SHOULD WE BE AFRAID OF HEDGE FUNDS?

The new Directive is a major challenge, but Luxembourg hedge fund practitioners believe that a sensibly regulated hedge fund industry is a force for the good in international financial markets.

In 1990, there were little more than 500 hedge funds worldwide; today, there are close on 10,000 with two thousand billion dollars under management. The impressive year-on-year growth of this industry is undeniable. Yet professionals of this asset class deplore the lack of information and misunderstanding that still exists concerning hedge funds. They are popularly credited with bringing down governments and escalating the recent financial crisis. But is it all true? And where does Luxembourg fit into the story?

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That hedge funds suffer from bad press is a fact. They are unregulated, risky and destructive, say critics. The opposite is true, replies AIMA, the Alternative Investment Management Association. They argue that the European hedge fund industry already complies with a number of EU directives and has a long history of working with policy makers and supervisors to secure effective regulation.

Furthermore, AIMA underlines that the primary aim of most hedge funds is to reduce volatility and risk while preserving capital and delivering positive returns under all market conditions.

Andrew Baker, CEO of AIMA, an association with more than 1,100 corporate members in over 40 countries, said during a recent conference in Luxembourg that he fully understands the needs of the press, which has to inform the public and produce stories. The result, however, is often articles or comments in the media that do not reflect reality. "Hedge funds have been contaminated by the bad press of the banking sector". The remedy is not to be afraid of building relationships with the press. For Andrew Baker it is important to dispel misconceptions by proactively placing stories in the media and responding to enquiries.

Didier Prime, audit partner at Pricewaterhouse-Coopers, is a member of AIMA, as well as of the ALFI hedge funds working group. He confirms what Andrew Baker is saying. "During the financial crisis, it was easier to criticise hedge funds, which are often created by independent companies, rather than banks whose trading activity was actually much higher than that of hedge funds. It was much easier to point the finger at a scapegoat which was not regulated enough or not regulated at all".

Are hedge funds to blame?

There is another myth the industry is fighting against, namely that hedge funds are volatile and dangerous.

AIMA stresses on its website that by definition, the activities of hedge funds are often counter-cyclical, acting to redress market imbalances. Many hedge funds use no leverage at all.

Régis Malcourant, coordinating the Hedge Fund Servicing of PricewaterhouseCoopers, shares the view of his colleague Didier Prime by insisting that hedge funds cannot be blamed for the collapse of the financial markets before or after the Lehman bankruptcy in September 2008. "Before the crisis, the leverage of hedge funds was on average between 2.2 and 2.5, according to the studies. This is way below what regulated banks were, and still are, allowed to build. One must not forget that during this crisis, hedge funds and funds of hedge funds were the first to pay the price of the liquidity crunch which reduced their leverage below 2 points (1.5-1.7). With each passing month, we take comfort in the fact that hedge funds were wrongly designated as scapegoats".

The negative press of hedge funds is not a new phenomenon: 12 years ago there was blanket coverage in the media about Long Term Capital Management (LTCM). In September, 1998 the Federal Reserve organised a rescue of LTCM, a very large and prominent hedge fund on the brink of collapse. The Fed intervened because it was concerned about possible consequences for financial markets worldwide if it allowed the hedge fund to fail. Afterwards, critics argued that the intervention was unnecessary because LTCM would not have failed anyway.

At the time, there were widespread calls for regulation of the hedge fund industry and the same calls were heard at the beginning of the financial crisis in 2008. This time, there was a great deal of political pressure, with the result that the European Commission rushed out a draft directive on Alternative Investment Fund Managers, the so-called AIFM Directive. Sohail Jaffer, a member of AIMA's EMEA regional advisory council, says that there are currently three drafts of this Directive in circulation, written respectively by the European Parliament, the Council and the Commission. "The Spanish Presidency of the European Union is due to report on the subject very shortly. The Economic and Monetary Affairs Committee of the Parliament, the lead committee for the AIFMD, will consider 2,000 amendments and vote on the draft in April. In May the three draft documents will be converged and the plenary vote in the European Parliament will take place in July". Sohail Jaffer deplores that the text is too reactive: the alternative investment industry was only consulted after its drafting.

