

Evolution

Our panel of experts debates servicing the hedge funds industry...

ISJ PANEL DEBATE HEDGE FUNDS

It has been a rough time for hedge funds in the public eye over the last few months – how has the increased public and regulatory scrutiny affected the hedge fund community?

Butler: The first point I would make would be to repeat the endorsement that Mr. Charlie McCreevey gave in a recent speech. Mr. McCreevey, the EU Commissioner, slated SocGen for their lack of controls and then went on to say that, under the circumstances, it was ironic that Sovereign Wealth Funds and Hedge Funds had been demonised, when it was clear that Hedge Funds have provided liquidity to the market when it most needed it and Sovereign Wealth Funds had provided capital to the banks when they most needed it.

His is, of course, one lone voice in the wilderness and you are quite right that Hedge Funds have had a rough time in the public eye, as a result of ill thought out or biased media reports which have resulted in more regulatory scrutiny, again, a lot of it ill thought out and, in my opinion, based on ignorance.

I think it is fair to say that the Hedge Fund Working Group (HFWG) came about as a direct response to the German led attack on Hedge Funds. HFWG has, I think, been a successful project, led by 12 major UK Hedge Fund Groups, together with one Swedish and one US Hedge Fund Group. HFWG introduced their Best Practices Report for Hedge Fund Managers. This report followed on from two Guides to Sound Practices, published by AIMA and by MFA and, it is fair to say that, not only did the HFWG carry many of the same recommendations that the AIMA Guide carried, but that a very high proportion, if not the vast majority, of Hedge Fund Managers already follow most of the Best Practices outlined in the HFWG.

In addition to the above, it is likely that, by the time this Panel is published, we may have the US President's Working Group Report, which will be a two-pronged affair, sub-divided into Investors



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Ross Munro, partner - Investment Funds & Regulatory. Ross Munro is involved in advising upon all aspects of the establishment and restructuring of investment funds under British Virgin Islands law, with particular emphasis on funds set up as Segregated Portfolio Companies. Before joining Harneys in January 2005, Ross Munro practised in the corporate finance department at Hammonds in Manchester, England.

and Managers input.

It can be seen, therefore, that the Hedge Fund Community is endeavouring to demonstrate that it is well regulated, albeit, to a certain extent, self regulated. Nevertheless, it is likely that more regulation will appear, particularly as a result of the Sub-Prime and Credit Crunch crises and that Hedge Funds will have to live with it.

O'Connor: I think that hedge funds are learning to communicate more effectively with the media – It seems to me like the lack of information on hedge funds is partly causing inaccurate media speculation about them, for example, at the start of the subprime crisis, hedge funds were being demonised, whereas the problem, lay with

regulated lenders, structured product providers, rating agencies, etc.

Munro: Given the success of the industry over the last few years it is no great surprise that it is coming under greater scrutiny from regulators, the tax man as well as the general public. Almost daily it seems, newspapers and news websites post stories of hedge funds being held responsible for the latest crisis in the financial sector. In part, this is a reflection of just how wide spread the influence of hedge funds is. The industry is certainly maturing as well as growing. Investors are becoming more sophisticated and have larger amounts invested in hedge funds – as a result, they demand and are getting higher

levels of corporate governance.

Despite the troubles, global asset growth in the hedge fund industry was estimated to be more than 50% over 2007, is this likely to continue this year and what will be driving this growth? What impact has the volatility had on the market?

O'Connor: Anecdotally the volatility has caused some hedge fund strategies to significantly reduce their exposure to the market to keep within their mandates. Obviously hedge funds have shipped heavy losses and some investors are loathe to put new money into what they perceive as risk strategies. The in-flows to hedge funds, particularly funds of hedge funds from the final quarter of 2007 look very respectable so hopefully growth will continue this year.

Munro: Most commentators believe that the increased flow from institutions into hedge funds will continue as they look to further increase exposure to the sector. Against that, one might expect funds from high net worth individuals to tighten particularly if concerns about the US economy prove to be accurate. The volatility in the markets, however, is an opportunity for top managers to demonstrate that they are worth the fees they charge. Clearly, some investment strategies, such as those investing in distressed debt or residential property, are likely to find it harder than others to attract new money.

Butler: The growth of Hedge Funds in 2007 was a result of organic growth as well as the increased institutionalisation of the Hedge Fund Market. In volatile times such as we have seen over the past six months or so, institutions are keen, not just to achieve respectable returns, but to preserve capital and many Hedge Fund

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strategies achieve both of these objectives. I, therefore, think it is likely that we will see continued growth throughout 2008 and that growth will be primarily reflect the continued interest from institutions who remain nervous of the equity markets. It is also likely that investors who might previously have invested in fixed income, credit and loan portfolios, will now look towards other strategies which provide hedged opportunities in the current markets, such as the Long-Short Equity Fund, which is where the whole hedge market started.

