

REGULATION OF ALTERNATIVE FUNDS IN THE CZECH REPUBLIC IN THE CONTEXT OF THE DEBATE ON THEIR POTENTIAL REGULATION IN THE EUROPEAN UNION¹

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This article analyses the implications of the European Commission's regulatory proposals for Czech alternative funds. The article has reservations about these proposals. Given the extent and depth of the current Czech regulations, however, the authors do not believe that adoption of the proposed European legislation will place any major burden on Czech alternative funds. The article recommends some changes to the current Czech regulations regardless of whether or not the Commission's regulatory proposals are adopted.

1. INTRODUCTION

The global financial crisis, ongoing since mid-September 2008², and the role of alternative funds in it³ has greatly increased the interest of politicians, economists and the enlightened public in the issue of regulation of such funds. These funds have not previously been regulated at the European level. The European Commission says that the financial crisis has underlined the extent to which alternative funds are vulnerable to a wide range of risks. These risks, it argues, are of direct concern to the investors in those funds, but also present a threat to creditors, trading counterparties and to the stability and integrity of European financial markets.⁴ For over a year, the Czech Republic has thus been confronted with the opinion of the Commission, European politicians⁵ and the High-Level Group on Financial Supervision in the EU⁶ that there is a need to regulate significant alternative funds. The US administration is also calling for regulation of alternative funds, or at least of hedge funds (a subclass of alternative funds). In its opinion, many hedge funds manage such large assets that they pose a threat to financial stability in the event of unlimited use of leverage.⁷

This article sets out to consider appropriate regulation of alternative funds in the Czech Republic. It contains a simple comparison of alternative and standard funds. Particular attention is given to the proposed new European regulations, which are compared with the current Czech regulations. The article concludes by assessing the proposed new European regulations and recommending various regulatory approaches for the Czech Republic.

2. DEFINITION OF ALTERNATIVE FUNDS IN THE CZECH REPUBLIC

Alternative funds are defined as all collective investment funds that are not standard funds (i.e. funds that are not regulated under Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities – the UCITS Directive). Although this directive has not yet been implemented into Czech law (the time limit for transposition is 30 June 2011), funds regulated under the UCITS Directive in the Czech Republic can be considered the same as the former standard funds

1 This article describes the legal situation as of 1 March 2010.

2 We regard the request of US investment bank Lehman Brothers Holdings Inc. of 15 September 2008 for protection against its creditors as the start of the global financial crisis.

3 See the Commission's statements on the role of alternative funds in the current economic and financial crisis given in section 3.

4 See p. 3 of the Explanatory Memorandum of the Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2004/39/EC and 2009/65/EC published on 30 April 2009 as COM (2009) 207 final.

5 See the report of the European Parliament with recommendations to the Commission on hedge funds and private equity (A6-0338/2008) ["Rasmussen" report] and the report on the transparency of institutional investors (A6-0296-2008) ["Lehne" report].

6 See the report of the High-Level Group on Financial Supervision in the EU ("de Larosière Group" report), 25 February 2009, p. 25. See http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf.

7 See http://www.usatoday.com/money/companies/regulation/2009-03-26-hedge-funds-regulationt-geithner_N.htm.

under Act No. 189/2004 Sb., on Collective Investment, as amended (the "AoCI"). Conversely, alternative funds can, in the present Czech regulatory environment, be compared with special funds constituted under the AoCI.⁸

From the regulatory perspective, alternative funds in the Czech collective investment market can be divided into two groups – alternative funds that collect money from the public ("publicly offered alternative funds") and alternative funds that collect money from qualified investors (alternative non-public funds, funds for qualified investors, FQIs).⁹ Alternative funds are (at least for the time being) regulated exclusively at national level.

Under the AoCI, publicly offered alternative funds can be constituted – in terms of the type of assets invested – as alternative securities funds (whose manner of investment is regulated in a similar way as standard funds), alternative real estate funds (which invest primarily in real estate and real estate companies) and alternative funds of funds (which invest in securities issued by other collective investment funds).

FQIs differ from publicly offered alternative funds in that they do not have a defined manner of investment and their securities can be acquired only by qualified investors. Any natural or legal person who declares in writing that they have experience in securities trading can become a qualified investor. Important distinguishing features from publicly offered alternative funds include a minimum investment amount of CZK 1 million and a ban on publicly offering or promoting such funds. FQIs may have no more than 100 shareholders.

