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INFORMING THE HEDGE FUND COMMUNITY

Symposium: The Future of Hedge Fund Regulation

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The evolution of the regulatory climate for fund managers is a topic that is open to a variety of interpretations. That makes the need for clear analysis and reasoned exposition an attractive proposition for hedge fund managers and investors. The Hedge Fund Journal attended a recent London symposium that debated key regulatory issues and was sponsored by Research in Motion, maker of the Blackberry and Eze Castle Integration, the out-sourced IT service provider.

Bob Guilbert, managing director of Eze Castle Integration served as a moderator. The panelists included: Gus Black, partner and member of the financial services team at solicitors Dechert; Stephen Burke, director at IMS Consulting; Chris Leonard, counsel on the team serving investment managers at solicitors Bingham McCutchen; and Jonathon Evans, UK director of Global Relay, a managed communications solution provider to banks and hedge funds.

Guilbert: We'll start by asking solicitors Chris Leonard and Gus Black to lay down the foundation for our discussion this evening. Chris, start with how we got to this particular point with the Alternative Investment Fund Managers Directive.

Leonard: I'll start with the background to the Directive. As many of you know the European Commission published the first draft of the Directive in April of 2009. It is useful to remember where we were at that point in time. The financial world was just beginning to get to grips with the collapse of Lehman Brothers, though some of the shock was beginning to subside. Although initially during the financial crisis, the hedge fund sector had been blamed for the crisis and targeted with prohibitions on short selling, more considered opinion at the beginning of 2009 and the EU's own detailed report and investigation into the financial crisis (the de Larosière Report) had realised that investment managers had not caused the financial meltdown and weren't to blame for the crisis. Nevertheless the draft AIFM Directive came along in April and proposed a complete restructuring of the framework in which investment managers were operating. In fact, the proposals went much further than the principles for financial regulation which had been discussed at the G20 slightly earlier in the year.

Some of the key proposals of that Directive included a requirement for all European domiciled managers of investment funds with assets in excess of €100 million to become subject to regulation in their home member state which perhaps isn't particularly controversial. Once they were authorised they would be allowed to promote and distribute their funds across the EU on a passport basis not dissimilar to the UCITS regime with which we were already familiar. However, where it did begin to get a bit controversial and departed from what anybody was expecting was EU managers would not be allowed to promote funds incorporated outside the EU unless that fund could be shown to be subject to similar or equivalent regulation and provided the jurisdiction in which the fund vehicle itself was domiciled had entered into tax transparency agreements with the EU member states into which it was to be distributed. Of particular interest to my clients was the fact that investment managers from outside the EU would be effectively prohibited from distributing funds within the EU. That was a big problem. It's also worth mentioning that in order to become authorised under the terms of the Directive, EU mangers themselves would be forced to comply with a number of organizational, capital and operating requirements. In particular, and famously, all fund managers would be required to appoint independent depositaries and those depositaries would be required to take on strict liability for any assets that are somehow lost. Fund managers would also have to appoint independent valuators and they would, in addition to their portfolio management function have to have an independent risk management function. The Directive also imposed new transparency requirements on managers and in particular required managers to disclose both the amount and source of any leverage they use to both their investors and the regulator.

It is fair to say that the draft Directive was hastily put together and it shows. Definitions were unclear and there were inconsistencies within the document. Nevertheless despite those uncertainties it was clear that the principles being put forward would fundamentally change the landscape in which the investment management industry operates. Somewhat to my surprise when the Directive was first published the response from the industry was quite muted. I suppose that as the financial world struggled to get back onto its feet priorities were elsewhere and there was a reluctance among some investment managers to put their head above the parapet to criticise the Directive. But by the autumn of last year the industry had found its voice and the criticisms of the Directive had reached a crescendo. Amongst those criticisms was the idea that the Directive was unclear and would be expensive to implement and impossible for certain types of investment managers to implement because the Directive had taken a one-size fits all approach. Private equity funds were to be subject to the same requirements and restrictions as hedge funds which didn't make sense. The Directive would reduce consumer choice and damage pension fund returns and ultimately would reduce the size of the EU economy. Those criticisms appear to have been heeded by some. In November of 2009 the Swedish government, which then held the presidency of the European Council, proposed an alternative draft of the Directive. The principle change is that it opened the door to the private placement of funds in the EU so each jurisdiction could decide whether it would allow non-EU mangers to promote funds

