

[Hedge Funds' response to proposed EU regulation](#)

June 26, 2009 |

Summary

The proposed EU Alternative Investments ("AI") Directive is wide ranging. Market participants need to consider what the EU is seeking to achieve. There is also a need to reflect on the part played by certain types of AI in the financial crisis. AI providers also need to think on the possible commercial benefits of EU regulation. Previous versions of this in mainstream mutual funds, ie the UCITS Directives, have been of massive benefit to fund promoters in distributing products globally, not just within the EU.

Analysis

The proposed AI Directive is, at present, just that. It is wide ranging, and much of it is non-controversial. For instance, what investor in a Madoff fund would not agree that it is a good idea to require independent custody and trusteeship of assets? In matters such as this, the EU is essentially bringing non-UCITS funds into line with their mainstream cousins, for which the custody provisions etc have been a requirement since the initial development of UCITS. Indeed, a common theme within the AI Directive is to bring the administration of non-UCITS funds more into line with UCITS requirements. These have stood the test of time, and are undoubtedly viewed as having a positive marketing impact.

AIs have not had a positive press during the financial crisis. The "shadow banking" system has undoubtedly been a major factor in the financial crisis. Remember it all kicked off with the failure of two Bear Stearns SPVs. One objective of the AI Directive is to exert more control on such structures in order to prevent their growth to a position where they threaten the entire financial system again. Nobody can object to this. The real issue is to ensure that "innocent" products and structures do not get hoovered up by the regulations, thus denying attractive investment products and innovation unnecessarily. Avoiding such things is rightly undertaken via the consultation process, and I would reiterate that consultation is just beginning. The AI Directive is a draft which, as far as I know, has yet to be debated either within the European Parliament and certainly at Council of Ministers level.

A key point to note in respect of the parliamentary debate is that the Directive will be considered by the new Parliament elected earlier this month. This resulted in a further right-wing shift in composition, meaning there ought to be a greater bias toward market solutions as opposed to state or supranational control. This should not be overstated, however, as politicians of all hues now argue in favour of closer financial services supervision. In addition, there are a number of maverick groups who are philosophically opposed to greater EU integration. We must assume they will oppose anything and everything that supports pan-Europeanism.

With respect to the opposition highlighted in The Times' article, I find some of the comments attributed to certain firms rather surprising. For instance, Brevan Howard's threat to leave the UK (and implicitly the entire EU) if the Directive is implemented as currently drafted, makes no sense when judged against that firm's other actions. It is only a few months ago that they were loudly proclaiming the launch of a UCITS-compliant hedge fund. Firms need an EU presence in order to manage and market such products. Indeed, there has been a tendency in recent months for firms to look for ways of making their AIs "UCITS-able".

It is worth stepping back and considering recent changes made to the UCITS Directives themselves, and how these have impacted AIs. UCITS III significantly relaxed investment restrictions on UCITS-compliant funds. UCITS III allows derivatives to be used for investment purposes (as opposed to just for hedging). It allows strategies such as shorting, and it provides for limited levels of gearing. In short, it allows "Hedge-lite" strategies to be incorporated into products saleable across all investor types in the EU. The UCITS "brand" has achieved global acceptance, such that the majority of fund inflows in recent years have actually been from non-EU domiciled investors.

One of the key complaints about AIs during the financial crisis is how liquidity dried up. Large numbers of AIs closed to redemptions or otherwise restricted them. One commercial benefit of UCITS-compliant funds is that there are restrictions on such behaviours. There is clear evidence that AI investors want such restrictions, which is partly why AI providers are seeking to build AI funds that fit into the UCITS structure. In some ways the proposed AI Directive attempts nothing more than try and provide products that still cannot fit into UCITS (eg because of their underlying investable universe) with a framework that allows such investments but with investor-friendly safeguards built in too.

Looking at some of the specific criticisms of the proposed Directive noted in the article, I suspect they will receive only limited sympathy in Brussels. For instance, I think the whole point of the proposed limit on debt in certain products is to stop them being marketed. If IAMA members are saying this is an effect of the Directive, Brussels is likely to take this as a positive verdict on its drafting. Why? Well there can hardly be a dispute, surely, that certain products were overgeared; that there has been way too much credit creation in the bank and shadow bank sector, and that a consequence of this has been the need for States to step in and prevent collapse of the mainstream banking system. All the AI Directive seeks to do is reduce the risk of States being forced to do this again in future. Essentially the Directive is saying that products whose returns to investors are effectively dependent on an implicit de facto sovereign guarantee can be subject to regulatory control. That seems a pretty reasonable protection of taxpayers' interests to me.

I find the notion that IAMA members are all going to up and leave the EU very hard to believe. Firstly, it would make marketing into the EU far more costly and difficult, and this is a market of 500 million (still) mainly affluent people. Nobody deliberately makes access to such a market harder. It is also fanciful to think that the other jurisdictions mentioned are not going to impose similar restrictions on AIs to those proposed here.

I can well believe that AI firms would leave the UK for more fiscally attractive jurisdictions within the EU, but that is a whole different story!