August 2009

AK Position Paper

Proposal for a directive on alternative investment fund managers and amending Directives 2004/39/EC and 2009/.../EC

(Hedge Funds and Private Equity)

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About us

The Federal Chamber of Labour is by law representing the interests of about 3.2 million employees and consumers in Austria. It acts for the interests of its members in fields of social-, educational-, economical-, and consumer issues both on the national and on the EU-level in Brussels. Furthermore the Austrian Federal Chamber of Labour is a part of the Austrian social partnership.

The AK EUROPA office in Brussels was established in 1991 to bring forward the interests of all its members directly vis-à-vis the European Institutions.

Organisation and Tasks of the Austrian Federal Chamber of Labour

The Austrian Federal Chamber of Labour is the umbrella organisation of the nine regional Chambers of Labour in Austria, which have together the statutory mandate to represent the interests of their members.

The Chambers of Labour provide their members a broad range of services, including for instance advice on matters of labour law, consumer rights, social insurance and educational matters.

More than three quarters of the 2 million member-consultations carried out each year concern labour-, social insurance- and insolvency law. Furthermore the Austrian Federal Chamber of Labour makes use of its vested right to state its opinion in the legislation process of the European Union and in Austria in order to shape the interests of the employees and consumers towards the legislator.

All Austrian employees are subject to compulsory membership. The member fee is determined by law and is amounting to 0.5% of the members' gross wages or salaries (up to the social security payroll tax cap maximum). 560.000 - amongst others unemployed, persons on maternity (paternity) leave, community- and military service - of the 3.2 million members are exempt from subscription payment, but are entitled to all services provided by the Austrian Federal Chambers of Labor.

Herbert Tumpel
President

Werner Muhm
Director

Executive Summary

The largest white spaces on the financial economy map are made up of private equity and hedge funds, often combined as "alternative investments". Up to the point where the current financial crisis, which was by then already 7 quarters "old", had – because of the collapse of Lehman Brothers – got the entire world fully in its grip, the European Commission had rather been of the opinion that it would be best for this market to rely on the rationality of well informed market participants. Being able to act freely without interfering influences by national regulations, they would be able to achieve optimal results. This kind of non-regulation was paraphrased as self-regulation. If the current crisis demonstrates just one thing, then it is the failure of self-regulation in this sector.

From the point of view of the Federal Chamber of Labour (AK), the intended step of the European Commission, only to regulate the fund managers but not the funds themselves does not go far enough. Such an approach could even turn out to be a step in the wrong direction because it creates a seemingly safety, which is by no means a reality. Most risks, which result from "alternative investments", are still not dealt with.

From the AK's point of view, the intended step of the European Commission only to regulate the fund managers but not the funds themselves does not go far enough.

The most serious problem in the sector of hedge funds is their contribution to a systemic risk through

a) their high leverage and the liquidity risk associated with it (which manifested itself during the current crisis) and the possible resp. actual spill over on other markets, as well as the

b) counterpart risk (reliability risk).

Another contributor is the low transparency, which prevented system risks from being assessed sufficiently. Apart from that, a lack of transparency and the circumstance that stated investment strategies are often not adhered to, can result in a wrong analysis of the actual risk by investors. A sheer improvement of transparency alone, however, cannot be understood as a contribution to reduce the systemic risk. Hence, the present draft of the European Commission does not or not sufficiently tackle the problem of the failed system of self-regulating "alternative investments", called shadow banking system by many.

The central problem in case of private equity funds is the one concerning equity annihilation by transferring debts to the target corporation. The thinning of the capital base, which is often referred to as "optimising the capital structure", can in times of economic difficulties lead to substantial problems, which might even become existence-threatening. Co-determination issues are also often affected in cases of restructuring.

Furthermore, the AK underlines that neither the systemic risk in the hedge funds sector nor the problems with private equity funds have been regulated in the present draft Directive.

Neither the problem of the systemic risk in the hedge funds sector nor the problems with private equity funds, which affect both capital base and co-determination, have been regulated in the present draft Directive of the European Commission.

The AK position in detail

The AK envisages above all the following concrete problems:

1) The Directive would cover all types of fund managers, provided they operate within the EU. Registration is also a condition for offering services within the EU. Although, this comprehensive approach by managers is welcome, it does, however, open significant loopholes, which might subvert the intention of the Directive by regulatory arbitrage. As the funds themselves are neither registered nor regulated or supervised, non-EU managers are still able to place domestic and foreign funds within the EU, without being subject to any registration, regulation or supervision.

In our opinion, the (planned) registration represents a pure formality, which does not call for any special requirements for the registration, neither for effective transparency, information on equity ratios (leverage), portfolios nor on strategies or fees. This, however, is not only imperative from the point of view of the AK; it has also been demanded by a large number of other commentators in the consultation process.

The AK points out that special requirements for the registration for effective transparency, information on equity ratios, portfolios as well as strategies or fees are essential.

