ALLIANCE TRUST
INVESTING FOR GENERATIONS

ALTERNATIVE INVESTMENT FUND MANAGERS (AIFM) DIRECTIVE

ISSUES FOR INVESTMENT TRUSTS - BRIEFING NOTE

This note outlines the position of Alliance Trust PLC regarding the Alternative Investment Fund Managers Directive, published in draft by the European Commission on 30 April 2009. Alliance Trust PLC is a self-managed investment company with investment trust status. With headquarters in Dundee, Scotland we are a FTSE-100 company which has been investing since 1888 and is the largest generalist UK investment trust by market value listed on the London Stock Exchange. As at 31 July 2009, we managed assets of nearly £2.3bn.

1 WHAT IS AN INVESTMENT TRUST?

Investment trusts are something of a peculiarity to the UK financial services market. A long-established part of the UK financial landscape (the first investment trust, Foreign & Colonial, was established in 1868), investment trusts offer individual investors access to global or regional equity markets, or other forms of investment, for example private equity or property, with greater portfolio diversification and lower risk than could be achieved by direct investment. Most investment trusts set a cap on gearing of 30% of their net asset value as part of their investment policy. Higher levels of gearing are unusual.

As listed companies, investment trusts operate within the framework of the listing rules of the UK Listing Authority or, for smaller trusts, the Alternative Investment Market (AIM). They also operate within the confines of section 842 of the Income and Corporation Taxes Act. These define the key characteristics of investment trusts which can be summarised as follows:

- Shares in the investment trust are widely held and traded on a recognised market
- Overseen by a Board of Directors appointed by shareholders and with individual directors subject to the duties of directors under UK company law
- Publish annual reports and are subject to the governance and disclosure obligations of all UK listed companies
- Investment decisions may be made by employees of the investment trust itself (referred to as self-managed) or outsourced to an investment house which manages a range of investment trusts and other funds
- Self-managed investment trusts sometimes operate a related business alongside investment, e.g. Alliance Trust's financial services, asset management and private equity businesses, but they must not conduct any significant trading activity
- Investment activity is in line with a published investment policy and with the objective of spreading investment risk. Significant changes to that policy require shareholder approval
- Principal source of revenue is income from shares and securities, of which no more than 15% can be retained from year to year, and the remainder distributed to shareholders
- No single holding to represent more than 15% of assets, to avoid undue concentration of investment

2 IMPLICATIONS OF THE AIFM DIRECTIVE FOR ALLIANCE TRUST

In principle

The AIFM Directive aims to increase regulation of those investment managers whose activities spread or amplify risks through the financial system, with investment strategies that are not adapted to the investment profile or needs of retail investors, offering funds which are illiquid and subject to high risk of substantial risk of capital loss. These characteristics are diametrically opposed to the investment policy of Alliance Trust and similar investment trusts. We do not believe that, in relation to investment trusts, the provisions of the Directive will add anything meaningful to the existing framework of investor protection.

It is recognised that there is a will among Member States to regulate more effectively those funds which do introduce systemic risk. However the scope of the draft Directive, which encompasses all non-UCITS funds, catches many other types of investment. The optimum approach for investment trusts would be for them to be excluded from the scope of the Directive altogether, on the basis that they do not create systemic risk. However there is a concern that allowing a complete opt-out for certain classes of funds such as investment trusts, might leave a loophole for the funds which are the main area of concern to avoid regulation. For that reason we are concerned to ensure that the Directive takes account of the legal and regulatory framework within which investment trusts operate, in the interests of good regulation.

If the directive is passed, Alliance Trust will be able to transfer responsibility for management of the portfolio to our existing asset management subsidiary, but this will create additional costs and regulatory obligations without any obvious benefit. It will also introduce additional complexity to the current relationship between the company and its shareholders. This option will not be available to all other investment trusts and as a consequence the directive will reduce the choice of investment vehicles currently available to investors.

High level concerns

Alliance Trust is already subject to regulation by virtue of its status as a listed company. The listing rules promulgated by the UK Listing Authority, a division of the Financial Services Authority, are based on EU Directives, namely:

- Consolidated Admission and Reporting Directive
- Prospectus Directive
- Transparency Directive
- Market Abuse Directive

The listing rules already incorporate a specific chapter imposing specific requirements on investment trusts and other listed closed-ended funds. In addition there is an existing requirement to produce accounts under IFRS and to report on compliance with the Combined Code on corporate governance.

Many of the issues now proposed within the AIFM Directive overlap, but are not consistent with, this existing regulatory framework – for example: conflicts of interest (Article 10), risk management (Article 11) or reporting to investors (Article 19).

Consequently these new provisions will create a “parallel-track” of duplicative regulation with differing requirements and therefore does not represent best practice in good regulation. For this reason we urge that, if investment trusts are not to be excluded from the requirements of the Directive entirely for the reasons stated above, that the focus should be on incorporating any additional requirements within the current listing rules framework, and only where the existing requirements are considered to be inadequate for investor protection.

The Directive also conflicts with current governance practice in that it places accountability on the manager. This undermines the principle that the Board of the listed investment trust is accountable to investors for its activities, including holding the manager to account for performance and changing the manager where necessary. The role of the Board is subordinated to the manager in the AIFM Directive.

