

Regulatory Challenges and the Convergence of Global Hedge Fund Standards.

MMS Regulatory Solutions Seminar, 1 July 2009.

Questions and Answers with:

Alan Leale-Green (“ALG”) *MMS Regulatory Solutions*

Andrew Baker (“AB”) *Alternative Investment Management Association*

Thomas Deinet (“TD”) *Hedge Fund Standards Board*

Q Can you outline the process the Directive must undergo before it is finalised and implemented?

AB: It is a codecision making process. It will not go through our government.

The Council of the European Union and the European Parliament jointly adopt legislation based on a proposal by the European Commission. Both Parliament and Council are required to agree on the text before a proposal can be adopted.

The Council is now the only place where the legislation can be contested (by the UK and any other countries that may oppose it). To pass the Directive would require a two-thirds majority, and a minimum of 255 votes. 91 votes are, therefore, required to block it.

The suggested focus of attention should be the Committees and Working Groups that will be set up by the new parliament, once it convenes.

There can be up to three readings of the bill and the Directive is highly unlikely to go through on the first given its complexity. The Directive will most likely be passed around Q1 2010 and implemented in 2011.

ALG: to whom should stakeholders address their concerns and otherwise lobby and petition?

TD: Individual member states should be lobbied. Many are still in need of education about the Directive.

MEP's may also be petitioned directly.

The UK government is on the case with, for example, the Treasury and House of Lords Committees.

AB: AIMA will be issuing a 'call to arms' shortly.

Dutch pension funds have already written to Charlie McCreedy [Commissioner responsible for Internal Market and Services].

We should also seek to mobilise Investors, Prime Brokers; all vested stakeholders. Establishing a non-UK voice is also important.

TD: The Directive is a key issue of the UK but seemingly not so important elsewhere. A recent visit to Germany revealed very little discussion of the proposals. Education is certainly needed elsewhere in Europe.

Q Is there a realistic prospect of delaying or achieving significant changes in the contents of the Directive and, if so, how?

AB: Delaying the Directive is not valuable in its own right but, the extra time [to consider it] will be valuable.

Outside the EU, awareness of the implications is extremely low. Essential objectives for industry should be:

- > Significant re-draft
- > Removal of [large] chunks that bear no resemblance to the way the industry works

The Directive has no abiding central architecture so it is much easier to attack. All member states dislike it for different reasons (some say it goes too far, others, not far enough).

If it was, for example, based:

- > on a harmonised Private Placement regime with sensible passporting for cross-border marketing; or
- > on universal registration for money managers, without the needless de minimus limits; or
- > around creating financial stability – in which it fails

Then it may have been a better Directive.

Dumping reams of information on what is considered to be the best regulator in Europe (i.e. the FSA) will serve no purpose; how will less equipped regulators cope with this volume?

TD: The Directive is extremely protectionist. In a time of economic crisis, it prevents European investors from legitimately investing outside the EEA and thus impairs diversification.

Amongst others, it will hurt pension funds that cannot suitably diversify.

The Directive can be said to have a negative effect on financial stability. In other words, it encourages instability and risk. For example;

- > Hedge fund leverage is much lower than investment banks
- > Imposing hard limits may increase the rapid unwinding of positions in difficult times thus increasing volatility and, thus, instability

Those who say that the Directive does not go far enough, have yet to voice any strong arguments in support of that idea. We are, therefore, in a strong position.

AB: Apropos of setting up an AIFM in Switzerland, you would be caught by the third country rules to the extent that EU investors will be targeted. As it is outside the EU, Switzerland would need to have [or be deemed to have] regulatory equivalence. If the fund itself is domiciled outside the EU, it would need to have both regulatory and tax equivalency. Currently very few domiciles can claim this.

To remain in the EU you would need to drop all EU investors or 'UCITise' your funds.

Whether you could remain in the EU and manage non-EU investors/money is unclear and much of the Directive needs to be clarified in this regard.



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TD: The Directive combines regulatory and tax aims, which can be said to be unhygienic from a legislative point of view. It does not make for a very clean piece of legislation.

Further, it does not address the issue of tax avoidance. Those that engage in such activities will remain offshore.

Q Have other EU member countries voiced concerns about the Directive and does the UK have allies?

AB: Allies may be found in unexpected places: Malta, Luxemburg, Ireland and Cyprus all have sizeable financial sections and are amongst those that may be considered to be allies of the UK.

The Directive raises questions about 'subsidiarity', with supervisory powers shifted from the member states to the EU, which certain eastern European countries are especially concerned about.

Germany and France are opposed to the idea of a European passport, protective, as they are, of their private placement regimes. The Hedge Fund industry, by calling for a proper European passport, is actually more European in this sense, resulting in a peculiar reversal of traditional stances/roles.

Q Are you able to tell the assembly what the current UK and newly elected European MEPs views are on the Directive?

AB: A member state's Ministry of Finance may not necessarily agree with its regulatory authority on the Directive but it is the former that has the vote.

