

18 January 2010

## INVESTMENT TRUSTS AND THE EU'S AIFM DIRECTIVE

**Summary:** *This short briefing note argues that investment trusts and Venture Capital Trusts (VCTs) should be exempted from the AIFM Directive, as these companies differ fundamentally from other types of funds covered by the proposed rules: they are listed companies governed by a board, and therefore do not pose the same risks. Including investment trusts under the scope of the Directive, as currently drafted, would create a fundamental conflict between EU law and existing UK law and could effectively spell the end of the sector. In addition, investment trusts and VCTs are subject to a sufficient degree of regulation already, both at the EU and the UK level.*<sup>1</sup>

*The AIFM Directive<sup>2</sup> proposes to regulate all fund managers which currently don't fall under the scope of the EU's so-called UCITS Directive, including private equity companies, hedge funds, real estate funds, infrastructure funds, commodity funds, long-only funds and listed closed-end funds, for example investment trusts.*

*Under the AIFM Directive, all fund managers who are based in the EU, or who market their funds to investors inside the EU, would be subject to a range of new rules. For example, managers would be subject to additional disclosure requirements, would face restrictions on the amount of money they can borrow, and would face limitations on which investors they can market their funds to. Managers would also be subject to several rules setting out how their companies must be organised and which activities they are allowed to outsource and to whom.*

### 1. WHAT ARE INVESTMENT TRUSTS AND WHY ARE THEY DIFFERENT?

Unlike other fund managers currently falling under the scope of the EU's proposed AIFM (Alternative Investment Fund Managers) Directive, investment trusts have been around for a long time. The first investment trust company was founded in the UK in 1868. UK investment companies currently have assets totalling some €100 billion and have about one million private investors, which are overwhelmingly based in the

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<sup>1</sup> This note builds on Open Europe's previous research on the proposed AIFM Directive, and in particular its comprehensive report published in September 2009, the "The EU's AIFM Directive: Likely impact and best way forward", see <http://www.openeurope.org.uk/research/aifmd.pdf>. The study was based on two separate surveys of the hedge fund and private equity industries. In total, 161 managers responded to the survey, together managing €545 billion worth of assets.

<sup>2</sup> The Directive proposes to regulate managers (the AIFM) rather than funds (AIF), see COM(2009) 207 final, tabled 29 April 2009, see [http://ec.europa.eu/internal\\_market/investment/docs/alternative\\_investments/fund\\_managers\\_proposal\\_en.pdf](http://ec.europa.eu/internal_market/investment/docs/alternative_investments/fund_managers_proposal_en.pdf)

EU. Like with all funds, the aim of investment trusts is simple and straightforward: to make money for investors.

Investment trusts have several special features which set them apart from other types of funds which the AIFM Directive is seeking to regulate. For one, investment trusts trade on already regulated markets. In addition, an investment trust is governed by a board and every investor becomes a shareholder in the company with voting rights and a share in the company's profit. These features make investment trusts much more similar to public holding companies, than to Alternative Investment Funds (AIFs), such as hedge funds and private equity firms – which are the main targets of the AIFM Directive.

## 2. WHY SHOULD INVESTMENT TRUSTS BE EXCLUDED FROM THE DIRECTIVE?

### *i) Investment trusts are already subject to a range of regulations*

- Investment trusts are listed companies, meaning that their shares are traded on a regulated stock exchange – like any other listed company's share. This means that investment trusts operate under a variety of regulations laid down by the UK's Financial Services Authority (FSA) – relating to listing, disclosure and transparency. This sets them apart from hedge funds and private equity firms, for instance, which are not subject to the same degree of regulation in the UK (although these funds are also subject to some regulation).

#### Which regulations are investment trusts already under?

UK-level regulations	EU-level regulations
<ul style="list-style-type: none"> <li>• <i>Income &amp; Corporation Taxes Act 1988</i><sup>3</sup> <u>Purpose:</u> Avoidance of double taxation of investors, reducing investment risk</li> <li>• <i>Companies Act 2006</i><sup>4</sup> <u>Purpose:</u> Transparency, good corporate governance, protection of investors and creditors</li> <li>• <i>The FSA's Listing Rules</i><sup>5</sup> <u>Purpose:</u> Preserving a credible UK market reputation, investor protection, transparency</li> <li>• <i>The Combined Code</i><sup>6</sup> <u>Purpose:</u> Good corporate governance, transparent investor communication</li> </ul>	<ul style="list-style-type: none"> <li>• <i>Market Abuse Directive</i><sup>7</sup> <u>Purpose:</u> Good market conduct, preserving orderly and stable markets</li> <li>• <i>Transparency Directive</i><sup>8</sup> <u>Purpose:</u> Market transparency and periodic disclosure of key information to investors and regulators</li> <li>• <i>Prospectus Directive</i><sup>9</sup> <u>Purpose:</u> Obligation to provide information to new investors</li> <li>• <i>Takeover Directive</i><sup>10</sup> <u>Purpose:</u> Information about markets, investor protection</li> <li>• <i>International Financial Reporting Standards</i><sup>11</sup> <u>Purpose:</u> Accurate and fair financial reporting</li> </ul>

