

EU AIF Directive Fantasy Roadmap

If the Directive is motivated by protectionism, politics and diversionary tactics, what *should* it be trying to achieve?

Christopher Miller - September 2009

- For face-saving purposes, the near-term outcome will be a watered-down version of the draft Directive
- We propose a new set of objectives
- We propose wide-ranging disclosure requirements including banks, companies, regulated funds, family offices and sovereign wealth funds
- Remuneration should be aligned with clients more than shareholders

Introduction & Summary

Introduction

Let us be clear: we do not genuinely expect our brainstorming, laid out here, to be taken up any time soon. The wide-ranging nature of the proposals make them hard to implement quickly anyway. But more importantly, there are too many vested interests to bog them down, and we are too politically naive to have left much room for horse-trading.

In principle, we believe strongly that the right regulation will strengthen the hedge fund industry and increase security for investors. But the Directive is not really moving even in the right direction, and at best, we expect a watered-down version that at least saves some face to be introduced possibly as early as during the Swedish EU Presidency.

We do not wish to dwell on why we have such unsatisfactory proposals any more than is strictly necessary. But in defining objectives we attempt to analyse some of the unspoken objectives that may have driven the debate thus far. And if this helps us achieve some of the more reasonable unspoken objectives in some other way, then we have a more workable solution.

Any solution that punishes innocent hedge funds and ignores the behaviour of Porsche and SocGen, as well as excluding family offices and sovereign wealth funds is unfair and unreasonable. So we propose a wide-ranging regime that is more transparent, proportionate and flexible.

The clandestine and inconsistent process followed by the EC in formulation of the draft Directive, highlighting the lack of public forum for debate, may have damaged the reputation of the European project and played into the hands of Eurosceptics, making the Irish vote somewhat less certain than before.

As they say, a crisis is a terrible thing to waste, so why not take this opportunity to reform the legislative process in the European Commission, so there is real transparency, democracy, debate and accountability?

Context of the Proposal

In the aftermath of the 2008 banking crisis, economists and policymaking grandees were generally unanimous that hedge funds had played no more than a bit part role. The real problems lay with excessive banking leverage and hidden risk. So why was the EU AIF Directive rushed forward and why are legislators spending so much time on it?

EU Legislation is something that usually just happens to us, and we usually get a chance to protest if there is something that offends our sensibilities. And so it is with the EU draft Directive on Alternative Investment Funds. But the problems with it are so severe that some people worry that mere modification will not be enough. Everyone agrees that there should be regulation, but no one can agree what form the final regulatory regime should take.

A few years ago, you would no more have expected hedge funds to be calling for regulation than for the press to be calling for it. But times change, and there is a growing body that recognises the reputational benefits from increased security.

As hedge fund consultants, with a great deal of experience advising investors, it is our business to advise them on what standards we think they should expect. And as we conduct a lot of due diligence, we are in a good position to know what sort of regulation would genuinely be beneficial for our work, and thus for investors.

Why are we discussing this?

Long before the credit crisis and breakdown in banking trust, many people had a deep mistrust of Hedge Funds and to an extent Private Equity. This was probably a function of a number of things:

- Alternatives are still not allowed to promote themselves, so there was very little information about them in the public domain, and almost no PR.
- Alternative managers are frequently quite introverted, often preferring that their modus operandi is not publicised.
- Alternative managers who have made their way into the press were most likely to be reported making vast amounts of money or doing outrageous things.
- Hedge fund managers do not captivate people's attention in the same way that a star footballer, singer or actor does.
- Profiting from others' losses (shorting) was seen as somewhat unethical.
- Bureaucrats at companies being shorted don't like their failings being exposed, or their share options being pushed out of the money.
- Unions and populist administrations are often jittery that there will be layoffs when activists or Private Equity are involved.
- In the credit crisis, there were accusations that hedge funds were at fault, started the problems, exacerbated the problems or simply made obscene profits from others' distress.
- The hedge fund related frauds exposed in the aftermath of the crisis make it hard to know who to trust.
- Belief that short-term trading fluctuations can affect long-term values.

Where are the interests?

Europe as a whole versus US

On one level we think that the intention was to make it very hard to operate a hedge fund offshore, and the inability to sell to EU investors was calculated to drive managers to come onshore, even US-based managers. This would bring US managers under European regulation in an even more iron-fisted way than the SEC's derided plan from 2007 which was ultimately aborted.

