hedgeweek

Comment: It's not what you do, it's the way that you do it...

1 July 2009

Mike Stepek, a partner in Geneva office of Hogan & Hartson, examines the contrasting approaches of Switzerland and of the EU and US toward direct regulation of the hedge fund industry.

As the focus moves away from rescuing the global financial system and on to the prevention of a repeat crisis, hedge funds and hedge fund managers are once again in the spotlight. The separate proposals for regulatory oversight of hedge funds recently published by the European Commission and the executive branch of the US government would impose direct regulation over hedge funds.

The draft Alternative Investment Fund Managers Directive seeks further oversight of the managers of hedge funds and private equity funds within the European Union. The proposed directive would introduce a harmonised regulatory framework for EU-domiciled managers of non-Ucits collective investment undertakings whose funds are domiciled or marketed within the EU. Hedge fund, private equity and other alternative investment fund managers such as commodity, real estate and investment trusts would fall within its scope.

On the other side of the Atlantic, President Barack Obama has unveiled a draft proposal to regulate the activities of hedge funds in the US. The proposed legislation would require hedge funds to register with the Securities and Exchange Commission as investment advisors and private equity fund managers and venture capital fund managers would also need to register.

The attention given by regulators to hedge funds in the US and EU stemmed from concerns about the excess leverage that had built up in the financial system, including hedge funds, and how it distorted the functioning of the markets in late 2008. Since then, most commentators have agreed that the hedge funds were not the catalyst of turmoil in the financial markets.

Regulators themselves, including members of the International Organisation of Securities Commissions, have concluded that the role of hedge funds in the recent financial crisis was minimal, and that they play a positive role for world markets. Similar comments have been made by senior regulatory personnel in the UK.

In terms of borrowing, it now seems accepted that in reality hedge funds were and are generally far less exposed than the most of the banking sector. Thus, in retrospect, it is difficult to see why the hedge fund industry is the subject of so much attention by regulators in both the US and the EU.

Although both these proposals are subject to further debate and approval, their significance to many of those involved in the global hedge fund industry lies not only in the detailed content of the final provisions, but the evidence that these proposals provide of the prevailing attitude to hedge funds in the EU and the US, which host the majority of hedge fund management activity.

Both sets of proposals have been criticised, with industry experts citing issues such as the lack of industry consultation and the lack of understanding of the role of hedge funds in the wider financial marketplace. The proposals are more a function of populist political agitation than sound regulatory engineering of financial risk.

This is not to say that some adjustment to the world's financial regulatory architecture is not in order. There seems broad agreement that some form of revised regulation of the hedge fund industry is appropriate. But special consideration of the unique position of hedge funds is required, and it is difficult to envisage an appropriate and effective system of regulation emerging without the close co-operation of all parties.

It seems that both the hedge fund industry and the regulatory bodies appreciate this. The commitments of the G20 nations at their London summit in April gave further impetus to these efforts, and Iosco has now formulated and published principles for hedge fund regulation which, so far, have been welcomed by the industry.

In light of these ongoing efforts, the proposals unveiled by Obama and the European Commission seem at best premature and at worst actively hostile to the hedge fund industry. In combination with actual and proposed fiscal measures that will have a significant impact on the tax liabilities of hedge fund managers in the US and parts of the EU, it is unsurprising that many are looking seriously at alternative jurisdictions in which to base their operations.

Additional and costly excess regulation of hedge funds in the US and the EU for political reasons could, however, benefit Switzerland, which launched an initiative in late 2007 to bring together industry representatives, regulatory authorities and government in an effort to increase the appeal and competitiveness of the country as a global financial centre. A key theme is the promotion of Switzerland to hedge funds and hedge fund managers through positive regulatory and fiscal reforms.

Regarding the debate about direct regulatory oversight of hedge funds, the Swiss regulator took the view that the system of indirect supervision of hedge funds through regulation of hedge funds' custodian-account banks and prime brokers was sufficient. Although it cannot be ruled out that this position might change in light of the recent financial crisis, there is notably no populist pressure to regulate hedge funds directly in Switzerland.

Further, Switzerland's experience in working with offshore jurisdictions and multilaterally in co-operation with other countries would seem to indicate more support for international efforts such as that presented by Iosco than for more

radical home-grown methods.

For the relatively mobile hedge fund industry, the most important question may now be which of the jurisdictions vying for their business can demonstrate that their government also understands and supports an international and consensus-based approach. On that front the Swiss appear to have the upper hand. The question for Switzerland may now be not whether it can attract hedge fund managers, but whether it can cope with the flood of applicants.