That is one of the impacts that volatility may have on the market. The other is that Hedge Funds which provide a truly hedged portfolio, i.e. some kind of arbitrage or long-short strategy, thrive on volatility. One final point with regard to growth – I was interested to read a report by Camden Media and Merrill Lynch that found that European Family Offices are planning to shift investments from traditional into alternatives, such as Hedge Funds and Commodities and that, in three years, these could make up more than 50% of a typical Family Office Portfolio in Europe.

Regulation of hedge funds has also been much discussed by regulators such as the SEC and the UK FSA – is there a need for greater

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regulation of the sector and what impact would this have?

Munro: There is little justification for materially greater regulation of hedge funds. Some additional regulation is inevitable but for so long as hedge funds source the bulk of their funding from institutions, high net worth individuals and other sophisticated investors increased regulation will provide few, if any, tangible benefits.

Butler: Hedge Funds continue to be affected by “blanket” regulations, such as the EU Savings Directive and MIFID and it is likely that this will continue. I should make it clear that I have nothing against regulation, per se, but I do

resent bad regulation, of which there are many examples, not the least the ultimate failure of the SEC to impose its requirement that Hedge Fund Managers in the United States should be registered. Personally, I don't see much need for greater regulation in the Hedge Fund Markets, providing the Hedge Fund Managers and other participants in the Market follow the Sound or Best Practices, as outlined by AIMA and HFWG.

I must also say that, although I am against “blanket” regulations, as opposed to targeted regulation, which is when a regulation targeted

at one particular sector, has, under the Law of Unintended Consequences, a dramatic effect on another sector. I do believe that, internationally, regulations with regard to retailisation of hedge funds is an area of concern. In this regard, I believe that regulations specifically targeted at the sales process – the marketing of hedge funds (or any other financial product for that matter) to the retail clients needs to be tightened up considerably and a perfect example of this is the Sub-Prime Mortgage Market, where all our current troubles started. If the Sub-Prime mortgages had been sold to people who could support them, then I think it is unlikely that we would have the current problems that we have with the Credit Crunch and monoline insurers, both of which appear to be derivatives of the Sub-Prime fiasco.

O'Connor: I think that regulation of hedge funds really means regulation of the operators of hedge funds and the managers and administrators and custodians of hedge funds, at least in Europe, are fully regulated, and increasingly so in the U.S. There seems now to be an acknowledgement in Europe and in the US that significant changes to the existing laws and regulations to target hedge funds specifically is unworkable (either for reasons identified in the US through Goldstein judgement or in Europe through a lack of support from the European Commission, the UK etc). The approach that now has appeared to gained traction on both sides of the Atlantic is that of a voluntary code of conduct for the managers of hedge funds and continued indirect supervision of the way in which financial institutions leverage hedge funds. The one area which still appears to be unsettled in some quarters is the political pressure for increased levels of disclosure of hedge funds engaged in shareholder activism in continental Europe.

What impact are strategies such as hedge fund replication, indexation and investment in 130/30 funds having on the hedge fund market?

O'Connor: We are seeing a lot of interest from promoters in these strategies, but the volume of funds actually setting up and trading this strategy do not seem to be making a significant dent on traditional hedge fund in-flows. Many traditional hedge fund managers who we speak to hold the

view that the 130/30 strategy will turn out in performance terms not to be as adept at generating alpha as traditional hedge fund strategies. 130/30 strategies orientated in the US and were partly driven by specific tax efficiencies which they offered under US federal tax rules and the same considerations do not apply in Europe so it remains to be seen whether they will really thrive in Europe..

If these strategies proliferate in the retail investor market as alternatives to traditional hedge fund investment, this would seem likely to result in a reduction in investment opportunities for traditional hedge funds, pressure to reduce fees, reduction in the investment management talent available to traditional hedge funds.

Butler: I am not sure that any of these strategies are having a huge effect on the market, although, obviously, there is some demand, otherwise they wouldn't still be about. I am not familiar with Hedge Fund Replication, although I have heard a number of presentations on the subject. Indexation is another matter and still remains problematic, because of the very nature of Hedge Funds and the fact that so many Hedge Funds close, either totally withdraw from the market, or just close to new investors, with the result that they no longer remain valid components of the index. Thus, in my opinion, notwithstanding the fact that there are several tradable Hedge Fund Indices, I still think that it is dangerous to rely on them as a true indication of the Hedge Fund Market's performance.