Don't overdo it

Industry specialists do not think that it was a good idea to rush things. Didier Prime says that the directive was produced "in a very unstable atmosphere". The results of this political pressure and the absence of specialist consultations led to several texts that do not complement each other for the moment. "Even if everybody agrees with the objectives of the draft Directive, we may have a deadlock situation which will not necessarily lead to more investor protection, but to over-regulation and probably more difficulty in competing with American actors".

Charles Cronin is regional head of the CFA Institute's Centre for Financial Market Integrity. He was recently a guest speaker at a conference in Luxembourg. In an interview with LFF he expressed his concern about overregulation. "This whole financial crisis has created its own political momentum whereby populist politicians can garner favour by pushing something further than it should be to take advantage of current popular opinion. Certainly in my own country (the UK), we've got elections coming up and it's an opportunity for people to push the envelope by looking for excessive regulatory solutions".

According to him, the problem with regulation is that it fixes one particular problem at one moment in time. When you pass a piece of legislation, the time lag since it was conceived and turned into a law can result in it becoming obsolete as the markets have already evolved and changed shape.

The Directive is aimed at tackling systemic risk in the financial system, a goal that is supported by AIMA. Andrew Baker summarises the situation like this. "We are in favour of large fund managers disclosing systemically relevant information to their supervisors and we support the universal registration and authorisation of hedge fund managers. But we should be careful not to flood the regulators with data".

Charles Cronin thinks that the Directive, which according to him is good in parts, is on the right track. He says that alternative investment practitioners are beginning to recognise that they cannot simply throw it out of their way and that they have to work with the European institutions. He adds that the CFA society has poled its membership on certain aspects of the Directive. "Our members believe that the code of conduct part of the Directive, which requires the manager to use good care and due diligence and always act in the best interest of the client, is an absolute must. We don't think there is anything wrong with that. We think there should be independent evaluation". But he adds "CFA members are against controls on short-selling and on leverage".

The growing importance of institutional investors

The outcome of the AIFMD debate is important, not only to industry lobbyists, but also to the economies of every EU Member State, says Andrew Baker. "Pensions, savings and jobs across Europe will be hit and we don't think that at a time of economic crisis, measures which could have these consequences should be considered without a thorough impact assessment". According to AIMA, 25 billion euros a year in performance will be lost by European pension funds if the Directive is not changed. Over 50% of hedge fund assets are in the hands of institutional investors, especially pension funds.

Other figures are used by AIMA lobbyists in order to shake political decision makers: the European hedge fund industry generates four billion euros per annum in tax revenues for EU governments and is responsible for 50,000 jobs in Europe. AIMA believes that, without significant rewriting, the AIFM Directive will lead to reduced choice and greater costs for investors in the European Union. "This is a threat to the whole of the EU, not just to London and Paris". The message is clear. Hedge funds play a beneficial role in allocating capital and creating price stability. By providing capital, they also help generate jobs and tax income. Because of the impact of hedge funds on national economies, it is important that the Directive put to the vote be solidly drafted and not have damaging consequences.

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What is the impact of the proposed Directive on Luxembourg's existing legal framework? Sohail Jaffer puts it this way: "The Luxembourg industry has set itself high standards in due diligence. So there will be less of a negative effect on a day-to-day basis. Managers and promoters will suffer most: that is London and Paris. The administrative and custody centres like Luxembourg and Dublin will suffer less". He adds that Luxembourg has shown an enlightened approach to EU legislation in the past by welcoming it and applying it. Jean Guill, Director General at the Luxembourg financial sector supervisory authority, CSSF, agrees with this assessment. "In actual fact, the AIFMD does not pose any new challenges for the CSSF. We already conduct a very thorough analysis of all vehicles qualifying as UCIs or SIFs". He adds that the CSSF knows the importance of the "rapid reaction" factor and takes this into account when reviewing hedge fund files.