Turning to the classification of funds by chosen investment policy, domestic funds – both standard and publicly offered alternative funds – include money market funds, bond funds, equity funds, mixed funds, funds of funds and real estate funds.¹⁰ In the Czech Republic, the vast majority of FQIs are constituted as tax-optimised schemes for real estate owners/investors. No hedge funds¹¹ or private equity funds¹² have been constituted so far under Czech law. In our view, the founders of hedge funds and private equity funds prefer jurisdictions with more advantageous tax systems and tried and tested regulations.¹³

8 Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), as amended by Council Directive 88/220/EEC, Directive 95/26/EC of the European Parliament and of the Council, Directive 2000/64/EC of the European Parliament and of the Council, Directive 2001/107/EC of the European Parliament and of the Council, Directive 2001/108/EC of the European Parliament and of the Council, Directive 2004/39/EC of the European Parliament and of the Council, Directive 2005/1/EC of the European Parliament and of the Council and Directive 2008/18/EC of the European Parliament and of the Council, has been implemented into Czech law (the AoCI). This directive is the predecessor of the UCITS Directive. As regards the issue examined in this article these directives differ only negligibly, so for the sake of simplicity they are regarded as one and the same.

9 The AoCI refers to alternative funds as "special funds", publicly offered alternative funds as "special funds that collect money from the public" and FQIs as "special funds for qualified investors". Funds constituted before the Czech Republic joined the EU were, under the act, classed after 1 May 2004 as special securities funds (part of publicly offered alternative funds). Some of them were later converted into standard funds. Since 1 May 2004, funds of all types (both standard and alternative) have been constituted.

10 Under the regulations, only alternative funds converted as real estate funds are permitted to invest in real estate. Standard funds are not allowed to invest in real estate.

11 Hedge funds can be characterised by the following features: they focus on the absolute yield of a portfolio and they use various investment methods to achieve their goals, including risky techniques such as naked short selling, high levels of leverage, and derivatives.

12 Private equity funds tend to invest in unlisted companies whose participating securities are subsequently admitted to trading on a regulated market, or in listed companies whose participating securities are subsequently delisted from a regulated market. Private equity funds' investments are long-term (5 to 10-year investment horizons).

13 Foreign hedge funds do operate in the Czech financial market, but their activities are not easy to distinguish from those of other foreign entities active in the Czech financial market.

3. COMPARISON OF ALTERNATIVE AND STANDARD FUNDS IN THE CZECH REPUBLIC

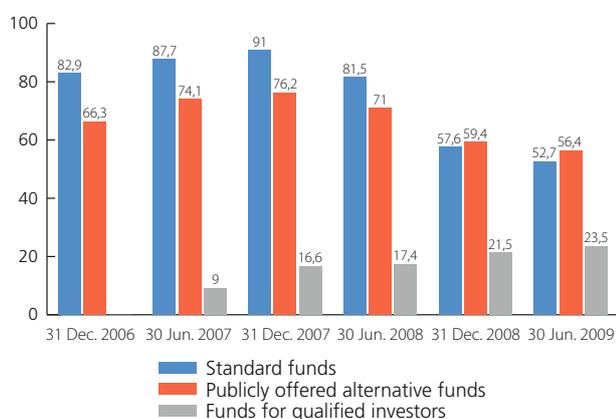
As the Commission holds the view that alternative funds exacerbated the current financial crisis¹⁴ and does not make the same claim about standard funds¹⁵, we regard it as important to focus in the following analysis on the domestic collective investment market, on the nature of alternative and standard funds, and on the way they behaved before and during the financial crisis.

The value of the assets managed by domestic funds stood at €5.12 billion (CZK 132.6 billion) as of 30 June 2009.¹⁶ Standard funds accounted for €2.04 billion (CZK 52.7 billion), publicly offered alternative funds for €2.18 billion (CZK 56.4 billion) and FQIs for €0.90 billion (CZK 23.5 billion).¹⁷ For comparison, the total volume of assets managed by funds in the European market was €6,107 billion (€4,554 billion by standard funds and €1,553 billion by alternative funds).¹⁸ The Czech collective investment market thus represented less than 0.1% of the total European market.