As regards 130/30 funds, which, as far as I can see, include 120/20 and 140/40 funds, appear to me to be variations on the Long-Short theme, which are, as far as I can see it, unnecessarily restrictive in the context of the ratios 130/30. It seems to me that it is an unnecessary and dangerous restriction to prohibit a Manager from changing the ratio from 130/30 to, say, 100/90, if the Manager believes that is the best way to attack the market, but maybe I am missing the point.

Be that as it may, Hedge Funds Markets and the numerous different strategies that are currently employed are thriving and will continue to thrive, despite Hedge Fund Replication, Indexation or 130/30 funds.

Munro: It is in part a sign of the growing maturity of the market. Exactly what impact it is having right now is difficult to gauge but in time replication and indexation is likely to make life more difficult for those managers who have not consistently generated alpha returns. The lower fees offered by replicated and synthetic funds are attracting a following and are likely to

continue to do so for so long as they deliver impressive performance at the cost of the less successful managers. On the other hand, those managers who have successful track records will be concerned about being replicated or forming part of an index and the impact that has on

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comparable performance. A further factor is that the scope for conflict of interests within service providers grows with the introduction of such products.

How has increased M&A activity and IPOs in the hedge fund market affected the community? What impact does this have for clients, counterparties, competitors and the fund services market?

O'Connor: I think the resources and infrastructure that institutional buyers of hedge fund service providers bring should be positive for the market. It may be that hedge fund manage IPOs will disincentivise the traders and the traditional alignment of their interests with those of the investors might not be as strong.

Butler: Depending upon which area of the Hedge Fund Market you are talking about, it seems to me that the big get bigger and the small carry on. It all seems an inevitable consequence of the Hedge Fund Market maturing and those who have been in it for the longest seeking an exit, on the one hand. On the other hand, there is no doubt that some Hedge Funds and Managers that have set up Publicly Traded Vehicles have an agenda to create an Investment Bank in the relatively near future.

If we are talking about Managers being listed, then this should not have a major difference for their clients (investors) or the counterparties (Prime Brokers) except that, as a Manager gets bigger, whether listed or not, so that Manager will be able to negotiate better terms from their Prime Brokers. I am not sure that there is any great effect on competitors, because the Market is getting bigger and there is enough cake for everybody.

If it is the fund that is being listed, then clients/investors will have the opportunity of greater liquidity, although the prices for the shares of their funds may not correspond with the NAV and could run at a premium or discount

to NAV. I am not sure that counterparties or competitors would be greatly effected.

In the context of M&A activity, I can see this having a greater effect on Hedge Fund Administrators, as demonstrated by the "consolidation" or "acquisition" trail over the

past several years. This has affected the clients (the Hedge Funds and Hedge Fund Managers) in instances where the Hedge Fund Administrator has been consumed by a larger traditional Fund Administrator and where the "Big Bank" culture relating to minimum client size has prevailed. We have seen several funds moving from some of the big banks, because they were deemed too small. I think it is fair to say that the majority of the big Hedge Fund Administrators around Dublin and the world will now not look at funds of less than USD200million or will price themselves out of the market, by introducing high minimums, notwithstanding the fact that something like 70% of all hedge funds in the world have a total Net Asset Value of less than US\$200million. As a result, smaller competitors of the big administrators are thriving.

The hedge fund services market has become increasingly competitive – how are players in the market adapting to the needs of the hedge funds?

Munro: As fund managers grow, they will inevitably become more demanding. This is an opportunity as well as a threat. As ever, getting the basics right will be key for any service provider but as the demands on compliance officers and in-house counsel grow there will be opportunities for those that services providers who understand the industry.

O'Connor: I think there is more focus on service levels now. Increasingly the larger hedge fund managers are taking a more institutional approach to service provider appointments and looking for tighter, and legally binding, service levels. And with increased competition, there is some downward pressure on prices. Promoter loyalty to a particular service provider seems to be a thing of the past with more promoters willing to move from one service provider to another.

Butler: There is no doubt that the Prime Brokerage Market has become increasingly competitive, although I am not really qualified to discuss it in any depth. What will be interesting is to see what effect the Subprime/Credit Crunch debacle will have on some of the Prime Brokers, which are divisions of major banking institutions who have suffered substantial losses in this area. As already stated, there is a risk that, a reduction in liquidity and lending power in the Prime Broker market could adversely affect the ability of Hedge Funds to go short and that could have a knock-on effect, as discussed above.