By contrast, the AIFMD will certainly result in additional conditions to be applied to fund managers and risk management. This qualitative approach has the support of the CSSF. Looking ahead, Jean Guill remarks that the AIFMD could be seen as an opportunity to create more alternative investment funds in Luxembourg.

Luxembourg tailors its ambitions

It is the United States, the United Kingdom and Switzerland that are the big players in the alternative market, together representing 80% of the hedge funds sold in Europe. In Luxembourg, the appetite for hedge funds and funds of hedge funds is growing. As at June 2009,

there were 614 hedge funds under administration, of which 74% were both domiciled and administered in Luxembourg. A further 1,288 funds of hedge funds are administered in the Grand Duchy. Nevertheless, Régis Malcourant of PricewaterhouseCoopers thinks that the Luxembourg industry should set itself more ambitious goals. "Maybe we will never become Europe's leading financial centre for alternative products, but we should aim at a market share of 15 to 20% on a worldwide basis. To achieve this goal, all the actors, especially service providers, should continue the efforts and investments most of them started in 2002".

However, before Luxembourg achieves this goal, its market share risks falling on a short term basis. Ireland, Luxembourg's fiercest rival, has been the recipient of a number of redomiciliations by offshore hedge funds. Didier Prime of PwC says that this is not the best starting point for picking up market share. "Many of these funds will make an onshore redomiciliation in Dublin as they are already listed in Ireland. Ten years ago, in Luxembourg, the opportunity presented by Cayman funds was not well understood and listings of offshore funds on the Luxembourg Stock Exchange were not permitted. This became the business of Dublin and they were remarkably successful at it and so they will benefit in terms of redomiciliation". However, hedge fund specialists at PwC admit that many efforts have now been made in Luxembourg to facilitate listings on the Stock Exchange. "Our regulatory framework is particularly flexible and well adapted to the redomiciliation of offshore funds".

Image is the key

If service providers are up to their job and regulation meets investors' and managers' needs, the problem that remains for the Luxembourg hedge fund industry is its image. Régis Malcourant concludes: "Luxembourg is not always perceived as an alternative centre. We need systematic physical presence at all major events and should also market ourselves in the leading markets such as Switzerland, the United Kingdom and the United States. In Asia, among other regions, the reference product for a hedge fund remains a Cayman fund, and it will take some time to turn the tide. Maybe the AIFM Directive will create a new label that will turn foreign investors' interest away from Cayman and divert it to Europe".

Luxembourg has a strong card it can play. Over the past two decades, the Grand Duchy has established itself as the runaway leader in internationally marketed retail investment funds, known as UCITS after the EU Directive that defined them. This label could be used to make the financial centre more attractive for alternative products too. "Providers know how to handle sophisticated UCITS products, so they shouldn't have particular problems dealing with alternative products. For instance, based on a recent review of the Lipper database, we found out that a good 40% of hedge fund-like UCITS are domiciled in Luxembourg", notes Régis Malcourant. His colleague Didier Prime observes that while Luxembourg may be pre-eminent in this space, it does not market itself as aggressively as other jurisdictions. "We know other domiciles are actively using the regulator as part of their marketing of the fund domicile. In Luxembourg, we prefer to maintain a healthy segregation between the industry and those supervising it when it comes to active marketing whilst retaining a close ongoing working relationship which has been one of the hallmarks of the success Luxembourg has and continues to enjoy".

When talking about image, quality of life is another important selling point. When a fund manager decides to leave London, Switzerland is typically the first choice for relocation. However, anecdotal evidence indicates that such a move can be difficult: a tight housing market and waiting lists for schools have made people think again. Luxembourg may lack ski slopes and sailing lakes, but the country has a lot to offer in terms of quality of life. It is relatively easy to find accommodation and there is a wide choice of educational establishments and systems. Furthermore, Luxembourg is located a short distance from decision making centres like Paris and Frankfurt. These are real competitive advantages and should enable Luxembourg to differentiate itself from other financial centres.