CHART 1

VOLUME OF ASSETS MANAGED BY FUND TYPE IN CZK BILLIONS (2006–2009)

(in %)



Source: CNB

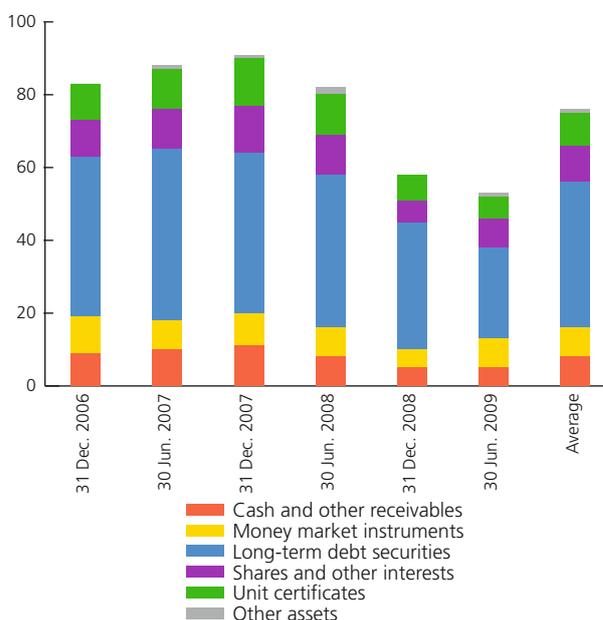
Unlike in the European market, where standard funds significantly exceed alternative funds in terms of volume of assets managed, the split between the two sectors in the Czech Republic recently has been almost equal (see Chart 1).

A more detailed look at the asset structures of publicly offered alternative funds and standard funds reveals that from the medium-term perspective (three years back) the asset structures of the two types of funds are very similar (see Chart 2). Almost half the assets are long-term debt instruments, and shares are in second place in both cases. The asset structures then differ slightly. In the case of publicly offered alternative funds deposits are in third place as regards asset volume, although their share in assets increased significantly only at the start of 2008, i.e. when the economic situation began to worsen ahead of the full outbreak of the current global financial crisis.¹⁹

CHART 2

COMPARISON OF ASSET STRUCTURES OF PUBLICLY OFFERED ALTERNATIVE FUNDS AND STANDARD FUNDS IN CZK BILLIONS (2006–2009)

STANDARD FUNDS



¹⁴ See p. 3 of the Explanatory Memorandum of the AIFM Directive.

¹⁵ See point 2 of the recitals of the UCITS Directive, which, in relation to standard funds, talks about “the development and success of the European investment funds industry”.

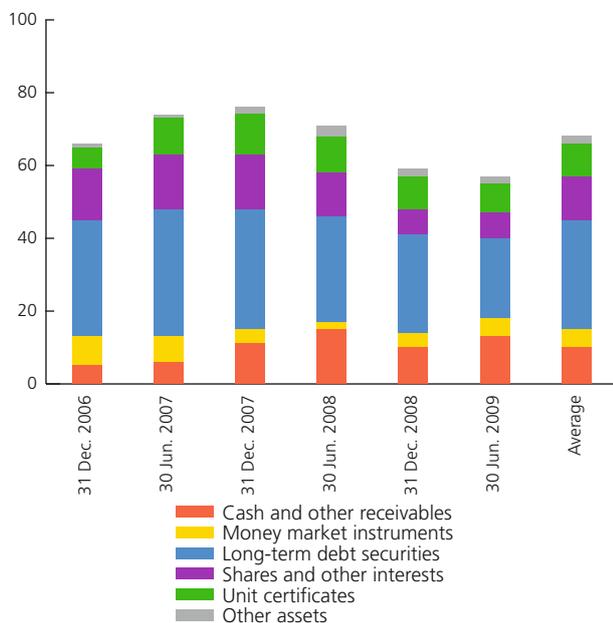
¹⁶ Czech funds managed an amount equivalent to 3.59% of Czech GDP for 2008.

¹⁷ Czech standard funds managed an amount equivalent to 1.43% of Czech GDP for 2008. The equivalent figures for publicly offered alternative funds and FQIs were 1.53% and 0.63% respectively (alternative funds altogether 2.16%).

¹⁸ See the data of the European Fund and Asset Management Association (EFAMA) at http://www.efama.org/index.php?option=com_docman&task=cat_view&gid=335&Itemid=-99. European funds managed an amount equivalent to 48.84% of EU GDP for 2008 (European standard funds 36.42% and European alternative funds 12.42%).

¹⁹ Based on the information known to us, it is impossible to state with certainty whether the increase in the share of deposits in portfolios was due more to expected negative trends in equity markets or to increased pressure from investors to redeem their shares from funds.

PUBLICLY OFFERED ALTERNATIVE FUNDS



Note: Average for 31 December 2006–30 June 2009.
Source: CNB

An important piece of information is the absolutely negligible share of financial derivatives in the portfolios of both types of funds. In Europe, it is usual even for standard funds to invest in financial derivatives and to use leverage. These practices are not common in Czech standard funds or even publicly offered alternative funds (where financial derivatives are used for hedging or efficient portfolio management).

