Changing Challenges and Opportunities

Q&A with Peter Astleford, Dechert

CONDUCTED BY HAMLIN LOVELL

Hamlin Lovell: We are delighted to speak to Dechert's Peter Astleford, a recipient of a special award for an outstanding contribution to the hedge fund industry from *The Hedge Fund Journal*. Since you joined Dechert in 1997, hedge fund industry assets have grown roughly 30-fold from about $100 billion to about $3 trillion. How has the legal services market changed over that period?

Peter Astleford: There's been a lot of change. I think the first thing is there's immensely more regulation now than there was, immensely more law that people need to think about, and the process of launching a new fund has become much more wrapped up in regulation than it was. There's less room for imagination now. There are more constraints on the timetable; more things that need to be thought about; and a lot more service providers out there who have a knowledge of the area and are looking to help people. Perhaps the other thought is that when we started doing this, it was an area still shrouded in confidentiality. People did not openly talk about setting up hedge fund managers, whereas now there are many hedge fund managers out there. Somebody setting up tends to talk to five or 10 or 15 of their friends in the same industry, instead of just quietly setting up solely on the advice of their one or two advisors.

HL: Right. So how big is your hedge fund team today and is it still growing?

PA: In London we have about 30 lawyers. We have been very broadly the same size since the start of the crisis; we didn't drop in size during the crisis and it's gently moved up since then. However, what we have done since the start of the crisis is thought much more about the way the world is moving. Certainly if you're based in Europe, Europe has much more of a focus than it used to do. Globalisation is also much more prevalent than it was. A lot of my time has been taken up in building our international network. We now have four partners doing funds in Germany, which is one of the larger fund groups in Germany; we have teams of fund lawyers in Luxembourg and Dublin, which no other law firm has. We have two partners doing funds in Paris; we have two partners doing funds in Dubai, covering the Middle East. We've had a team in Hong Kong doing funds for a number of years now. We set up a funds practice in Singapore last year. The type of significant double-digit growth that we had, up until the time of the crisis in London, has continued in our international practice since then, but much of that has been fuelled by the growth and development we've had in other offices.

HL: How do you actually measure your market penetration leadership, and what are your strongest and weakest areas?

PA: So to try to put some numbers on that, when I joined Dechert in 1997, we had 33 lawyers in the States doing funds, and that was the whole gamut of funds work. I was the first lawyer doing funds outside the States. We now have over 120 lawyers in the States doing funds and we have 65 lawyers outside of the States doing funds. At 185 lawyers, I think that's the largest funds group in any law firm. Our teams helping on tax, ERISA and other areas are in addition to that. The core group is about 18% or 19% of what Dechert is doing, so a significant force within Dechert and, as I said, in our area I think it's the largest globally.

HL: Right, right. Where do you see your greatest strengths and any weaknesses or gaps in coverage?

PA: Our strengths will be handling anything on a cross-border basis. If somebody's thinking about whether or not to set up their fund in Cayman, Luxembourg or in Dublin, I don't think anybody else can independently and impartially answer that question from another law firm. Whereas for us we are perfectly happy whether they go to Luxembourg Dublin, Cayman or Malta. Adding on a feeder in the US or doing SEC registration or advising on the CFTC is all bread and butter for us. For somebody who wants to do fund registrations or private placement sales around the world, we're well placed to provide cover. We have a new product which we've recently rolled out called World Compass, and that provides advice on private placement marketing in over 100 countries around the globe.

World Compass also covers the selling of services, so if you want to offer a discretionary mandate to somebody you can look up the rules on our internet-based system. It also covers share disclosure levels, so if you're invested up to a certain percentage in a company, you can check your obligations. Just by visiting our proprietary database, you can see whether you need to make disclosures and to whom. In the cross-border area I don't think anybody is doing the same level of work that we are. Now what we're doing less of is the pure commodity start-up work. If somebody wants to set up a Cayman fund in the cheapest possible way, they're not looking to do it in a co-ordinated, cross-border way and they really don't want to consider an institutional-type product for the next few years; that would be an area where we would be less keen to be.

