Hedge Fund Services
Market Guide

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2009

Change ahead

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Looking forward

Disaster has stalked the financial markets this year, but on the whole the hedge fund sector has survived and evolved

Over the past 10 years, funds have become the centre of the investment world. Some even say that Hermes, the god of commerce, was named after a well known independent fund manger. However the gods have not smiled upon the hedge fund industry in 2008. According to early estimates from hedge fund industry consulting firm Hennessee Group, the average fund lost 18.0% last year. After Bernie Madoff put the biggest bang in the 2009 fireworks, many of his investors may be quick to point out that not only is Hermes is the god of commerce, but also the god of thieves and liars.

However outrage and name-calling achieves nothing, and we hope to use this guide to prove that there is enough silver lining out of this current situation to prove that 2009 will be a year to remember, rather than forget. The first step is to analyse 2008. On page 27, Dermot Bulter highlights the mistreatment of hedge funds by the press thought last year, most notably the early attempt by the media to pin the credit crisis on the hedge fund door. Looking forward pragmatically, on page 24 we examine how hedge funds' operations matter most in a bear market, and what can be done to avoid failure.

You can find our silver lining spirit as early as the following page, where John Donohoe, CEO, Carne Global talks about the growth and change of the industry at a time where everyone is focusing on redemptions. This is not to say that we are sticking our heads in the sand and ignoring the systemic problems in the hedge fund industry, but we see change as a positive factor. On page 38, Mark Mannion of PNC Global Global Investment Servicing talks about surviving during this period, and Alan Flanagan, BNY Mellon continues this positive theme of change by discussing the positive aspects of 'convergence', particular between the hedge fund and private equity arena. Peter John of Fidessa LatentZero perhaps sums up our ideology for 2009 most succinctly by stating that: "There is every reason to be optimistic about the future".

Looking forward it is important to remember that Hermes is also the god of invention, and we are undoubtedly looking forward to how an innovative industry will solve the problems of 2009.

Giles S. Turner

Growth & Change

John Donohoe, CEO, Carne Global Financial Services

Fund service providers are living in interesting times, a period of both consolidation and transformation. Larger fund managers are turning to them to distribute their product globally, and these firms expect their custodians and administrators to move with them across the multiple locations in which they operate.

Asset managers have also broadened their product set to an unprecedented extent via acquisition and a process of diversification, and are expecting their service providers to keep pace with them. The development of new structures, like UCITS III funds, is leading to a cross-migration between the retail and institutional funds space, as well as between traditional and hedge fund strategies, which can throw up new challenges for service providers.

At Carne we have been seeing an unprecedented build-out in the capabilities of the leading fund service providers in the last year as they move to meet these demands. There are now only a limited number of service providers that can call themselves a one stop shop, and which can compete at the required levels of price and scale in this market. But at the top end of the industry, consolidation has seen the creation of a handful of large, globally-oriented players with the budget to provide the sophisticated services big money managers are asking for. At the same time, the smaller provider which can cater to start-ups, smaller managers or niche products, still has a role to play.

The growth of the asset management industry also translates into an increasing level of international awareness for service providers, manifesting itself in the use of cheaper markets for labour-intensive back office activities, and the recognition that money managers outside developed markets also now require their services to be delivered locally. The need for a global footprint means administrators often have to work round the clock, seven days a week if necessary, and they are finding it has become a requirement for a larger proportion of the industry.

In the current market turmoil, we at Carne have seen increased emphasis on the safety of assets. The future is a complex one, but we see many in the fund administration, custody and prime brokerage space rising to the challenge.

Investment management firms will need to address other issues as well in order to ensure their competitive advantage, including governance, compliance, and outsourcing challenges. We expect that the accurate and timely pricing of assets will also continue to be high on the agenda for those funds we advise, and for their investing clients. We have seen more of our clients becoming interested in the recommendations of the Hedge Fund Working Group, and expect more of them to sign up in the future.

Administrators will now, more than ever, be asked to play a key role in ensuring portfolios are accurately valued, and that NAVs are delivered on a timely and regular basis. This is becoming increasingly difficult in an environment where investors are more ready to resort to redemptions and legal action.

There continues to be speculation about whether the current financial circumstances will prompt further consolidation within the industry. Certainly, we may see more hedge funds and prime brokers being acquired by larger banks, or mergers between existing asset managers. But for the service providers themselves a different world will emerge in the next three to six months.

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Interesting times

Ian Headon, product manager, alternative asset administration, Northern Trust

Hedge funds have never been more topical. If memory serves, we have made this statement almost every year in the last decade or thereabouts.
However, over the last 12 months, we have seen drives to self regulation in Europe and the US, increased scrutiny of the sector from regulators, accusations of hedge funds "talking down" of quoted companies, a heightened level of activism and a widening of the grey area between the classically agreed notions of what is and what is not considered to be a hedge fund.

All of this has occurred in a financial environment described by Alan Greenspan as "..probably a once in a century event". The global credit crisis has changed hedge funds behaviour as many managers have actively sought to reduce exposure to the traditional prime brokers and others have struggled with the tightening of credit availability.

Clearly, it remains to be seen how the hedge fund industry will cope with the difficult market conditions together with the infrastructural changes to the market in areas like regulation. However, we expect to see a drive to quality in all aspects of the industry and continued cultural changes around

Risk management, governance and transparency.

Firstly, there is no agreed definition of a "hedge fund"; they take many forms and legal personalities, have multiple investment strategies and investor bases and are exposed to varying degrees of tax and regulatory supervision.

Notwithstanding this, the hedge fund industry has taken a lead, in the U.S. via the Presidents Working Group ("PWG") and, in Europe, via the Hedge Fund Standards
Board ("HFSB").

The PWG issued two reports in April 2008: Best Practices for Asset Managers and Best Practices for Investors. The former calls on hedge funds to adopt comprehensive best practices in all aspects of their business, including, critically, disclosure, valuation of assets, risk management, business operations, compliance and conflicts of interest. The latter includes a Fiduciary's Guide and an Investor's Guide.

The HFSB produced a single report covering, essentially, the same themes and topics. We are beginning to see hedge fund clients modify procedures and governance structures to be consistent with the themes in these papers and significantly, we are beginning to see the investor community demand that compliance.

A key element of these papers is security pricing. Both bodies, together with the AIMA Guide to Sound Practice for Hedge Fund Valuation, have greatly clarified the respective roles and responsibilities of the various parties involved in a hedge fund – it is now incumbent on those parties to implement specific processes and communications to give effect to these shared principles.

This development is to be welcomed.

We see a drive to quality in these uncertain economic conditions. We see investors demanding greater transparency, greater reporting of counterparty exposures, increased demands for clarity in the valuation process, more frequent reporting and a noticeable stepping-up in governance and control models.

Interestingly, we still encounter hedge funds in the US which self administer – in Europe this is almost unheard of – though we are seeing an increase in the trend to outsource, often driven by investor demand.

While many hedge funds have struggled with performance and asset gathering and retention, we expect the hedge fund industry to continue to grow. It has shown its resilience before and we expect that it will continue to do so. Some hedge funds will fail – others will prosper.

One thing is certain – it will be a space well worth watching.

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Counterparty risk in the hedge fund industry

Fortis' regional director for sales and relationship management, Charlie Woolnough, explores counterparty risk

Looking across the current alternative asset management landscape it is apparent that fund managers now have additional risks to consider other than those which lie in their portfolio. In the current financial environment counterparty risk has become the new hot topic. Obviously the recent plight of some longstanding prime brokers has dramatically increased scrutiny on this specific area of the industry. However, other service providers in the supply chain are now also coming under closer scrutiny from managers and investors alike.

It has almost become implicit that any fund manager wishing to attract institutional quality investors needs to have recognisable and respected service providers named on their offering documents if they are serious about raising assets in any meaningful way.

This is especially true of fund administrators where the relationships are often one of mutual dependency and cannot be changed or revoked very quickly. Indeed, it is quite common for contractual agreements between fund administrators and their clients to contain a three month notice clause.

As such, it is apparent that the relationship between administrator and manager is somewhat more embedded than that which exists, for example, between a manager and his prime broker for example. It is, therefore, becoming increasingly important for larger managers to be comfortable that their fund administrator has the capacity and resources to keep apace with their own growth and future plans. Indeed, we have witnessed many examples whereby very large alternative asset managers have become concerned about the capitalisation and corporate structure of their administrator as they increase their own assets under management and 'out grow' a counterparty they once considered to be perfectly adequate. Leaving aside the quality of the service they are receiving, a large part of this is no doubt borne out of a fear of having to explain to their investors why they chose a smaller, less secure and perhaps less obvious option should disaster strike.

Increasingly aware of this concern, many fund administrators have merged to create critical mass or now find themselves part of a larger financial organisation. This has had the affect of decreasing the level of counterparty risk that fund managers now have with their fund administrator.

As with fund administrators, those managers who are serious about raising assets will typically employ the services of one of the 'Big Four' accounting firms to act as their audit partner. This enables the investor due diligence process, as it relates to counterparties, to become something of a box ticking exercise as the majority of investors are able to gain comfort from such brand name counterparties. Perhaps less onerous than changing administrator, there may nevertheless be a hurdle to changing auditors in that an incoming firm would typically require an audit to be completed by the incumbent before they accepted the mandate. As such, this may delay matters if the manager does not wish, or is unwilling, to pay for an interim audit and chooses instead to wait until the fund's year end. Obviously if the change is being dictated due to the fact a service provider is in a distressed situation, then the rules of the game may be reasonably expected to differ somewhat.

Whilst the failure of administrators and auditors in an operating sense is relatively rare, given recent market events the same can not now be said for prime brokers. As such, it is no coincidence that this area of the industry is now attracting most attention from the Chief Operating Officers of hedge funds.

The dynamics of the primer broker relationship are very different from those which a hedge fund manager will have with his administrator and auditor partner in that the latter do not typically provide any form of financing or safe keeping of assets. As such, the day to day financial health of a manager's prime broker is of the utmost importance at all times.

The role of the prime broker has changed over recent years insomuch as very few funds now have only one prime broker. Whilst this trend was perhaps initially driven by a desire on behalf of managers to create greater competition between their counterparties and thus improve services and reduce costs, there is no doubt that recently the trend has been expedited by the need to diversify counterparty risk.

With this need to diversify prime broker concentration has also come closer scrutiny on the role and practices of prime brokers in general. Hedge fund managers are now paying increasing attention to the ultimate custodian of their assets, which is not necessarily the prime broker, and the degree to which their assets are segregated and/or rehypothecated. Standard prime brokerage agreements would generally allow the broker to appropriate their clients' assets for their own benefit instead of requiring clients to post cash collateral in order to access such services as securities lending, leverage and FX. Whilst this would appear to be a sensible compromise, it is the extent to which assets are being rehypotecated which is now of major concern. Carte blanche rights to rehypothecate assets when a fund is not currently employing leverage or taking substantial short positions may now be seen as unjustifiable.

That said, by limiting a prime broker's ability to rehypothecate assets, you are in essence limiting their ability to generate revenue. Therefore, it is safe to assume that margins would increase elsewhere to compensate.

This whole discussion has also served to heighten the scrutiny on the ultimate custodian of a fund's assets. In a clear trend of a flight to stability, many managers have been moving securities and cash balances to those large banking groups which they deem to be more robust in the current climate than broker dealers who are required to finance themselves in the cash markets to varying degrees. As such, one can envisage a growing trend whereby fund managers have counterparties for execution purposes and counter parties for the safe keeping assets where the latter does not provide any form of financing and, therefore, any form of credit risk.

Minimising Counterparty Risk

So, what steps can a hedge fund manager take to minimise his counterparty risk?

