Alternative Investment Analyst Review

(R)Evolution of the Regulatory Landscape in the UK

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Once upon a time in the UK, a long time before Brexit was voted – not that long, in fact, after the UK opted to come in to the group of European states that would later become the European Union (EU) – it was decided the existing regulatory landscape ought to change in order better to supervise a financial sector that had been evolving.

Back at the turn of the century, it was a question of consolidating a regulatory system, lest the ever expanding – and diversifying – financial institutions might escape supervision, or fall into gaps created as a result of the regulatory landscape being atomized. The Barings Bank had recently collapsed; it was time to reform a system that had not performed in the way it had been expected to.

In 2012, a reverse course of action was taken, as it was then decided that the Financial Services Authority – the UK single regulatory entity that had come together in 2001 – ought to be dismantled to some extent. The Financial Conduct Authority (FCA) was created instead, in 2012.

The following seeks to provide further details about the "new" regulatory system in the UK, and to discuss how it fits in with the hedge fund industry, especially in the context of the recently-voted Brexit.

Before the FCA

The first element to mention is that it seems customary for regulatory bodies to be created following major failures of their predecessors to prevent crisis, scandals, or bankruptcies, often of a systemic nature, or with a potentially systemic impact.

It was the collapse of the Barings Bank in 1995 that had prompted the reshuffling of the regulatory landscape in the UK a few years later: as a result of the creation of the Financial Services Authority (FSA), the Bank of England – the country's central bank – lost its regulatory powers in favor of the newly-created body;

other existing bodies (known as "self-regulatory organizations") also merged into the FSA.

In addition to the fraud at Barings that had led to the bank going bankrupt (over 300 years after its creation), financial product innovation had been such that a new regulatory system had become necessary: while Barings was the trigger, the evolution of financial services firms was the underlying cause for the change. Previously, each firm could neatly fit into a well-defined bucket: for instance, a firm could be either a bank or an insurance company – not both. There no longer was any such clear delineation. The idea of the FSA was therefore to integrate, and to reform, the existing rules, and to make them applicable across all firm types, fine tuning them depending on risk and "topic" – not on the way the firms themselves were called.

Rules on capital requirements for all firm types, for instance, would be integrated with those applicable to banks. (Those rules applicable to banks themselves had come in application of the international Basel Accord on Capital, which, on top of it all, was also being re-negotiated at the same time as those national changes were going on in the UK.) A new "Integrated Prudential Sourcebook" would be created, in which all firm types (banks, insurance companies, asset managers) could look up rules applicable to their specific risk profiles or to the products it was dealing with.

The 2008 crisis

Not so long after all that had taken place, the global financial crisis emerged, raising questions about "who to blame" for what had gone on. Two culprits were found, at two ends of the "risk" (and freedom) spectrum:

- Regulators (worldwide) were seen as not having done their jobs properly. In the UK, and elsewhere, questions were asked about how structured products (i.e. mortgage-backed securities) had been treated in the light, precisely, of capital requirements: the risk inherent to those products had been underestimated, included by the FSA, which had approved many such structures without probing much further or seeking banks to set aside more capital given the level of risk. Formally as a result of yet another scandal – this time: the run against mortgage lender Northern Rock in 2007 – the head of the Prudential Standard Division at the FSA lost his job, the beginning of some of the changes that would ultimately result in the FCA being created in 2012.
- Hedge funds had until then not been regulated much in the UK. The FSA had been toying the question of "what to do" with hedge funds pre-crisis, notably in a Discussion Paper it published in 2005. It had not, however, made a decision about a way forward, two reasons for this being the lack of obvious problem / emergency and the difficulty to define what a hedge fund was. The FSA essentially gathered data via prime-brokers at the time – usually not directly from the hedge fund themselves. It is only post-crisis – starting, in fact, in 2009, when the EU issued a proposal for a new Directive on alternative investment products – that the UK started to take steps to regulate hedge funds the shorting techniques of which they suddenly seemed to be re-discovering.

The FCA, the regulation of hedge funds in the UK – and thereafter

Paradoxically, the creation of the FCA meant the Bank of England got back some of the regulatory powers it had lost at the beginning of the preceding decade. It did not get back banking supervision since the cross-sectoral approach the FSA had taken was kept. However, everything concerning prudential regulation did go back to the Bank of England (via the Prudential Regulation Authority, or PRI), which started to cover for that topic various types of financial services firms across the industry.