The asset volumes of the two types of funds followed very similar paths before and during the crisis – very slight growth in assets until 2007, an appreciable fall in the first half of 2008, a sharp decline in the second half of 2008 and a slower decline in the first half of 2009 (this fall was due not only to a decrease in the assets' market value, but also to increased redemptions in the case of open-ended funds).

FQIs have a specific position in the Czech capital market, as they do not invest actively on that market but invest almost exclusively in real estate. Thanks to this, they recorded asset growth during the financial crisis, although this was due primarily to the foundation of new funds and to the inflow of new investments. Given their predominant investment method (purchasing real estate and holding it in their portfolios), we are of the opinion that FQIs could not have caused or exacerbated the crisis in the Czech Republic.

According to the analysis, we can also say that the publicly offered alternative funds sector and the standard funds sector in the Czech Republic are practically identical in terms of asset value and structure. This is no surprise when one considers that the two types of funds are subject to similar regulation as well. It is evident from the aforementioned asset composition that the instruments used by the two types of publicly offered funds could not have caused or exacerbated the crisis in the Czech Republic. What is more, if the Commission is right in its view that standard funds did not cause or exacerbate the crisis, the same view must also apply to Czech publicly offered alternative funds given their similar asset structure.

4. DIRECTIVE ON ALTERNATIVE INVESTMENT FUND MANAGERS

On 29 April 2009²⁰ the European Commission published a Proposal for a Directive on Alternative Investment Fund Managers²¹ (the "AIFM Directive"). The AIFM Directive is being presented by the Commission as part of the response to the financial crisis. The Commission is trying to create a unified and effective regulatory system for alternative fund managers (hereinafter also "managers") in the European Union.²² The Commission does not intend to regulate the investment policies of individual alternative funds directly.²³ That would be a difficult task considering the diversity of those investment policies.

²⁰ The Proposal published by the Commission on 29 April 2009 is the only official proposal so far. For the compromise proposals of the Swedish and Spanish Presidencies, see section 6.

²¹ Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2004/39/EC and 2009/65/EC published on 30 April 2009 as COM (2009) 207 final.

²² See p. 5 of the Explanatory Memorandum of the AIFM Directive.

²³ See point 8 of the recitals of the AIFM Directive.

A manager is defined as any legal or natural person whose regular business is to manage one or several alternative investment funds. The directive is therefore not limited in scope solely to hedge funds and private equity funds, but covers all collective investment funds to which the UCITS Directive does not apply.²⁴

The AIFM Directive lays down rules for the authorisation, ongoing operation and transparency of managers. Every EU-domiciled manager that manages assets exceeding €100 million invested in an alternative fund will require authorisation to operate. For managers which only manage unleveraged alternative funds and do not grant investors redemption rights during a period of at least five years, a *de minimis* threshold of €500 million applies. This exemption is targeted mainly at private equity funds, which pose a lower systemic risk.²⁵

Managers will be required to comply with relevant capital requirements, which are specified analogously to those for investment companies constituted under the UCITS Directive.²⁶

To obtain authorisation, managers are required to demonstrate that they are suitably qualified to provide management services. Managers will have to provide detailed information on their business activities, the characteristics of the alternative funds they manage and their governance systems. They will also be required to

comply with information obligations towards investors and supervisory authorities.²⁷

The AIFM Directive will offer managers with due permission (an opt-in) from the home state an advantage in the form of authorisation to market alternative funds to professional investors²⁸ throughout the EU. Cross-border marketing will be subject only to a notification duty whereby the manager will provide notification of its intentions and file relevant information with the home supervisory authority, which will forward that information to the host supervisory authority. Managers will also be able to provide management services for alternative funds domiciled in other EU Member States.

The directive also allows alternative funds domiciled in third countries outside the EU to be marketed in the EU provided that such states meet strict requirements regarding regulation, supervision and international cooperation, including the OECD's requirements for exchange of information in tax matters. This last requirement will be probably critical with regard to alternative funds domiciled in offshore centres,²⁹ although the Commission believes that offshore centres will have a strong incentive to adapt to these conditions and that this requirement is consistent with the G20's objectives to enhance transparency in such jurisdictions.³⁰ By contrast, the AIMA³¹ is convinced that this requirement will put European managers of European alternative funds at a disadvantage compared to non-European ones.³²

24 The AIFM Directive thus also regulates real estate, commodity and other asset funds regardless of their legal form and regardless of whether they are nationally regulated or supervised. See p. 5 of the Explanatory Memorandum of the AIFM Directive.