in their jurisdiction and on what basis. That was a welcoming development certainly to the non-EU managers. The Swedish proposals also did away with the requirement for an independent valuator and it softened some of the requirements for the liability of the independent depositary. For many these changes were welcome. But they came at a cost. The Swedish proposal also now required that all investment managers implement a remuneration policy which was intended to insure that remuneration policies at hedge funds promoted sound and effective risk management and discouraged what was termed excessive risk taking.

Simultaneously with the launch of this new draft from the Swedish president of the Council the EU parliamentary process continued and a rapporter was appointed and asked for comment from the alternative funds industry on the draft. The deadline for those comments passed on January 23. In the meantime, it's been reported that prior to those industry comments being delivered MEPs have tabled in excess of 1000 amendments to the Directive. So we are now faced with an odd situation. There are at least two working drafts of the Directive in circulation, one of which was issued by the Council of Ministers and one which is working its way through the European parliament. In my view, it is very difficult to try and assess what is going to come out of the sausage machine. But I will pass over to Gus who will try to do just that.

Black: It seems to be a case of reproduction. The drafts that are being circulated are reproducing; the number of committees involved are reproducing. We've got ECON Committee (the Parliamentary Committee) and as of a few weeks ago we've got a legal committee, JURI, which has popped up with a bunch of commercially unworkable suggestions, seemingly out of left field, which go far beyond the "legal" remit the committee has. We've got proposed amendments breeding by the minute: the figure I have is 1300. Who knows how many we will have when we get to the middle of March when the first votes in the committees are supposed to start happening on these various drafts. It is not clear how they are going to achieve a uniform draft at the end of these processes, but the general idea is that the various committees, the Council and Commission that are putting out their various reports will have a process of trialogues (or dialogues between different parties) to agree upon a draft text. The intention is that in July there will be a vote in the main plenary session and the whole thing will be enshrined into law.
Recent comments from the Rapporteur Jean-Paul Gauzes outline three types of amendments: those that seek to "demolish" the Directive, which he attributes to the eurosceptic groups; those that seek "the cure", which he attributes to the Greens; and then he has those that seek to make changes to improve the drafting, which would presumably include the work we have been doing on the AIMA technical committee to try and make something sensible out of all of this. Most of the lobbyists we speak to in Brussels say there is only one inescapable conclusion from all this: that it is not going to happen by July. It is going to run on and on over the year into 2011. That's an anecdotal report from a lobbyist, not a piece of legal advice.

The mood seems to be that it is, however, going to happen. The most significant thing in this respect, according to the de Gauzes statement, is that a lot of the amendments that have come through have been amendments that want the Directive to go further: people have been unhappy with the various compromises and concessions that have been proposed. It is all quite cosy for us in terms of our community here to sit down in London and say "here is a nice compromise" and "we can actually make it workable". But when you get out into the wastelands of realpolitik within Europe you have to understand that there are a lot of people who think this thing should go a heck of a lot further: regulate the funds, impose real limits on leverage and investments and that sort of thing. There is a great deal to play for at this stage, I think.

Guilbert: We will ask Stephen to give his perspective on what to do now.

Burke: It is a question of what you do now bearing in mind the timetable that Gus discussed. The first thing is not to panic. There is a lot of water to go under the bridge before we get anything out the other end that is a workable Directive. Most hedge fund managers don't tend to plan ahead more than 18 months to two years so by the time this Directive makes the statute book there will still be plenty of time to react and restructure your business, if indeed you need to. I see a lot of firms starting to discuss where they should set up the fund. Today 95% of the people we meet are still Cayman master-feeder structures and very happy that that is the right decision. There is some talk about Luxembourg, Ireland and Malta. For existing managers it is very much sit on your hands at the moment in terms of doing something, but do engage with the debate. AIMA has a very active group of interested parties. Similar things are happening with the Investment Managers Association and the British Venture Capital Association. There is a lot of uncertainty at the moment. But it is not just the Directive. There is the impact of the credit crunch and the changed fiscal environment. In two or three years time there may be a different government and there may be a changed tax system. I'm betting on 2012 or 2013 on being the time when you may have to do something. In terms of what people are doing we are seeing people thinking about bringing their funds on shore in reaction to this and setting up parallel fund ranges such as UCITS.