<sup>3</sup> This regulation sets out requirements for how to achieve investment trust status, See here, [http://www.opsi.gov.uk/acts/acts1988/Ukpga\\_19880001\\_en\\_1](http://www.opsi.gov.uk/acts/acts1988/Ukpga_19880001_en_1)

<sup>4</sup> Sets the framework in which companies with limited liability status must work. See here, [http://www.opsi.gov.uk/ACTS/acts2006/ukpga\\_20060046\\_en\\_1](http://www.opsi.gov.uk/ACTS/acts2006/ukpga_20060046_en_1)

- In addition, investment trusts must have their investment trust company status approved annually in the UK by HM Revenue & Customs – such an approval requires that the company meets a range of different criteria. These include that no single investment holding can represent more than 15% of total assets (which avoids concentration of risk) and at least 85% of income derived from shares and securities must be distributed each year. Investment trusts are also regulated by several EU Directives (see above).

**ii) Investment trusts have a fundamentally different structure to other funds**

The AIFM Directive has been designed and written with the typical AIF structures in mind and therefore does not fit the traditional structure of UK investment trusts.<sup>12</sup> This, in turn, has led to a number of unintended consequences (see below). The organisation and activities of investment trusts differ from other AIFs/AIFMs in several ways:

- A Board of Directors is collectively responsible for the management of the investment trust. As with all public limited companies, the Board of Directors is appointed by the company's shareholders and each Director is legally obliged to look after the interests of the shareholders, under national company law. Again, this is radically different from other AIFs/AIFMs where no Board exists, and therefore not the same structure of legal accountability.
- There are two types of investment trusts:
  - *Internally-managed* investment trust companies, in which investment decisions are made by employees of the investment trust company under guidance of the Board of Director and no external manager is employed.
  - *Externally-managed* investment trust companies, in which the Board outsources investment decisions to one or several external managers. The external manager still answers to the Board and can be replaced at any time.

Both of these models differ from the typical AIF structure in which the manager himself bears the ultimate responsibility for investment decisions. This difference is

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<sup>5</sup> Sets out the minimum requirements for the admission of securities to listing, the content, scrutiny and publication of listing details and the obligations of issuers after admission, see <http://fsahandbook.info/FSA/html/handbook/LR>

<sup>6</sup> A set of principles of good corporate governance, which provides a code of best practice for companies listed on the London Stock Exchange. The code is overseen by the Financial Reporting Council, see <http://www.frc.org.uk/corporate/combinedcode.cfm>

<sup>7</sup> A set of EU-wide rules aimed at avoiding insider dealing and market manipulation, see <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2003:096:0016:0025:EN:PDF>

<sup>8</sup> Establishes minimum requirements on periodic financial reporting and on the disclosure of major shareholdings for issuers whose securities are admitted to trading on a regulated market in the EU, see [http://ec.europa.eu/internal\\_market/securities/transparency/index\\_en.htm](http://ec.europa.eu/internal_market/securities/transparency/index_en.htm)

<sup>9</sup> Setting out the initial disclosure obligations for issuers of securities that are offered to the public or admitted to trading on a regulated market in the EU, see [http://ec.europa.eu/internal\\_market/securities/prospectus/index\\_en.htm](http://ec.europa.eu/internal_market/securities/prospectus/index_en.htm)

<sup>10</sup> Intended to create a framework of common laws for takeovers in the EU, see <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32004L0025:EN:HTML>

<sup>11</sup> A series of standards and frameworks for reporting and accounting. All listed EU companies have been required to use IFRS since 2005. The standards are adopted in the form of EU Regulation, see [http://ec.europa.eu/internal\\_market/accounting/ias/index\\_en.htm](http://ec.europa.eu/internal_market/accounting/ias/index_en.htm)

<sup>12</sup> The Commission's consultation of stakeholders, for instance, covered only hedge fund managers, see *HM Treasury/FSA*, "European Commission Consultation on Hedge Funds: response by HM Treasury and the Financial Services Authority (the UK Authorities)", January 2009, p. 7, see [http://www.hm-treasury.gov.uk/d/hedge\\_finds\\_response\\_100209.pdf](http://www.hm-treasury.gov.uk/d/hedge_finds_response_100209.pdf)

key to understanding why the AIFM Directive, as currently drafted, isn't appropriate for investment trusts (see below).

