Bidding to capitalise on EU alternatives regulation

By *Anonymous*
Created *30/07/2009 - 19:50*

Many practitioners in the alternative investment industry are worried about the impact of the European Union's proposed Directive on Alternative Investment Fund Managers, from managers concerned about new capital requirement and burdensome oversight procedures to service providers in offshore financial centres fearful of an exodus of business toward EU jurisdictions. But in Luxembourg there is a widespread belief that, at least as it is currently drafted, the directive could help to solidify the country's position as a burgeoning domicile and servicing centre for alternative funds.

Practitioners from the grand duchy point to the country's extensive and well-established infrastructure for servicing retail Ucits funds (it is Europe's largest fund domicile and second worldwide only to the US), its skilled multinational workforce with a dizzying array of linguistic capabilities, and its geographical location in the heart of continental Europe, sandwiched between Belgium, France and Germany.

But more specifically they cite the solid yet pragmatic approach adopted by the industry regulator, the Financial Sector Supervisory Authority (CSSF), and the success of Luxembourg's attempt to reinvent itself as a centre of alternative fund expertise with the launch two and a half years ago of the Specialised Investment Fund, governed by a flexible regulatory regime that has been enthusiastically adopted by promoters not only of hedge funds but private equity, infrastructure and property vehicles.

A total of 883 SIFs accounting for total assets of EUR140.bn were in existence at the end of May, representing the launch of around 660 funds since the legislation authorising them came into effect on February 13, 2007 - this in the teeth of a global downturn for the investment industry that has seen alternative managers in particular struggle to attract investment and establish new funds. The initiative has put Luxembourg on the map with managers worldwide that previously might not have looked past its position as the main hub of pan-European retail funds.

Now, with the EU effectively pushing managers toward a much higher level of regulation, the SIF seems to fit the bill perfectly as a vehicle that meets the requirements of those insisting on closer supervision while offering the structural flexibility and investment freedom sought by managers - and a domicile in the world's leading centre for cross-border fund distribution.

Ironically, Luxembourg's hedge fund industry is also benefiting from concern among managers that the proposed European directive will prove extremely burdensome. The jurisdiction is benefiting probably more than any other from a new trend to offer alternative strategies through Ucits structures, an option that entails greater regulatory restrictions but within a legal framework tried and tested over nearly two decades - and that delivers a not incidental bonus in access to investors of all kinds across the 27 EU member states and increasingly beyond.

'There's a global trend toward regulation, and the draft EU Directive on Alternative Investment Fund Managers is a manifestation of that,' says Henry Kelly, who heads advisory firm KellyConsult and is a leading proponent of alternative fund business within the Association of the Luxembourg Fund Industry. 'As a result, I believe hedge fund promoters will look to domicile their new products in Luxembourg or other EU jurisdictions, and we are already seeing to some extent the redomiciliation of funds from non-regulated to regulated jurisdictions.'

Luxembourg's fund industry is looking to the future with equanimity despite last year's severe stock market decline and investor redemptions, which sharply cut the jurisdiction's overall asset base and brought to a temporary halt the hitherto rapid growth in its hedge fund industry. Even before the launch of the SIF, Luxembourg had a toehold in the sector through structures such as funds established under Part II (non-Ucits) of successive versions of the country's fund legislation.

'A few years ago it was difficult for Luxembourg to enter the alternatives business,' says Didier Prime, partner and head of alternative investments with PricewaterhouseCoopers in Luxembourg. 'But in 2002 the regulator issued a circular clarifying the rules for hedge funds domiciled in Luxembourg, and it was a success, mainly for funds of hedge funds, because it struck a very good balance between flexibility for investment managers and investor protection.

'The circular was a key element for Luxembourg in gaining the credibility to attract funds of hedge funds, including the redomiciliation of offshore funds, and has helped to make the jurisdiction highly visible in the sector over the past five or six years. It was more difficult to compete for single-manager hedge funds until the SIF legislation in February 2007, which provided an appropriate regulatory framework for hedge fund and fund of hedge funds managers. Service providers have also invested a lot in their business to gain credibility and demonstrate that they are ready to serve this industry.'

Olivier Sciales, a partner with law firm Chevalier & Sciales, argues that Luxembourg's focus on regulated structures, part of its philosophy as a centre for retail funds, will now serve it well in the new global climate, along with its established base of fund services expertise. 'Luxembourg has positioned itself very well by choosing regulation,' he says. 'There are a lot of institutions here, including all the large administrators and custodians that can service large funds, along with the know-how of the workforce.'