Black: Let me take up that point about bringing funds into Europe. If you were to re-domicile your fund into a Luxembourg or Irish fund because of the Directive, what you are effectively saying is "I'm going to take the known quantity that is my Cayman fund and put it into a jurisdiction where it is potentially going to be subject to a set of rules in the future, but I don't know what those rules are going to be now". So I would say the Directive alone is absolutely not a reason to re-domicile a fund to Ireland or Luxembourg at this point in time - unless you have thought all of that through. There may be very good reasons for coming to Ireland, Luxembourg or indeed Malta: reasons like your investors are saying that they want the fund structured in one of these jurisdictions. But to try and "game" the Directive by re-domiciling at this point in time, you have to be prepared to take a fairly relaxed attitude to the risk of what some of these changes are going to look like. It might actually be better to stay outside of it with a Cayman fund, or at least wait until there is a bit more clarity about what the restrictions are going to be.

Burke: It is probably far too early to do anything. There are people who believe they will be able to rely on the private placement

regime continuing in different countries across Europe. There are very few people who believe equivalence can be made to work. But there is a very short history of that happening. And the reverse solicitation relaxation which now seems to be accepted would seem to open a window for overseas funds. It is worth remembering that something like 40% of hedge funds and 35% of private equity funds currently operating in Europe are managed outside of Europe. So there is an awful lot of our industry that will suddenly become offside.

Leonard: The important thing to understand is what your business is now and where you are trying to sell funds. If your investor base is in the EU you need to be aware of the Directive and you need to be thinking about how you are going to promote your funds to those investors in the event the Directive is implemented. But we are not at the stage yet where you can actually make a decision. There is just too much uncertainty about what the Directive is going to look like and when it is going to be implemented. I do think every manger will be in a different place. If you are a UK manager with European managers there isn't a huge amount you need to do other than examine the domicile of your fund. but if you are a US-based manager with investors in the EU you do need to consider maybe slightly earlier whether you are going to continue to be able to access the European market and if not what steps you will take to mitigate that risk when it becomes appropriate to do so.

Guilbert: Are there questions on this specific topic concerning what steps to take?

Question: We've heard there are two versions of this Directive: one at the parliament and one at the council. What does the European constitution say about which one will make the final cut?

Black: As I understand it there is a trialogue process and it works by consensus until everyone agrees. Ultimately if any one of those players wants to veto and dig their heels in, I think they can do so. There is a process by which parliamentary approval is required because at the end of the day it is a parliamentary democracy, but the way the process is supposed to work prior to that is that the drafts gradually converge and by consensus agreement you get the text and then you present it for a vote. MiFID showed that even when you get to the parliamentary stage, there can be more amendments (I heard there were over 200), with MEPs horse trading in the corridors of the parliament building.

Leonard: There are also quite a lot of things in the draft Directive that are reserved for later discussion and decision at level two. A lot of those could well be the more challenging areas of what actually emerges. You get the law and you get the detail later.

Question: There is a lot of uncertainty and a lot of managers are launching products that are almost good marketing tools to leverage that uncertainty such as UCITS, managed accounts and ETFs. Other than looking at it as a great opportunity to be able to leverage investor uncertainty by launching safer products is the general statement to everybody else to wait for an appropriate interval before you take action?

Black: There are certainly things to do now. There is a great lobbying effort under way. Active participation in that is absolutely something that people can do. We can be following what's going on and understanding the potential implications so that we get more clarity around things. If you are a US manager and in the final reckoning the result is you are going to have to establish an office in London in order to be able to sell to European investors, for example, then that's obviously got a long lead time to it so the more advanced visibility you have of that the more you can plan around it. But you hit it on the head: the key thing people can do to capitalise is look to see if there is a "safe" product that works for their strategy – UCITS being one everyone is talking about. It is completely outside the scope of this Directive. We know how the UCITS framework operates so it is a known quantity. Finding a way to exploit the uncertainty is absolutely the best thing to do.