25 The Commission assumes that these limits cover around 48% of all managers managing almost 98% of all assets deposited in EU-domiciled alternative funds. A prediction of the coverage of individual fund managers, including hedge fund managers, and their assets at various *de minimis* thresholds is given on pp. 48–51 of the AIFM Directive Impact Assessment, which is available at http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm. In the Czech Republic the AIFM Directive should apply to four investment companies managing around 84% of the managed assets of all alternative funds (according to data as of 30 June 2009).

26 See Article 7(1)(a) of the UCITS Directive. The requirement ensues from Article 21 Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (Basel II) applying to investment firms (in the Czech Republic banks with licences to provide investment services and investment firms).

27 See Articles 19–21, 23, 24 and 27–29 of the AIFM Directive.

28 Investors within the meaning of Annex II of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (MiFID).

29 See the *AIMA Position Paper on the European Commission's Draft Directive on Alternative Investment Fund Managers (AIFMs)* available at <http://www.aima.org/download.cfm/docid/84F2C795-8895-4945-AED17E9521E45C60>.

30 See the Commission document *Directive on Alternative Investment Fund Managers (AIFMs): Frequently Asked Questions* available at <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/211&format=HTML&aged=0&language=EN&guiLanguage=fr>.

31 Alternative Investment Management Association (an international association of hedge funds).

32 See the *AIMA Position Paper on the European Commission's Draft Directive on Alternative Investment Fund Managers (AIFMs)* available at <http://www.aima.org/download.cfm/docid/84F2C795-8895-4945-AED17E9521E45C60>.

The Member States will be entitled to permit the marketing of alternative funds also to non-professional investors (in particular consumers) on their territory. In such cases they may stipulate additional legal requirements for managers.

5. COMPARISON OF REGULATION OF ALTERNATIVE FUNDS IN THE CZECH REPUBLIC WITH THE DIRECTIVE ON ALTERNATIVE INVESTMENT FUND MANAGERS

The Czech regulations, unlike the AIFM Directive, do not concentrate on laying down rules for the activities of managers. The AoCI contains detailed rules for the types of assets in which publicly offered alternative funds are allowed to invest. In this way, differently to the AIFM Directive, it greatly limits the number of asset-type categories. In the Czech Republic, only FQIs are subject to similar regulation as in the AIFM Directive in terms of asset-type freedom.

The AIFM Directive took over a whole range of rules from the UCITS Directive. The UCITS Directive is the main inspiration for the AoCI. Most of the passages of the mandatorily harmonised regulations for standard funds under European law were also applied to alternative funds under the AoCI. Managers of standard and alternative funds are subject to the same rules in the AoCI. The only exception applies to FQIs, which are subject to limited requirements as regards transparency and information obligations towards the supervisory authority. The AIFM Directive differs from the regulation of managers currently contained in the AoCI mainly in those places where it was not inspired by the UCITS Directive.

The new passages not previously addressed in European collective investment law concern regulation of short selling, the obligation to appoint an independent asset valuator, restriction of the use of leverage by the supervisory authority, and regulation of alternative funds having controlling influence in issuers. Extensive information obligations towards investors and the supervisory authority are a systemically new measure. These correspond in scope to the UCITS Directive, where, however, they are laid down

with regard to the fact that standard funds are offered to the public.³³

One of the frequently criticised activities of hedge funds is short selling. The AIFM Directive pays special attention to this issue in its passage on risk management. All alternative funds to which the AIFM Directive applies are subject to regulation of short selling. The AIFM Directive empowers the Commission to issue measures intended to protect alternative funds from exposure to excessive risk due to short selling. Generally, this special regulation is surprising, as short selling is also used by other institutions from the investment banking sector (banks and investment firms) without it being regulated in such way.³⁴ Although neither the Explanatory Memorandum nor the recitals of the AIFM Directive say so, the fact that hedge funds often use short selling to “punish” countries or companies whose currencies or investment instruments are overvalued may be an important motive for restricting short selling.³⁵ At first sight, restricting this activity of hedge funds might prevent sudden changes in exchange rates and investment instrument prices and the financial instability that ensues from such changes. On the other hand, one should not underestimate the purging effect of “punishment” by hedge funds. As Czech FQIs do not use short selling for speculative reasons,³⁶ we believe that they will be virtually unaffected by such regulation under the AIFM Directive. The AoCI forbids standard funds and publicly offered alternative funds to perform short selling.³⁷

Another new measure is the manager's obligation to appoint an independent asset valuator for each alternative fund it manages. According to the Commission, the creation of this function is meant to protect investors. Such assets, for which transparent market prices often do not exist, are difficult to value, which means there is scope for manipulation.³⁸ In our view, for the Commission to achieve its goals it would be enough for the manager to perform the valuation with professional care and the valuation to be independently and properly verified by the depositary. The AoCI assumes such a rule. In our opinion, creating the new function of independent asset valuator would mean an unnecessary extra cost for Czech alternative funds.

