WAR BREAKS OUT OVER EC HEDGE FUND PLANS

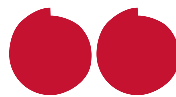
Financial centres

The European Commission's first draft for its directive on alternative investment fund managers and overseas financial centres has brought about furious accusations of protectionism, anti-Anglo-Saxon bias and unnecessary meddling.

WRITER *Silvia Pavoni*

ANGLO-SAXON FINANCE has been under attack over the past months and the regulatory efforts to curb the alternative investment market, which some fear could result in the decimation of European hedge funds, have been infuriating the industry since a draft directive on alternative investment fund managers was first presented in April. Sentiments are now so heated that, privately, the tensions between the European Commission and the industry are being described as a 'war'.

Hedge funds, private equity firms and other alternative investment fund managers, are not alone. UK and Dutch institutional investor groups have also raised their concerns in a letter in June to EU internal market commissioner Charlie McCreevy.



SOME POLITICIANS HAVE STATED A LOT OF CREDIBILITY ON THIS DRAFT... THIS IS VERY UNFORTUNATE BECAUSE INDIVIDUALS' AMBITIONS SHOULD NOT GET IN THE WAY OF THE ECONOMY

Andrew Baker

PROTECTIONIST ACCUSATIONS

Speaking at a seminar last month hosted by JPMorgan on behalf of Business New Europe, Sir James Sassoon, advisor to the UK's Conservative Party on financial regulation and formerly an advisor to the UK treasury, said that because the draft directive had been rushed through, it was "poorly drafted" and "protectionist in effect if not in intention".

The UK's City minister, Lord Myners, who was in the audience for the seminar, agreed with Mr Sassoon that the directive is flawed as it stands, including its "brutal and blunt" suggestion of leverage limits for hedge funds. He stressed, however, that the directive is only in draft form and that he is confident that the various parties currently working together could establish a more workable and equitable version.

Jacques de Larosière, chairman High Level Group on Financial Supervision in the EU, who was also speaking on the panel alongside the chairman of the UK's Financial Services Authority, Lord Turner, agreed with Lord Myners that the there is still a "lot of work to be done" on the draft directive. He stressed that private equity – also targeted in the draft directive – was not even mentioned in the report released by the High Level Group in February. "[Regarding] hedge funds, I have some doubts on the wisdom of some aspects of this proposal," said Mr de Larosière.

The draft directive on alternative investment fund managers prohibits non-European funds, not harmonised under retail fund legislation, to be marketed and sold to European institutional investors, unless they come from a jurisdiction that has integrated key Organisation for Economic Co-operation and Development's (OECD's) requirements on taxation into their home regulation.

Lord Turner's and Mr de Larosière's reviews of the financial markets, along with the International Organisation for Securities Commissions (IOSCO), have all come to the conclusion that the financial crisis was not a hedge fund crisis. Which, for many observers, begs the question: why has the European Commission put together a document that seemingly wants to control systemic risk by curbing the alternative investment industry, and offers protection to institutional investors perfectly capable of carrying out their own due diligence?

POLITICAL IGNORANCE

"Politicians have been given very accurate information saying that hedge funds and private equity are not to blame for this crisis," says Christopher Fawcett, CEO of Fauchier Partners. "Being given that information, they continue to go on about hedge funds. So they are not speaking in good faith. They were given the Turner report, the de Larosière report: two serious, respectable reports that politicians chose to ignore. The problem is that some politicians have stated a lot of credibility on this draft. If the draft is amended in a sensible way, they will feel that their political credibility is damaged. This is very unfortunate because individuals' ambitions should not get in the way of the economy."

Professor Joe Bannister, chairman of the Malta Financial Services Authority, adds: "People don't seem to read [reports]. The de Larosière report does not say that systemic risk and the crisis came from hedge funds, but it came from investment banks that were releasing money and providing leverage to these funds. It would be better if those were more controlled."

But the directive is not about banks. If

anything, it may give European banks a boost in the fund management business.