HL: How many of your clients are using competitors for particular domiciled jurisdictions, products and services? And do you feel comfortable with clients also working with competitors?

PA: It's a very fun question to ask because mostly if you ask lawyers this they will tell you that their clients use them for everything – and of course I might tell you the same thing. But I know when I meet investment managers I have not met before, I always ask them which law firms they use, and they usually use a variety of law firms. I think we should all assume that our clients use someone else as well. For some investment management clients I think it's a good thing for them to have more than one relationship; conflicts arise from time to time. It's good for somebody to have an alternative law firm to look to, particularly in certain areas. Alternatively they might have very lumpy needs, so at particular times of the year they have huge legal demands, and other times of the year none. You know, that might be a good thing to split up with more than one law firm.

There might be a specialist subject that people need to do like advice on pensions, which in London we don't do: we sub-contract that. So there would be a variety of reasons why people would use different law firms, which are very legitimate. All I would say on the other hand is, of course, if there is an investment manager that is spreading their business amongst too many law firms, then they cease to be a significant or important client for any of those law firms, and perhaps that doesn't work in their best interests. Or perhaps something falls between the cracks because each law firm thinks another law firm is dealing with it or they have not been given the full picture. If the work was primarily directed towards one or two law firms then the chance of that happening would be much lower.

HL: So which areas of regulations are you most focused on now in 2015?

PA: This year, 2015, we'll see, but if I had to guess it's the tail end of mopping up AIFMD compliance which is still ongoing; not everybody's there yet. It's coming to grips and perfecting reporting under EMIR; getting derivatives regulation fully sorted out; it's the front end of MiFID 2 which will cause its own problems. And then of course there's the bulk of regulation continuing to come out of the US. There's an immense amount. There are other areas like UCITS, although the changes there are well flagged, like what the continuing approach to executive remuneration will be. We think we understand what is planned now, but we don't know what new slants that will take on over the next year, and clearly that's a very sensitive area.

HL: AIMA, the Alternative Investment Management Association, have told us that judging by the number of consultation papers they get asked to comment on, the pace of regulatory change may finally be slowing down. Does that match up with your experience?

PA: I deeply hope that AIMA is right. I don't have huge confidence in it. If we split out the US and the EU, I think in the US there is now a wide understanding that regulation is needed and is good, but not at any price. While budgets in other areas need to be controlled, you can't have an unlimited budget in the regulatory area. So there has been a noticeable slowdown in new regulation in the US, over the last couple of years. Rules which were due to be issued have not been issued simply because there hasn't been the budget in the various departments, to employ the people who would have written the rules. Therefore in the same way that almost every aspect of spending is controlled and limited, so that's evident in what's happening in the States. I haven't seen any evidence of that being true in the EU. This seems to be the only area where there can be an unlimited amount of money spent on it by governments, by regulators; and therefore in response by individual investment management companies. I don't think that's healthy and I think we've reached the point where the industry has not been able to keep pace with the arrival of regulation, and ultimately that will backfire. So I deeply hope that you're correct that there has been a slowdown in Europe, but I'm not conscious of it yet.

HL: Right. And regulation is probably one reason why prospectuses seem to get longer and longer every year. And one may wonder will this process ever stop? In 10 years' time will a single fund prospectus be something like half a million words long, and are there any alternative approaches that could reduce the length of prospectuses?

PA: So clearly fund prospectuses have doubled, tripled and maybe quadrupled in length over our working lives. Some of it is helpful disclosure, but generally it's dealing with new regulations. Having a prospectus of 80 or 100 or 150 pages, which most investors will not read from cover to cover, is not helpful in terms of disclosure; it's not helpful in terms of cost. Longer prospectuses cost more money to produce and to keep up to date. They cost more money to check; and, from an investor's viewpoint, they cost more when they're doing their due diligence to understand it. So I don't think this is a helpful development for the industry. What do we do about it? Well with all of the regulatory material that now needs to be covered, of which the latest is the European FATCA equivalents, there's considerable documentation now to provide the information which may subsequently need to be disclosed, cross-border in the future. I think shorter prospectuses would be a good thing; I work to keep ours shorter, but a move that will allow it in any material way I don't see on the horizon.

