FOCUS ON

HEDGE FUND STRUCTURES

Mark Schoen of Northern Trust discusses hedge fund packaging in a post-AIFMD Europe

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It is a time of change for the European hedge fund industry as the roll-out of the AIFMD gathers momentum, potentially driving powerful shifts in hedge fund packaging. *HFMWeek* spoke to Mark Schoen of Northern Trust Hedge Fund Services to preview what we can expect in 2014.

HFM: WHAT IMPACT WILL THE AIFMD HAVE ON THE EUROPEAN ALTERNATIVES LANDSCAPE IN 2014?

MARK SCHOEN (MS): The AIFMD coincides with greater investor appetite for alternative investments, provided these are able to demonstrate transparency around the risk and attribution process. From Northern Trust's viewpoint, the majority of our institutional investor clients are looking to increase their allocation to alternatives; however the nature of that allocation to hedge funds is changing. While previously a significant proportion would seek this allocation via the fund of hedge funds (FoHF) route, as they have gained more experience they are now looking to access direct via single hedge funds.

With the greater demand comes greater scrutiny. The AIFMD anticipates this with its provisions focused on regulators having better oversight of the manager and more security of the assets. Northern Trust recently polled clients attending its AIFMD regulatory seminar and as a result we believe the AIFMD is likely to resonate with some institutional investors who will potentially boost their hedge fund allocations. While the path to implementation has been far from smooth, it potentially creates a long-term framework to manage the rising institutional investor allocations.

On the supply side, we see that managers are investing heavily to promote growth, expanding into new strategies, jurisdictions and types of fund structures. They are also devoting more resources to operations: looking at outsourcing more operational processes in order to scale the anticipated growth.

HFM: WHAT WILL THE AIFMD MEAN FOR HEDGE FUND DOMICILES?

MS: The AIFMD will undoubtedly have an impact on the dynamics of the onshore and offshore hedge fund industry. But we still see the Cayman Islands as the primary location for most launches and do not expect that to change in the near term. Having said this, offshore jurisdictions face further challenges in 2014 arising from the demand for transparency on tax affairs from all offshore jurisdictions from the OECD plan adopted by the G20 at St Petersburg as part of measures to 'de-offshore' the global economy.

A significant portion of hedge fund allocations still comes from the private wealth sector. For some managers there is perceived value in having an onshore domicile. We have recently seen a number of hedge funds launching in Emea as a result.

The industry will be closely following the AIFMD's impact on US managers of Cayman funds looking to market in Emea and the use of reverse solicitation rules over the next couple of years: will the US managers effectively stop marketing to the EU, or seek to comply with AIFMD regulations or private placement regimes? Or will they launch new funds domiciled in the EU?

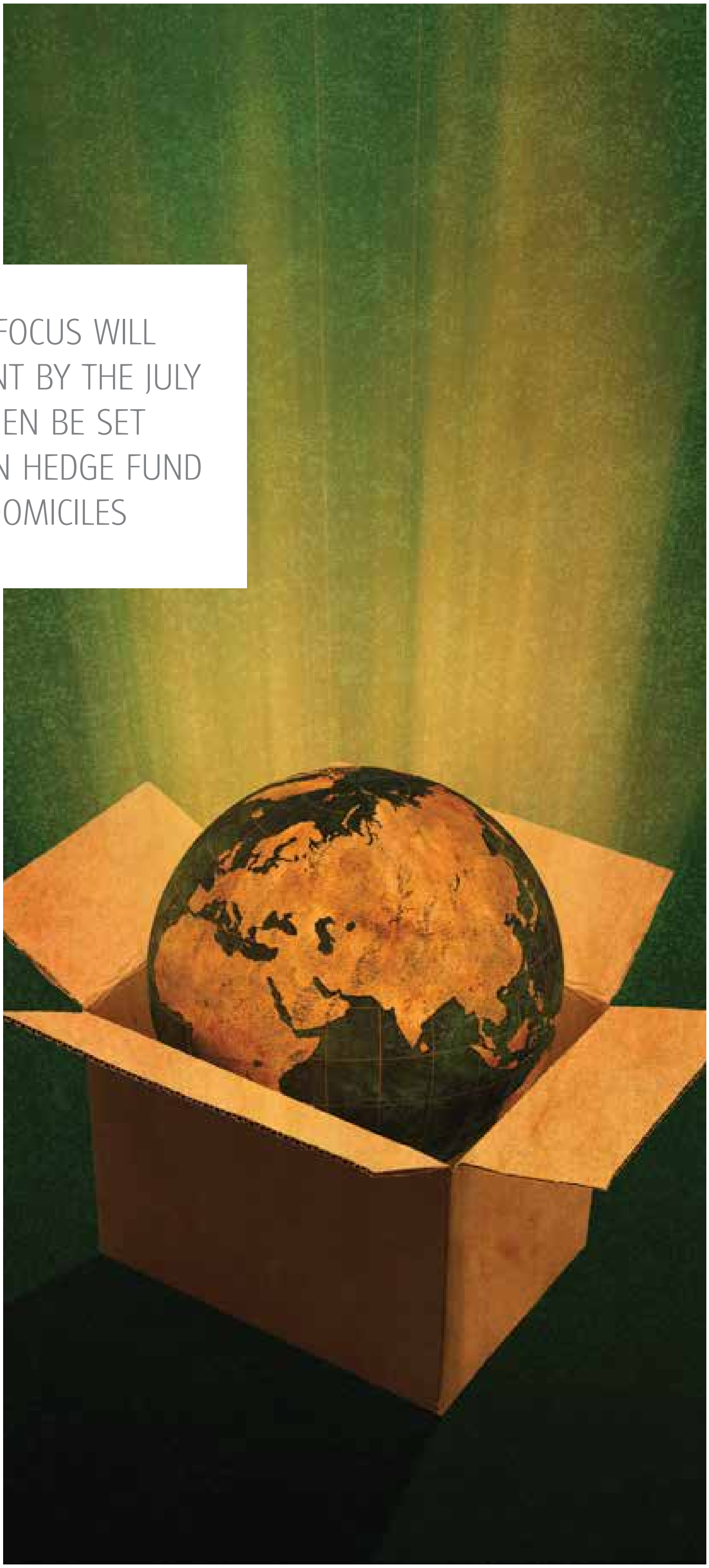
International finance centres such as Guernsey – geographically based in the European area but not part of the European Union – are also boosting efforts to retain and attract alternative funds. Guernsey has adopted two parallel regulatory regimes for investment funds: the existing regime remains in place for managers and investors not requiring an AIFMD fund, including those using EU national private placement regimes and those marketing to non-EU investors, and an opt-in regime that is fully compliant with the AIFMD.