There are also a number of other important differences between investment trusts and other AIFs:

- For example, investment trust companies are closed-ended and so their shareholders have no rights to require redemption.
- Investment trusts very rarely borrow large amounts of money to buy more assets – unlike hedge funds for instance. Since these companies are not as 'geared' as hedge funds, they don't pose the same risk to market stability.

### ***iii) Including investment trusts violates the Commission's 'Better Regulation' principles***

Including investment trusts violates the Commission's 'Better Regulation' principles – in particular that of proportionality.<sup>13</sup> This is because several of the risks and problems that the Commission is trying to address through the AIFM Directive simply don't apply to investment trusts and, where they do, are already addressed through existing regulation, as noted above.<sup>14</sup> For example:

- *Macro-prudential or systemic risk*, relating in particular to the use of leverage: UK investment trusts use no or only limited gearing and invest predominantly in transferable securities. This means that investment trusts do not give rise to systemic risks.
- *Micro-prudential risks* (internal risks, counterparty risk and operational risks, for instance): Again, investment trusts focus primarily on transferable securities and trade on already regulated markets – and are therefore not exposed to the same risks as other AIFs/AIFMs.
- *Investor protection and transparency*: Are already addressed by existing Directives and regulations (e.g. Transparency Directive, mandatory application of IFRS standards, company law and corporate governance regulations, etc – see the box above).

### **3. WHAT IMPACT WILL THE DIRECTIVE HAVE ON INVESTMENT TRUSTS?**

Most critically, in its current form, the AIFM Directive doesn't recognise the structure of investment trusts, and in particular fails to acknowledge the role of the Board in directing investment decisions and protecting the interests of shareholders.

This creates a number of problems:

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<sup>13</sup> The EU's guidelines for policymakers for how to formulate regulatory proposals repeatedly stress that regulations should "not go beyond what is necessary in order to achieve the objectives pursued", see EUR-lex, Joint Practical Guide for persons involved in the drafting of legislation within the Community institutions, see <http://eurlex.europa.eu/en/techleg/10.htm#6> . For more on the EU's Better Regulation Agenda, see Open Europe, "Out of Control? Measuring a decade of EU regulation", 1 February, 2009, <http://www.openeurope.org.uk/research/outofcontrol.pdf>

<sup>14</sup> For a discussion on the objectives behind the Directive, see Directive of the European Parliament and the Council on Alternative Investment Fund Managers and amending Directives 2004/39/EC and 2009/.../EC, [http://ec.europa.eu/internal\\_market/investment/docs/alternative\\_investments/fund\\_managers\\_proposal\\_en.pdf](http://ec.europa.eu/internal_market/investment/docs/alternative_investments/fund_managers_proposal_en.pdf)

- ***It turns the entire structure of an investment trust on its head.*** The AIFM Directive is built around *the manager*, (the AIFM). It's the AIFM that is being regulated, authorised and the one considered to have ultimate responsibility for investment decisions (and therefore obligated to protect investors' interests) under the Directive.

In contrast, the central entity in an investment trust is the *Board*, which is legally obligated in the UK to safeguard the interests of shareholders, while also having the final say over investor policies. The Board also has the mandate to replace a manager or internal staff. Under the Directive, this relationship would effectively be flipped around, with the manager getting the final say. This, in turn, creates a conflict between UK law and the AIFM Directive.

- ***In practice this could spell the end of the sector.*** Under the new EU rules, the Board would no longer be allowed to issue new shares, since only an authorised AIFM is allowed to issue new shares if the Directive comes into force as currently drafted. Again, this leads to a fundamental conflict of laws, since under UK law it is the company which issues its own shares through a resolution of its Board of Directors. This function cannot legally be carried out by a third party manager (which would count as the AIFM under the Directive).<sup>15</sup>

In other words, the AIFM Directive would effectively spell the end of much of the sector, as investment trusts would have to take on a different legal form and structure in order to issue new shares. An Impact Assessment on the AIFM Directive for the FSA put the cost of dissolving the existing structures of investment trusts at €543 million.<sup>16</sup> As the Impact Assessment also pointed out, "There is no apparent benefit associated to the forced liquidation of investment trusts."<sup>17</sup>

- Many of the other provisions in the Directive, intended to regulate the organisation and activities of genuine AIFMs, are also inappropriate for investment trusts. For example, the Directive requires funds to offer redemption on demand for investors. This simply doesn't make sense for closed-ended funds where investors realise their capital by buying and selling shares on a market and there is no link to the liquidity of the underlying portfolio.

