before the collapse, regulators were alerted to potential problems with Madoff's operations. After some considerable hesitation the US regulator engaged in an inept investigation of Madoff and was unable to uncover anything because it failed to follow up and verify the information provided by Madoff. Lack of due diligence and ineffective regulation allowed Madoff to be in operation. Madoff would have been revealed a lot sooner had regulators and others checked his fund's account at the Depository Trust Corporation (DTC).

*Example 2 -Long Term Capital Management (LTCM) –*

In 1998 the collapse of this highly leveraged hedge fund staffed by Nobel Laureates did raise concerns that a financial crisis was in the making. However, at the time the Federal Reserve under Greenspan's Chairmanship was willing to let the fund fail. It was only through the actions of the New York Federal Reserve that the fund could unwind its positions with the injection of private sector capital. The failure of LTCM did not place the banks under any pressure even when the failure of LTCM indicated other leveraged AIFMs following the same strategies could also fail. The one area that should have generated regulator interest following the collapse but did not was why LTCM was able to obtain high levels of leverage on very generous terms from its lenders. LTCM failed not because of fraud but because it did not allow for extreme market movements. The speed of its collapse was attributed to the reported 25 to 1 leverage ratio.

*Example 3 CF Arch Cru-*

The CF Arch Cru Investment and Diversified Funds were two UK open ended investment companies authorised and regulated by the FSA. These funds invested in illiquid high risk assets such as private equity and commodities. It appears that these funds were mis-sold and the 20,000 investors are now seeking redress. This example highlights the importance of having high professional standards and placing clients' interests first. The lack of product governance is noticeable in this example.

Investors (and their advisers) that have placed funds with AIFMs should be aware of the risks and having the disclosures is only the starting point for any due diligence process. Further investigation is required by investors (or their advisers) before considering an allocation of capital to any fund regardless of whether it is AIFM or non-AIFM.

### Leverage

Using leverage to generate returns is a feature of many investment approaches. The question of leverage also impacts the private equity arena although the headline grabbing leverage buy-outs (LBOs) provide more focus than the rest of the sector. During the period in the run up to the crisis the fervour of financial institutions, especially the banks, to facilitate LBOs on the most lax terms, demonstrates why the financial system became so fragile. One has to ask the question which is the greater risk the entity that makes bad lending decisions or the borrower that cannot refuse an easy loan? Admittedly, it is important that professional AIFMs demonstrate restraint but when they do not, investors should ensure their vigilance and due diligence picks up these red flags especially when the regulator has failed to do so.

The use of leverage is a key component of many (not all) property fund as well as many commodities funds where the leverage is provided by the use of derivatives contracts (indirect leverage) to provide exposure. Having full disclosures and meeting the appropriate requirements are only the starting point, the rest relies on expertise and professional judgement which cannot be prescribed by regulation. Effective regulation is valuable and we hope that the new UK regulator is more active in the supervision and enforcement of all market participants, regardless of the asset class or investment approach they take.

The AIFMD's focus on leverage ratios is welcome although there should be more emphasis on the source of that leverage and how well the AIFM can manage that leverage under stress. As the recent financial crisis demonstrated the source of the leverage was the banking sector which engaged in a variety of lax lending practices. We hope that the UK regulator takes a broader view of leverage and those that provide the leverage. AIFMs may be known for using leverage but leverage is also by other financial firms most notably banks.

### Potential restrictions of choice to investors

There is little in the CP about the potential impact of AIFMD on investors. AIFMs can provide diversification benefits to investors. Institutional investors in particular have multi-asset portfolios that aim to invest in a variety of funds and asset classes. The lack of emphasis on

client outcomes is notable and CFA UK would have hoped that the EU and FSA would have provided evidence as to how potential detriment to the client may be reduced by AIFMD. If investors are unable to access the asset classes and managers they need to achieve the required risk-return trade-off in their portfolios; they may achieve sub-optimal outcomes by losing out on the diversification benefits AIFMs have to offer.

Responses to the Questions

Given that the UK regulator is to produce another consultation we do not feel able to answer the questions, given scope is still a significant issue.

We trust that these comments are useful and would be pleased to meet with senior FSA/FCA officials to explain them or to develop them.

Yours,

A handwritten signature in black ink, appearing to read 'N. WinterFrost'.

Natalie WinterFrost, CFA FIA  
Chair Professional Standards & Market Practices  
Committee, CFA UK

A handwritten signature in black ink, appearing to read 'Will Goodhart'.

Will Goodhart  
Chief executive  
CFA Society of the UK

A handwritten signature in black ink, appearing to read 'Sheetal Radia', with a stylized, cursive script.

Sheetal Radia, CFA FRSA

Policy Adviser CFA UK