But we think that this unilateral aggressive approach is unnecessary and counter-productive. There is a somewhat distasteful irony that in Europe, the current approach to hedge funds is to force them to be offshore with a tax regime at massive disadvantage compared to investment trusts or UCITS vehicles. But the proposed regime is to force them onshore, and no one is even talking about a level playing field for taxation which would *enable* hedge funds to operate onshore.

Systemic risk

Systemic risk is the main stated justification for regulating alternatives. We think the draft Directive not only exaggerates the systemic risk posed by hedge funds but that it misrepresents previous statements made, e.g. in the de Larosière report: "The Group considers that appropriate regulation must be extended, in a proportionate manner, to all firms or entities conducting financial activities which may have a systemic impact..." The draft Directive imposes disproportionately harsh measures on funds as small as €100m, which could hardly be described as systemically important.

The G20 meeting in April 2009 referred to "...appropriate... oversight..." Admittedly that is vague, but it suggests that oversight rather than draconian regulation is desirable. We consider the draft Directive to have overstepped the mark by a considerable margin.

Balance of payments

We haven't got research to demonstrate this on a micro level, but we think it is intuitively obvious that if 80% of the world's hedge funds are based in the US, then the US is probably a net exporter of hedge fund services to Europe, with the possible exception of the UK. By bringing more operations into the EU, there would be more employment, less import of services and more fiscal capture, even if the main operations are still overseas.

Fiscal battle

Literally days before the draft Directive was published, in April 2009, the Obama administration talked about clamping down on overseas subsidiaries of US companies that are able to shelter from US tax. The countries that are home to many of these subsidiaries, and receive considerable fiscal revenues, are predominantly Ireland and the Netherlands (plus Switzerland and to a lesser extent the traditional tax havens).

France & Germany

Paris and Frankfurt have long wished that more financial services activity could be based there instead of London.

Coincidentally, Deutsche Bank and SocGen both own the two largest managed account platforms. We have heard a legal opinion that both platforms could relatively easily be structured so as to be entirely outside the scope of the draft directive.

As it happens, we like the idea of managed accounts, but they can be more expensive and, counter-intuitively, provide less liquidity.

Harmonisation & protectionism

Harmonisation is the carrot to go with the stick of regulation. We suspect that France and Germany fear the opening up of their markets to US and UK managers because they consider that it would result in greater offshoring of their domestic investment management industry. It is classic protectionism, and it is probably because of the protectionist fears that the classic barriers to non-EU managers have been put up. They are reminiscent of the comical French policy of allowing imports of video recorders but requiring them to be routed through one inspection point¹.

¹ http://hansard.millbanksystems.com/written_answers/1983/feb/24/video-recorders-imports

Party of European Socialists

Poul Nyrup Rasmussen, the Danish President of the PES, could be considered the chief architect of the draft. There are certainly some other influences, and we know that he considers the draft "unacceptably weak", so it is worth exploring what the PES and wider political agenda could be.

The PES agenda is not exactly clamouring for free markets. Rasmussen blames "...bankers and politicians whose doctrine of neo-liberal markets plunged us all into this crash... In Europe, we have been protected from the worst effects of the crisis thanks to welfare states built up over the past 60 years to cushion citizens from the threats posed by the free market... The simplistic dictum of more markets and less government... has failed on a momentous scale."

But we think that one of the primary causes of the credit crisis was the attractive fiscal revenues generated directly and indirectly from the financial services industry. We have always known that bankers are greedy, and that is why regulators exist. But the regulators were asleep because their political masters were making too much money from finance which was poured into even greater expansion of social security and the public sector.