With regard to fund administration, a manager should choose a provider who has experience of the strategy they are running, who has the necessary brand and pedigree to satisfy their target investor base and who has the capital structure and resources to ensure that they can continue to meet their requirements as they grow. Some managers also choose to add an additional fund admisntrator as they grow. However, the merits of this option are not always quite so clear cut as it can lead to the requirement for more operational staff within the fund manager's business to monitor the relationships. Additionally by using two providers a manager may not enjoy the same level of service that perhaps they did previously by being part of an exclusive partnership. As such, it is really for the manager to decide if they happy with the service level and stability of their current counterparty before they decide to add a second provider. If the answer is yes then it may not be necessary.

With regard to primer brokers, the situation is somewhat different and the merits of having two prime brokers are now abundantly clear. However, simply adding more and more prime brokers in an effort to diversify risk even further where the fund size or strategy does not justify it may actually do more harm than good. This is to say that if the relationships are not mutually beneficial a manager may find that they are no longer a highly valued client and, in turn, access to their broker's balance sheet and hard-to-find shorts for example can suddenly dry up. The natural outcome would be that performance of the fund suffers as a result.

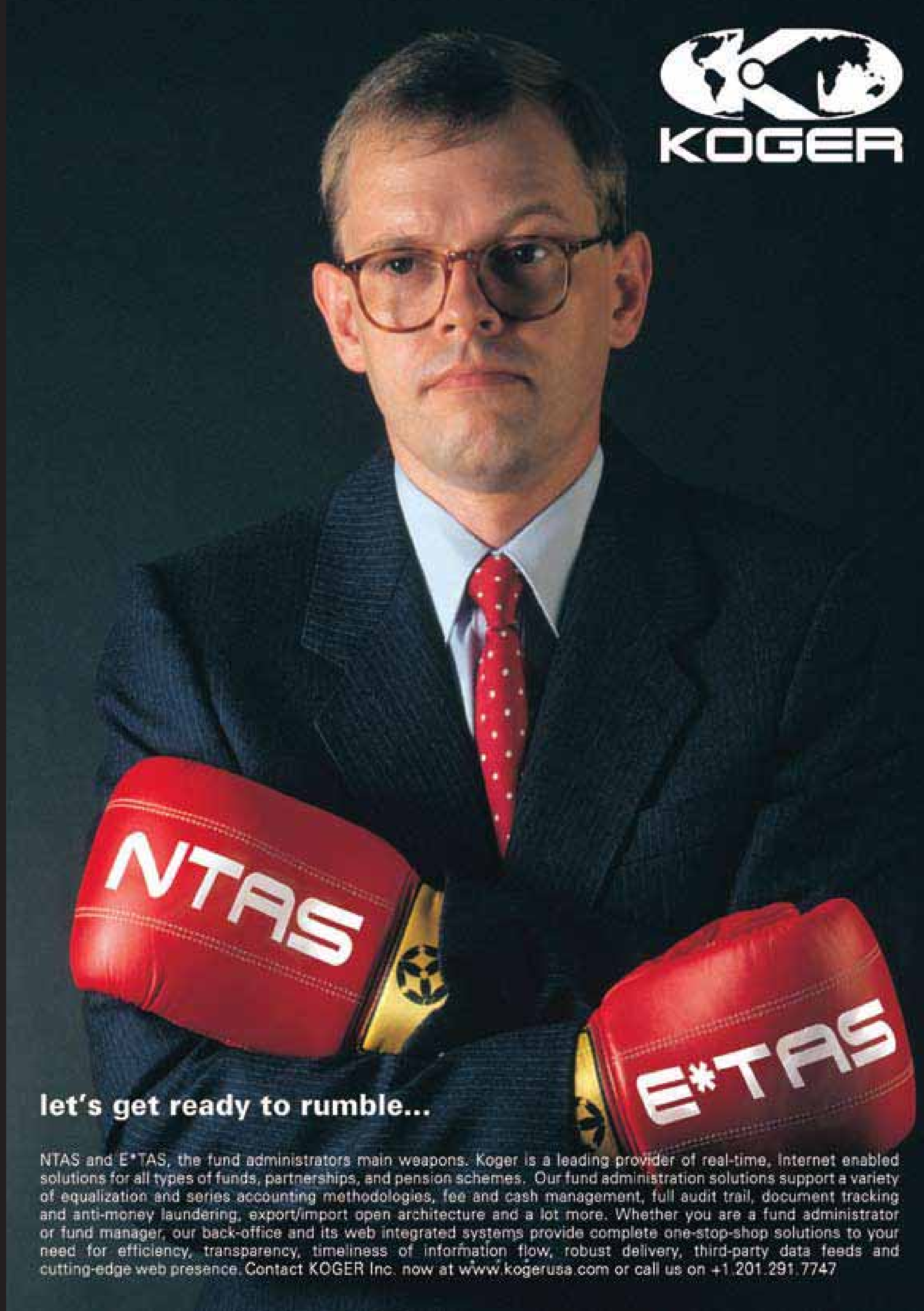
In addition to this, where a fund manager finds themselves under a period of stress it may be more beneficial for them to have deeper relationships with fewer prime brokers who truly understand their trading strategy and are more prepared to stand behind them until the situation improves rather than cutting trading lines at the first sign of trouble.

By using two providers a manager may not enjoy the same level of service that perhaps they did previously

Conclusion

Simply adding more and more service providers is not necessarily the best method of reducing counterparty risk. Ultimately fund managers need to undertake intelligent due diligence on all counterparties to their business in which they place any form of reliance that can not easily be retracted or transferred elsewhere at short notice. Indeed, it is no longer enough for the due diligence exercise to be a static process. The due diligence process needs to be continuous and can no longer be confined solely to quantitative metrics regarding a service provider's financial health, if indeed such financial information is readily available. As has been demonstrated recently, seemingly stable financial institutions can disappear over night. Therefore, greater emphasis ought to be placed on that qualitative market intelligence which is also available as this could often be the first warning sign of potential trouble.

From an investor perspective, investors should be more willing to question a manager on their choice of counterparty and to ask what procedures are in place to ensure sufficient monitoring of these critical relationships takes place on an ongoing basis.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Using OTC instruments - are you exposed?

Peter John, derivatives product manager, Fidessa LatentZero

Using OTC instruments - are you exposed?

Among the seemingly endless supply of depressing results in the last twelve months, and the atmosphere of general gloom, a few glimmers of light still shine. Where the crisis in the global banking system has cut total shareholder value by at least USD100 billion, hedge funds are largely emerging from the rubble in robust shape. For example, Brevan Howard have grown their assets 73% from June 2007, to USD26.3 billion, and the top 10 hedge fund managers have grown their assets under management by almost a fifth in that 12 month timeframe, according to analysis by Financial News.

Transparency and technology

The numbers reflect the growing status attributed to hedge funds within the investment food chain. But that recently acquired status has ushered in major changes to the landscape. Investors and strategies are altering - and both the hedge funds themselves and the environment in which they operate are under levels of scrutiny from both investors and regulators.

A new mood can be discerned within the hedge fund market – one that is preparing for greater transparency and control. There is an understanding that institutionalisation in one form or another is taking place, and accompanying all this is a substantial shift in attitudes to technology.

Of course, hedge funds have always had an interesting and diverse relationship with IT. For example, in its earliest incarnations, DMA was particularly associated with a group of funds conducting statistical arbitrage before wide adoption by more institutional funds.

At the other end of the scale there are plenty of hedge funds that have almost no IT infrastructure at all. On occasion it can be hard to spot the traders in the mountain of paperwork that surrounds them.

Enter the vendor

But there is a growing trend between these two extremes to look at vendor solutions, such as those supplied by Fidessa LatentZero. Hedge funds are no longer flying underneath the radar when undertaking activist strategies, which means they need to have the right technology in place in order to meet both regulator and investor requirements, and to succeed in today's increasingly complex trading world.

One of the key factors for hedge funds is that the provision of the more sophisticated systems is no longer the sole preserve of sell-side suppliers. And, for an industry sector for whom secrecy is essential and a fundamental operating principle, the idea of exposing trading activities through a tied execution system from one broker has, understandably, been an anathema.

THE HOLY GRAIL OF POWERFUL, REAL-TIME P&L AND PRICING ANALYSIS, VALIDATION, AND REPORTING HAS REMAINED ELUSIVE

No wonder that, where broker solutions have been used, there are usually up to four or five in place. This in its own way has been a barrier to STP and the full automation that many hedge funds have been looking for. But buy-side sourced front office systems like Capstone that offer broker neutrality combined with sell-side levels of technology and sophistication have started to overcome this particular hurdle.

The other issues that vendors have overcome are those associated with cost and implementation. Robust 'out-of-the-box' solutions that require little, if any, customisation and have a standardised set up have reduced the time and costs involved in deployment, keeping overheads low and time-to-use short.

But the really interesting developments have taken place in functionality, especially with the asset classes and strategies that can now be handled by these sophisticated, broker-neutral systems. In fact, there has been a large scale swap taking place within the financial services world. As institutional investors have adopted more diverse asset classes and the occasional high risk/ high reward strategies more commonly associated with hedge funds, so too are hedge funds increasingly using the trading technology from their more traditional counterparts. This exchange of respective intelligence has considerably enhanced the capabilities of technology on offer. As institutional investors take on board more sophisticated strategies and instruments borrowed from hedge funds, then the software that can support them has become more sophisticated, flexible and scalable – and more interesting to hedge funds in return. Derivatives have gone mainstream, and technology is now available from Fidessa LatentZero to trade OTC instruments effectively.

Hurdles and hedging

However, the holy grail of powerful, real-time P&L and pricing analysis, validation and reporting has remained elusive, and with it the realisation of an end-to-end investment management workflow.

The primary hurdle has been the difficulties associated with measuring exposure to underlying instruments. However, having developed the ability to calculate both primary and underlying exposure of derivatives within a fully cross-asset system, Fidessa LatentZero's technology opens up a new range of opportunities in terms of modelling and portfolio management. With integrated data and analytics incorporated into the system, a more interactive approach to hedging has become possible.

Until now the standard method of changing exposure to a given market for anyone on the buy-side was to buy or sell bonds or securities to change the duration. Portfolio management tools generated models, and anything that was misaligned against targets was highlighted. Portfolio managers were able to balance the portfolio against any variants, usually by buying or selling more securities.

Interactive hedging

But the ability to calculate an accurate and comprehensive exposure number changes all that. The portfolio manager can now change duration through an interest rate swap, with the certainty that he is getting the exposure to markets that he wants from the choices that are available. It is no longer necessary to hold the underlying asset, and incur the management and cost issues that come with it, since a swap can be created and the system populated with all the resultant data with three simple clicks. As an example, say a fund manager wants to change the duration on exposure numbers. He holds bonds plus interest rate swaps for managing duration, credit default swaps for managing the credit risk of the portfolio, and inflation swaps to hedge inflation. One option open to him is to arrange an interest rate swap.

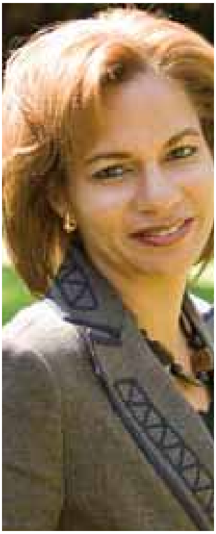
However, with interactive hedging capabilities, he can highlight a number of bonds that need duration management, and then use the system to propose the most appropriate swap. The duration numbers can then be massaged and, with one swap, can be changed for a portfolio of 20 bonds in a move that would previously have required buying and selling several bonds with different lengths of maturity. The same technique can be applied equally successfully to inflation and credit management, or even to LDIs (liability-driven investing) that need very long term duration.

