

More regulation means more security but do investors really care. And if they do, how much?

Increased regulation of the European funds industry, inevitable in the wake of the events of seven or eight years ago, has increased complexity and costs for fund providers. But the key question for Northern Trust executive Ian Headon is whether investors and fund managers will perceive that the additional security such regulation promises is worth the money and extra hassle, as he explains in this interview with Finance Dublin's John Stanley.

In the last few years the European funds industry has found itself managing an influx of new and updated regulations. Ian Headon, head of Depositary Regulatory and Technical Services at Northern Trust, has no particular difficulty with the fact that this has become a highly regulated space. 'We all understand that. This is about managing other people's money and the events of 2007, 2008 and 2009 amplified the concerns of regulators. This has led to AIFMD and UCITS V, with UCITS VI coming down the tracks behind it.'

But while a lot of this regulatory activity is intended to make the playing field fairer and to increase investor comfort, for Headon the big question, one largely unanswered as yet, is whether the investor community actually sees any value in it.

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'If a manager wants the added protection of an EU fund, to what extent are they simply living with the extra hassle involved?' he says. 'Is there any evidence that managers who have historically favoured "offshore" jurisdictions, such as the Cayman Islands, Bermuda and the British Virgin Islands, are being attracted to European investment locations in any significant number, such as Luxembourg and Ireland?'

AIFMD

Given that AIFMD has only been in force for the past 12 to 15 months and



Ian Headon

UCITS V remains to be implemented, he accepts it is still too early for definitive answers. 'But that does not mean we should not be asking these questions,' he insists.

'It is still far from clear whether increased regulation, and all that this supposedly provides to investors in terms of greater reassurance and security, has either attracted people in or driven them away from Europe in any number. We see some anecdotal evidence, but no mega trends as yet.'

Unintended consequences

While there has certainly been no sign to date of a 'seismic shift' in investor behaviour, Headon says 'the funds industry needs to move beyond talking simply about the effect that regulation has on the cost base of its European operations and engage in that wider debate.'

To their credit, he says, EU regulators are now asking specific questions in their discussion papers which indicate they are aware that some of the things that have been introduced have had unintended consequences. 'They are smart people and there was a policy making imperative that the rules had to change. But in fairness there has always been willingness by them to at least listen to the industry and

to take our queries.'

The fact remains, however, that less regulated areas, such as the Cayman Islands, still have a clear edge in some investors' minds, particularly in respect of alternative investments.

Investor demand

The key question for Headon is the relationship between the policy making imperative and its objective of providing better protection for investors. 'Are we totally sure that investors want that level of protection? By and large investors, into alternatives in particular, are still voting with their feet and selecting Cayman funds.'

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'When an investor subscribes, particularly into an alternative fund, they are naturally concerned about safety. An average pension fund or endowment, for example, will likely allocate between 8% and 12% of assets into alternatives and it will be concerned about both return and security,' Headon says.

'But the question, once again, is whether they equate safety with a regulated funds structure. It's a simple fact that the vast majority of alternatives remain in those offshore domiciles – around 75% of assets in alternatives are in the Cayman, Bermuda, BVI and Channel Islands. Everything we know tells us that the majority of investors are happy to live with less expensive, ready to market products and there's a job of work for the industry in Europe if we want to change that.'

'We have not seen a seismic shift in investors in alternatives from the traditional Cayman funds to either

Ireland or Luxembourg. Do we see some shift? Yes. But do we see a seismic wall of money moving? Absolutely not. It's now October 2015. If we roll the clock forward three or four years when AIMFD and UCITS V has settled down, will we be able to say something different? I don't know. That is the fundamental crystal ball moment.'

'We asked our clients this question at an event earlier this year, and almost 75% told us that their investors see the extra regulation as a cost overhead with limited value. That number has remained more or less static in the last three years and we will be watching closely over the next couple'.

EU conundrum

Like others, he says, Northern Trust has 'the great privilege' of a global business with clients all over the world and is largely 'domicile agnostic' as a result. 'But the question for the Irish, UK, Luxembourg and EU industry in general is how do we go about taking the regulatory environment that's in front of us and deal with the ongoing client demands that we have, presenting and marketing this in a way that can maximise its attractiveness to investors?'

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'We have a significant Channel Islands business for example, and we are watching with interest how the local regulator is dealing with this; essentially retaining the non EU features for those managers for whom that is important, yet at the same time embracing the potential for securing the AIFMD badge from the EU in due course.'

Headon believes there are many things that the industry can and is already doing to address this issue - from roadshows to engagement with the regulators - and in this regard he welcomes the Irish government's creation of a specific strategy for the IFSC and its appointment



Despite a raft of new regulations to protect investors in alternatives in Europe, the Cayman Islands (George Town pictured), Bermuda, BVI and the Channel Islands continue to dominate the hedge fund industry as investors choose less expensive and more flexible funds regimes.

of a dedicated minister with responsibility for it.

Matching investor requirements

But understanding exactly why investors and managers still appear to give priority to 'warmer climate' jurisdictions is an ongoing task for the industry, he says. 'Is it that the various regulatory protections that have been created do not match investor requirements? Is it that investors don't value them or is it that they see the costs outweigh the value? Is it that they believe a key part of investing in an alternative fund is the flexibility and nimbleness that ostensibly might be available to a Cayman hedge fund relative to a more regulated fund?'

'These are the fundamental questions that the industry has asked and continues to need to ask in order to maximise the message for global investors and global managers. This is not something we are going to crack overnight, clearly. This is a marathon, not a sprint, and we need to play the long game on this one.'

Cayman inertia

One answer to these questions is that many investors are simply comfortable with what they already know. 'What we all hear consistently is that, particularly amongst hedge funds, there is a speed to market and a familiarity with Cayman. Many Cayman funds do a very nice job

for their investors and, important to note, they are not totally unregulated. The stand out message we get is that "Cayman is just easier, it's something we're all familiar with." So it's almost a behavioural question as much as it's a

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regulatory or even a cost one.'

Headon says some investors clearly got burned as part of the events of 2007 and 2008 which resulted in some behavioural change. 'But that's very much a minority,' he adds. 'We have seen some institutions only investing in alternative funds if they carry the AIMFD badge. But what we have not seen is any big shift. Cayman funds offer more flexibility, they are quicker to market - it's simply less hassle. We still see Cayman, Bermuda and BVI winning this battle and the consistent message is that it's just easier. So that remains a competitive challenge for all of us here in the EU.'