HL: You authored the Comparative Jurisdictions Guide; so post-crisis, do you see more convergence or divergence between various domiciles where people may set up funds? And would you like to flag up any particular advantages or disadvantages of certain domiciles, perhaps focusing on the major ones like Cayman, Luxembourg or Ireland?

PA: I think the number of jurisdictions that you would consider to be serious jurisdictions has steadily reduced and these have converged in terms of service offering. From a hedge fund perspective, the main jurisdictions now not in any particular order would be Cayman, Luxembourg, Ireland, Malta and Delaware. 10 or 20 years ago that would have been a much longer list. There are good reasons to set up funds in other places. Other sectors like, for instance, private equity would particularly like the Channel Islands. However the hedge fund jurisdictions have become more and more delineated. You would ask yourself to check more closely if somebody wanted to set up in a different jurisdiction. What you expect in the chosen jurisdictions has become more standardised.

HL: Right, and are all regulators being forced to raise their game, or are there some domiciles out there that are still sort of light-touch, lasissez-faire places? In that regard, Monaco is sometimes mentioned.

PA: So Monaco I would say has quite strict regulation but achieves it by alternative means, by controlling who comes in, in the first place. But more generally I think some jurisdictions are trying to compete by being more laissez-faire, but certainly from a hedge fund perspective the jurisdictions that are doing well are those who take regulation seriously.

HL: Have some domiciles frankly become beyond the pale because they are simply not keeping up with regulation, or they're not transparent on tax issues or perhaps they have weaker controls over money laundering or whatever else it might be?

PA: I don't want to single out jurisdictions, but I'll mention a few: Panama, Bahamas, Lichtenstein. They're not places where you would rush to set up a hedge fund today. One could go on and name others. But all of them were once contenders.

HL: Service providers who get paid to advise on regulatory compliance constantly seem to be putting out surveys claiming that the cost of compliance is inexorably rising and that the minimum critical mass for starting a hedge fund nowadays is hundreds of millions of dollars or euros. At the same time, anecdotally I'm sure we all know people running $50 million or $100 million who say that they are quite happy doing that, and who also tell us they can outsource compliance for less than the cost of employing a secretary. So how would you reconcile these two stories?

PA: It is correct that the minimum critical mass is increasing in size and I think there are two aspects to that. One is, how much do you need to run your business? And I think that number is going up. There is a second lower number which is how much money do you need to have under management before somebody will take you seriously, and consider you as a potential fund to invest in? I think that's a lower number but that number is rising as well. So that to me is inescapably clear. There are lots of players out there who are smaller than the sizes you mentioned. Many hedge funds who start up are smaller than the headline numbers that people assume they're at. I think the answer to that is that for a period of time you can operate your business on a very simple basis from a compliance viewpoint, quite properly. You can use outsource providers, quite properly. You can put parts of the cost of setting up your systems into your start-up or sunk expense, so that you don't think of it as a regular ongoing expense. It's still a real expense, but it's an expense of getting into business, rather than an expense of running a business. And so yes there are still lots of small players out there, and clearly it works. But the willingness of people to stay in business at those smaller sizes is dropping off. Another journal put out some figures that showed that in 2014 there were more fund closures than start-ups, and I think that primarily had to do with the fact that people just said, the opportunity cost of me running this fund is too high, I'm not getting enough money out of it, I'm not enjoying it any more, the regulatory burden is too high, I'm going to close down; not because anything dramatic happened, but just because the opportunity cost in their mind became too great.

HL: Liquid alternatives are converging with traditional mutual fund structures and at the same time hedge fund strategies such as direct lending are often being wrapped up in a private equity structure. Other hedge fund strategies can be fitted in to a dedicated managed account or even a managed account platform. Does Dechert run the gamut in terms of all of these vehicles and ways of accessing hedge fund strategies?

