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Regulation and the Coming U.S. Election – Competitiveness as Alternatives Jurisdiction Hangs in the Balance

While much has changed over the last few years in the alternative investment industry, the most notable transformation in the United States has been the increased presence of the government and regulatory bodies. The upcoming presidential election in the United States has the potential for further major impact on the future trajectory of the regulation and the very competitiveness of the United States as an alternative investment jurisdiction could very well hang in the balance.

In an effort to contain bank failure risk, the scope of recent changes to regulation sought by the United States government and its regulatory bodies has also, rightly or wrongly, impacted alternative investment industry. Legislation such as *The Dodd–Frank Wall Street Reform and Consumer Protection Act* has been a notable example, the fallout of which is still being determined. In addition, the Internal Revenue Service has introduced the *Foreign Account Tax Compliance Act (FATCA)* which seeks to force the disclosure of U.S. account holders or U.S.-controlled accounts to authorities.

Another example of note is *Form PF*, the Securities and Exchange Commission's most recent data gathering attempt. Quickly becoming a compliance nightmare for alternative investment managers, it is a landmark shift by the SEC which seeks unparalleled access to a fund manager's trading strategy. As costs mount for the investment manager in terms of legal bills, internal time spent, and a host of other direct and indirect items, the frustration intensifies.

It is worth noting that the situation in the United States is not unique in the sense that governments around the world have been focused on hedge funds for some time. For some nations, this takes the form of strong regulatory bodies and increased costs. In Canada, for example, the entire hedge fund industry is highly regulated, with the various provincial securities commissions insisting that money managers register and provide information on a regular basis. In addition, audits and compliance requirements are the norm and, quite simply, a cost of doing alternative investment business in Canada. Despite a strong financial system and the world's largest investors on their doorstep, the Canadian alternative investment industry is relatively small, with the regulatory burden currently in place cited as a primary cause.

On the flip side, other nations are looking to expand their influence through the promotion of their country as a preferred centre for hedge funds. The recent re-election of New Zealand prime minister John Key is one such example, with Key being a major driver for the promotion of New Zealand as a fund domicile, especially for funds looking to make headway into Asia. A number of other jurisdictions around the globe are also putting similar frameworks in place in order to attract hedge funds from more traditional domiciles such as the United States, Bermuda, and the Cayman Islands.

To be more specific, a major jurisdiction which is growing rapidly is Hong Kong. EurekaHedge has estimated that the hedge fund industry has grown six-fold over the last dozen years in Asia and the pace is expected to continue. With such growth, it is not surprising that many managers are seeing the practical benefits of locating their funds in such a centre. In addition, the domicile has been purposely built to allow a wealth of different products to be marketed to investors, furthering the area's appeal.

To be sure, regulation in some form is here to stay, but the most important thing for governments to decide is the impact they wish to have using those regulations. Do they seek to police an industry and its individual participants? To gather data in order to mitigate and better understand systemic risk? To simply tax the industry as much as possible to bolster government coffers? The intentions behind regulation have enormous implications and deserve close scrutiny to ensure they are in the best interests of a nation over the long run.

The regulatory bodies of the United States are very much at a crossroads with the alternative investment community. There is a strong desire to regulate the industry in order to better understand it (and, let's be frank, to profit from it through taxation, filing fees, etc.), but this desire must be appropriate and balanced. The globalization of the industry, coupled with the relative mobility of talented personnel, means that the United States could risk a long-term exodus of capital from the country.

As touched upon earlier, there are jurisdictions around the world that would do nearly anything to attract just a fraction of the assets domiciled in the United States and the people who work in the industry. If the incentives given by a foreign domicile (or if the *dis*incentives in place in the United States) were sufficient, billions of dollars could move offshore for good along with untold numbers of well-educated workers with high-paying jobs. In a recent interview with HFMWeek, former U.S. congressman Mark Kennedy put it rather succinctly: "When I look at regulations of hedge funds, the thing that is on the top of my mind is that capital goes where it feels welcome. If a government makes hedge funds and other financial players feel less welcome, they will go elsewhere."

Regardless of who is elected come November 2012, the alternative investment industry will be watching closely. More specifically, everyone will be looking to see what direction the government and regulatory bodies go with respect to oversight of the alternative investment industry. Those with their names on a ballot this year would be wise to give the topic some serious consideration and ensure that their approach to regulation and compliance is the right one. One of the major adjectives that describe the alternative investment industry in general is *flexible*; it is that flexibility that allows alternative investment managers to deliver alpha, regardless of the market environment. If regulators cannot offer a flexible structure, the industry could go shopping for a new, more adaptable partner.