Interactive speculation

And with interactive hedging comes interactive speculation: the ability to look at the impact of using derivatives on a cross asset class portfolio and act accordingly. It is possible to model any number of strategies, including butterflies, caps and collars, barriers and 130/30s, build positions that cover all possible scenarios, and then respond to immediate moves in the market by executing the preferred, pre-prepared strategy. What this means is that hedge fund managers with multi-asset portfolios will have the tools to test theories, to look at portfolios from a modelling point of view and implement strategies only when satisfied that they will work and deliver the expected results.

There is every reason to be optimistic about the future

There is every reason to be optimistic about the future. Hedge funds that have developed the technological infrastructure to support their operations will ride out, and could even profit from the current volatility in the markets by shorting.. There is also little question that hedge funds will benefit from the execution and order management capabilities initially developed for institutional asset managers. Interactive hedging and speculation will radically alter the way funds are able to respond to market moves, and are one example of how innovations on the buy-side are now matching if not outpacing sell-side systems. The trend for more vendor-supplied solutions is set to continue for some time yet.



Bermuda Thriving

Bermuda enjoys a booming investment business and a world-class (re)insurance market that is quickly closing on the leading position for insurance domiciles says Cheryl Packwood of the Bermuda International Business Association

A long-standing history of cooperation between government, regulators and industry in Bermuda has generated progressive legislation and regulation on the Island. As a result, Bermuda enjoys a thriving investment business and a world-class (re)insurance market that is quickly closing on the leading position for insurance domiciles says Cheryl Packwood of the Bermuda International Business Association.

Most of the Fortune 100 companies have a Bermuda captive insurance presence. Recently released figures show the capitalisation of Bermuda's reinsurance industry rose more than 20 percent to reach USD129 billion by the end of the third quarter of 2007. That staggering figure is greater than the 2006 gross domestic product of many countries, including Pakistan and New Zealand and oil-producing Nigeria, according to International Monetary Fund (IMF) figures.

And, in the investment industry, Bermuda also enjoys a world class reputation. At the end of 2007, after making the decision to leave London, leaders of Invesco quickly arrived at the conclusion that Bermuda was the best place to redomicile. With more than USD500 billion of assets under management, the company picked the Island because of its legal and regulatory environment and the similarities of those to the laws of the US state of Delaware. A company spokesman said that a number of the large companies already domiciled in Bermuda were recognised and respected by Invesco, which presented an additional reason in the Island's favour.

He went on: "The third factor was we wanted to make sure the transaction in moving our domicile was tax neutral for our shareholders. Moving to the US would not have been a tax neutral situation. When it came down to it, it was a very short list of places that we considered and Bermuda was at the top."

Packwood cites the ongoing cooperative support and consultation that thrives between government, the business community and regulators which ensures that appropriate yet flexible legislation and regulation remains a priority. The passing of the Investment Funds Act 2006 in December last year by Bermuda's House of Assembly was applauded by the business community in Bermuda.

The Bermuda International Business Association gave its full endorsement to the legislation, which outlines more clearly the regulation of public funds and refines the framework for non-public, institutional funds. Packwood states: "As I commented at the time the legisla-

Highlights of the Investment Funds Act

- public (retail) funds and institutional or non-public funds;
- refined powers to exclude funds from particular requirements, giving certainty as to the minimum requirements expected of fund operators;
- more clearly defined exclusions from fund regulation, so funds of a 'private nature' are not captured;
- the inclusion in the legislation of partnerships,
as well as mutual fund companies and unit trusts (under previous legislation partnerships were not covered);
- regulation and licensing of fund administrators;
- the introduction of a new class of funds, known as 'administered funds'. With the introduction of licensed administrators, it is now possible to register funds under this class with the level of regulation adapted on the grounds that the administrator is based in Bermuda and subject to codes of conduct and fund rules that will ensure the proper level of governance of the fund;
- clearer definition of the rules for the appointment of service providers and delega tion of powers;
- a new section enabling unit trustees to hold property in segregated accounts and defining how these accounts will be managed. This affords trustees the same ben efits as companies operating with segregated accounts;
- rules for prospectuses of funds that are clearly set down and distinguished from the general rules under the Companies Act of 1981;
- enhanced powers for the BMA to inspect funds and to require more information;
- more clearly defined requirements and powers for sharing of information with other regulators;
- the introduction of a right of appeal to a tribunal, similar to other financial institutions.

tion was enacted, this Act is yet another example of the positive results of collaborative consultation between Bermuda's private and public sector partnership. It is the policy in Bermuda for the Ministry of Finance and the Bermuda Monetary Authority (BMA) to collaborate on writing financial legislation.

"On this occasion, as is traditional in Bermuda, they also asked for the input of the financial industry in reviewing the Act and recommending pertinent changes or additions to it prior to presentation before the House of Assembly. It is this ongoing collaborative spirit between government, industry and the regulatory authorities that is one of the primary reasons for Bermuda's success in introducing legislation that is effective
and works."

Finance Minister Paula Cox, who piloted the Act through Parliament, said that it was necessary for Bermuda to streamline the incorporation process for investment funds and eliminate unnecessary administrative procedures to augment the jurisdiction's competitive edge by bringing more clarity and certainty to the authorisation process. She explains: "There will be less time required to set up a fund as the rules are more clearly stated. The Act is another example of Bermuda's continued efforts to ensure that we maintain the right balance as a reputable international financial centre."

Although the passing of the Act means that Bermuda's fund administrators will be licensed for the first time, Minister Cox has been quick to point out that it is not the case that there has been no regulation of service providers.

HEDGE FUNDS ARE LARGELY UNREGULATED, SO LISTING PROVIDES A LAYER OF COMFORT TO INVESTORS THAT THERE IS AN INDEPENDENT, REGULATORY BODY MONITORING THE FUNDS TO ENSURE PROPER CORPORATE GOVERNANCE AND COMPLIANCE

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Prior to the Act, fund administrators were regulated entities under the Proceeds of Crime Act 1977 and were subject to a higher level of due diligence when handling subscriptions and redemptions similar to those imposed on banks, trust companies and investment providers. While many funds register in other jurisdictions, Bermuda is one of the leading choices for companies to administer their funds, regardless of where they choose to domicile. Bermuda actually administers a substantial proportion of the funds which register in Cayman, for instance.

Combined with Bermuda's superior infrastructure, reputation and intellectual capital, the island is poised to effectively garner its share of the booming global fund business.

Another attractive feature for those choosing to register and list in Bermuda is a unique vehicle whereby funds can be simultaneously approved by the BMA and listed on the Bermuda Stock Exchange (BSX) in as short a time as two weeks.

In late 2005, a New Product Development Committee was established as a joint initiative between the private sector, engaged in funds and trust business, the BSX and the BMA in order to stimulate creative thinking and devise new products that would appeal to global investors.

The first product developed, 'Launch 'n List', leverages the fact that Bermuda has a fully electronic stock exchange with Designated Investment Exchange status, as well as a regulatory authority with a practical but effective approach to regulation that supports development of bespoke products for the investor. As of December 2007, the BSX was designated by the Board of the United Kingdom's HM Revenue and Customs as a "Recognised Stock Exchange".

The committee is chaired by Conyers Dill & Pearman partner, Julie McLean who explained: "Funds usually list for two main reasons. The first is that listing insures that the shares of the funds are considered liquid assets, which many institutional investors prefer since they are frequently prohibited, for various reasons, from investing in illiquid assets. Secondly, hedge funds are largely unregulated so listing provides a layer of comfort to investors that there is an independent, regulatory body monitoring the

The larger exchanges had approach to the extent that it impinged on fund managers' out their investment strategy

funds to ensure proper
corporate governance and compliance with stated investment strategies and restrictions."

The feedback the committee received was that the larger exchanges had increased their regulatory approach to the extent that it was inappropriate and impinged on fund managers' ability to effectively carry out their investment strategy. Julie McLean said that exchanges needed to have a balanced approach whereby investor protection is achieved while still allowing funds to carry out effectively their investment

As mentioned above, the co-operation between the Bermuda authorities and the BSX in the 'Launch 'n List' process means that funds can apply to incorporate and be classified under fund regulations at the same time that initial application is made to the BSX for listing.

Greg Wojciechowski, president and CEO of the Bermuda Stock Exchange and a member of the New Product Development Committee comments: "We continually see issuers coming from jurisdictions all over the world seeking to incorporate in Bermuda and list on the BSX.

increased their regulatory was inappropriate and ability to effectively carry

strategy. "This is what we feel the BSX offers," she added.

The 'Designated Investment Exchange' recognition given to the Bermuda Stock Exchange reflects that it is a properly managed exchange with sophisticated trading platforms and not just a mere listing board. In addition to the effective regulation of the BSX, the exchange has the ability to be nimble and flexible in its approach to listing funds. "An example is funds with side pocket investments," said Julie McLean. "The BSX has never had an issue with listing such shares."

The Launch 'n List product was a logical extension to offer our clients a one-stop solution."

Mr. Wojciechowski also pointed out that the new product will not only apply to the funds industry but will also be important for products such as private equity and
debt transactions.

The 'Launch 'n List' product is an example of the innovative yet quality business that Bermuda can provide to the discerning global investor and is the brainchild of a successful collaboration between the public and private sector.

Regulation in emerging markets

As emerging markets gain in popularity with investors, regulation remains one of the largest relevant factors

Although emerging markets are traditionally seen to be less regulated than developed markets, economic development will inevitably mean that regulatory environments change and develop as well. Fund managers operating in these markets must make sure their systems are flexible enough to adapt to regulators' demands or they run the risk of incurring additional costs and the wrath of regulators.

A recent presentation by Stijn Claessens, Professor of International Finance at the University of Amsterdam to Cass Business School highlighted a number of factors that drive financial sector development such as; macroeconomic and fiscal stability, the legal and judicial system, proper regulation and supervision, access to credible information and competitive and contestable markets. Within this he also demonstrated a direct correlation between stock market capitalisation and shareholder rights, and noted that a balanced approach to regulation – one that is not overly restrictive but still supports market discipline – is most beneficial. For regions looking to expand their financial services industry, this will require careful handling.

Drivers for investment

Emerging markets are increasingly appealing to fund managers and investors wishing to escape negative trends seen in more established markets. The lack of significant debt – corporate and consumer – and simplicity of products gives a welcome clarity for investors, allowing for more straightforward understanding of a company's position and potential. The strong reserves of natural resources - in BRICs countries particularly – along with a growth in consumer spending and investment in infrastructure are giving local corporations some fairly straight forward economic returns. Domestic consumption in emerging markets is in most cases still lower than that seen in developed regions allowing room for growth.

Inflation in some countries is causing concern, while others are seeing dramatic increases in wages as external investment drives up competition, for example in the Indian IT services industry. A recession in the US could also cause problems for countries relying upon them for commodities exports. For the moment there is money to be made, and a balanced approach, stretching across regions could hedge against economic shifts.

This has led to emerging markets - through growth potential and transparency - being perceived as lower risk investments by some, in comparison to developed markets. However a less rigorous regulatory framework in these areas can present its own risks where potential investments are not always required to be as transparent as investors would expect.

Some see moving into such a market as a short term affair. The funds launching only into emerging markets could be overlooked when the developed markets see a return to liquidity and so others are keeping their options open. It is notable that many funds, including sovereign wealth funds (SWFs) that are responsible for a large chunk of liquid capital in the emerging markets, are investing outside of their geographies.

Drivers for regulatory change

What is not in doubt is that the need for regulation is paramount for investors. Where there are no governmental rules, there is the potential for private contracts to be drawn up so that investors have improved protection. But the evidence is that regulators are attempting to resolve concerns in emerging markets through improved transparency – for example in China where the retail market for investors has grown exponentially in recent years, the government has made reforms to eliminate non-tradable shares to assist with corporate governance.