PA: We work with the full gamut. I think one of the effects of the liquidity problems that we were seeing during the financial crisis was that hedge fund managers had to look at themselves more closely and say, what is the real liquidity of my fund and what do I really want to offer? And so instead perhaps of saying we should have monthly liquidity or quarterly liquidity because that's what our marketing team advised they can consider more closely what they actually need in this strategy. Those funds that were truly liquid have moved in the direction of offering much better liquidity. Others are coming up with an alternative, which offers much better liquidity. Those funds that are truly liquid are now much more upfront about that. I think that's a good development, and we're working on aspects of that.

HL: I think most people now know that reverse solicitation rules can be different in the 28 European Union Member States. What we're also hearing is that interpretations of reverse solicitation rules can differ within the same country, and that is naturally a cause of concern and worry for hedge funds. Do you think that over time, regulators will hone and refine their definitions to the point where the situation is much clearer?

PA: Yes, it is looked at in different ways by different people and the same legal question might have a different answer based on the particular behaviour of the manager or the particular behaviour of the private placement agent – so you look at it in a wider context. But one of the good things that's happening in regulation is ESMA, and the European regulators in general are, I think, working very hard to find these areas of difference and to come up with advice and interpretations that mean there's greater conformity across Europe. It seems to me that sooner or later that must happen in the area of reverse solicitation.

HL: Right. So when the dust has settled, do you think that European Union investors should be confident that they can continue accessing any hedge fund they want to invest in, in the United States, without having to worry about regulatory obstacles?

PA: Let's assume they're eligible investors for a start to make the discussion easy; I'm going to give you a very qualified yes as the answer. There are a meaningful proportion of hedge fund managers outside of Europe who have decided or are deciding that Europe is just too complicated and they're going to stay away. In the same way there are European managers who say the US is just too complicated and they're going to stay away. These European managers turn away US money today, even though they could perfectly, legally accept it, because they just think the whole concept of getting on top of US regulation and the risks that go with that are too great. Some non-Europeans will take the same view about Europe. So directly and indirectly, there will be less access to non-European funds by European investors. The big European insurance companies tell me they think that's a very bad thing, because with less access to different managers they will have poorer diversification and overall lower returns. They'll have a smaller pool to select from. I think that's just one price that we pay for AIFMD having arrived.

HL: So moving on to derivatives, this is another complicated area of regulation where there are differences between the different countries. Do you think that the United States is on a mission to regulate the whole world through extra-territorial rules, and how do you decide which jurisdiction has ultimate authority in a cross-border derivative transaction?

PA: Well first of all if you were interviewing one of my US colleagues they would tell you that Europe has become the expert in extra-territorial jurisdiction. There is clearly an issue that different managers, whether they're in the States or in Europe, or outside the States and Europe, feel conflicting demands of their domestic rules and international rules. They are having to do two or more sets of reporting which are similar but not identical. They're having to work different sets of rules into their compliance manuals. That's bad for business; it increases costs; it reduces initiative, thought and entrepreneurialism.

Becoming more conceptual, when people are looking back in 10 or 20 years, they will say the last few years have been a heaven-sent opportunity, when the EU and the US were looking at reforming their regulatory systems at the same time. Two sets of regulators (of course, it would be much more than two sets) could have sat down together and said, how can we work together? How can we make allowance for each other? How can we work out what's important and come up with a simpler but more effective system? I think that opportunity has been lost. It has been lost because there weren't physically enough people to do it. It was lost because there wasn't the political will to do it; it was lost because people were scrabbling to deal with and recover from the crisis and didn't have the vision to say, we could really do something more. It's a shame. Maybe it's not too late now but it's a shame. There were blank sheets of paper on both sides of the Atlantic and nobody seized the opportunity to say, we can create a legacy that makes the globe a better place.

HL: So clearly the failure to harmonise regulations was a lost opportunity for the hedge fund industry, but earlier on you have flagged up lots of other very compelling opportunities for the industry going forward. Thanks very much for your time and insights today.

PA: Thank you. **THFJ**

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