The FCA authorizes and regulates hedge funds, in-keeping with the Alternative Investment Fund Managers Directive (AIFMD) published in 2011 and coming into force in 2013, thus coinciding with the creation of the FCA.

In the pre-Brexit era, many hedge fund managers resented the new European Directive, which made it more onerous to run a hedge fund business than before. As one of the member states of the EU, the UK had no choice but to integrate the AIFMD rules into its regulatory framework. Among other features, the new rules require hedge fund managers to increase their minimum capital requirements and to separate its reporting lines in order to keep the risk function "separate" from portfolio management. (Managers have to show that the separation is both "functional and hierarchical".) All this – and much more – can be costly for smaller managers, and hence create barriers to entry.

It is not certain whether those new requirements will disappear as a result of Brexit: while the FCA may no longer be under the obligation to have a similar regulatory framework to that of its European neighbors once it moves out of the EU, it may well choose to keep AIFMD-like requirements. This is because a discrepancy between the UK regulatory regime and that applicable in the rest of Europe may result in the UK attracting managers with lower compliance standards; conversely, such a discrepancy might also make it difficult for EU countries to accept the local distribution of UK managers as they may be seen as being of lower operational quality.

At the moment, the AIFMD makes it possible for managers authorized in one EU country to raise capital throughout the rest of Europe. That possibility is, to some extent, available to non-European managers also. Obviously, the UK leaving the EU, and throwing the AIFMD out of the window, would put that possibility into question, especially if the remaining EU member states decide a revamped UK regulatory regime for hedge funds is of inferior quality to that applicable in the rest of Europe.

While the current regime has advantages and disadvantages, for hedge funds and the rest of the financial services industry, the following points can objectively be made:

- Whether one decides to look at the creation of the FCA or the coming about of the AIFMD, the fact is that both constitute reactions to what happened within the industry – and beyond. The extent to which that may be deemed to be an over-reaction is obviously a matter of opinion: many in the hedge fund industry argue that the AIFMD was a political stance, aiming to find a culprit in the context of the financial crisis. In any event, one can wonder whether the "catch up game" between the regulators and the industry – with the latter taking advantage of loopholes of an existing framework, and then regulators changing their ways of doing things as a result of negative events – constitutes an optimum policymaking process.

- Looking at the situation from a market perspective, the recently-created UK regulatory framework can also be assessed as far as its impact is concerned. The point about the creation of barriers to entry has already been made. In addition, one can also look at it in terms of demand and supply: the objective of the AIFMD was to protect hedge fund investors (even though they are in principle institutional, or otherwise sophisticated, investors); with the increased cost of running a hedge fund, it is possible that investors may end up having less, not more, choice, with a consequential impact on the quality of the offering. The FCA has several objectives, one of which – like its predecessor the FSA – is to enhance competition; one can legitimately question whether the AIFMD meets, or contradicts, that objective.

- Finally, a hedge fund manager interested to do business in Europe, or to seek regulatory authorization in one of the European countries, may want to know whether any European jurisdiction might be more business friendly than the next. In spite of the fact the AIFMD exists across the EU, some margin of interpretation is left for each European state. In addition, "super-equivalence" may apply in certain cases, which means EU states are allowed (for any Directive) to make their national rules stricter than the Directive requires in certain specific areas. Obviously the regulatory practice overall – and other factors outside purely regulatory concerns – is also something to take into consideration: speed of authorization process, business friendliness and "approachability" of the regulators are all important points.

What happens to the regulatory framework once the UK is out of the EU is still highly uncertain at this stage.

Author Bio

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"Marianne Scordel set up Bougeville Consulting in 2012. She assists hedge fund managers in establishing their businesses or in moving across jurisdictions. In doing so, she has interacted with various regulators across borders. Bougeville Consulting won five awards in the past five years, including from Financial News, a national publication in the UK. In 2017 Marianne Scordel relocated her business from the UK to the US and has spent the past few months supporting US hedge funds doing business in Europe. She is French and graduated from the University of Oxford.