At the Annual Conference of International Organisation of Securities Commissions (IOSCO) in Paris this year, Martin Wheatley, CEO of Hong Kong's Securities & Futures Commission (SFC) issued a call for greater consistency in regulation globally, particularly as there is a growing trend of consolidation in the exchanges market which differences in "structures, currencies, languages, political frameworks and culture across the region" could inhibit.

Emerging markets are being perceived as lower risk investments by some, in comparison to developed markets

Preparation is key

The flexibility to operate in new markets, or across markets, will require funds to invest in understanding the markets they are moving into. That means acquiring local knowledge and the processes to use it, acquiring technologies – that are flexible enough to adapt to movement between regions or updates to the legal frameworks surrounding them.

For institutional investors of all sorts, reforms in these markets will require them to adopt systems that can move with the reforms, generate reports for regulators where required and ensure that a firm is aware of any limits or restrictions that might lead them to stray into non-compliant territory.

Aquin's MIG21 system is a hugely flexible investment compliance solution that utilises a high degree of automation to reduce the burden of work upon fund managers and their compliance officers. Its adaptable rules engine is designed to function in a changing regulatory environment with comprehensive oversight for all new and existing asset classes. As such it will serve across geographies and regulatory regimes. It facilitates pre- and post-trade checking of legal, contractual and internal investment guidelines in one single system thus reducing the cost and time associated with investment process controls. Order management systems can be easily integrated to extend compliance into pre-trade. To help compliance officers cover compliance regimes of new jurisdictions quicker Aquin offers its unique LawCard service. LawCards are predefined rule libraries that cover investment restrictions of the most important investment jurisdictions: UCITS III and national implementations in Europe, SEC 1940 Act, Hong Kong Mutual Provident Fund Scheme and others.

Scale and support

One of the challenges to funds investing in infrastructure and systems for movement into new territories lies with the costs and support involved. Even where systems can be flexible to match a fund's needs, the fund will not necessarily have the expertise to support the technology in-house and the cost for this may be prohibitive for smaller ventures.

One solution for funds that find themselves in this position is to utilise the economies of scale provided by a custodian bank or infrastructure provider. Aquin has provided solutions to a number of banks – for example Citi and BNP Paribas – that are then offered via their custody services. By utilising a custodian's service provision a fund manager is able to take a full range of services through a single point of contact reducing the complexity of relationship management across the enterprise.

Another alternative is to utilise the technology offered through a service provider. Aquin and PCE Investors, the London-based infrastructure platform for hedge funds announced a partnership this year, through which PCE will use the award-winning compliance solution from market leader Aquin as the system of choice for its infrastructure. With assets exceeding USD1.4 billion across 15 hedge fund strategies, PCE is the first non-long only participant to acquire such a leading-edge, flexible compliance solution and this ground-breaking rules engine will significantly enhance the operational excellence that PCE is able to offer hedge funds.

PCE Investors and Aquin can now provide PCE's clients with the full range of support from its institutional scale operating environment whilst ensuring they are able to meet current and future needs of both regulators and retail clients via Aquin's technology.

By using such technology through an infrastructure provider, fund managers are able to cope with regulatory burden and the need for disclosure without significantly impacting their business. MIG21 provides that and, combined with PCE's holistic service offering, gives fund managers the benefits of scale across their operations.

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Why hedge funds' operations matter in a bear market

Matthew Nelson, director, market intelligence, Omgeo LLC

Before I ruffle any feathers, let me state that in my opinion operations always matters. Bull or bear market, operations is the grease that keeps the machine running. But in a bear market, when the front office is struggling to eke out single basis points to please investors, operations not only keeps the machine running, but it can actually help the machine to perform better.

News that hedge funds have struggled thus far in 2008 should come as no surprise to anyone with access to a television, newspaper or computer. The media is replete with coverage of the housing collapse, subprime meltdown, credit crunch and other catchy taglines that have been associated with the problems that have plagued the global economy for the past year. So to many, the news that hedge funds are struggling comes as no surprise; everyone's struggling in this market, right?

Well, that's not entirely right. Hedge funds are designed to make money in good times and in bad. When compared to global equities, hedge funds are doing quite well in 2008. The -3.8% return through July 31 of the HFRX Global Hedge Fund Index compares favorably with the S&P 500 and MSCI EAFE which are down a painful -13.7% and -15.6% respectively.

But as stated above, the problem is that hedge funds are absolute return investments, meaning that they should generate positive performance in a bull or bear market, in the latter using short positions and derivatives. Therefore, a more appropriate performance comparison is versus cash as a benchmark (although one would hope that hedge funds would add some value, so perhaps cash plus 1%). When measured in this light, hedge funds, on average, are severely underperforming in 2008 and in fact have underperformed for 2 of the last 3 years.

Now consider the dynamics of the hedge fund industry. No one knows for sure, but roughly 3,000 hedge fund firms (not funds, mind you) exist globally and the biggest managers oversee billions of dollars in assets. Many of these firms have become household names in the industry and they garner the same clout as the largest traditional asset managers. Their trading volumes and aggressive styles make them important participants in markets around the globe and in asset classes from the most basic to the most complex. And the lines that separate hedge fund managers from traditional asset managers are blurry at best. Many traditional asset managers have at least partly transitioned (either openly or secretly) into hedge fund managers themselves. A look near the top of Alpha Magazine's hedge fund league table reveals names like JP Morgan and Barclays Global Investors, once known as traditional asset managers, now known equally known as alternative asset managers. In fact, in many cases you'd be hard-pressed to tell the differences when you look beneath the covers of traditional and alternative fund managers; operationally they are very similar.

Competition for investor assets in the hedge fund industry is fierce. According to Hennessee Group, nearly 70% of hedge fund assets now come from demanding institutional investors. In difficult market conditions, every basis point counts and managers need to be keenly aware of where money is made and lost and where it is being spent. Although it's often overlooked, operational inefficiency may account for hundreds of thousands of dollars in unnecessary spending on technology, data and personnel. Likewise the risk stemming from operations may expose the firm to thousands, if not millions of dollars in potential losses due to error-prone manual processes, unknown risk exposure to entities and counterparties and failed trades. Institutional investors are demanding, not only in terms of

Matthew Nelson

performance but also in terms of operational soundness. They are more likely to invest their money with firms that can prove that they have a strong operational infrastructure.

For mid-sized and smaller hedge funds that may outsource some or all of their operations to a prime broker, fund administrator or a combination of the two, operational efficiency is still something that must be measured. Outsourcing doesn't mean wiping your hands clean of all the details surrounding operations. On the contrary, fund managers need to establish strong service level agreements with their providers and then regularly monitor them to ensure that the entire trade lifecycle. Phoning, emailing or faxing trade confirmations, re-keying trades into multiple systems, and using spreadsheets as "work arounds" to fill in technology gaps, are common practices that should all be eliminated. Spreadsheets are fine for modeling and analyzing investments, but not for managing collateral or reconciling positions; that's a ticking time-bomb. Although they may be the easy, low cost solution, spreadsheets are a poor fit for these mission-critical functions. Versions change, macros break, developers change jobs; this is risk that the firm can do without.

ARCHEUS CAPITAL IS A GOOD EXAMPLE OF WHAT CAN HAPPEN WHEN COMMUNICATION BETWEEN THE FUND MANAGER AND SERVICE PROVIDER BREAKS DOWN

the providers are meeting their obligations. Archeus Capital is a good example of what can happen when communication between the fund manager and service provider breaks down.

In this dynamic, challenging and competitive industry, hedge funds need to be more considerate of operations than ever before, particularly when alpha is as scarce as it is today. That means both rationalizing unnecessary technology and smartly investing in technology that will improve operational efficiency. Manual processes should be eliminated wherever possible, across Hedge funds, like their traditional asset management brethren, should always focus on operations just as they do on trading. The hedge fund industry is a maturing industry and it's time that ***all*** hedge funds, not just the largest firms, start acting like it. That means looking at the entire firm and ensuring that the best, most efficient business is being run. Though little money can truly be made in the middle and back offices, money can be saved there; both in real savings and averted potential losses. But in a bear market like this one, operations really does matter.

Mayhem in the Markets – and the Media

Custom House's Dermot Butler explores the media's treatment of hedge funds in the midst of the financial maelstrom

I hope that those of you who read my comments in the 2008 Hedge Fund Services Market Guide will not assume that I have tunnel vision concerning the media and its effect on the perception of hedge funds, both by the general public and by the regulators. However, it is an on-going topic that needs to be aired and the last Guide was a year ago.

So what has happened in the intervening twelve months, apart from the continued deterioration of the credit markets and the knock-on effect on almost everything else. Try as they might, the media has not been successful in attempting to blame the credit crunch entirely on hedge funds, because there is absolutely no evidence that anyone is to blame for the credit crunch other than the banks and the huge losses that banks have sustained has demonstrated this quite clearly. Nevertheless, there has been a call for regulation of hedge funds when, in the context of problems in the credit markets, those regulations should more properly be addressed to banks. It does appear, to this outside observer that it is not the lack of regulation in the banking industry, which is arguably the most regulated of all industries, that has been the problem, but the failure of the existing regulations, including Basel 2 and, perhaps, the failure of the oversight of the regulators themselves, although many senior members of the regulatory community have waived warning flags, which have apparently been ignored by the banking fraternity, whose focus has been more driven by avarice than prudence. As we all know, banks have historically lent to people, who did not need it, when they did not want so. Either they didn't know what their positions were, or they had not assessed the risk in those positions or they had no idea how to value the positions, or, most likely, all three. But certainly it wasn't hedge funds that caused those problems and I was delighted when Charlie McCreevy, who is the EU Commissioner responsible for this area, gave a speech in which he was highly critical of that French bank that had suffered substantial trading losses as a result of lack of controls and no-one could doubt the validity of his criticism. What interested me however was that he finished the speech by drawing attention to the irony of the "demonisation", in

If it wasn't for hedge funds then the markets could easily have dried up for lack of liquidity

it and withdrawn liquidity from people, who do need it, at the time that they most want it. Nothing new here, but what is new is that for most of the past year, banks have been reluctant to lend to other banks. But the problems with UBS, Northern Rock, Merrill Lynch Fannie/ Freddie debacle and the collapse of Lehman does not encourage banks to lend to anyone – but is that cause or effect?

The regulators certainly have a problem on their hands with regard to the valuation of many of the derivative products that have brought the banks down and, to be fair, the regulators, as well as AIMA and IOSCO have all been waving this red flag for some time now. AIMA's first pricing research paper, which highlighted this risk area, was released seven years ago.

It is difficult not to be skeptical about the controls and procedures that banks have (or, perhaps, do not have) in place, when two major banks announced, earlier this year, losses of between USD3 billion and USD4 billion each, only to double those figures within a month or the press, of sovereign wealth funds and hedge funds. He went on to say that certain banks that had suffered horrendous losses were rescued by injections of capital from sovereign wealth funds.

Furthermore, if it wasn't for hedge funds then the markets themselves could easily have dried up for lack of liquidity. It is a rare comfort to hear a politician talking sense and giving a point of view that won't necessarily win him any votes. All of that is a continuation of the banking crisis that we first saw in 2007. In addition, 2008 has featured the huge rises in oil and wheat and indeed in all foodstuffs and the universal complaint that it was all due to the speculators and hedge funds. I would suggest that this is merely more hysterical balderdash.