33 See point 58 et seq. of the recitals of the UCITS Directive.

34 The main new measure is authorisation of the supervisory authority to limit the extent to which managers may use leverage.

35 This reason, however, can be inferred from the justification given for regulating leverage. See point 15 of the recitals of the AIFM Directive.

36 Czech FQIs have used traditional short selling only a few times in the past, to cover impending losses of liquidity.

37 The AoCI forbids them both traditional and naked short selling.

38 See point 13 of the recitals of the AIFM Directive.

The AIFM Directive sets out to increase the transparency of alternative funds and enhance market discipline.³⁹ One of the means of achieving this objective is a detailed prescribed information obligation towards investors. These rules are quite surprising, because according to the AIFM Directive alternative funds are not intended primarily for the public. In respect of regulation of FQIs, the AoCI is based on the view that professional investors and FQI managers will agree on the extent and depth of the information obligation themselves. Under the AIFM Directive, managers also have an information obligation towards the supervisory authority. Compared to the information obligations of FQIs towards the Czech National Bank under the AoCI, the AIFM Directive assumes the provision of a substantially larger set of information to the supervisory authority.⁴⁰ The use of this information for prudential supervision is debatable, as alternative funds may only be marketed to professional investors and the AIFM Directive does not specify investment methods with regard to limiting risks for alternative funds or the market. It is also debatable whether the AIFM Directive should limit risks at all, as taking on greater risks is one of the ways of achieving higher returns.⁴¹

Highly debatable provisions relate to managers managing alternative funds using a systematically high level of leverage and alternative funds acquiring controlling influence in issuers of participating securities that the alternative fund has in its assets. Under the AIFM Directive, in the first case the supervisory authority will be entitled to restrict leverage, while in the second case the managers of such alternative funds will have an extensive information obligation towards the issuer, its shareholders and representatives of employees. The information obligations towards issuers also include a duty to provide information on development plans. These rules laid down in the AIFM Directive currently have no precedent in Czech law. The only legislation that comes close is the harmonised regulation of takeover bids,⁴² which, however, concentrates solely on the acquisition of controlling influence in listed issuers. The information

obligations towards issuers run counter to the principle of freedom to do business (in particular the obligation to create and disseminate a development plan for an issuer). In addition, there is practically no justification for it to apply only to managers and not to other investment banking institutions (banks and investment firms).⁴³ Entirely baseless – and unique on the financial market – are the information obligations of an issuer (not a manager) following the delisting of its participating securities from a regulated market in which an alternative fund previously acquired a controlling stake. The issuer has to meet the information obligations for a further two years after leaving the regulated market, as if its participating securities were still listed.

In return for compliance with the strict regulatory rules imposed on managers, a single European passport for managers is to be created. Managers certainly welcome this rule, as under the AoCI it has only applied to standard funds up to now. In the context of unification of the single European passport rules for the marketing of securities to the public, this Commission activity should be welcomed by Czech regulators.

The AIFM Directive allows Member States to permit managers to market alternative funds to non-professional investors as well. In such cases, the Member States are entitled to require managers and alternative funds to meet other requirements.⁴⁴ In this context, surprisingly, it does not refer to the UCITS Directive, which regulates funds designed primarily for non-professional investors (especially as regards information created and disseminated, given the consumer nature of the investors).

6. ASSESSMENT OF THE DIRECTIVE ON ALTERNATIVE INVESTMENT FUND MANAGERS

The Commission's efforts to create a single European passport for managers, and thus also for alternative funds

39 See p. 9 of the Explanatory Memorandum of the AIFM Directive.

40 See Article 57(3) of the AoCI and Articles 19–21, 23, 24 and 27–29 of the AIFM Directive.

41 Taking on greater risks can be dangerous not only for alternative funds, but also for the market. See the aforementioned passage on the regulation of short selling.

42 See Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids, implemented in the Czech Republic into Act No. 104/2008 Coll., on takeover bids, as amended.

43 Commercial law allows partners that control unlisted companies to decide freely on their existence and non-existence. They do not publish development plans, but issue final fundamental decisions as entrepreneurs. It is surprising, therefore, that alternative fund managers are to be an exception among entrepreneurs.