Another factor in the crisis was easy money for mortgages, which had some interesting implications:

- Free housing created feelgood factor for voters
- Fuelled demand for housebuilding and property prices
- Beneficial for banking bonuses

If you think that politicians had no interest in the banks giving easy mortgages, with up to 125% mortgages, then we have examples from 2002² and 2004³ in the US, when George Bush said: "One other thing I've done, is I've called on private sector mortgage banks and banks to be more aggressive about lending money to first-time home buyers. And the response has been really good. There's a lot of people in this -- our communities around the country that deeply care about the issue of homeownership, and they've been responsive." Tony Blair also spoke of "...special help for first time homebuyers..."⁴

Denmark

Mr Rasmussen's fervour against alternatives can perhaps be understood better in the context of the Private Equity pillage of TDC⁵ (the former national telecom operator in Denmark) by a cartel of major names in 2006. The consortium paid cash of DKK9bn and the balance of the purchase was paid for using 7.5x leverage. Within weeks, they had paid themselves a dividend of DKK43bn and the company was saddled with huge debts. We are not Private Equity experts, so perhaps we are being unfair, and we do know that this is very much the exception to the rule for Private Equity activity, even if the names involved were some of the biggest household names.

Norway

The Nordic region was also hit in 2007 by a hedge fund scandal in Norway. Eight of Norway's municipalities made some leveraged Hedge Fund investments with exposure of around USD200m which went badly wrong in the credit crisis⁶. Such experience has probably shaped local opinion. However it is fair to say that Sweden is quite alternative-friendly, with a thriving industry and "...leaders of the Swedish metalworkers' union... said their members were better off in private equity-owned companies than in listed companies."⁷

² <http://www.hud.gov/news/speeches/presremarks.cfm>

³ The reference was: <http://www.whitehouse.gov/news/releases/2004/03/20040326-9.html>, but it seems to have been removed

⁴ http://news.bbc.co.uk/1/hi/uk_politics/3697434.stm

⁵ <http://www.regulateonline.org/content/view/976/102/>

⁶ <http://www.globalpensions.com/global-pensions/analysis/1457883/limiting-times-norwegian-funds>

⁷ <http://www.ft.com/cms/s/0/97b827d4-669f-11de-a034-00144feabdc0.html>

Fiscal revenues

In the UK, even before the new tax rate of 51%, of every billion sterling paid in bonuses, there was around 13% of employers' National Insurance, 11% of employees National Insurance and then 40% tax. This means that over 60% of these bonuses go to the government intravenously, and the rest tends to go towards buying things and feeding into the economy quite fast. Now it is more like over 70%.

Populism

Times change and today, the public needs to be reassured by tough stances: tough on bonuses, tough on bankers, tough on hedge funds etc. But we would be amazed if the politicians actually believed everything they said, so we don't know how much of the rhetoric will be converted into law.

Diverting blame

We think it is accepted that in the credit crisis, hedge funds were more the canary in the coal mine than the perpetrator of a crime. And they were innocent clients of banks who were hurt when the banks' imprudent behaviour meant they had to reduce their lending to hedge funds unilaterally.

But that does not negate the fact that some very large (est. >\$1bn) hedge funds could have a systemic impact on creditors, trading counterparties and the financial markets

Industry participants

It goes without saying that industry participants usually stand to lose from increased regulation. But there will be winners and losers, so it is hard to be specific. Allenbridge HedgeInfo's current business model probably stands to lose from a reduction in the industry size or from a reduction in the need for due diligence from increased regulation; but conversely, we stand to benefit from increased awareness of the need for due diligence. We are ready to change our business model if the market changes.

Defined objectives

We believe that the EU should seek to:

- minimise systemic risk in a proportionate way,
- harmonise oversight within the EU and internationally,
- increase transparency and communication to facilitate investment decision-making and risk management,
- reduce protectionist barriers to intra-EU and international trade,
- increase confidence in the financial system,
- engineer risk-efficient structures for oversight and remuneration,
- encourage market participants that increase liquidity and efficiency,
- discourage fraud and market abuse,
- establish and maintain a level or proportionate playing field for all market participants, and
- establish national risk watchdogs.

Notice that none of the above is related specifically at alternative investment funds. This is because they are not the only actors in the market. There are others that pose greater and less risks, and the EU proposals we have seen are both discriminatory and ineffective.

What should be happening?

The ideas outlined below are so wide and varied that they could not be implemented in just one Directive:

Register everyone

We like the UK FSA's approach, which is that anyone investing or advising for someone else needs to be registered, approved and subscribe to high level principles, irrespective of the product or investment vehicle in question. It is just the level of oversight that should vary with size and/or risk.

Data reporting

The foundation of our views on regulation is that investors and regulators can't make well-informed decisions without good information.