I was talking to a senior commodity trader a short while ago about the allegations that the managed commodities community had ramped up the prices of oil and wheat and ramped them down again, just like the "Grand Old

Duke of York". According to both the tabloid and broadsheet press, this was the fault of the speculator, for which read "hedge fund". I would suggest that in the case of wheat it is well documented that a huge acreage of wheat was diverted to the production of ethanol largely in response to the encouragement of the US Government. As such I suppose it is the farmers who could be accused of speculation, but then farmers speculate the day they plant their wheat, albeit they are speculating on weather and supply and demand balances rather than with the intention of manipulating prices, which is the accusation laid against hedge funds. It matters not that the demand for food stuffs has grown, partially because of the increased wealth in some of the emerging markets such as India and China as well as the reduction in wheat available for food stuffs because of ethanol and weather patterns and of course problems in Zimbabwe haven't helped, but even the most imaginative journalist can't blame hedge funds for the vicious eccentricities of a madman like Robert Mugabe.

WHO CAN EXPLAIN TO ME WHY SOME HEDGE FUNDS ARE RESPONSIBLE FOR PRICE RISING IN COPPER AND WHEAT WHEN THEY OBVIOUSLY HAVE NOTHING TO DO WITH SIMILAR BEHAVIOR IN THE PRICES OF IRON ORE AND RICE?

Ultimately the price of raw materials such as commodities is entirely dependent upon supply and demand. At the risk of stating the obvious, the greater the demand the greater the price. If the price goes too high then demand will look for substitution, or greater supplies. It is not that easy to turn on the tap with oil except for the OPEC nations, although they have historically been more inclined to turn the tap off when prices go down, as they recently did when oil started bouncing around the USD100 mark. With crops, supply can be turned on quite quickly, subject only to weather and no doubt we will see a reduction in prices for wheat and grains as new year crops comes on line.

What I hadn't appreciated, until it was pointed out to me, is that while base metal prices – copper, zinc, aluminum – have all risen on the back of Indian and Chinese demand and speculators were deemed guilty of exacerbating those price movements, nobody has explained why iron ore and certain of the minor metals also increased by approximately the same percentage as copper and this, despite the fact that there are no free futures markets in these metals, which would encourage the infamous speculator to squeeze prices. So have these prices risen purely in reaction to demand? Similarly, I understand that the price of rice has largely followed the price of wheat and again there is no easily accessible rice futures market that could be manipulated by the hedge funds. Who can explain to me why some hedge funds are responsible for prices rising in copper and wheat when they obviously have nothing to do with similar behavior in the prices of iron ore and rice?

Those who read last year's Guide may remember my comments about a media panel at a conference in South East Asia. At the same conference this year, a similar panel with representatives of the Financial Times, Bloomberg, CNBC and the Wall Street Journal appeared and, to my surprise, I was encouraged by the attitude of the panelists, who suggested that if the hedge fund community was more open with the press then the press could be more accurate in their reporting. I can see the value of this, however there are many hedge fund managers who have spoken to the media, only to be horrendously misquoted and to have their comments distorted beyond recognition. The problem with trust is that it has to be on both sides and this is something that AIMA has been trying to develop in their focus on the press and media relationships for some years now. It is definitely getting better but it has a long way to go.

Legal and regulatory protection for hedge funds in difficult times

Dillon Eustace's Peter Stapleton explores how the troubles facing investment banks will affect hedge funds

"As yet, there has not been a threat to financial stability. But if there is, it is the job of the regulators to make sure that no element of the banking industry is over-exposed to (hedge funds)" – Charlie McCreevey, European Commissioner for Internal Market speaking in an interview with the Financial Times in February, 2007.

Perhaps few in the hedge fund community will accuse Commissioner McCreevey of a lack of foresight as fewer, if any, thought it possible that shortly after that interview the first ripples would appear in a credit tsunami which has decimated the world's leading financial institutions. At that point hedge funds were widely perceived as a substantial danger to global financial markets and lobbyists were resisting calls for increased regulation in favour of the self-regulatory models since issued by the President's Working Group on Financial Markets in the US and the Hedge Funds Working Group in the UK.

Looking back to 2007, an interesting observation is not that so few foresaw the magnitude of the current crisis but rather that the greatest cause of financial instability to date (some notable hedge fund collapses excepted) has come from the investment banking industry. At the time of writing Lehman Brothers Holdings Inc. has filed a petition under Chapter 11 of the US Bankruptcy Code and Lehman Brothers International (Europe) has been placed into administration in the UK. Merrill Lynch has agreed to forego over 90 years of independence and looks set to be acquired by Bank of America. The incredible events of 15 September, 2008 follow the fire-sale of Bear Stearns to JPMorgan Chase earlier in the year and recent US government intervention to put Frannie Mae and Freddie Mac into conservatorship.

Most commentators and analysts believe that there will be further shocks to the global financial markets before we regain a period of stability.

However, in the short to medium term, the collapse and restructuring of the investment banking sector raises important questions for hedge funds, their management and investment advisors who have heavily relied upon investment banks to provide prime brokerage services, including financing, short sales and derivative trades, necessary to implement their investment policy.

For Irish hedge funds there are regulatory safeguards inherent in the appointment of prime brokers which can be availed of, particularly in the areas of custody protection, independent monitoring of positions and netting of exposures. There are also important lessons to be learned from recent derivative close-out procedures and active monitoring of existing terms.

On the regulatory side, Ireland offers a hedge product which can be set up within a short time period under a flexible regime.

At the first instance there are quality requirements and only prime brokers who are regulated by a recognised regulatory authority, with shareholders' funds in excess of EUR200 million and a minimum credit rating of A1/P1 can be appointed (the shareholders' funds and credit rating criteria can also be fulfilled by the parent company). While a useful industry standard these criteria alone are not sufficient protection as recent developments have shown.

Other limitations which can be strengthened or monitored by funds include restrictions on the amount of assets which a prime broker can rehypothecate from a hedge fund. The ability to rehypothecate allows prime brokers to offer their counterparties competitive financing rates as they can use these assets for their own purposes, e.g. short selling securities. However, assets used in this manner create a credit risk for the fund and it only has an unsecured contractual right to the return of equivalent assets which can be impaired or even rendered worthless in the event of an insolvency of the broker. Irish hedge funds must limit this amount to 140% of their indebtedness to the prime broker (PIFs). While Irish hedge funds established as QIFs have no regulatory limit on rehypothecation, it is common for their lawyers to contractually agree a limit with the prime broker or for the prime broker's own regulatory authority or internal controls to limit this amount. Irish prime brokerage agreements must also incorporate a procedure to mark positions to market daily, in order to meet the foregoing requirements on an ongoing basis. This is similar protection to that afforded under market standard derivative agreements and enables funds to monitor their exposure to prime brokers.

FOR IRISH HEDGE FUNDS THERE ARE REGULATORY SAFEGUARDS INHERENT IN THE APPOINTMENT OF PRIME BROKERS

Under Irish rules the arrangement must incorporate a legally enforceable right of set-off for the hedge fund and netting arrangements must be recognised under the law which will govern the insolvency of the prime broker. Unlike the ISDA Master Agreement, prime brokerage documentation and the provisions therein are not standardized. Each broker tends to have a house style and the default position is for the credit and legal close-out risks to be weighted against hedge fund clients. In jurisdictions where similar protections are not hard-coded into the rules it is possible for the contract to have insolvency and set-off provisions which are unilateral in favour of the prime broker. As a result, the netting and set-off protections many market participants take for granted under industry standard documentation, including the ISDA Master Agreement, may not apply.

The prime broker must also be appointed as a sub-custodian of the local Irish trustee. This can be a long and difficult negotiation process, however, it is one of the characteristics which separates Irish hedge funds from models in traditional offshore jurisdictions and even some European countries. The assets passed to the prime broker which are not rehypothecated must held by the prime broker in a sub-custody account which is within the local custodian's network. While there is an argument for further flexibility and some changes may be introduced in the coming months, the current situation facilitates the oversight and monitoring role discussed below. The Irish regulator requires a responsible person on behalf of the hedge fund (currently the Irish trustee) to monitor positions outside the custody network on a daily basis and reconcile them against the fund's records. Any discrepancies arising from the reconciliation, which cannot be satisfactorily resolved with the prime broker are to be reported to the management of the fund requesting them to take remedial action. Periodically the Irish trustee is required to request a confirmation from the prime broker that it does not hold assets other than in accordance with the above noted rules.

Hedge funds need to ensure that documentation and legal risk issues are addressed

Hedge funds and their management would be well advised to check that the above requirements are being adhered to in practice and to consider whether some of the options available, e.g. limiting rehypothecation, should be re-visited.

Outside of prime brokerage documentation and the regulatory framework the traditional positions offered by investment banks may need to be looked at. For example, hedge funds have been used to dealing with investment banks who, with some justification historically speaking, have seen the hedge fund client as the credit risk. They have insisted on unilateral credit support documentation, high initial deposits (Independent Amounts) and imposed strict NAV based termination triggers while retaining flexibility in credit rating threshold for themselves.

Hedge funds need to ensure that documentation and legal risk issues are addressed. Often funds will enter into trades with counterparties pursuant to a confirmation with a good faith agreement to put in place a master agreement at a later stage. However, these negotiations can become bogged down as the parties try to agree important carve-outs and changes to standard provisions, including valuation models, changes to cross-default, thresholds, NAV triggers and limited recourse wording to protect related funds, service providers or investment advisors from cross-contamination claims under the contracts. Any unsigned documents outstanding with active counterparts need to be resolved.

Funds also need to be aware of their rights under existing documentation, to be able to actively monitor their exposure and know how to move quickly to protect themselves should an event of default arise. Should it become necessary to terminate a relationship, they need to know whether optional termination is permitted on a voluntary basis or must they wait for a trigger event. Small technicalities can interfere with efficient early termination of derivative contracts and service of close-out notice against a counterparty. Parties need to be aware of the valuation provisions that have been selected and whether they can value a claim with a good faith estimate (e.g. Loss) or need to seek independent quotations from the market which can be difficult and time consuming in volatile conditions.

Even with the above noted protections in place and rights to net or set-off exposure, few hedge funds will have any secured claims against collapsed investment bank counterparts and risk being left to prove pari passu for a limited amount of unsecured funds with other creditors. Active monitoring and familiarity with key contractual provisions can assist in getting out of bad positions before such defaults arises.

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A new kind of fund: Shariah compliant funds examined

Norton Rose LLP has advised on the launch of the Al Safi trust, a fund intended to comply with the principles of Shariah. Whilst the methodologies to be utilised by the trust are not in themselves out of the ordinary, enabling such methodologies to be used in a way that is intended to comply with the principles of Shariah has been pioneering. With this and other fund structures being discussed, we are no doubt witnessing the rise of a new area of structured finance. By Dean Naumowicz and Uzma Khan.

Investor Services Journal | Hedge Fund Services Market Guide 2009

Islamic finance: the story so far

The Islamic finance industry has seen phenomenal growth over the last decade and continues to grow on an international scale. It is anticipated that the assets of Islamic banks will grow at a rate of 24% per annum to around USD1.85 trillion by 2013 (excluding the Islamic branches of conventional banks and excluding growth in investment in the Takaful industry). As demand for financing based on the rules, principles and parameters of Islamic Law (Shariah) continues to grow, the industry has experienced further development of the more traditional Islamic finance methods.

Demand for returns linked to Shariah complaint equities

Islamic finance traditionally provides halal (or permissible) alternatives to debt financing involving the payment of interest. Increasingly, however, new structures are being devised and applied to a wider range of financing techniques, including equity products. Such structures have enabled Islamic and non-Islamic investors to access a broader range of exposure profiles with respect to Shariah compliant equities.

Islamic funds

The traditional Islamic fund structure is based on the concept of profit and risk sharing between investors and a fund manager. However, Shariah recognises the need for investor protection and so new asset classes and hedging instruments are increasingly being utilised in order to strike the required balance between greater exposure and diversification of investments whilst maintaining the mitigation of risk. Shariah scholars have been working within such a framework in order to develop Shariah complied products. Are we witnessing the rise of the Shariah compliant "hedge" fund?