44 Otherwise the AIFM Directive can be viewed as involving maximum regulation of alternative funds, for which the Member States may not lay down stricter requirements. See point 9 of the recitals of the AIFM Directive.

themselves, should be welcomed. However, we feel that the Europe-wide regulations have not been chosen ideally.⁴⁵ We are not sure whether, in the case of the AIFM Directive, the costs associated with each new regulation do not exceed its benefits.

It is hard to say that the Europe-wide regulations will protect non-professional investors (in particular consumers).⁴⁶ As mentioned above, the AIFM Directive assumes that alternative funds will be marketed primarily to professional investors. Professional investors are mostly banks, which should have very sophisticated risk management systems in place, so they need no extra protection from the AIFM Directive. In practice, moreover, such investors see to it themselves that the manager provides them with enough information and has appropriate risk management. In the case where a Member State decides that alternative funds may also be marketed to non-professional investors in its jurisdiction, the AIFM Directive leaves it to the discretion of that Member State to decide on any further rules.

The AIFM Directive should, among other things, probably protect the financial market against shocks that might arise from certain activities of alternative funds.⁴⁷ Based on the comparison given in the previous section we have doubts about whether the regulatory and supervisory tools envisaged in the AIFM Directive will contribute effectively to achieving this objective. As this regulation was created without any in-depth Europe-wide analysis, the aforementioned doubts can be raised from the Europe-wide perspective as well. The open questions that further analysis might answer include why this regulation applies only to alternative funds and not to other investment banking institutions (banks and

investment firms), which use the same instruments in the course of their activities.⁴⁸

According to information from the Swedish Presidency⁴⁹ Sweden has proposed a revision of the AIFM Directive. It has recommended deleting the limit on short selling and the obligation to use independent asset valuers and suggested softening the rules for limiting leverage and the obligations linked with controlling interests in issuers. In our opinion, this is a step in the right direction. The question is, though, whether this proposal will be accepted by the other Member States, especially by those advocating tight regulation.⁵⁰ In a compromise proposal, the Spanish Presidency has further recommended a change regarding relations with third countries outside the EU. Fund industry representatives regard this change as being too protectionist.⁵¹

7. PROPOSALS TO REGULATE ALTERNATIVE FUNDS IN THE CZECH REPUBLIC

In the Czech Republic the AIFM Directive is expected to apply to four managers (investment companies) managing around 84% of the assets managed by all Czech alternative funds.⁵² From the Czech Republic's perspective, we can say that these alternative funds were certainly not among those that exacerbated the financial crisis. However, the question remains whether this was due to stricter domestic regulation and whether we would have to have made different conclusions under hypothetical laxer regulation.

We believe, however, that the current relatively high level of regulation will represent a substantial advantage for

45 Jacques de Larosière, author of the report of the High-Level Group on Financial Supervision in the EU, joined FSA chairman Lord Turner and Sir James Sassoos in criticising the draft AIFM Directive. See <http://www.cityam.com/news-and-analysis/trio-regulators-slam-ecs-hedge-fund-regulation-plans>.

46 On p. 3 of the Explanatory Memorandum of the AIFM Directive the Commission talks about "investor protection". The Explanatory Memorandum does not make clear whether this term also encompasses non-professional investors.

47 See p. 3 of the Explanatory Memorandum of the AIFM Directive.

48 The Commission is also aware of this potential criticism. On p. 5 of the Explanatory Memorandum of the AIFM Directive it announces a further unspecified "review of relevant EU Directives" in this context.

49 See http://www.nytimes.com/2009/11/17/business/global/17inside.html?_r=1, <http://www.hedgefundsreview.com/hedge-funds-review/news/1556271/news-focus-sweden-raises-issues-draft-eu-directive> and <http://online.wsj.com/article/SB125737892834929505.html>.

50 French Finance Minister, Christine Lagarde, has said that France is opposed to the original draft AIFM Directive because it is too minimalistic (a similar opinion was expressed by Poul Nyrup Rasmussen, a prominent member of the European Parliament's Committee on Economic and Monetary Affairs, while he was an MEP). France would prefer to regulate individual funds directly. See <http://www.iiea.com/blogosphere/eu-shuns-funds>.

51 See the comments made by Andrew Baker, Chief Executive Officer of AIMA, at <http://www.hedgeco.net/blogs/2010/02/16/aima-warns-of-protectionist-outcome-in-aifm-hedge-fund-directive/>.

52 The share of the assets managed by the four largest managers (investment companies) in the Czech alternative funds sector is calculated using the data as of 30 June 2009.

the Czech funds industry if the AIFM Directive is adopted. Although we have reservations about the AIFM Directive owing to the aforementioned objections, we believe that its adoption will not have any major impact on the existing business of Czech managers (unlike in the case of institutions not accustomed to a high level of regulation).