Practical issues

There are various practical issues which need to be addressed for the Directive to work in practice and have not to date been considered fully:

- In relation to share capital for example, Article 4 would prevent further issuance of shares by investment trusts, so preventing the formation of new trusts or any capital reorganisation by existing trusts. In addition Article 12, which requires a redemption policy, is inconsistent with the corporate structure of an investment trust, which has a fixed share capital, with investors selling their shares in the market rather than redeeming units as for open-ended funds.
- With regard to the proposed role of the independent “valuator”, in addition to creating overlap with the role of the auditor in a listed company, the requirement for valuation of assets each time shares are issued or redeemed will create additional expense for companies while not adding to investor protection.
- Some investment trusts use multiple managers to implement their investment strategy. For those trusts, it is unclear who would be the AIFM. There is also a prohibition on the use of non-EU service providers, which will affect trusts who use, for example, an Asia-Pacific firm to manage their assets in that region.

Private equity

As mentioned previously, Alliance Trust has a subsidiary business, Alliance Trust Equity Partners (ATEP), which manages a private equity investment portfolio on its behalf, typically in the form of funding commitments to limited partnerships with investment periods of 5 to 10 years. This forms a small part of the Trust’s investment portfolio (less than 4%) but provides a useful source of long-term capital growth and diversification of risk. ATEP is regulated by the FSA in its own right.

The particular issues for Alliance Trust arise from the fact that ATEP manages funds predominantly on behalf of the Trust rather than for third parties. For this reason some of the additional requirements which the Directive imposes on private equity firms are either unnecessary or duplicative, for example:

- Minimum capital and liquidity requirements – as mentioned previously, these do not appear to be relevant to support redemption rights in the context of closed-ended funds generally. Specifically in relation to ATEP, the fact that it manages funds on behalf of its parent company means that minimum capital and liquidity requirements are unnecessary for the protection of investors.
- The requirement for an independent depositary – the funds in which ATEP has invested operate subject to contractual commitments (limited partnership agreements). Custodial systems are designed to deal with share-based or unitised investment holdings, and are not relevant to private equity limited partnerships. The requirement for an independent depositary creates additional cost for the underlying investor with no resulting benefit.
- The requirement for an independent valuator – in addition to the comments above, for ATEP specifically the valuation of its investments is undertaken according to industry guidelines and then disclosed within the company’s annual accounts which are subject to audit. Again the requirement for an annual independent valuation would duplicate the existing requirements and result in added cost and no benefit.
- The exclusion of non-EU domiciled funds – this restricts the investment choices available to ATEP who are well able to assess the risks within any such fund as part of their due diligence.
- Additional disclosure requirements – to the extent that these duplicate the disclosures made in the accounts of ATEP’s parent company they are unnecessary. Additional disclosure will not benefit ATEP’s stakeholders and, in a wider context, would have a detrimental impact on the relative performance of private equity fund portfolio companies against their competitors.

3 IMPLICATIONS FOR SHAREHOLDERS

An impact assessment undertaken by the FSA as part of its review of the Directive concluded that if the Directive passed into law unchanged, the current legal structure of investment trusts could not be maintained, with the result that trusts would be forced to liquidate and transfer investors into alternative structures complying with the new requirements. The assessment identified a cost of some 500m Euros across the industry, which would fall to be met by the trusts concerned and ultimately their shareholders.

In the event that the Directive is amended to the minimum extent necessary to avoid this outcome, investment trusts will still incur additional costs, for example to meet the additional responsibilities of the depositary or for the valuator, or for the additional disclosures required. These costs would adversely affect the traditionally low-cost structure of investment trusts.

The Directive will also reduce the investment choices available to investors within the EU, either by removing investment trusts altogether, or by removing access to non-EU funds.

4 RECOMMENDATIONS

The impact of the AIFM Directive as currently drafted on Alliance Trust and other self-managed trusts would be significant and would provide no additional benefit or protection to investors to justify that impact.

We recognise that there is a will at EU level to provide regulatory oversight of non-UCITS funds and, while we do not accept that this should extend to the activities of investment trusts given their very different character to those other funds which create systemic risk, we understand the reasons for using this definition within the scope of the Directive.

In support of the principles of good regulation, we believe that the Directive could be strengthened by the following points:

- Recognise the existing regulatory obligations on investment trusts which are subject to the Listing Rules and avoid any mismatch with these existing requirements
- Acknowledge that not all investment trusts are managed by FSA registered firms and allow self-managed trusts to continue to operate on that basis
- Maintain the responsibility of the Boards of investment trusts as responsible for their management
- Avoid imposing additional reporting requirements which conflict with the existing disclosure regime
- Avoid creating new roles such as the valuator which overlap with existing roles, i.e. the auditor.

It is for this reason that we are urging the Commission to progress the implementation of the Directive for investment trusts by way of amendments to the Directives which underpin the Listing Rules and with changes to the existing Directives only where they would demonstrably provide additional protection for investors.

5 FURTHER CONTACT

For further information, please contact Donald McPherson, Company Secretary on **01382 321234** or via email at **donald.mcpherson@alliancetrust.co.uk**.

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