"We will see less competition in the market and less products to serve our pension fund industry," says Laura Cox, partner and head of the financial services team at PricewaterhouseCoopers Legal. "It will drive people to choose between being onshore and offshore, and with very separate business models for each emerging. I think that only the larger players will decide to stay onshore, and they are likely to do it in the context of a bank – rather than a traditional asset manager – because if you are an EU bank, the directive does not apply to you. So we will have an unlevel playing field between traditional asset managers and banks. To me this is a key problem of the directive; it really puts banks at an advantage from a cost perspective."

THE CASE FOR THE DEFENCE

Mr McCreevy defends the draft as a first attempt across European jurisdictions for the direct regulation and supervision of the alternative fund industry. "It puts in place a robust framework to ensure that the sector operates safely and responsibly and is subject to regulatory oversight," he says. "The proposal has already been the object of immense political debate. The European parliament and the industries concerned have made their views known. For some, the proposal goes too far. For others, not far enough."

It is the robustness of the draft that the industry is concerned about, with a text flawed by confusion on how the market works, and the influence that some European countries have allegedly played. France, in particular, has been singled out as the strongest supporter of the directive, and the one that has influenced it the most. The French finance ministry was not available for comment.

Should the draft become law in its current shape, hedge funds, a big chunk of which are domiciled offshore, will have to reconsider their business model for Europe, or reconsider their involvement in European markets all together. The choice would be between closing EU accounts and relocating elsewhere – Switzerland, Canada, the US and Hong Kong are all viable options, providing that the current business model does not rely purely on European clients – or shutting down.

"[Hedge funds] might not only have to stand still on existing holdings, there will be a point when they'll have to disinvest from existing holdings," says Andrew Baker, CEO of the Alternative Investment Management Association. Two-thirds of the hedge fund industry is located in the US, while European hedge funds make up no more than 25% of the global total. If up to three quarters of hedge funds and other alternative vehicles will not be available to European investors, there will be an effect on investors' asset allocation, risk return, asset liability structure and access to certain strategies for asset liability matching. "You don't need to get out a calculator to [understand] that this will have a significant impact on those big institutional investors that have in place substantial alternative asset allocation programme," says Mr Baker.

INVESTORS SUFFER

Institutional investors, which the directive wants to protect, would be worse off. Some products will be more expensive or simply no longer available to them, either because investors won't be able to invest in a certain fund, or because certain investment strategies won't be possible.

"As I told a consultant recently, if the European Commission has its way, your EU-domiciled clients will only be able to invest»

THE EUROPEAN COMMISSION'S DRAFT DIRECTIVE ON ALTERNATIVE INVESTMENT FUND MANAGERS

Contested points:

Regulation on managers, rather than funds.
Only European firms can sell funds on the European market.
Industry reaction: why cut out institutional investors from investment opportunities, just because they are not European funds?

Restriction on funds.
Jurisdictions where funds are domiciled have to comply with OECD tax information exchange rules.
Industry reaction: tax matters have nothing to do with the investment market's regulation.

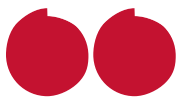
Limit on leverage.
Maximum leverage values are to be determined by European Commission, regardless of what the leverage would be used for.
Industry reaction: not all leverage is negative. Leverage can also be used to mitigate risk.

Restriction on what depository houses to use.
Only European custodians/prime brokers to be appointed.
Industry reaction: this is not good for competition.

Constraint on marketing activities.
Authorisation needs to be granted from manager's home regulator and potential investor's regulator.
Industry reaction: why burden fund managers with unnecessary bureaucracy?

Appointment of independent valuer for private equity investments.
Industry reaction: a private equity firm is better placed to value the company it is investing in. Private equity investors use top advisers already. What can an additional valuer add?

Limited consultation with industry.
Industry reaction: does the EC really understand the market? Parts of the directive are confused while others have been put together from existing regulation (FSA and Hedge Fund Standard Board).



I WANT TO SEE AN INSURANCE COMPANY IN FINLAND AND I NEED TO SEND THE INFORMATION TO THE FSA, WAIT ON MY HANDS FOR 10 DAYS AND THEN THEY MAY OR MAY NOT GIVE ME PERMISSION... THIS IS A JOKE *Douglas Shaw*

in EU-domiciled funds managed by EU managers, with positions in EU securities, serviced by one of only four EU prime brokers," says Douglas Shaw, managing director of proprietary alpha strategies at Blackrock. "Any professional investor would struggle to think of this as a good outcome."

