



How the landscape has changed for hedge funds

The legal and regulatory environment for hedge funds has changed beyond recognition over the course of the last 25 years



By Iain Cullen

Hedge fund manager registration and reporting became mandatory in the US under the Dodd-Frank Act, which was enacted by Congress in the wake of the financial crisis.



Little did those of us who sat around the table in a hotel in Montreux Switzerland (some say it was in Lausanne, others Geneva!) in the summer of 1990 imagine that what started out as a fledgling idea of a few individuals involved in various capacities in the managed futures and futures broking business, would grow into an organisation of the size, influence and reach of AIMA.

Reflecting its founders' affiliations, the association was initially called the European Managed Futures Association (EMFA). Some seven years later, in 1997, in recognition of the evolution of the alternative investment management industry to encompass a much broader range of strategies, EMFA changed its name to the Alternative Investment Management Association (having for a mercifully short intervening period been known as the European derivatives and investMent Funds Association).

From a boutique association for a boutique industry at launch, AIMA has now become a global association for a global industry. When formed, it had between 11 and 17 members (recollections also vary on this!). By 2003 (when the SEC held its first Hedge Fund Roundtable in Washington D.C. which I attended on behalf of AIMA) it had 500 corporate members from 29 countries. When AIMA celebrated its 15th anniversary in 2005, it had 870 corporate members from 46 countries, and now it has in excess of 1500 corporate members based in over 50 countries.

From the legal perspective, the most important development came about due to the growth in the size of AIMA's membership



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when, in 2002, AIMA was converted from an association with unlimited liability to a company with limited liability.

Whilst there have been substantial developments in the regulation of hedge fund managers in the 25 years since AIMA's foundation, the way hedge funds are structured has not changed to the same extent. In the early days, it was common for separate standalone funds to be established for different types of investors, with such funds investing in parallel. This gave rise to the need to rebalance the portfolios of such parallel funds whenever investors subscribed or redeemed therefrom, leading to unnecessary operational complexity. As a result, it became common for such funds to be established as feeder funds into an offshore master fund, such that there was a single portfolio of investments to be managed and thus no requirement for rebalancing.

Similarly, in the early days, where it was desired to offer investors the ability to subscribe for shares denominated in different currencies to reflect investors' preference for a particular currency exposure, separate offshore funds were established with shares denominated in the desired currencies. This resulted, however, in the existence of additional parallel funds and it was not long before separate classes of shares in a single fund but denominated in different currencies began to be launched.

Around the same time, managers who had been rebating to their partners and employees the management and performance fees charged on shares held by them in their funds, on the basis that it made

no economic sense for them to be paying fees to manage their own money, began to realise that such rebates constituted taxable income in the recipients' hands. As a result, many funds started to create so-called management shares for partners, employees and, sometimes, family and friends which were identical in all respects to shares issued to investors save that no fees were payable thereon.

In terms of domicile, most offshore corporate funds have always been established in the Cayman Islands, although for largely historic reasons certain managers have established their funds in the BVI. So far as limited partnership funds are concerned, the majority have tended to be established in Delaware although for various reasons in more recent times a sizeable minority have been and continue to be established in the Cayman Islands.

Whilst the dominance of the Cayman Islands has continued, both Ireland and Luxembourg have also attracted a number of hedge funds, usually where the manager wished to target European institutional investors. Such investors are generally considered to prefer, and to some extent are restricted to, investing in funds established in jurisdictions where they are more highly regulated.

Lastly, it is perhaps worth mentioning that there was a time when many new funds sought a listing of their shares on the Irish Stock Exchange which it was thought would assist in marketing the fund to institutional investors. It was also thought a listing might give investors in an offshore fund established in a more lightly regulated jurisdiction, such as the Cayman Islands, a level of comfort

that some body (albeit not a regulatory one as such) would have an ongoing oversight role in relation to the fund's activities under the stock exchange's continuing obligation rules. In more recent years, however, the number of such listings has substantially decreased.

Although the structure of hedge funds may not have changed much, there have been many changes in the way hedge funds are operated, driven frequently by the demands of an increasingly sophisticated investor base rather than by regulation. These include the appointment of administrators, unaffiliated with the manager, to provide an independent valuation of a fund's assets, though in this regard the EU Alternative Investment Fund Managers Directive has to some extent turned the clock back as it places the responsibility for valuation on the manager. Another change has been an increased focus on corporate governance which has led increasingly to the appointment to the boards of funds of a majority of independent directors who are unaffiliated with the manager or the fund's service providers.

LTCM debacle

AIMA's industry views were not always sought or welcomed in the early days by regulators, politicians or the press. It was the LTCM debacle in 1998 that was the catalyst which led to the world's leading regulatory authorities first seeking to understand what the hedge fund industry was all about. That the willingness to listen to AIMA's views and those of its membership changed, at least so far as the regulators are concerned, is demonstrated by the willing participation of regulators from the US and Europe at AIMA's first International Regulatory Forum in 2000. Despite serious concerns about the potential of hedge funds to cause systemic risk, the main consequence of LTCM was that prime brokers began to demand greater portfolio transparency from their clients.