Question: The Directive proposes that risk management be a different function from portfolio management. What would the impact of this proposal be?

Burke: A lot of managers have already incorporated this in how they organise themselves. The Swedish proposal was that it ought to be black and white, recognizing that many managers are really quite small organisations and to get adequate separation of duties may be a challenge. It is proposed that an appropriate and proportionate test be put into the Directive to allow a slightly more relaxed approach to dealing with it. However, the Gauze proposals are quite happy with the original text so there isn't a concession. But it remains to be seen exactly how this element plays out. It is also proposed that there will be an annual requirement to review risk management systems. Whether that needs to be done independently or whether that needs to be done by the manager is not clear. Arguably it could be a role for an external auditor. You need to identify, measure and monitor the risk on an ongoing basis, including appropriate stress testing. There is also a debate on short selling and whether short selling risks need to be included within the proposals. At the moment the Directive is asking for there to be specific controls for access to securities for settlement in relation to short selling and the risk management function around the risk of failing to deliver. There is also provision for disclosure directly to the regulator on short positions and it is difficult to say if that is more granular than the current disclosure requirements that the FSA has and CESAR are proposing.

Guilbert: Let's continue to look at compliance, risk and governance structure: what approach should firms be using to operationalise their clients and governing structure?

Leonard: As we've come through the credit crunch the FSA has thought about how it is going to improve its governance and the way

it engages with firms. Certainly the larger firms have a lot more engagement with the FSA than they had before the credit crunch. The FSA has 30% more staff and it is really looking to head things off at the pass rather than watch things happening. Some firms describe the FSA now acting in a non executive capacity in terms of wanting to be at the elbow of the directors in understanding what is going on and be close to the firm day-to-day. That tends to be something you will see with the larger firms. What in essence the FSA is doing through its wholesale markets division, (even with medium sized firms) is trying to get closer to the firm in terms of how it's operating. The FSA is interested in interacting with the senior people in a firm and understanding how it is governed. Over time they have found that if a firm has good governance and a good attitude to compliance then everything else follows through. Concerning firms that have a dominant chief executive the FSA may begin to take an interest in whether that is or isn't appropriate. I haven't examples of this happening but it is something that is certainly feasible under the way the FSA is beginning to think.

Black: I completely agree. If you look at what the FSA publishes there is this really common theme running through it: that senior management should be involved and aware of compliance issues. You have to find ways to institutionalise that within the management firm. One way might be to have a meeting at regular intervals and to compel senior managers and compliance to attend, and for things to have to be escalated. The more you can build in these processes and routines and the more you bring the senior people into it the more you have a "back story of compliance" to show to the FSA when they come and knock on the door.

Leonard: Increasingly as managers join new firms or get promoted and seek approved person status, the FSA is taking a much more interventionist approach than it previously did in interviewing people. A number of our clients who have gone through the process describe it as being distinctly uncomfortable. Hard questions are asked. Evidence of understanding of the regulatory regime and the compliance system that has been put in place within the firm are expected to be demonstrated. So far we haven't had anyone who has been turned down but the FSA is clearly taking a much more active approach to assessing the quality of people who are being put in charge of management and compliance in firms.

Black: Some people who have gone through it have failed. And the FSA has recently widened the net as to who has to go through it. Directors of off shore companies (obviously it is very common in the asset management industry to have off-shore holding companies) and people who are business owners and attached to those companies may sit in London but hitherto have not been on the FSA's radar because they haven't had a direct role with the FSA regulated firm. But the FSA has recently put some guidance out to clarify the way that situation works. If the reality is that people on the ground in London look to someone like that as "the big cheese" then he's probably going to have to get approved. It's all about bringing the senior people and decision makers into the regulatory realm.

Guilbert: Two questions for the panel:
1) Fines have increased this year; does the hedge fund industry need to worry at all about this?
2) Do you think the FSA's enhanced revision is going to make any difference in strengthening the financial industry in any way?

