

AIFM, EU Directive dividing managers and giving effects for the Swiss Confederation

As an offshore centre the country will have to fine-tune its laws in order to fit the draft regulation. The change is pushing managers to take into consideration a new life away from UK

by Marco Degrada

The global hedge fund industry

Number of funds	8,860
Asset under management	1331.7

Source: HFR.
Data updated to March 2009.

The European draft Directive on AIFMs submitted by the European Commission in late April has split the European alternative investments industry between those for it and against it. Despite the rain of criticism, there is the feeling that the draft will not pass through the final hurdles as it has been written by the European Union executive, but there are some parts of it that managers consider positive, like the setting up of an alternative industry European passport, provided that it is accompanied by adequate rules for, and restrictions to, access applicable to funds outside of the single market. In this scenario, what are the possible consequences for the Swiss alternative market? Will the Swiss hedge fund industry come out with advantages because it is outside the European Union and so beyond the scope of the Directive's application?

The possible impact on Swiss regulation

"Switzerland is not part of the EU and therefore, the Directive will not apply", says **Dominique Lecocq**, attorney at law, partner of *lecocq* associate, a law firm specialized in regulatory banking law. "In addition, there has been no announcement so far by the Swiss Financial Market Supervisory Authority (FINMA) that similar rules will be enacted in Switzerland. At this stage, a license by FINMA is only required for hedge fund managers of Swiss-based hedge funds. Managers of offshore funds do not have to seek a regulatory license in Switzerland".

"The European proposal will provide an EU passport for the marketing of those third country funds which comply with

stringent requirements on regulation, supervision and cooperation, including on tax matters" point out **Anne Simond**, marketing and business development of UBP Alternative Investment. "However more time will be needed to do the necessary preparation and groundwork to make this a success. Therefore the rules allowing the marketing of third country funds will come into force 3 years after the rest of the Directive. In the meantime third country funds will continue to be sold in those Member States which currently allow that. This will be a strong incentive in the years ahead for the jurisdictions and managers concerned to deliver the necessary improvements in supervision, cooperation with European supervisors and compliance with the OECD Tax code. This approach is consistent with the objectives of the G-20 to enhance the transparency and the quality of regulation in offshore financial centres". As an offshore centre also "Switzerland will have to adjust its regulation to fit the Directive" so it will allow the distribution in the European Union of Swiss hedge funds, "otherwise its defeats the purpose of the Directive".

The opposition of Paris

The French government was among the first to ask for decisive action on the alternative sector to increase its transparency, and it was also the first to affirm that the European draft is still too lax, demanding further tightening, in particular the rules that should manage the setting up of a European passport for hedge funds.

"We think that the current draft of the directive is not appropriate, since it only discusses management companies but

does not address the issue of funds that are poorly regulated in offshore places”, says **Christophe Chouard**, managing director of HDF Finance. “The draft is not in line with the objectives outlined in the last G20 meeting”, add Chouard, underlining that “our current domestic market is regulated onshore, so this draft directive is not a constraint”. Moreover, the head of HDF convict that the draft of the proposed Directive will not pass: “Given the reactions of French and German officials to the draft, I think that it is unlikely that the draft will pass as it is today” and, regarding to an EU passport including offshore funds, Chouard says: “I think that this is unfair that poorly regulated offshore funds get the European Passport”. Anyway, Chouard does not believe that the HF industry have to be without rules: “Given the lack of regulation initiatives, we were the initiator of the new Guide of Sound Practices for Funds of Hedge Funds Managers that has just been released by the AIMA” point out Chouard. “As the initiator and as one of the contributors to this guide, we endorse the new norms. These norms are much more relevant to investors and to managers than those that any good regulator could put in place”.

Low impact in Italy

The European draft regulations for the alternative industry will have little direct impact on the Italian hedge fund market, where the regulations are already tight in many areas. **Enrico Ascari**, vice general manager of BNP Paribas Asset Management SGR, affirms, “The general principles prescribed in the European draft Directive in terms of compliance, the strength of the organisational models, authorisation procedures, etc. are already prescribed in the Italian regulations. The biggest and most significant news for the Italian market may be the introduction of an alternative industry European passport. Mr Ascari emphasises, “If the problems of tax harmonisation are solved, the introduction of marketing in Italy of European passport products is the factor that will have the biggest impact on the alternative investment market in Italy in terms of risks and opportunities. The risks for the domestic industry are clear: there will no longer be a need for

Italian speculative funds and the road is open to the relocation of management, such as for UCITS products. Another risk is also clear (though for clients it may be an opportunity): a reduction in the number of domestic industry players, entirely to the advantage of global asset managers with centres of expertise located in other European capitals. On the other hand, this process could be an opportunity for the market, its transparency, and the interests of final clients.”

