Foreign managers kept waiting as hedge fund regime clicks into gear

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Some two years after the launch of Spain's registration regime for hedge funds and funds of hedge funds, the development of the market has been steady rather than spectacular, as a mixture of the country's big banking institutions and niche institutional managers unveil a series of products aimed at institutional and (in the case of funds of hedge funds) retail investors.

Although take-up of the new products has not matched the somewhat extravagant pre-launch expectations of the asset management industry, managers and service providers express confidence that investors are becoming more comfortable with the idea of alternative investments, although they stress that knowledge remains patchy and that education on the risks and rewards of hedge funds for institutions as well as retail clients is a priority.

The authorities are playing their part, taking steps to remedy uncertainties and potential problems with the initial legislation and also removing some of the obstacles to institutional investment in hedge funds. This year is expected to be an important one for the fledgling industry in terms of asset-raising, as many funds are currently small, but performance over the coming months can play a vital role in winning investor confidence.

However, participants say the industry remains hamstrung by the unwillingness of the country's securities and stock market regulator, the Comisión Nacional del Mercado de Valores (CNMV, or National Securities Exchange Commission), to authorise products that do not have a Spanish-domiciled investment manager - not even those domiciled within the European Union. This reluctance makes the market less attractive, they say, because it severely limits the range of products on offer.

Despite the handicap, those foreign managers who remain committed to the development of the Spanish market still have a number of options to reach investors by indirect means, most importantly by entering into investment management agreements with local hedge fund managers.

They can also make unsolicited sales, mostly to Spanish institutional investors, including funds of hedge funds, pension funds, insurers and banks, as well as to managers of Ucits funds for the 10 per cent of assets that they can allocate to non-eligible products. They can offer 'hedge fund-lite' strategies through Ucits III vehicles domiciled in other EU member states, mainly Ireland and Luxembourg, market closed-ended funds through private placements, or create structured debt products linked to hedge funds or hedge fund indices, which now enjoy the same tax treatment in Spain as funds.

Spain recognised hedge funds for the first time with the entry into force of the Regulations on Collective Investment Schemes on November 9, 2005, a royal decree implementing provisions of the 2003 Law on Collective Investment Institutions. The decree established a regulatory framework for hedge funds, described in the regulations as 'free investment funds', and funds of hedge funds ('funds of free investment funds'), which was complemented by a ministerial order in April 2006 and a circular from the CNMV the following month.

Under the November 2005 decree, hedge funds may be sold only to qualified investors, encompassing authorised financial market participants including banks, insurance companies, investment funds and their managers, pension schemes and other specialist investment businesses, state and international financial and government institutions, and large companies as well as smaller firms that opt to be treated as qualified investors.

To qualify, individual investors must meet two of three criteria: to be regular and substantial traders in securities markets, have a securities portfolio of more than EUR500,000, or have worked in the financial industry with experience of securities investment. Spanish-registered funds of hedge funds are not subject to marketing restrictions, which means they can be actively sold to retail investors.

Following the authorisation of the first funds under the new regime in December 2006, last year Spanish-registered hedge funds took in investment totalling EUR445.8m, while funds of hedge funds attracted almost exactly EUR1bn, compared with a total Spanish asset management industry total of some EUR260bn.

As of June 29 the CNMV had registered 23 single-manager hedge funds from 15 managers and 39 funds of hedge funds from 28 managers. The funds' managers include leading domestic banking groups such as BBVA, Caixa Catalunya and Santander, foreign groups with a Spanish presence including Barclays, BNP Paribas, DWS Investment, JPMorgan and UBS, and independent firms such as Altex Partners and Cygnus Asset Management.

'Hedge funds and funds of hedge funds were the only investment categories in Spain to experience an increase in assets in 2007, although obviously they were starting from nearly zero,' says Juan Sosa Pons-Sorolla, a managing associate with law firm Simmons & Simmons Mochales & Palacios in Madrid.

'The next few quarters will be crucial to see whether there will be a boom in investment in these types of scheme. This is a very good environment in which to show whether these strategies really are market-neutral and can deliver effective performance. Their results in 2007 were not very impressive, although average losses by hedge funds were relatively small compared with those of equity markets.'