Impact on US managers is potentially far greater than for UK managers who are already regulated. We should therefore not sit back and rely solely on the UK government or the FSA to fight our corner.

TD: Dan Waters [FSA Sector Leader for Asset Management], recently gave an important speech where he was very, perhaps surprisingly, outspoken about the negative aspects of the Directive. It is recommended reading.

[The speech may be found at the following link:

http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0624_dw.shtml]

AB: The negotiating position of the Government is weak as the Government itself is weak and fatigued by current issues. The Conservatives have made unusual, marginal, allies across Europe and the FSA will seek to protect its own place/status.

We cannot, therefore, rely upon the UK Government alone.

Q How do AIMA and HFSB fit in with the Directive?

TD: HFSB practices are more sound, efficient, and sensible. They reflect the way the industry works and have been shaped by industry specialists, like those of AIMA. The regimes provide flexibility and air to breathe. We feel we have a strong case [for industry led solutions] and are in a strong position.

Further, our guidelines:

- > Allow for the granular detail of the Directive to be swept away
- > Have the support of the FSA, in their use as guidance
- > Are endorsed by the G20 and Financial Stability Board

AB: We have to be alive to the topical accusation that industry led standards have not worked. It is important, therefore, to strike the right balance between hard rules and industry led solutions.

On April 20, 2009, the G20 via the Financial Stability Board set a mandated action that the industry should create global standards. Only weeks later the EU, completely ignoring the G20, create and issue its own rules. This unilateralist approach is another angle to attack.

AB: Apropos of concerns about the number of industry groups and the potential for diluting the key messages; AIMA and HFSB are creating a joint steering group to coordinate our response but the industry has always had many voices. Presently, the "AIFM" community does not have a single voice and now may be an opportune time to create one.

However, as the industry is diverse many still want their own standards and directives.

AB: When registering objections to the Directive, it is prudent not to mention the idea that the Directive may prompt businesses to relocate offshore. It readily aggravates the current political/social climate/mood, confirming prejudices and raising suspicion about the activities of the industry.

The European markets will be undisturbed by the Directive. If its intention was to exert control over the capital markets, it fails.

TD: The conclusions in the De Larosiere suggest that there are many areas where industry solutions are positive.

Q How do we, as Alternative Investment Managers, influence the process?

ALG: Question has been part answered in the course of the morning but, is there any way in which we can coordinate our efforts?

AB: As the Commission did not consult on the Directive, in an effort to release it within the lifetime of the current, now previous, parliament, AIMA will shortly be conducting a survey of its own.

In efforts to influence the process, managers should:

- > Raise awareness with clients/investors
- > Inform AIMA of any strong contacts in the EU

Elsewhere, AIMA can assist with any lobbying activities, Press, Conferences/Seminars. A range of support and assistance can be provided here.

TD: We should seek to reach out to the investors who can be a very powerful voice, especially Pension Funds and big institutional investors.

AB: Approaching individual MEP's will have limited success as they are unlikely to respond to individual firms' initiatives. The consultation period, such as it was, is over.

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Q Do you know how investors feel about the Directive?

TD: All investors suffer a limitation of choice. It interferes with asset allocation and could severely restrict investments in some emerging markets.

The Directive also influences a number of related industries though such parties may not be aware of it as yet.

Q Is there anything, other than the simplification of marketing cross border services, which you consider to represent a positive outcome of the Directive?

AB: As noted previously, the positives are:

- > The license / registration of Hedge Funds Europe wide
- > Passporting / harmonisation of marketing
- > Transparency: whilst the FSA do not want to be inundated with excessive data, they would like aggregated high-level data with which to assess systemic risk

In recent months, the FSA has been conducting a survey of approximately 17 or 18 large managers. An extensive questionnaire was issued to firms and the collated findings are to be published shortly. The survey is due to be rolled out to all managers in Q4. This demonstrates that the FSA is already active in our sector, and gathering important, relevant data.

Q If we turn to specific issues within the Directive, are you able to expand on those areas where you have particular concerns?

ALG: In closing, are there any miscellaneous issues and/or comments?

Performance Fees

AB: There is no mention of performance fees in the Directive. It is primarily aimed at the activity of managing and any attempts at product control should be resisted. This is not the UCITS world.

Fund of Funds

AB: The Directive makes the activities of Fund of Funds practically impossible. As investors and managers, they are impacted in both respects.

Prime brokers

AB: Prime Brokers have their own association within which to raise their concerns, but they have given a platform to AIMA.

Big institutions have multiple arms – Asset Management, Prime brokerage, Custody, - each with their own concerns. Thus, they have a variety of views to consider and may have difficulty finding a unified one.

There is also the issue of extended liability the Directive imposes upon custodians for any sub custodians.

Grandfathering provisions

AB: The Directive is silent on Grandfathering. There are numerous outstanding questions on the transitional position; the proposals are not at all clear in this respect. The industry will find great difficulty living with the uncertainty; for example, whether or not to launch new funds, business etc.

The Directive threatens to stifle the industry before it is implemented. ■

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