To us, good information means granular data that can be analysed in different ways by different people. We advocate periodic reporting of all performance and exposure data in a harmonised format to each local regulator by all market participants and investment vehicles.

This means that both counterparties to a transaction, whether investment or loan, will report the same data, and it can be reconciled automatically. To be proportionate, small investors may obtain an exemption, medium sized investors should report monthly, large investors weekly, and very large investors daily. In hedge funds, such reporting is already done to administrators, usually in a harmonised format and on a real-time or daily basis, so the administrative burden is very low.

The double reporting makes fraudulent trading or hiding of activities incredibly difficult. It could be structured to avoid incidents like the Jerome Kerviel episode at SocGen, which of course is exempt from the Directive as it has been drafted.

The inclusion of lending will capture excessive borrowing at multiple lenders, and as part of the loan appraisal process, a lender should in any case be considering the ability of the borrower to pay in the light of other commitments.

The wide scope also captures the activities of participants such as family offices and sovereign wealth funds, which seem to have been overlooked by everyone except the FSA⁸.

It also helps with one of our nightmares when conducting due diligence. We can't be sure about the completeness of the list of counterparties we are given. There could be hidden derivative contracts with undisclosed counterparties.

Data communication

Where relevant, the data should be available unedited to other regulators globally in order that they may assess the other exposures of participants they also have oversight of, as well as the systemic risks posed by other countries, sectors, companies and investors. The excessive leverage at Porsche could potentially have been avoided by sensible oversight of all market players, but not by the draft Directive as it stands.

Prospective investors and counterparties may by mutual agreement have access to unedited data to ensure that for example, the entity they propose to lend to already has excessive leverage.

Anonymised data may be published for the good of the markets. For example, we may want to see short interest in shares, or size of voting and economic interest in companies, including derivatives. This would have made Porsche's abusive short squeeze impossible.

And it would have been clear to market participants what the true level of banking leverage was, because, on average, banks have far more leverage than hedge funds⁹.

⁸ http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0624_dw.shtml

⁹ See Turner Review Exhibit 2.5: http://www.fsa.gov.uk/pubs/other/turner_review.pdf

Data analysis

It is not sufficient to analyse just leverage. In fact every risk metric is flawed in some way and should not be used in isolation. Sophisticated investors already use metrics that look at VaR, gross and net leverage, greeks, volatility, range banding, DV01, contingency risk, and many other even more arcane measures. The data must be granular enough to be (a) reconcilable, and (b) used as inputs for as yet undefined risk calculations.

This arrangement can reduce the risk attached to excessive reliance on individual metrics such as VaR, which was overly relied on in the case of LTCM and by investment banks.

Data storage

Clearly the demands of such a volume of data is impractical at a EU level. We suspect that in many EU countries, industry or product specific databases may be used and then accessed on an aggregated basis. In this way, the database becomes modular and independently usable, irrespective of the availability or failure of an individual component.

Enforcement

Member state regulators may choose to enforce a reduction of risk after a subjective assessment in the light of risk management principles. Other regulators will see where such action would be necessary and could put pressure on the state regulator. Equally, an EU level risk monitor could arbitrate in the event of dispute.

Bonuses

Bonuses may have played a part in the crisis or they may not. On the basis that you get what you pay for, they were probably a contributory factor in the absence of enforcement of existing regulatory provisions. And there is no harm aligning interests a bit better.

We do know of banks and hedge funds who have very aligned remuneration structures. For example, one of the largest London based hedge fund managers has a structure whereby bonus is issued as units in the fund, and it vests over three years. They have very low staff turnover, as the retention aspect is very effective. Performance is also very good, and it is possible that the alignment of interests with clients and manager's performance fees encourages good performance. They certainly have done well. However, we know that they had a similar arrangement at ABN AMRO, and it didn't help them much.

One possible variation on that theme is to allow for clawback of performance fee. In general, we prefer the idea of the performance fee remaining at risk in the fund alongside client money rather than being issued as shares in the firm (be it a hedge fund or a bank). The distinction is important because managers are often both employees and shareholders.

Bonuses may appear huge and unfair, but if one individual can genuinely make millions more profit than other people, then there's no reason why remuneration should not be measured in millions. But we think it is important to distinguish between:

- guaranteed bonuses, which are only a way of paying part of the salary, in a way that does not incur pension contributions; and
- performance-related bonuses, which motivate people to perform better and is less of a risk to the business in the event of lower available profits.