With regard to the increasingly competitive nature of the Hedge Fund Administration

applies here.

Is there likely to be further consolidation in the hedge fund services market and will it be the larger players that win out?

Butler: By further consolidation in the hedge fund services market, I presume you mean fund administration. It is, I think, a case of swings and roundabouts. As I have already said, the larger players restrict themselves to larger accounts and there are thousands of smaller accounts. Therefore, the smaller players will still be able to make a very healthy living, subject only to the possibility that too many people will try to get into that market and there will be some

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Service, this is true, but in a rather stratified manner. The consolidation at the larger end of the market is introducing competition, but the market is certainly big enough for all parties at the moment and there doesn't appear to be any sign that the large traditional administrators are suffering in the hedge fund area.

At the smaller – under USD200million – end of the market has become increasingly competitive because several new smaller hedge fund administration companies have been set up in order to capture part of the very large group of small hedge funds.

As to hedge fund administrators adapting to the needs of hedge funds – this has always been the case, whether it be with regard to providing systems to enable compliance with new regulations (EU Savings Directive), or facilitating risk monitoring and specialist pricing services. Other areas in which hedge fund administrators are meeting the needs of hedge funds is, in our case, the provision of an automated German Tax Reporting module, which we hope to have in place very soon.

One of the things that clients have got to appreciate is that, regardless of the competitive nature of the market, margins are finite and costs aren't. Therefore, as clients seek more and more, so they will have to be prepared to pay more. It was, I think, Nicola Horlick, who recently berated the value of outsourced services generally, but explained the poor quality that she, and many of the mutual fund industry, suffered because the clients' weren't prepared to pay. The old joke about peanuts and monkeys

natural culling, over time. What the larger players should also be aware of is the reluctance of some larger managers to go with the larger administrators, for a variety of reasons, including the belief by many that Chinese Walls are made of Gruyere cheese and the fact that a small to medium sized firm is likely to provide a better and more personal service than the larger firms. We have clients who have indicated that they would not join us or would leave us if we were to sell out to one of the major banks and I don't think it was an idle threat.

Munro: I expect there to be some consolidation but not perhaps at the same rate of recent years. The credit crunch is likely to impact on the willingness of the banks to make acquisitions at least in the short term. In addition, the industry is still receptive to new entrants who can offer good service at reasonable prices. The barriers to entry are not huge in an industry that still counts on recommendations and personal relationships. The reality or perception of conflicts of interest when a single organisation provides multiple services will also act as a brake on consolidation.

O'Connor: Perhaps with the cost of money and the turbulence in the financial sector at the moment, the first half of this year might see reduced activity in this area, but we feel that there is still appetite there and that increased competition will inevitably lead to further consolidation over the medium term.

What are likely to be the main challenges and opportunities for the hedge fund market over the next year?

Butler: The main challenges for the hedge fund market is going to be the survival in a low liquidity environment and this will depend upon how soon the market recovers from the Sub-Prime/Credit Crunch problems. Against this, there is still a huge pool of cash, around and ironically some lending requirements are now being met by hedge funds that have become the lender of last resort, as the banks have pulled in their horns.

So this, in itself, becomes one of the opportunities for certain hedge funds. Other opportunities include the development of totally new markets. We have seen in the last few years the development of Carbon related funds, Green funds, Africa funds and the growth in commodity funds. The Emerging Markets will always be emerging, whether it is China and India or Vietnam and Uganda. Obviously, China and India are the greater opportunities, purely on a volume related basis.

Perhaps the main challenge for hedge funds is to ensure that their strategies maintain capital and that they can take advantage of any volatile situations to generate real returns, whilst the rest of the market is either in decline or, probably by mid-year, just out of favour.

O'Connor: I would image that performance will be the main challenge this year, as it is every year, due to the difficult few months funds have experienced. On the legal side, the work that the EU Commission is undertaking on the removal of obstacles within Europe to the private placement of non-UCITS funds will hopefully result in some positive opportunities for hedge fund distribution.

Munro: There can be little doubt that the volatility and, in some cases, lack of liquidity in the markets will help investors to distinguish those managers who are capable of generating alpha returns and those that who have merely successfully ridden the bull market of recent years. For those with a track record of generating alpha returns, there is an enormous opportunity to attract new money. For those who can not, life is likely to get harder. A number of funds are facing liquidity issues and will be reviewing the fine print of their offering for suspension of redemption rights, gates, side pockets and other mechanisms for controlling the outflow of funds. ■