Ander Lopez, head of alternative investments in Spain with Lyxor Asset Management, notes that early hopes of rapid growth in hedge fund assts, fuelled by retail demand, have not been fulfilled. 'After the approval of the legislation a couple of years ago, there was supposed to be huge growth in alternative assets,' he says.

'However, many institutions realised that most clients were not sophisticated enough to buy funds of hedge funds, while sales staff found it difficult to explaining the sources of return and risk in alternative investments. Finally, the market environment has been extremely tough since the first funds were launched a year and a half ago, so hedge fund investments have not enjoyed the best performance.'

However, Sosa says the hedge fund sector has been helped significantly by a series of legal and regulatory developments that have removed a number of obstacles to its growth, notably a royal decree in March last year that clarified and amended some of the original rules. Its introduction prompted a flood of new funds to come onto the market in the second quarter of 2007 from managers that had been waiting for the amended rules to be published to finalise the details of their schemes.

One change that is set to take place this year is set to assist the fund of hedge funds sector by allowing the calculation of net asset values using estimated NAVs provided by underlying managers, rather than having to wait for finalised figures. 'The hedge fund industry has been pointing to small things that need to be changed to make the Spanish regime more flexible and effective, as it is in the rest of Europe,' says Elena Mesonero, head of coverage for institutional investors with BNP Paribas, an administrator and custodian of hedge funds and funds of hedge funds in Spain.

Her colleague Daniel Gonzalez, head of global fund services for BNP Paribas in Spain, says a circular is expected from the CMNV in the coming months that will confirm the ability of funds of funds to rely on estimated NAVs and that will also resolve outstanding issues relating to the calculation of performance fees. 'These changes should contribute to stimulating growth in the market,' he says. 'It will no longer require seven weeks to calculate the NAV of a fund of hedge funds because you need 100 per cent official figures for the underlying assets.'

The government has also eased restrictions on institutional investment in hedge funds. Pension schemes may now invest in OECD-domiciled hedge funds even if they are not registered in Spain, as long as they comply with certain standards. For now this leaves pension schemes with more flexible investment rules than insurance companies, which are currently limited to hedge funds or funds of funds that are registered with the CNMB. Says Sosa: 'We are likely to see similar changes for insurance companies in the future, but I am not aware that any proposals are on the table yet.'

He adds that the industry would also benefit from the lifting of a requirement that sets a ceiling of 2 per cent on the average management fee that pension schemes are allowed to pay. Perversely, pension funds are currently liable to run into problems if hedge funds they invest in perform well, triggering performance fees of up to 20 per cent that could take the overall fee level above the threshold. 'At present this requirement makes hedge fund investment less attractive for pension funds because they will take up a higher proportion of their maximum fee expenditure,' Sosa says.

He adds: 'The recent legal developments are very positive for domestic schemes, offering major improvements to the initial provisions of November 2005 and April 2006 in areas where this was most urgently needed, and the number of schemes have grown as a result. The changes in rules for institutional investors are also significant for foreign fund managers, but the main problem remains.

'The situation has not really changed over the past 12 months - the restrictions on registration of foreign hedge funds remain in place, and there is no sign of any change of heart from the CNMB. When I last spoke to officials there, they had no plans to ease the rules for marketing of foreign hedge funds more lenient, even those domiciled not in offshore territories but within the EU. We hope they will open up sooner or later but it will not be this year.'

Sosa says the use of structured products linked to hedge funds or hedge fund indices is becoming increasingly popular following tax changes that took place at the beginning of last year and which extended to other savings products tax advantages hitherto enjoyed exclusively by funds. Previously a structured note with an underlying hedge fund would have been taxed for individuals at marginal rates of up to 43 per cent, compared with just 18 per cent for funds, but now the playing field has been levelled.

Another area of discrimination in favour of funds is also set to disappear following the announcement by the Spanish government in April that the country's net worth tax is to be abolished from the beginning of 2009. 'The taxation of funds and of fund-linked notes is now basically the same,' Sosa says.

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