He is echoed by Mariusz Baranowski, managing director of fund administrator Custom House Fund Services (Luxembourg), who says: 'Centres like Luxembourg will emerge well out of the crisis. End-investors in an alternative fund and hedge fund managers are looking at the domiciles that have the ability to reinvent themselves, and that have learned from history and previous crises. The Luxembourg industry is very well known, and while the majority consists of long-only traditional funds, that means the service providers, the structures, the experience and the history are all here.'

KPMG Luxembourg partner Georges Bock notes that in general Luxembourg funds have not suffered from unduly high levels of redemption over the past year or so, with most of the decline in assets accounted for by market declines. He says: 'If you look statistically at how Luxembourg has been affected by the crisis, it's minimal - although you can't operate a EUR2trn fund platform and have no defaults at all.'

Net assets for the fund industry as a whole stood at just under EUR1.62trn at the end of May, having recovered from a trough of EUR1.53trn in February.

Says Kelly: 'The hedge fund industry in Luxembourg has suffered as elsewhere - why should it not? - but it's held up reasonably well. Obviously there's been a shake-out in the hedge fund sector globally, and both funds of hedge funds and single-manager funds have had valuation problems.

'However, the factors that have underpinned the growth of hedge funds and funds of hedge funds in recent years remain valid. In addition Luxembourg is an EU domicile with a regulated product regime. Particularly after the market crisis over the past year, institutional and retail investors are looking for the assurance of a regulated product, and from that respect Luxembourg is well placed.'

Whereas in recent years fund promoters may have sought out fund structures and domiciles involving minimal levels of supervision, seeing costs and investment freedom as the most important criteria, today opting for a higher level of regulation may make fund-raising easier. Says Bock: 'Luxembourg has always believed in an adequate level of regulation. SIFs were created for professional and institutional investors that understand what they are doing and can deal with a lower level of regulation.

'However, what we created now reflects most of the requirements of the EU directive, so we will be able to benefit from our past experience. Good regulation - good does not necessarily mean heavy - is part of our brand, and it is one that also enjoys considerable respect outside the EU. A significant proportion of Luxembourg products are distributed throughout Asia and Latin America, where they are acknowledged as suitable for the broad investment market.'

But the grand duchy and its brand have not had everything their own way over the past year. It has found itself at the centre of a sometimes acrimonious debate about European rules on fund custodians after it emerged that a number of French and other individuals had invested with Bernard Madoff's Ponzi scheme through Luxembourg-domiciled Ucits feeder funds. An argument about responsibility for the resulting billions of dollars of losses is continuing and may yet end up being resolved by the courts.

And in April the country suddenly found itself on the spot when, in response to a request from leaders of the G20 countries meeting in London, the Organization for Economic Co-operation and Development published an assessment of progress toward meeting international standards on tax transparency and exchange of information. Despite having hastily signed up to the OECD principles days earlier, to its chagrin Luxembourg found itself on a 'grey list' of international financial centres and so-called tax havens that had not yet satisfactorily implemented them.

Its initial failure to make the 'white list' of countries and territories with appropriate agreements in place to exchange tax information was galling, especially since it contained not only rival centres in the Channel Islands and this Isle of Man but other OECD members that themselves had not met the criteria required.

'How many tax treaties do the Germans have?' asks one Luxembourg fund expert sarcastically, adding: 'Between 2006 and 2008, 99.3 per cent of requests for exchange of information addressed to Luxembourg received a favourable response, and reasonably quickly. If there is a problem, it has been that other countries are not asking enough questions. You certainly can't say Luxembourg wasn't co-operating.'

Be that as it may, Luxembourg has speedily accumulated the required 12 agreements through the reworking of existing double taxation agreements, and was moved to the OECD's white list in June. The country's extensive roster of more than 50 double taxation agreements is another factor that makes it particularly attractive as a fund domicile, notes Nina Kleinbongartz, product manager for alternative investments in Europe with Citigroup Global Markets.

She agrees that Luxembourg's established regulatory structure leaves it well positioned to attract a larger share of the global alternative investment industry. 'Most of the proposals in the draft Alternative Investment Fund Managers Directive are already fact, for instance the role of the custodian bank,' Kleinbongartz says. 'This is good for Luxembourg but not necessarily for US or UK managers of offshore funds. From a marketing perspective it is highly visible, and its unique distribution capability, the flexibility of the CSSF, qualified staff and product innovation are all advantages.'

- Articles and Features

Source URL: http://www.hedgeweek.com/2009/07/30/bidding-capitalise-eu-alternatives-regulation