CONFUSED LEGISLATION

The draft directive presents many confused points. Highly contested is the limit on leverage that would be introduced by the European Commission. In addition, individual country regulators could further reduce that limit. The problem is that, the industry argues, not all leverage is negative. Leverage is also used to buy protection against currency or interest rate exposures, for example. "High leverage doesn't necessarily mean high risk," says Mr Shaw. "This is a big issue, particularly for some macro funds and some fixed income houses."

Furthermore, the draft directive requests authorisation by the local regulator before marketing a fund to investors. This means that before seeing a potential client, the hedge fund manager needs to send a notification to the regulatory body, explaining what the fund is about and where it is domiciled. Then it has to send a prospectus, a memorandum of articles and articles of association, accompanied by any additional information about the fund, including presentations and pitch books, and any information on arrangements the manager has put in place to make sure that the fund is marketed only to professional investors. The regulator would then reply within 10 business days.

"I have this brilliant idea and I want to see an insurance company in Finland and I need to send the information to the [UK's] FSA [Financial Services Authority], wait on my hands for 10 days and then they may or may not give me permission," says Mr Shaw. "So now I've sent millions of e-mails to the FSA which are cueing up, and I'm waiting to buy my ticket to Finland. Plus I have to wait to know if the Finnish government thinks the [offshore centre the fund is domiciled at] is a good authority, as there is a clause that says that a country can delay the 10-day period waiting to check if the [directive's] conditions are met. This is a joke."

If this were a joke, for companies the size of Blackrock it would be a bad one indeed. "Blackrock has a couple of hundred funds caught in this," says Mr Shaw. "So for 200 funds and 27 places [in Europe] I want to go to, it requires 5400 e-mails, just from me, to the FSA."

There is also the worry that some countries could exacerbate these restrictions. "We can't exclude the possibility that certain member states may gold plate these rules, resulting in measures that are even more disproportionate and inappropriate than the proposed directive," says Didier Guennoc of the European Private Equity and Venture Capital Association. Mr Guennoc heads the EVCA unit that represents large buy-out investors. "However it is far too early too tell which country will follow that route," he adds.

The proposed legislation also indicates which prime brokers will be able to provide custodian services. It says that only European custodians should be used, which dramatically limits the pool that hedge funds can choose from. This could be good news for the likes of BNP Paribas, Deutsche Bank and Barclays Capital, and could develop a market for new, niche providers. But limiting the number of players one can do business with (hoping that others will emerge) is, the industry argues, not a good idea.

PRIVATE EQUITY PROVISIONS

Provisions have been made for private equity funds to have a separate custodian and depository and a separate valuer. Private equity firms usually own a majority portion of the business they invest in and, therefore, they are the ones that would very much know how to value it, the industry says. Private equity invests in companies for which only limited public information is available. An independent valuer might struggle to carry out a valuation with the same depth. Furthermore, private equity investors are typically institutions, pension funds or ultra-high-net-worth individuals, which are advised by top accountants and lawyers. One might wonder how an additional adviser would add value to this process. There is also uncertainty on who will appoint the valuer and on how to deal with possible conflicts of interest.

There are not any publicly available figures as yet to show the potential impact on the alternative investment industry or on jurisdictions' economies, but some have privately engaged in this exercise. "I know that clients have tried to quantify the cost of this directive to their business and investors and the figures come up in the millions – and that's for a medium-sized fund house," says Ms Cox.

The protection that the directive seems to want for institutional investors resembles that in place for retail investors, which finds its regulatory framework in the Undertakings for Collective Investment in Transferable Securities (UCITS). In fact, the

directive is addressed at alternative investment funds that are not UCITS-compliant. Some hedge fund strategies, such as a macro fund that deals with index products or some long/short strategies, could be put into an UCITS wrapper. For anything that is not liquid, this will not be the case. Distressed debt, a number of arbitrage strategies and a lot of fixed income-related strategies which are big users of derivatives won't be available to European institutional investors, say hedge fund managers. Such strategies represent a material chunk of the hedge fund offering.