In the years leading up to 2005 when politicians (who can forget the senior German politician's description of hedge funds as a "swarm of locusts?"), journalists, central bankers, academics and company managements first began to comment on the need for increased regulation of hedge funds, AIMA actively pursued, in line with its objectives, an agenda which involved: educating its members on the benefits of sound practices; publishing its first DDQ in 1997; the first edition of its *Guide to Sound Practices for Hedge Fund Managers* in September 2002; and in 2005 the first editions of its *Offshore Alternative Fund Directors' Guide* and of its *Guide to Sound Practices for Hedge Fund Valuation*.

The first occasion when regulation was actually mooted was in January 2004 when the European Parliament submitted to the European Commission a proposal for a directive introducing the concept of a sophisticated alternative investment vehicle (the so-called "Purvis Report"). Subsequently

this was quietly dropped; indeed, very few people now recall its existence.

Later the same year, the French *Autorité des marchés financiers* (AMF) worked with AIMA and the French fund managers' association on the development of the AMF's new regulations for French domestic hedge funds, in particular with respect to their relationships with prime brokers. Approximately one year later, in June 2005, the UK Financial Services Authority (FSA), as it then was, issued two discussion papers, the first seeking to assess the risks posed by hedge funds and to identify the risk mitigation steps it would consider taking; and the second seeking views of the investment community in relation to the possibility of permitting wider retail access to hedge funds. Neither of these papers led, however, to any concrete proposals for regulation.

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A range of international bodies, including IOSCO, the G8, the Bank for International Settlements, the Bank of England and the Financial Stability Forum (now the Financial Stability Board) amongst others, published pronouncements and reports commenting on the risks posed by hedge funds to financial stability and on ways potentially to mitigate those risks from 2005 onwards, both before and after the 2008 financial crisis. Somewhat surprisingly, whilst the 2008 financial crisis led to developments in fund documentation relating to gates, suspension provisions and side pockets, it did not lead to any immediate changes in regulation, perhaps because there was no evidence that the activities of hedge funds posed any systemic risk.

AIFMD introduced

In an effort to head off regulation of the industry, the Hedge Fund Standards Board (HFSB) was established in 2009 by 14 leading hedge fund managers to develop practice standards to be adopted by its members, compliance with which the FSA stated would be taken into account when making supervisory judgements. This was a laudable aim but with hindsight it came too late as, by then, bureaucrats within the European Commission had already begun dreaming up what, in 2009, became the first concrete proposal to regulate the hedge fund industry, namely the proposal for an Alternative Investment Fund Managers Directive (AIFMD).

As General Counsel of AIMA I was privileged to see, and to be allowed to comment on,

early drafts of several provisions of the draft directive and subsequently to lead the AIMA working group commenting on later drafts of the directive published by the European Council, Commission and Parliament, until AIMA's highly competent Asset Management Regulation team took over the running.

As is now all only too well known, AIFMD, which finally came into force in July 2014, has had a significant impact, and will continue to do so, on the management and marketing in the EU of alternative investment funds such as hedge funds. Most recently this has been reflected in the European Securities and Markets Authority's advice and opinion on the possible extension of the marketing passport under AIFMD to non-EU alternative investment fund managers and/or alternative investment funds. Looking ahead, AIFMD provides that by 22 July 2017 the European Commission must commence a review of the application of the directive and, if appropriate, make proposals for amendments to it. In other words, AIFMD 2 may be upon us in the not too distant future.

This tour d'horizon would not be complete without an attempt to identify what else the future might hold for hedge funds and their managers. It seems likely that the slowdown that we have seen in the last few years in the formation of new hedge fund managers will not be reversed, at least in Europe, and that new managers will instead continue to join existing platforms. This is because not only are the costs of compliance and of the necessary operational infrastructure unlikely to reduce but also the difficulty of raising assets is unlikely to decline if the institutionalisation of the hedge fund investor base continues. It also seems likely that hedge fund managers which pursue an activist investment strategy will begin to set their sights on European companies despite the perceived difference between the legal regimes in Europe and the US where they have mostly concentrated their efforts to date.

It is also noteworthy that the Financial Stability Board recently announced that it was temporarily shelving plans to designate particular entities, such as hedge funds, as systemically important financial institutions and would instead concentrate on looking at whether certain activities that asset managers undertake are particularly risky. Hot on the heels of that announcement, however, came a statement by Mark Carney, the Governor of the Bank of England, that the Bank was now looking at whether risky activity had migrated from banks to hedge funds such that the Bank might need more power to regulate such funds!

In conclusion, it seems fair to say that, like it or not, the regulatory environment for hedge funds will continue to develop, even if the legal environment does not. ●