As discussed previously, the state takes so much of financial services bonuses in tax anyway that we think the clampdown is largely symbolic and will probably reduce the fiscal yield, especially if we assume less motivation in the industry. Whatever is not paid in tax often goes round the economy quite fast, as the yachting, Champagne, motor, and housing industries rely on financial services bonuses to support the jobs of many ordinary working people.

However, one possible side effect would be to increase bank profits at the expense of staff remuneration. This would increase dividends or share prices, and the price at which governments with state owned banks could sell their stakes. It would also offset the hidden non-performing loans on balance sheets and bolster pension black holes.

UCITS

Regulated vehicles such as UCITS should not be excluded from these rules because we already know of risk loopholes in UCITS III funds.

Caveat emptor

Periodically we hear of financial disasters at local governments, pensions or other large investors. This includes investing with Icelandic banks as much as it does with Norwegian municipalities finding loopholes to invest in leveraged hedge funds. The vast majority of people controlling such large investment portfolios are experienced smart people who know what they understand and what they don't, and take care not to make imprudent investments. However, clearly such roles have as much opportunity for delusions of grandeur as hedge fund managers. And as such, like anyone else, they need proper boundaries and oversight. Hedge Funds and derivatives are very powerful tools and can be used for risk reduction just as much as for taking risk, so it is important to know what their features are and what the risks are.

Caveat emptor means literally "buyer beware". Buying investment products from hedge fund or bank salesmen can be dangerous. They have a duty to tell the truth, but not the whole truth, and sometimes investors are their own worst enemies. That is why we recommend taking independent advice when making hedge fund or fund of funds investments. Free education from the salesman is asking for trouble. We are, of course, talking our own book here, so if anyone is considering using our services, they had better take references.

Valuation

In principle, independent valuation is vital, and we are comfortable about the requirement in the draft Directive for independent valuation, but consider that protectionism should be avoided, and there should be provision for hard to value investments to be treated differently. For example, managers should charge fees only on realisation of profits, and closed ended limited tranches in the Private Equity model should ensure that there is little scope for fraudulent behaviour.

Depositaries

We think that the idea for onshore depositaries that would effectively insure against fraud is protectionist, bizarre and removes choice. Some investors may want to pay for insurance, but others don't want it and don't need it.

We far prefer the idea of depositaries with no contagion risk. In other words, segregated assets in a vehicle which has no risk. Making a bank financially responsible for asset management fraud is like forcing it to become an insurance company. Banking and insurance are two different things, and we are having enough of a debate about narrow banking versus banking with asset management as it is, without bringing insurance into the equation.

And neither is it the job of depositaries to conduct due diligence. There seems to be considerable blurring of boundaries between commercial activities.

Abuse

Abusive shorting should be treated in the same way as abusive price ramping or short squeezing. As it happens, we have no evidence that hedge fund managers are any more or less abusive than any other investors.

But we think it is important to point out that short-term behaviour does not theoretically affect long-term prices for long-term investors, unless the short term traders are right.

Onshore tax treatment

This is one of the most important points that has been left out of the Directive. In order for funds to operate onshore in a tax-neutral environment, there needs to be a facility for tax to be paid in the hands of the investor, wherever he may be, not at fund level. Without this measure, there can be no onshore hedge funds. This is independent of the Directive, and it is very much the primary requirement and first step.

In order to allow hedge fund managers to bring operations onshore, some tax measures need to be taken that will result in increased economic value added and fiscal revenues. These measures are independent of any proposals at EU level. They will allow hedge funds to operate largely onshore, with onshore service providers, without making them uncompetitive to overseas investors. The returns would be taxed in the hands of the investor at the investor's own tax rate wherever he is, instead of at the fund level.

Allenbridge Contact Details

To receive future research, please register at www.hedgeinfo.com.

Allenbridge HedgeInfo

17 Hill Street
Mayfair, London
W1J 5NZ United Kingdom
Tel: +44 20 7409 1111
Email: info@hedgeinfo.com
Web: www.hedgeinfo.com

Contact:

Christopher Miller
Chief Executive Officer,
Allenbridge HedgeInfo
Direct: +44 20 7318 6303
Email: christopher.miller@hedgeinfo.com