But this draft directive is not bad news for everyone. Firms specialising in managed accounts – structures that offer a one-to-one relationship to big investors – are not targeted by the draft directive and could take up some of the hedge fund business. Also, suggesting an UCITS-style alternative investment market for institutional investors could benefit some financial centres. Fernand Grulms, CEO of Luxembourg for Finance, is a supporter of such a view. "Luxembourg has a wide experience in the distribution of UCITS products, not just in Europe," says Mr Grulms. "We have the know-how for cross-border distribution of financial products in foreign markets. We think we'd gain from a memorandum of understanding about distribution of other types of financial products [besides UCITS]."

THE BLAME GAME

In finance, as in life, blame is a very common reaction to bad events. As with hedge funds, offshore centres have received increased attention from policy makers. They had both been under relatively light regulatory regimes and have both been the object of politicians' efforts to speed up economic recovery – in the case of offshore jurisdictions, by hoping to recoup taxes lost to their centres. Tax matters seem to play also a big role in the EC's draft directive, which requires that jurisdiction that funds are domiciled at should comply with the OECD's tax information exchange rules. And as hedge funds and offshore jurisdictions are often highly interlinked, many such funds are based offshore and take advantage of tax efficient regimes.

"Hedge funds didn't play a starring role in the story of the causes of the credit crisis," says Barney Reynolds, London's head of the financial institutions advisory group at law firm Shearman and Sterling. "The fact that some people appear to dislike them is often based on perceptions." He adds: "The economic boom the world experienced in the past few years was also driven by financial markets and their sophistication."

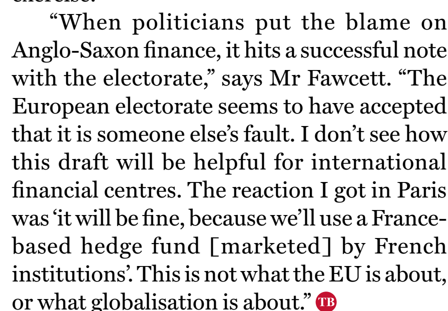
Furthermore, a study by Professor Walid Hejazi, academic director at the Rotman School of Management at the University of Toronto, to be published this summer, proves that tax-efficient financial centres play a very important role in the economy, as it allows corporations to expand abroad in a cost-effective way, and in a way that would not otherwise be possible without such jurisdictions. And when a corporation grows, the country in which the corporation is headquartered – even if some of its operations are located offshore – grows with it, argues Mr Hejazi.

HEDGE FUND EXTINCTION

As for the industry, financial centres are also lamenting the lack of involvement in drafting this directive and are confused about the real, ultimate goal of the proposed legislation. Systemic risk? Investor protection? Tax transparency? One professional with close knowledge of the situation believes that it is none of the above. The real aim is to "kill locusts", he says. "They don't want a hedge fund industry. And the people proposing this don't have one anyway. There isn't a hedge fund industry in Germany, Denmark or France. Eighty-five per cent of the hedge fund industry in Europe in based in London."

The common view is that this proposed legislation is a protectionist exercise and, on a wider note, the industry wishes for actual co-operation between the EC, the US Securities and Exchange Commission and IOSCO. About 25% of the funds raised by European players come from the US. It would not be good news for anyone if the US decided to retaliate and introduce similar rules. "Europe and the US talk a lot about the need to avoid protectionist legislation and to open competitive markets, but this legislation creates a 'Fortress Europe'," says Ms Cox.

Clamping down on alternative investment funds and their offshore jurisdictions seems to many just a biased, self-serving exercise.



"When politicians put the blame on Anglo-Saxon finance, it hits a successful note with the electorate," says Mr Fawcett. "The European electorate seems to have accepted that it is someone else's fault. I don't see how this draft will be helpful for international financial centres. The reaction I got in Paris was 'it will be fine, because we'll use a France-based hedge fund [marketed] by French institutions'. This is not what the EU is about, or what globalisation is about." TB

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