Shariah compliant funds

Equity linked funds provide a platform for investors to gain exposure to equities which often exploit techniques selling such equities "long" or "short". In general, conventional short selling involves a fund borrowing an equity and selling this in the market with the understanding that the loan must be repaid by buying the equity later (hopefully at a lower price). This is prohibited under Shariah as it would involve selling an equity which the seller does not own. With respect to Shariah complaint investments, there have been some interesting developments recently utilising a traditional and well established Shariah contract - the Arbun. The Arbun can be used to provide exposure to Shariah complaint equities by creating a similar economic effect to short selling. The Arbun is a sale involving a deposit in respect of the purchase price of an equity with complete performance of the contract due at a future date. Under this model, ownership is established before the subsequent sale and, as a result, this technique has received scholarly approval for complying with Shariah.

Al-Safi: a case study

Norton Rose LLP has been advising a number of clients in leading the way in the development of structured Shariah compliant products. We advised on the recent launch of the Al-Safi umbrella trust platform. The Al-Safi platform seeks to provide an innovative, Shariah compliant structure which aims to assist investors in maximising their potential returns.

Trust structure

Al-Safi is a Cayman-based multi-class trust. The trust is structured as an "umbrella" trust having multiple sub-trusts. Pursuant to a trust deed, the trustee will have the power to create sub-trusts and issue different classes of units with respect to each sub-trust. Each sub-trust may have separate investment objectives and therefore invest in different sectors/geographical regions as appropriate.

This structure is no different to a conventional fund structure, other than the exposures being created and the fact that the trust will need to comply with Shariah (e.g., no interest can be paid on any cash held). Investors can therefore take comfort on the robustness of, and market conventions relating to, such structures.

This umbrella structure has been used to minimise cross liabilities between any sub-trusts and therefore assists in the mitigation of risk by preventing cross-contamination of liabilities across different sub-trusts. The trust deed will not permit the trustee to be indemnified out of, or to have recourse to, the assets of any sub-trust other than the sub-trust to which the liability pertains. Therefore, any liabilities or expenses incurred with respect to a particular sub-trust are enforceable against the assets of such sub-trust only.

The trustee has appointed service providers to the trust to provide, inter alia, investment management, prime brokerage, Shariah advisory and administration services to the trust.

An information memorandum has been issued in relation to the trust and a separate offering memorandum will be issued in relation to each sub-trust. Each offering document will set out provisions relevant to that particular sub-trust, which may differ from other sub-trusts, particularly in relation to investment objectives, redemption and liquidity provisions. Also, a subscription agreement will be entered into between the investor and the trustee on behalf of the relevant sub-trust whereby the investor will subscribe for units in the relevant sub-trust.

Shariah guidance

In order for the trust to remain Shariah compliant, the investments of each sub-trust must remain in accordance with the principles of Shariah. Therefore, investments in certain industries (such as gambling and the manufacturing of armaments), certain products (such as alcohol and pork) and certain investment strategies (such as speculative or interest-related strategies) are prohibited.

A Shariah board, consisting of leading Shariah scholars has been appointed with a remit to oversee the business, activities and investments of the sub-trusts and to provide a Shariah oversight function. In addition, an expert Shariah advisor has been appointed to advise the Al-Safi platform and will provide day to day monitoring of the investments of the trust. The Shariah advisor receives daily "exception reports" from the prime broker highlighting any potential deviations from the investment guidelines and the Shariah advisor will suggest, with final approval required from the Shariah board, how such investment will be dealt with either by divestment or a purification procedure.

Final thoughts

Market demand for Shariah compliant investment alternatives has led to the creation of funds which seek to comply with Shariah. The current economic climate has also encouraged the development of such innovative and alternative financial products to provide investors with new platforms for investing in order to maximise their returns whilst managing risk.

There is an acceptance across the Islamic finance industry that if the industry is to continue to develop, the more traditional boundaries of Islamic finance will need to be expanded. Consequently, these developments have received the approval of a number of high profile scholars which will inevitably open the door to further progress in this latest area of Islamic structured finance.

Hassans

The Gibraltar Experienced Investor Fund Regime

Hassans partner James Lasry explains how the Experienced Investor Fund regime in Gibraltar has proven to be an extremely versatile way of setting up a fund within the European Union.

Experienced Investors

In order to qualify for this regime, marketing must be restricted to investors who are deemed to be experienced under the Financial Services (Experienced Investor Funds) Regulations 2005 (the EIF Regulations). The EIF regulations define Experienced Investors as investors who have a net worth of 1m aside from their residential property, individual investors whose normal business activity includes investment related activity (i.e. investment professionals) or investors who invest a minimum of 100,000 in the fund. It is important to note that these definitions are individual and not cumulative so it is sufficient for an investor to invest 100,000 for it not to have to prove any of the other conditions.

Promoters

Unlike in other jurisdictions there is no requirement for the promoters of the fund to be licensed. It is sufficient for the fund administrator to perform the normal know your client and client acceptance procedures for them to be able to set-up a fund in Gibraltar.

The reason for this is that each fund must have two directors who are authorised by the Financial Services Commission ("FSC") to act as EIF directors. The EIF directors' role is to ensure proper governance of the fund. Where the fund is a unit trust with a corporate trustee or where the fund is a limited partnership with a corporate general partner, two directors or the trustee or general partner, as the case may be, must be FSC authorised directors.

Management

Although many funds in Gibraltar do not have investment managers and are managed by their boards of directors, an EIF may choose to appoint an investment manager in Gibraltar or in any other jurisdiction. It is sufficient under Gibraltar law that that investment manager or adviser is licensed or entitled to give investment management/advice in its home jurisdiction. An investment manger or advisor license in Gibraltar is a full European Union license. This means that the license can be passported anywhere within the European Union. As such, the normal capital adequacy requirements that exist in other European jurisdictions also apply to the Gibraltar managers or advisors. A Gibraltar investment manager/advisor must have a physical presence and staff in Gibraltar.

Depositaries

An EIF that is open ended must have a depositary. The fund may also appoint brokers to assist with their trading activity. Neither the depositary nor the brokers need be in Gibraltar although in the case of Protected Cell Companies "PCCs" there may be some advantage to having these in Gibraltar, as there is more certainty that a Gibraltar court will enforce the statutory segregation of cell assets than a non-Gibraltar court that may not be as familiar with Protected Cell Companies legislation.

Prospectus

An EIF must issue a prospectus that is consistent with industry standards and which will allow an investor to make an informed investment. The prospectus/private placement memorandum (PPM) must state the fees that are chargeable out of the property of the fund, the investment objectives, borrowing or investment restrictions, if any, and the risks associated with such investment. The prospectus/PPM is a private document in all cases except if the fund is incorporated as a public limited company. As mentioned above, however, there is no legal requirement to use a public limited company for a fund in Gibraltar even if the fund has more than 50 investors.

Authorisation and Regulatory Requirements

One of the key unique selling points of the Gibraltar fund is the authorisation process. For an EIF it is sufficient for the fund to incorporate, appoint its service providers, produce its prospectus and hold a board meeting to launch itself as a fund. There is no regulatory pre approval necessary for launch. Within 14 days of launch, a fund must notify the FSC of the launch along with a copy of the prospectus, the memorandum and articles, a legal opinion from senior Gibraltar counsel stating that the fund was set-up in accordance with the EIF regulations and other relevant legislation, a form signed by the administrator and the license fee of £2,500. This is very significant as it means that effectively there is no regulatory down time and the fund may be launched as quickly as necessary. The FSC will then review the submitted documents and may come back with questions or comments. Going forward is necessary for an EIF to ensure that it complies with the EIF regulations. Breach of certain regulations requires the directors and/or administrator of the fund to notify the FSC.

The directors authorised (especially the directors) and the administrators are charged with ensuring on-going compliance with Gibraltar legislation and with corporate governance requirements. An EIF must have a fund administrator that is authorised and has a presence in Gibraltar. In addition to the two Gibraltar based EIF directors, the fund must also appoint auditors that are registered in Gibraltar. Three out of the four "big four" auditors are based in Gibraltar as are several other firms that have ample experience in fund audit.

There are no restrictions on borrowing or owning investments. A fund may invest in any class of investment and at any percentage given that this is a fund that is targeted to experienced investors who are informed and are able to bear the risks of such investments. The fund may, however, impose certain restrictions on itself. These are disclosed in the prospectus and, of course, must always be adhered to.

Taxation

Gibraltar funds may obtain an exemption from the Commissioner of Income Tax on any tax on investment income. There is no capital gains tax, inheritance tax, wealth tax in Gibraltar. There is a stamp duty of £10 on the creation of share capital of a company and on any increase in share capital. Furthermore, there is no tax in Gibraltar on dividends from quoted securities or on income from trading listed securities. Indeed, a fund may find it more beneficial not to apply for the certificate of exemption from the Commissioner of Income Tax in certain cases and to rely on the regular internal tax regime of Gibraltar which will invest in the majority of cases not tax any income or gains earned by the fund. The reason for this is that Gibraltar, being part of the European Union, can benefit from the European Parent Subsidiary Directive. This means that payments to a Gibraltar company from subsidiaries in certain European jurisdictions (such as Luxembourg) will not be subject to withholding tax. This is another one of Gibraltar's unique selling points and it is particularly relevant in private equity and real estate funds.

There is no withholding tax on payments from a Gibraltar fund to its non-Gibraltarian investors.

The valuation methods for EIFs must be disclosed within the prospectus. There are no particular rules on valuations other than their disclosure. Although any internationally accepted accounting standard might be used for the audit, many Gibraltar funds are audited under IFRS or UK GAAP.

Protected Cell Companies (PCCs)

The third unique selling point of Gibraltar is that it is possible to set-up a fund in Gibraltar as a Protected Cell Company (PCCs). PCCs are companies, which can segregate their assets into cells, which are statutorily, protected and are remote from each other in bankruptcy. This means that if one cell incurs a liability, the creditors of that cell will be unable to satisfy their debt from assets attributable to another cell. This is particularly useful to investment mangers that wish to set-up several funds with several strategies under one vehicle and save with economies of scale. Investors can invest in one or more cells according to their investment strategies.

Conclusion

The quick and easy regulatory notification process, the possibility of setting up PCC funds and Gibraltar's position within the European Union are all factors that are certain to make Gibraltar a very interesting and competitive jurisdiction for the set-up of funds.

Survival of the fittest

Mark Mannion, managing director, PNC Global Investment Servicing, explores how to survive in the new era

The global financial landscape continues to transform almost daily. Many experts do not see the crisis plaguing the markets over the last 18 months slowing in the near future. During the market's peak, investors continually searched for alpha outside of the traditional strategies. As a result, we have witnessed the convergence of traditional and alternative products and strategies to produce what could be termed hybrid products. At the very least we've seen 'hybrid managers' offer or deal with these products. Thus, hedge funds have ingrained themselves in many more corners of the financial services industry.

RUMOURS OF THE HEDGE FUND'S DEMISE HAVE BEEN GREATLY EXAGGERATED.

As a result, some hedge funds have wound up at the forefront of the global market decline. In many ways, these alternative investment products—with complex and intricate strategies—have now become the shock absorbers of the downturned market.

However, the rumors of the hedge fund's demise have been greatly exaggerated. In fact, for the astute and skilled hedge fund manager, opportunities for growth continue. Some managers are already responding to the current market to meet the evolving needs of investors and changing regulatory landscape. Fund managers as well as administrators are currently introducing new products and services that embrace the alternative mindset, but are designed to perform in varying market conditions. That said, no strategy is without risk and a manager must commit to adhering to best practices and risk management, especially within the current market.