In London: homeland of single managers

“The proposed Directive will require a closer relationship with the FSA to ensure that hedge fund businesses are being managed appropriately”, comments **Matt Hollier**, head of product management of Old Mutual Asset Managers (Uk). “We expect the formal requirements to increase, but as a manager of hedge funds and UCITS funds, we are very accustomed to operating in a regulated environment. We obviously approve of high standards being applied to the hedge fund industry, providing the application of those standards is pragmatic. There has been little opportunity for consultation to date but over the next few months the Commission should incorporate reasonable feedback from the industry”. So, the European Commission should have to wait for redefinition of the International scenario (as proposed by the G-20) before proposing the Directive? “Yes, it would have been best if the Directive could have been developed in coordination with other markets, and with greater consultation with the industry” says Hollier. “But we understand the political pressures and the current momentum, therefore the objective must be to make the proposed set of rules work in practice”.

In detail, one area where the English hedge fund manager ask greater clarity is the requirement to disclose critical trading or portfolio data to regulators, while he rejects as “potentially overly prescriptive rules around the role of a depository”.

Finally, about the creation of a new EU passport, Hollier says: “We see this as an opportunity to bring well designed products to appropriate investors

across the EU. Just as UCITS has established itself as a global brand for retail products, we think that the right standards for alternative investment products may be compelling to investors and create a broader market for the products both within the EU and globally". But not all London managers are of this opinion, and many are already thinking about relocating at least some of their operations outside of the European Union, with Switzerland, in this case, at the top of the list of possible destinations.

Moving to Switzerland from the European Union

The European draft Directive on AIFMs has had a direct impact on the Swiss alternative market: Switzerland has become even more attractive for European Union managers, especially for those UK managers that seem to be most negatively impacted by the new rules, in addition to the imminent tax reform coming down the pipeline in the country. "Since the introduction of the Directive, local consultants and lawyers have been inundated with queries from UK asset managers enquiring about setting up in Switzerland" says Simond. "The Directive has rendered Switzerland more attractive because of its light regulation environment. Cantons like Zug or the city of Pfaffikon in the canton of Zurich will become more attractive to UK HF managers". The same trend is testified by Lecocq: "There are many hedge fund

managers relocating in Switzerland to date due to a favorable tax environment, the quality of life and the Swiss banking industry. The Tax administration is currently confirming a new practice to grant an attractive tax treatment to performance fees. With the enactment of the Directive and the additional regulatory burdens for hedge fund managers in the EU, we expect that the relocation of hedge fund managers in Switzerland will continue". So are we going to see a greater number of HF managers moving to Switzerland as result of the EU proposed Directive? "I believe that the Swiss HF market is still at its infancy, unlike the fund of hedge funds market" reply Simond. "Only cantons around Zurich have managed to attract a sizable numbers of HF managers for the obvious tax reasons. Possibly some HF will move part of their operations such as their head offices or Investors Relations (like is already the case in Geneva) however the investments and operations parts of the business are likely to remain in the UK. Switzerland offers high quality of life, reasonable to very low taxes, however the type of people necessary to run of HF are the making of London, not Geneva or Zurich. The only real HF market in Europe is in UK, it is interesting to note that the FSA was not consulted prior to the release of the Directive. However UK is undergoing it's own challenges currently and adverse regulation and tax pressure could damage the local market". ■

The proposal of EU directive about Alternative Investment Fund Managers

- Asset management companies with more than EUR 100 million need to register;
- Minimum capital requirement: EUR 125,000, +0.02% every million over EUR 250 million under management;
- Minimum standard risk management practices;
- Independent custodian bank;
- Minimum of transparency towards investors in terms of: description of the strategy and any change occurred, name of custodian bank, auditor, evaluation policies and level of fees;
- Retail investors accepted, even with more stringent rules;
- Funds domiciled in countries outside EU can be sold to professional investors if they follow European standards and if there is an exchange of information with Authorities in EU;
- Adhere to anti-laundry rules and fiscal transparency.