#### **4. BUT WOULDN'T EXEMPTING INVESTMENT TRUSTS CREATE LOOPHOLES IN THE DIRECTIVE?**

One of the rationales for including *all* funds currently not regulated by the UCITS Directive – as the AIFM Directive proposes to do – is to close off all possible 'loopholes'. The Commission's Impact Assessment accompanying the proposed AIFM Directive highlighted the need to "eliminate opportunities for regulatory gaming within the AIFM sector" by taking an "all-encompassing approach".<sup>18</sup> The European

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<sup>15</sup> Incidentally, the Board of Directors has to have a general authority of shareholders before it can allocate shares. This safeguards shareholders against dilution.

<sup>16</sup> Charles Rivers Associates, "Impact of the proposed AIFM Directive across Europe", prepared for the FSA, October 2009, see [http://www.crai.com/uploadedFiles/Publications/Impact\\_of\\_AIFM\\_Directive.pdf](http://www.crai.com/uploadedFiles/Publications/Impact_of_AIFM_Directive.pdf)

<sup>17</sup> *Ibid.* p. 6

<sup>18</sup> The Impact Assessment states: "an attempt to single out particular business models may fail to deliver sufficient traction over the risks, since those AIFM not captured by the definition, but generating similar risks, would not be subject to the measure. It would also avoid the difficulties associated with developing robust legal definitions of specific business models and would thus eliminate opportunities for regulatory gaming within the AIFM sector. A related advantage concerns the innovative nature of the

Commission seems to fear that exemptions for some funds could lead to AIFMs taking on a different structure in order to avoid being regulated by the proposed Directive.

But excluding investment trusts from the Directive would not pave way for such a scenario. If other AIFMs would want to take on the structure of an investment trust to circumvent the new rules, they would be bound by the regulations that already exist for investment trusts (see the box above). In addition, the AIFM taking on such a structure would have to become more transparent, less risk-inclined and through the creation of a board, more accountable to both investors and regulators.

In other words, it is highly unlikely that AIFMs would convert to investment trusts in order to avoid being regulated. And if they were to convert, it would probably be a good thing from a transparency and regulatory point of view.

## 5. VENTURE CAPITAL TRUSTS

In addition to investment trusts, so-called Venture Capital Trusts (VCTs) also deserve special attention. VCTs are similar to investment trusts: each VCT is a company with a Board of Directors; they are listed on a regulated stock exchange; they are based exclusively in the UK; and they are subject to a set of tax regulations. VCTs invest mostly in small firms looking to expand and new shares of companies that are traded on the Alternative Investment Market. Therefore, VCTs play an important role in providing capital for potential high growth business which may otherwise struggle to obtain the finances required to expand and get through the start-up phase.

VCTs are small with no more than a few tens of millions of euros under management and there are strict regulations governing how much they can invest in individual firms, both in terms of shares and the amount of money. For example, recently launched VCTs cannot invest new money in a company whose gross assets exceed £7million. There is also a maximum limit of £1million that any VCT can invest in a single company in any tax year, and each individual investment cannot consist of more than 15% of VCT assets.<sup>19</sup> Therefore, as with investment trusts, there is a strong case for exempting these firms from the scope of the Directive.

## 6. HOW SHOULD THE DIRECTIVE BE AMENDED?

Excluding investment trust and VCTs could be achieved legally by adding the following text to article 2.2 of the Commission's original draft<sup>20</sup>:

“This Directive shall not apply to any of the following:

**(...) AIF which do not grant their shareholders any redemption or repurchase rights, use no or only limited leverage, and have their shares traded on an EU regulated market.**

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AIFM industry and the potential for the emergence of new AIFM business models.”, see p. 35 in [http://ec.europa.eu/internal\\_market/investment/docs/alternative\\_investments/fund\\_managers\\_impact\\_assessment.pdf](http://ec.europa.eu/internal_market/investment/docs/alternative_investments/fund_managers_impact_assessment.pdf)

<sup>19</sup> See <http://www.hmrc.gov.uk/guidance/vct.htm>

<sup>20</sup> A slightly different version of this amendment was proposed by five of the UK's leading investment trusts in a briefing note. These investment trusts were: Alliance Trust PLC, Caledonia Investments plc, Personal Assets Trust plc, the Scottish Investment Trust PLC and the Independent Investment Trust plc.