Successful strategies are those that continue to deliver capital preservation and absolute returns in a market downturn. Put simply, those that substantially decorrelate from equity markets are better positioned. There is variation between periods in performance of individual strategies, as returns driven by specific sectors inherently positioned to capitalize on certain opportunities during periods of market dislocation. While these instances generate successful decorrelation, they are specific in nature and not representative of a larger strategy. Looking at the industry at large, the correlation between HEDGE Index and the MSCI World demonstrates that during times of market stress we see a sharp decline from HEDGE's previous peak levels of positive variable equity correlation with MSCI World. This demonstrates the ability of hedge funds to decorrelate from broad equity market indices. During market bull runs, we see hedge funds exhibit trends of correlation.

During a financial crisis, almost all sectors are affected. Those holding fundamentally strong stocks are more likely to retain them until the market recovers. However, it is more difficult for those with hedge funds that are highly leveraged to do so, as investors are faced with squeezed liquidity and margin calls. Hedge fund strategies popular at the moment—partly because of credit crunch—are those that have demonstrated this decorrelation, such as global macro; managed futures and Commodity Trading Advisors (CTAs); and equity market neutral strategies.

NO MATTER THE STRATEGY, THE FUND MANAGER MUST DEVOTE A LARGE PORTION OF HIS OR HER TIME TO VALUATION

Global macro and managed futures have benefited from opportunities due to continued volatility and rising commodities prices. They've posted solid gains because of the continued unpredictability within the market and central bank cycles that have offered opportunities for managers trading in a variety of economic and market conditions. Macro funds have higher levels of cash therefore offer greater liquidity, leading some to see these funds as a ship riding the wave of the perfect storm within the financial markets.

Another strategy that has gained in popularity is associated with managed futures and CTAs, which focus on investing in listed bond, equity, commodity futures and currency markets. These strategies capitalize on a bull market run within the commodities market, especially within the energy and agriculture sectors. Managed futures have benefited from increased energy prices, the depreciation of the U.S. dollar, and supply-side pressure. CTAs leverage unanticipated surprises. The futures markets move gradually to reflect new conditions, which in its full extent were not anticipated by the general investing public.

The equity market neutral strategy has benefitted from the decrease in the availability of capital and lower levels of leverage. Thus, there are fewer dollars chasing similar opportunities within quantitative trading. Higher levels of market volatility provide a robust short-term quantitative trading opportunity. A quantitative approach to trading and neutral positioning partly insulates strategies from challenging periods within the equity or credit markets. As with managed futures, quantitative strategies make use of what could be termed the 'herd mentality' of the markets.

It must be remembered that hedge funds accentuate a downturn due to their size, and strategies that employ aggressive investing using leverage and derivatives not only increase the opportunity for profit, but also the potential for higher losses. All of the strategies that have gained in popularity are specific to a market environment and require an immense level of financial acumen and knowledge.

In less liquid markets, the price impact of any crisis is larger, has a greater effect on balance sheets, and effects more participants. Illiquidity has resulted in a shift in investor strategy and popularity of sectors. At this end of the spectrum are managers who have moved away from less liquid strategies and sectors and into those that offer greater liquidity and less risk. This has resulted in a greater popularity of funds of funds. However, these complex instruments require greater flexibility and risk management from the manager.

No matter the strategy, a fund manager must devote a large portion of his or her time to valuation, especially in an illiquid market. A manager has to ensure a fund uses fair and proper prices for positions held within the fund. Employing robust standards to do so is essential to encouraging investors to invest in a fund. This not only provides confidence to investors, but is a requirement for new capital allocations.

In addition, issues related to valuation can underlie many of the operational risk factors faced by hedge funds. The correct handling of valuation is paramount to preventing such problems. A recent study by Capco on the causes of hedge fund failures found that 35% of could be attributed, in either the primary or secondary instance, to problems with valuation. And according to the UK Hedge Fund Standards Board, valuation is one of five general areas on which funds should focus.

IT IS TOO EARLY TO SOUND THE DEATH KNELL FOR HEDGE FUNDS, HOWEVER IN THESE EXTREME TIMES MANAGERS MUST APPROACH ALL INVESTMENT STRATEGIES WITH PRUDENCE

The accurate valuation an asset or position within illiquid markets poses challenges. This is not as significant an issue within liquid securities, as a manager can use recent transaction prices and readily available marketable bids and offers to provide fair and impartial valuations. However, in less liquid securities that trade more infrequently, transactional prices are not always available. In such instances, it is necessary to seek broker quotes to gain an idea of a positions value. Adding to the difficulties within markets that are traded infrequently, obtaining quotations and they may be unreliable. For example, broker quotes for some types of mortgage backed securities can vary by 20-30%.

So, what is the best way for a manager to tackle valuation on behalf of the investor and his or her interests? First, don't create valuation—source it independently from an asset manager. Alternatively, a manager can source valuation from range of brokers, counterparties, and contacts. There are also very capable specialists who make valuation their focus. A rule of thumb is to always attempt to obtain a valuation from more than one source. There is a high level of risk associated with valuation from those investors who want to know the exact extent of their gains and losses, and managers should be extremely mindful of this.

As stated, it is too early to sound the death knell for hedge funds. However, in these extreme times, managers must approach all investment strategies with prudence and thoughtful judgement. Clearly opportunities exist. But they must be handled by those who possess the keen intellect to gauge the investment strategy against the risk. With the investor's interest at heart, such a manager can not only ensure a portfolio maintains its liquidity, but also increase the value of their client's investment.

BNY Mellon

Hedge funds ride the J-curve

We often hear of the term “convergence” within the alternatives world, particularly in the hedge fund and private equity arena. The term refers to the blending of these two distinct asset classes into a new type of investment vehicle. Alan Flanagan, BNY Mellon’s managing director in the Product Management explores the forces driving this trend and how are they taking shape.

Hedge Funds vs. Private Equity

Traditionally, the hedge fund model involves an open-ended structure, meaning investors have the option to enter and exit at predetermined frequent intervals, such as monthly, quarterly, etc. Hedge fund strategies generally seek market inefficiencies and pricing anomalies in publicly traded securities to generate returns. Their portfolios are generally short-to-medium term plays, well diversified, and typically hold no more than a small interest in any specific security.

A private equity fund, on the other hand, would typically begin as commitment from investors. This affords the manager an opportunistic approach to investing. The manager or general partner (GP) places a call on committed cash from an investor as and when investment opportunities arise. The funds are closed-ended, meaning redemptions are prohibited and the fund only distributes proceeds as assets are liquidated. Private equity funds have a typical life term of usually seven years. The investment strategy generally tries to create value by taking full or partial control over the companies in which they invest. Simply put, private equity managers attempt to buy companies at good value, and then improve or add value by introducing new management, growing the business by strategic purchases, refinancing and/or restructuring measures that augment the company. The ultimate goal is to sell the acquired company in 5 to 10 years for a profit, either through a private sale or an IPO.

The Emergence of Hybrids

We can readily see how these two distinct businesses –hedge funds and private equity –have very different characteristics. They are each born from unique cultures and organizations driven by the manner in which their respective portfolio managers invest capital. However, despite stark differences there are two fundamental commonalities; they both represent private pools of investor capital and they both purport a modus operandi of achieving above-market returns. In this regard convergence into a hybrid investment form was merely a natural progression.

The original hybrid occurs when a fund invests in both liquid and illiquid investments. Hedge funds engage in hybrid investing through the use of a “side pocket.” Side pockets, otherwise commonly known as “designated investments,” arise when a hedge fund enters into private equity type investments and these investments are accounted for on a deal-by-deal basis in a “side pocket,” which as the name suggests is a segregated account which tracks that investment.

MIXING HEDGE FUND AND PRIVATE EQUITY INVESTING IS NOT WITHOUT ITS CHALLENGES

Side pocket investments contain transfer restrictions similar to private equity deals. The hedge fund manager would typically be less involved in the management of the side pocket than that of a typical private equity manager. Once an asset is designated into a side pocket, new investors do not participate in its performance and existing investors can only redeem their liquid share holding. Their side pocket remains locked up until the side pocket investment is liquidated. This promotes the liquidity of the hedge fund with a closed private equity investment and presents a broader base from which to generate returns. Investors benefit from the added efficiency of being able to invest in both markets all under one roof. This has the added benefit of reducing the administrative costs of having to deal with a hedge fund and private equity firm separately.

Mixing hedge fund and private equity investing, however, is not without its challenges. These center around accounting complexities, in terms of management fees and performance fees, and careful consideration should be given to the drafting of the fund documents when considering this option. The strategy may also present liquidity problems. If too much of the fund's investments are in side pockets, the managers could find themselves in a cash flow crunch when redemption notices arrive. To avoid liquidity issues funds have typically limited their side pocket allocation to a maximum of 20%.

Seeking Opportunity Amid the Credit Crunch

The arrival of last year's credit crunch saw the emergence of a new type of hybrid, more commonly known as the credit hybrid. This trend is clearly a sign of the times and takes the form of hedge fund investing wrapped in a private equity structured vehicle. These new funds are investing in a wide range of debt instruments - everything from mortgage portfolios and asset backed and other structured products, to traditional distressed debt and bank loans. Since the liquidity crisis first arrived, hedge fund managers were generally not prepared to take these positions in a regular open-ended structure due to the market volatility. And this reluctance still exists due to the belief in the hedge fund community that the crunch has some way to go.

The fact that the vehicles are locked up provides investors, who can see beyond the volatility, an opportunity to gain access to long-term credit opportunities during these turbulent times. Seasoned hedge fund investors may see their returns severely impaired if the price of the underlying asset falls more than forecast, or if the credit crunch lasts longer than expected. This is a where the hedge fund manager takes the plunge down the dreaded J-Curve, with the hope of longer-term upside. On the other hand, this is a path well trodden by the seasoned private equity investor.

Unlike true private equity funds, where lock-up periods range from 5 to 7 years, the lock-up periods for hybrids are usually 3 to 4 years. Some are stretching out longer into the private equity realm, but involve penalties for exits after shorter periods such as 10% at the three-year stage. Similar to private equity funds, the vehicles are structured with a finite life and upon reaching a certain point in time must return all their profits and principal to the investors. Most private equity funds will not take performance fees until investments are realised, and even then are subject to claw back based on the overall performance of the fund. But the hybrids are structuring their fees differently. They are paying performance fees after reaching a preferred return (generally 8% to 10%) without the claw back and then entering into the more typical catch-up, 80/20 split there after.

In conclusion, there is clearly a continuance of the convergence trend through the creation of hybrid vehicles, which share both hedge fund and private equity components. What is most compelling is that we are seeing the theme evolving through ever changing market conditions. While we may not see any measurable impact for some time yet, the trend of hedge fund and private equity fund convergence does not seem to be going away.

Stephane Leroy - head of global sales & marketing, QuantHouse

"How is trading technology changing the behaviour of the financial community?

There has been an ongoing revolution in trading since the first exchanges went fully electronic back in the 1990s. At that time, screen-based trading applications began to be created to meet the needs of users regarding reliability, speed and volumes.

More than a decade ago, full end-to-end automatic financial processes like electronic trading, black box trading, algorithmic trading, automatic execution engines and direct market data feeds were concepts on which a few leading edge experts were working. Systematic trading innovators were already showing the path along which trading technologies would ultimately evolve.

Recent modifications such as the combination of regulatory changes, technology's rapid evolution and new trading needs are forcing the financial community to change at an even faster pace to stay ahead.