> "THE INDUSTRY WILL BE CLOSELY FOLLOWING THE AIFMD'S IMPACT ON US MANAGERS OF CAYMAN FUNDS LOOKING TO MARKET IN EMEA AND THE USE OF REVERSE SOLICITATION RULES OVER THE NEXT COUPLE OF YEARS"

HFM: HOW WILL THE AIFMD IMPACT HEDGE FUND STRUCTURES. IS IT A TWO-HORSE RACE BETWEEN UCITS AND AIFS FOR ONSHORE HEDGE FUNDS? AND HOW WILL FUND OF FUNDS AND MANAGED ACCOUNT PLATFORMS FARE?

As featured in HFMWeek

MS: Since the 2008 financial crisis, alternative Ucits have attracted significant new inflows and become an established part of the European hedge fund industry as they offer the appeal of the highly regulated Ucits brand. But they have not been a complete solution. While they have worked for the classic long-short structure, other strategies such as CTA and swap replications are better suited to the greater flexibility that the AIFMD provisions provide.



> "OVER THE NEXT SIX MONTHS THE FOCUS WILL BE ON BECOMING AIFMD-COMPLIANT BY THE JULY 2014 DEADLINE. THE STAGE WILL THEN BE SET FOR AN INTRIGUING RACE BETWEEN HEDGE FUND STRUCTURES AND THEIR VARIOUS DOMICILES"

Meanwhile, FoHFs have yet to recover to their pre-2008 financial crisis allocation levels, as investors seek the greater transparency and lower costs of direct hedge fund investments. This is not to say FoHFs will not continue their appeal for certain investors, both the wealth sector and particularly new investors, who generally find FoHFs the easiest way to get allocations to a spread of hedge fund managers and strategies.

Some FoHF managers have changed their business model to include customised managed account services as the more sophisticated investors demand more transparency around the risk and returns process. In 2013, the industry saw quite a lot of talk, but limited progress in the managed account services environment.

HFM: THERE HAS BEEN A LOT OF INDUSTRY FOCUS ON THE AIFMD'S CHALLENGES BUT WHAT ABOUT ITS OPPORTUNITIES?

MS: By introducing a pan-European marketing passport for alternative investment fund managers, the AIFMD gives qualifying hedge fund managers a streamlined approach to fund distribution and brand recognition. This will be especially important for larger managers who will also benefit from the consolidation and simplification of management companies.

That said, there still remain some frustrations around the transposition process, with not all jurisdictions ready or consistent in their approach. Hedge fund managers can benefit from partnering with an asset servicing provider who has a focused cross-disciplinary team, able to design solutions to help them comply and take full advantage of the new regulatory landscape.

Over the next six months the focus will be on becoming AIFMD-compliant by the July 2014 deadline. The stage will then be set for an intriguing race between hedge fund structures and their various domiciles. Ultimately, it is likely there will be a range of winners as the deepening investor base widens the spectrum of European hedge fund solutions. ■

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