However, the adoption of the AIFM Directive would imply a major revision of the AoCI. Changes would need to be made above all to the provisions on authorisation of investment companies and investment funds, the performance of their activities (in particular governance) and the regulation of information obligations and supervision. New passages would introduce obligations for alternative funds using leverage and alternative funds acquiring controlling influence in issuers as well as regulation of the single European passport for managers. The implementation of the AIFM Directive would also necessitate major amendments to, or the replacement of, a whole range of implementing regulations. In this regard, it would be worth considering whether to issue a new collective investment act. The present AoCI has already been amended ten times (including one major revision)⁵³ and the new UCITS Directive will have to be implemented into Czech collective investment law by mid-2011.

The key principle of any implementation of the AIFM Directive should be a requirement for Czech alternative funds not to be subject to stricter regulation than that under the AIFM Directive (apart from the exception given below). The AIFM Directive contains virtually no discretions for the Member States. The only significant scope for discretion we can see for Czech legislators is the potential setting of stricter requirements for managers of publicly offered alternative funds. We suggest abandoning the current regulation of publicly offered alternative funds' investment policies and replacing it with regulation of managers pursuant to the AIFM Directive. From the UCITS Directive it would be appropriate to adopt the information obligations targeted at non-professional investors (in particular consumers).

Even if the draft AIFM Directive or some other European alternative funds regulation is not adopted, it is still worth

considering changing the Czech regulations. Our first suggestion is to unify the rules for public offers of collective investment funds and investment securities to the maximum possible extent.⁵⁴ We also see no reason to have two similarly regulated sectors of standard funds and publicly offered alternative funds standing side by side. We see room above all for relaxing the regulation of publicly offered alternative funds. The AoCI offers substantially fewer types of publicly offered alternative funds than the regulations in other Member States.⁵⁵ The main absentees are private equity funds, commodity funds and infrastructure funds. With regard to the protection of non-professional investors we are more circumspect on the issue of the potential inclusion of hedge funds among publicly offered alternative funds; the proposal for commensurate regulation in the Czech Republic has not, at least according to our information, been carefully considered. The question is whether regulation alone is the main barrier to greater development of Czech funds. For the Czech Republic to become attractive to the alternative funds sector, the related tax regulations need to be revised, as they have some deficiencies compared to the European competition.⁵⁶

8. CONCLUSION

This analysis of the Czech collective investment funds market has shown that Czech alternative funds neither caused nor exacerbated the crisis. The possible reasons for this include their small relative size and cautious investment policies and the existing regulations. However, we see the existence of two similar collective investment sectors – alternative and standard – as problematic. In particular, the publicly offered alternative funds sector is practically identical to the standard funds sector in terms of both manner of regulation and the structure of the assets they hold in their portfolios. Consequently, we see scope for reform towards regulating the alternative funds sector separately and thereby creating a more effective competitive environment.

We view the draft AIFM Directive as a forced response by the Commission to the calls for regulation as a way of averting another crisis. Unfortunately, the original plan to regulate

53 By an amendment implemented by Act No. 224/2006 Coll., amending Act No. 189/2004 Coll., on Collective Investment, and Act No. 15/1998 Coll., on Supervision in the Capital Market Area and on the Amendment of other Acts, as amended.

54 The regulation of public offers of investment securities and securities prospectuses under Act No. 256/2004 Coll., on Capital Market Undertakings, as amended, does not apply to collective unit certificates. The AoCI lays down rules for public offers of unit certificates separately.

55 If alternative fund managers are not going to be regulated, it would be appropriate to regulate the investment policies of alternative funds.

56 See, for example, the comments of Deputy Finance Minister Peter Chrenko at <http://www.financninoviny.cz/zpravy/investicni-fondy-ma-lakat-nizi-dan/364709>.

only systemically relevant alternative funds has turned into excessive regulation of practically all alternative funds. The potential adoption of the AIFM Directive and its subsequent implementation into Czech law should not entail any drastic changes given the current high level of domestic regulation of Czech alternative funds. However, we feel it is not economically efficient to introduce such a strict system for almost the entire European alternative funds sector. It would be useful to conduct a Europe-wide analysis of alternative funds and to open a fundamental debate on the regulation of alternative funds with the other G-20 members.⁵⁷

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⁵⁷ In February 2010 the FSA published the results of a survey on the behaviour of hedge funds with regard to financial stability. This survey revealed no clear evidence to suggest that the activities of hedge funds give rise to systemic risk. See http://www.fsa.gov.uk/pubs/other/hedge_funds.pdf.