Leonard: The FSA announced last year that as part of its policy of increasing credible deterrents it was going to increase fines. There are three core elements to that. A fine would require any wrong doer to disgorge any benefit to deter any wrong doing by others and carry a punitive element. There is certainly going to be larger fines. One of the key elements is that for all market abuse cases the base fine will be £100,000. Certainly firms do need to be conscious of it and the increased appetite of the FSA to take on firms and to be seen to be taking a large scalp. As ever, firms need to be vigilant and need to ensure particularly with market conduct issues that they are on the ball and that their traders understand what the limits are. Firms need to be aware that the FSA are increasingly just picking up the phone to traders and asking them to explain transactions about which the FSA has a suspicion. The compliance team need to make traders aware of that possibility and to have put in place systems to control that relationship. You want to kill off any curiosity the FSA may have, but equally you don't want to be giving the FSA information that it has no right to have.

Burke: You will remember back in 2008, the FSA described the (hedge fund) industry as complacent. An awful lot has been done subsequently to ensure that that message has been dealt with. That is the substantial risk hedge fund managers face in terms of FSA discipline.

Question: Can the FSA be challenged at tribunal?

Leonard: Will it be? It depends on the appetite of the individual and the firm. I think that if the FSA become more aggressive as they say they will and if the incentive for settling early is reduced firms are more likely to take on the fight and go to tribunal. I think it is within the FSA's powers to set the level of fines. There are no statutory restrictions on the fines they set. If market abuse is established – that's the hard bit – but once it is established the game is over and you have to take the punishment that is given

Black: It is not just a question of market abuse. The FSA can prosecute insider dealing. There you have a different construct: unlike market abuse, which is a tribunal with a right of appeal, you are into the criminal courts and you are potentially going to jail as well as getting a fine. Indeed, the FSA has started to use that power as a prosecuting authority more in preference to the market abuse route because it is tougher. It dates back to the days when the SEC was doling out fines that were four times the level of the FSA's and putting people in jail. The FSA felt a poor relation and that it didn't have the teeth that its counterpart had.

Guilbert: That leads to technology. How do you prevent a rogue trader operating in your organisation?

Evans: From a tech perspective we support over 1000 hedge funds on a second by second basis. It is not really until you sit down with people that they begin to understand the challenges associated with technology not only from a litigation standpoint but from an internal governance perspective. From our experience in financial services we know that people are using a myriad of different email solutions and instant messaging systems – Yahoo, MSN, Reuters and Bloomberg, not to mention the prevalence of the Blackberry.

There are a couple of challenges for clients. Operationally how do you manage all these different forms of communication? We look at it from a technology angle first and foremost because it is always changing. The new social messaging tools people are using to blast messages out to traders. how do you put in place a process to manage that? You've got an email problem, you've also got an instant messaging challenge and a Blackberry challenge. It gets technically very expensive. The aspect I look at it is where does all this information sit? We are in a highly mobile world. Do we know where all the data is? What happens, say, when a hard disk goes and there are many years of email? You've got a potential problem.

The second challenge is not only regulatory compliance, which is a big issue we see with our clients in North American markets, but also internal governance. At some point in time you are going to have to find a piece of information about who said what and when was it said. You can have teams of people looking through three years of email for five or six messages. It gets very costly. We try to advise our clients to put a strategy in place that enables good e-discovery and fast indexing of all different types of messages within one place. We approach the technology issue to provide hedge funds with a single solution to manage and archive all the different types of communications they use in their business. It's quite a unique solution. We look at email and messaging and we have a powerful solution for Blackberry. The challenge we are seeing is that information is starting to cross different regulatory jurisdictions. How do you manage that? There are potentially three or four different systems: one in the UK, one in the US, one in Singapore. We approach this to provide one solution, it's a managed service for all of your communications worldwide. We have an internal general counsel and an audit team and we work with big prime brokers.

Guilbert: I have two closing observations. If your firm goes through an investigation having a discovery in place makes it much more easy to be able to find those messages that are being pinpointed and that may be years old. The second aspect is having it in that place allows you to basically court the best investors out there who are looking for best practice.