

A single market for hedge funds

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In the past decade significant progress has been made in achieving a single European market for investment funds. The ratio of cross-border fund flows has reached an estimated level of more than 20%, and in some European countries the number of registered non-domestic investment funds exceeds that of domestic funds. These are important achievements for the industry. A true single market in the fund business is not just 'nice to have'. Only an enlarged and unified single market will allow the industry to achieve economies of scale. Today, the average fund size in the U.S. is six times that of Europe.

The same is true for economies of scope. 25,000 funds in Europe do not reflect variety in offers but duplication of product types. The evolution of business models will depend to some degree on the single market, e.g. the larger and more integrated the market the better the opportunities for niche providers.

The UCITS success

To a large extent, the progress towards the single market can be attributed to the European regulatory framework for investment funds - the so-called UCITS Directive, which aims at approximating conditions of competition, ensuring effective investor protection, and simplifying cross-border marketing.

The UCITS Directive is based on three principles:

- Minimal harmonization of national legislation regarding investment funds.
- Mutual recognition.
- Home-country control.

The Directive only covers the products which comply with certain standards, e.g. redemption at net asset value at the holder's request, investing in transferable securities and other eligible assets, operating on the principle of risk-spreading, and entrusting their assets to a depositary. UCITS investment funds, which fulfill these requirements, can be marketed freely across borders in Europe without further permission. They only need to be registered in the host country.

Despite popular criticism of Brussels-rulemaking, the UCITS Directive has become a world-wide recognized model for fund regulation providing a high level of investor protection. It is this investor protection that has helped the strongly-developing European investment fund industry to preserve its integrity and encouraged investor confidence.

The hedge funds challenge

Not all investment funds are harmonized UCITS benefiting from the single market framework and the passport for going cross-border. Outside this Directive, member states allow other types of investment funds in their jurisdictions.

Unfortunately, among these 'non-harmonized' investment funds there are obviously some fund types that are innovative and increasingly popular. Real estate funds are one example, hedge funds another. The case of hedge funds demonstrates that the single market approach - despite the merits of the UCITS Directive - needs an overhaul.

Hedge funds differ from traditional investment funds in various aspects. They use a wide range of investment techniques and instruments, in particular derivatives; they do not follow general stock and bond market trends, but seek absolute return and aim at limiting downside risks.

That sounds good, particularly after the recent bear market years. It explains why hedge funds - and in particular funds of hedge funds as the more diversified version - have become increasingly retailized. That means that they are increasingly marketed to a broader segment of private clients.

Hedge funds have traditionally been based in offshore jurisdictions and are regulated loosely. Retailization, however, means more explicit regulation. Both are two sides of the same coin. This is why countries with large domestic markets - such as Italy, France, and Germany - have recently introduced hedge fund regulations in order to support a guided retailization and create a framework for domestic production of hedge funds (traditionally produced offshore).

The critical point is that although national regulations strive for the same goals, they differ significantly in structure. Some examples:

- In Germany and France, hedge funds may be managed by UCITS fund companies. In Italy a separate management company is required.
- In Luxembourg and France, hedge funds are subject to restrictions on the product side, regarding borrowing and short sales, whereas in Germany and Italy no such restrictions exist.
- In Italy, high minimum investments are required. Germany takes a different approach allowing fund of hedge funds to be marketed publicly. France separates retail, qualified, and relatively informed investors, all requiring a different marketing approach.

The list could be extended. The differences have implications on the cross-border marketing of hedge funds. As hedge funds are not harmonized, each country will allow the registration of foreign funds only if they comply by and large with its own national rules. This seems to be fair. However, due to the differences in national regimes requirements will vary significantly from country to country. A pan-European business approach outside the restricted area of institutional placement is strongly discouraged, if not made impossible.

New ways forward

Is there a case for striving for a single market for hedge funds? Certainly yes - a fragmented market in Europe will not be a basis to build up competitive onshore production.

So what should happen? A new EC directive for hedge funds as proposed recently by the European Parliament would not be a good solution - one fund directive (UCITS) is sufficient. So why not extend the UCITS Directive and its well-established principles of harmonization and single market creation to hedge funds and all other future innovations?

Past experience has shown that the process to create or

amend an EC directive may take years; it is too lengthy a process to keep up with developments in the industry creation. By the time the process is concluded the rules could once again lag behind the state of product innovation.

What is required is faster and more flexible rule-making procedures. Legislators and the fund industry should concentrate on solutions in this area.

One idea certainly worthy of consideration is the so-called Lamfalussy approach to EC legislation. It offers a more streamlined approach towards financial legislation, regulation, and supervision. The intended extension of this process to investment fund regulation could be the solution. The Lamfalussy structure is currently applied to securities legislation. A proposal by the EFC that has been endorsed by the ECOFIN council proposes to extend this to banking and regulation - and at the same time to include UCITS regulation in the securities' pillar. Thus, the merits of this approach (although practical experience is rather slim so far) would be extended to the fund industry and the UCITS Directive.

The European fund industry, therefore, has not hesitated to welcome this development as it might contribute to solve the challenges it is currently facing.