2) The distinction between (based on their size) systemic relevant corporations, whose managers should be subject to this Directive and those, to whom this does not apply, is arbitrary and ex ante not possible. The current crisis has above all demonstrated that the determination as to what is systemically relevant can only take place when the case or event arises.

Apart from that it would be very easy to exercise a formal separation and therefore fall short of the limit, which the draft Directive regards as systemically relevant. Therefore, the AK comes out against such a limit and is on the contrary in favour of registering all instruments and providers.

3) The already initially mentioned systemic risk, which springs from hedge funds, is on the one hand the result of significant leverage and the liquidity risk associated with it, which can – in particular in view of the high leverage – very quickly grow into a solvency risk. In addition, hedge funds can assume maturity transformation functions via structured products. These functions do actually represent functions of credit institutes. To the same extent to which hedge funds assume functions of credit institutes, they should for reasons of systemic stability, of security (employees are also affected by these risks through institutional investors such as pension funds) and not least for competition policy reasons also become subject to a similar regulation as credit institutes.

The draft Directive fails to provide any answers to these problems. The AK

The AK asks for capital deposit and liquidity regulations for all "alternative investments".

therefore demands capital deposit and liquidity regulations for all "alternative investments".

4) From our point of view, the transparency provisions concerning customers and supervision are insufficient, whereby one should add that transparency does not equal regulation but is only a requirement for regulation.

5) In the opinion of the AK, the issue of valuation is also inadequately regulated. In particular in case of products, which are often not traded on regulated stock exchanges, it is essential to provide for the valuation by independent third parties. As the valuations are also relevant for value and performance-related bonuses it does not make sense to provide those with scope for interpretation and room for manoeuvre, who would directly benefit.

Apart from that, this by and large unregulated sector has shown that the depot management by independent third parties is an important security facility, which the OGAW-Directive has not without reason elevated to norm standard.

Besides, the AK criticises that the Directive does not contain any regulations for the taxation of investors, funds and their managers.

6) Furthermore, the transparency provisions for private equity funds are inadequate and the restrictions for leveraged buy-outs are missing. There are neither sufficient restrictions concerning the transfer of outside capital to the target corporation in case of small and medium-sized businesses, nor provisions on information and consultation of labour representatives.

The thinning of the capital base, which is often referred to as "optimising the capital structure", can in times of economic difficulties lead to substantial problems, which might even become existence-threatening. Co-determination issues are also often affected in cases of restructuring.

7) Apart from the regulatory arbitrage, tax arbitrage is another significant problem with "alternative investments". Tax evasion through constructions, which were only set up for this purpose and the (pseudo) relocation of activities in tax havens is not only a problem for the national states, but also for the internal market and ultimately for the international community of states. Target-oriented starting points – at least with respect to assessment bases – would in the light of the G20 resolutions, in particular in a draft Directive for "alternative investments", which often intensively use both regulatory and tax arbitrage, become necessary.

8) The Directive does not contain any regulations for the taxation of investors, funds and their managers. The proposals in Chapter VII do only concern a limited selection of cases – namely the sale of funds registered in third countries – not, however, the problem of preventing tax evasion with regard to daily operations.

9) Even with an improved Directive, alternative investments remain a product, which is oriented towards professional investors. In order to rebuild the stability of the financial markets and

for reasons of consumer protection it is not enough to approve of a ban of selling these products to consumers. This is just holding on to the status quo. In order to prevent unfair competition, such a ban has to be introduced throughout the EU; another consideration is to prescribe appropriately high denominations (at least € 50.000) as entry threshold and particular information duties and warnings. Otherwise the practice will continue that banks in Member States, where the sale to consumers is prohibited, will offer their clients such products from Member States, where it is allowed.

10) In this context it must also be provided for that institutional investors (banks, insurances, pension funds) are only investing in those funds, which are in keeping with the present Directive (which requires be improved in many aspects).

Moreover, the AK warns that the periods of 10 days and two months respectively are too short for the national supervisory bodies to examine and accept AIFM.

11) The periods, which have been suggested for the national supervisory bodies to examine and accept AIFM (10 days and two months respectively) are too short for such complex legal relationships.

12) With regard to legislative technique it has to be rejected that the European Commission intends to regulate essential points of the implementary regulations in regulatory format pursuant to the procedure of Art 49 of the draft proposal. This threatens to leverage the parliamentary co-determination. In contrast to the statement included in the proposal, these are by no means measures, which do not affect significant amendments to the Directive – for example: Art 10 Section 3 (Definition of conflicts of interest), Art 11 Section 5 (Requirements of risk management), Art 12 Section 3 (Liquidity Management), Art 13 (Requirements for AIF and AIFM), Art 25 Section 3 (Restriction of leveraged financing), Art 31 Abs 3 (Sales restrictions for AIF). This legislative technique must therefore be rejected.

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