Finance and Technology are merging…

In today's world of discretionary trading, the vast majority of traders are specialised by asset classes. Those specialisations are the consequence of years and years of human experience dedicated to trading those specific instruments and asset classes. Human traders are known for their in-depth knowledge as they "feel the market". They also ensure the success of the trading desk they are working for through their strong relationships with their clients built over years. Traders working for Market makers, clients and prime brokers are evolving in a known universe driven by human behaviors.

…and the Quants are coming !

Everything could carry on like this forever if the "Quants" were not on their way. For this new community of trading actors, GBP/USD, SoyBean or IBM stock are just signals in a universe of data. They research all markets and analyze it through statistical or mathematical filters to detect patterns and trends they could leverage to generate profits.

If you want to talk to a human trader… press #1,to connect to a "Silicon Valley" trader… press #2 !

The entire financial community is going through a quantum leap. New profiles are joining the traders' community with an improved analytical and scientific background. The IT/development teams who were seen as minor in the picture are becoming key elements of the trading teams inside each systematic trading firm.

Each organisation has to find its own evolution path and manage its transition from discretionary trading business models to systematic trading oriented organisations.

Whether you work for a buy side, a sell side or an exchange … it's maze time!
Look for a next generation provider to help you go through this Quantum gap.

It's time to reassess your business model in light of what's going on in your landscape: new competitors, new technologies, new market rules. As there is a high probability that you're not in a relationship yet with a next generation provider who could help you and your company find your way in this maze, be on the move!

Eric Marcombes – CEO Cogitam

"Technology is progressing at a swift rate, and sectors such as aerospace, automotive, engineering and even Hollywood are managing to take full advantage of the most recent advances. However the financial sector still lags significantly behind in this area. Whether it be in regards to risk management, valuation, communication, messaging, or other functions, what role would you like to see technology play in the day-to-day management of your fund? How could technology improve the operations of the fund?"

I do not believe that the financial industry is behind in regards to technology; at least it is not the case in France. The first center of calculations in this country is in the energy sector and the second biggest is an investment bank, whilst other financial institutions rank in the top places. These investment banks are renowned for their efficient valuation, pricing, and the options-based hedging calculations which are primarily used for structured products.

COGITAM is a high-frequency, bi-directional, systematic, long/short, quant asset management company which specializes in alternative investment, and though we launched our first fund but a year ago (the 5th of September: COGITAM T 15 Systematic) the combined experience of our personnel amounts to many years of market experience.

We have no intention of predicting what the market will do; we do not have a dynamic hedging system to cover our positions; we content ourselves to simply acknowledge the past. We find that what has happened before, will happen again (wasn't it Winston Churchill who said that history repeats itself? or was itNapolean?!). Presuming this (and proven, since the inception of the first fund that the team created back in 2004: Ecofi Quant Trésorerie Dynamique), we think that this phenomena will continue and that we can capture this, and can therefore extract money from the markets. Of course to do this requires statistical models which are not that simple and require a reasonable amount of powerful technology.

Our intention is to profit from technological advances to heighten the frequency of observation. Today we look, and react if the predetermined criteria are met, at prices on several markets every minute. We have the systems to be able to observe them tick-by-tick.

Otherwise, technological progress will allow us to perfect the algorithmic, order-routing system of our program trading process; since we want to be able to react to the markets tick-by-tick, we will therefore have a new frontier to pass our orders efficiently.

We are permanently obliged to be on the cutting edge because there is stiff competition between those active in this sector. The world-wide quotation systems are faster and faster (example being the new system eminent in New York by NYSE-Euronext) and we must match these technological advances to remain in the game.

Everything COGITAM does is automatic: from the investment decisions, to order passing, the risk control systems, including execution capture, to our client and market reporting, so to be at the height of technology is a necessity; it is a challenge, however it is one that we feel comfortable betting on.

Katya Azzopardi - GVTH

Why redomicile an existing fund into Malta?

There has been a sharp increase in the number of funds domiciled in Malta lately, especially since Malta's accession to the European Union in May 2004. From the number of funds that have been licensed this year up till June 2008, it is clear that the growth of the previous years has been sustained. Amongst these funds one finds a number that have been incorporated in another jurisdiction and have since been redomiciled into Malta.

A redomiciliation means that there is a change in the nationality of the company and hence in its regulator in the case of a licensed entity such as a fund. The company is not terminated but merely continued into another jurisdiction. Therefore the assets remain unaffected and do not need to be transferred and the status of the unit holders remains unchanged too.

All funds domiciled in Malta are regulated by the Malta Financial Services Authority, (MFSA), which is the single regulator of all financial activities in Malta. A redomiciliation may be carried out in terms of the Continuation of Companies Regulations 2002. The requirements to continue a company into Malta are not too onerous. It is possible to redomicile companies which have been in existence for a minimum period of one year. The process involves primarily submitting a number of documents, resolutions, certificates and declarations which all seek to ensure that any funds redomiciled are reputable and satisfy Malta's regulatory standards.

There are a number of reasons why a fund manager may wish to redomicile an existing fund into Malta. Here there is a flexible and EU compliant regulatory regime, a transparent tax regime along with an extensive list of double taxation treaties. Furthermore, the costs involved such as the licensing and registration fees, audit fees, legal fees, office space rental and salaries are very competitive when compared to other jurisdictions.

There have been a number of legislative developments to ensure that Malta keeps abreast with this dynamic industry. One to the main developments in the past twelve months has been the introduction of the Professional Investor Fund (PIF) targeting extraordinary investors. This is the third type of PIF available in Malta, the other two being the already very popular regimes of PIFs targeting experienced investors and PIFs targeting qualifying investors. The minimum entry level for a PIF targeting extraordinary investors is EUR750,000. This PIF can be licensed within three days of the submission of application since the due diligence is carried out post licensing. PIFs promoted to Extraordinary Investors may choose to provide clients with a Marketing Document, which must have the latest version of the scheme's constitutional document or a summary thereof attached to it.

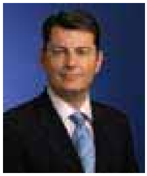
The Marketing Document must contain the following information:

- a list of service providers including the Directors, General Partner(s) or Trustee (as applicable), and their respective contact details;
- a definition of Extraordinary Investor;
- a risk warnings section;
- investment objectives, policies and restrictions of the Fund;
- details of fee structure;
- details of the classes of Units on offer; an overview of the safekeeping arrangements (where a custodian/ prime broker is not appointed);
- a statement identifying the holders of the voting shares of the Fund. This section should also provide that the identity of the ultimate beneficial owners of the holders of voting shares will be disclosed upon request;
- Standard text excluding MFSA responsibility
- the Subscription Form;
- Extraordinary Investor Declaration Form.

Nicholas Griffin - head of transaction services Europe, KPMG

Will M&A activity continue in the hedge fund administration sector in 2009?

2009 may well prove to be an industry-defining year for the hedge fund administration sector. 2008 witnessed a series of transactions that included outright acquisitions of administrators, asset book sales, equity investments and the purchase of technology companies to enhance propositions and improve efficiency.



Deutsche Bank acquired Hedge-Works, Fulcrum Group acquired the much larger Butterfield Fund Services in a transformational deal, Custom House and Equity Fund Services merged, ALPS Fund Services acquired the assets of Price Meadows, XL Capital acquired a minority stake in Equinoxe Alternative Investment Services and BNY Mellon acquired Lamp Technologies. No doubt other off-market transactions were executed quietly.

Interestingly, 2008 activity failed to produce a major transaction between the largest players. The majority of hedge fund administrators, and in particular the largest players, had clients under pressure due to the credit crunch. Several had large funds fail. Consequently, much of the year was spent focusing on the immediate agenda of servicing current clients rather than making acquisitions.

It is likely that 2009 will be a year in which several of the largest players decide whether they are in hedge fund administration for the long haul. We may well see at least one player sell because its parent needs the cash a deal would generate to repair the group balance sheet. Other major banking groups are assessing the long-term prospects for operating margins and returns on capital. Several realize they need to invest heavily to achieve or sustain a top 3-4 position, or exit to willing buyers who are keeping valuations high at the top end of the market.

The medium-term prospects remain good for strong market growth at double digit rates. However, as I predicted in this journal last year, the 'barbell' effect, whereby a handful of players hold 65-70 per cent market share and a large number of small players occupy the other end of the market, is starting to have significant consequences for the small-medium sized providers. Working on a good proportion of the transactions that have taken place over the last few years, I have observed a distinct change in the attitude of buyers to the acquisition of smaller administrators.

Previously, valuations, by almost any metric, were high across the board from the largest to the smallest. This was driven in part by the belief that 'anyone can be a market leader' given sufficient capital and access to distribution. Buyers are now more discerning as they realize this assertion to be unproven, if not simply untrue. The gradient of the valuations curve is becoming steeper. Several smaller players are struggling to sell their businesses as they continue to hold out for valuations last seen in 2006 and the first half of 2007.

There is the prospect of a 'roll-up' play among the smaller players. A financial investor may spot the opportunity to buy a smaller-sized player with a strong technology platform and good management. The strategy would then be to bulk up by acquiring stressed and distressed administrators.

Predictably, the industry-defining deals will be those involving the largest players. One or more very large transactions are likely as those at the top end make bold strategic choices. Perhaps, by the time you are reading this one of those will have happened or the process may well be underway.

Chris Cattermole
European sales manager, Advent Software

"How does a fund's selection of a technology suite impact other areas such as choice of fund administrator - is the compatibility of technology between front, middle and back office systems a decisive factor?"

Traditionally, hedge funds have taken an operational-lite approach to their organisational set up, preferring to concentrate on their core investing competencies and to outsource the infrastructure suite that supports those functions to their prime brokers and hedge fund administrators. Increasingly though there are compelling reasons for a hedge fund to include robust middle- and back-office IT systems in-house.

For one, hedge fund managers are diversifying into a broader and more complex range of instruments and asset classes. But rather than relying on their fund administrator to provide daily or intraday reports on their positions and valuations, which can be costly and cumbersome, many hedge funds want the capability to bring that tracking in-house, so as to have an immediate view of their current exposures and how they need to react to them.

Another driver, which is especially important in today's market conditions, is counterparty risk. The Bear Stearns collapse and wider liquidity crisis has served to sharpen the focus of hedge funds – and their investors – on this area, exacerbating managers' desire to diversify their trading across multiple counterparties. However, given a fund will have different financing agreements with each counterparty, if it doesn't have in-house systems that can track those then it will be reliant on its administrator for details of its exposures.

By contrast, an in-house technology platform enables a hedge fund to prove to its investors that, with the click of a button, it can see where its counterparty risk lies at any given time. This capability is of particular importance where a fund has institutional investors, who tend to be more risk averse and have a more onerous due diligence process, and so will only commit monies to a fund that has a transparent and robust infrastructure.

And having this level of IT set up has even more credibility with institutional investors when a hedge fund can show it uses the same platform as its fund administrator and/or prime broker. Where that is the case, the transference of information between the prime broker, fund administrator and hedge fund is faster and more accurate, the data is consistent making reconciliations easier, and there will be less manpower required to maintain the sundry processes. As a result, the hedge fund will have a more cost efficient operation, and be able to scale its business and so grow more effectively.

The compatibility between the front, middle, and back-office systems of a fund and its service providers can therefore produce sizable benefits. All other capabilities being equal, it may then prove to be a decisive factor for the manager in its choice of software vendor and/or service partners.

It is also important to note that by holding its books and records in-house, supported on an industry-leading platform that is widely-used by market participants, a hedge fund will benefit from greater flexibility and negotiating power should it decide at any time to switch administrators in favour of a more suitable provider, since it won't have to endure the agonies of extracting and transferring its entire back office from one firm to another. And that can only serve to enhance its operational competitiveness.

This trend is however causing fund administrators to react and to be more proactive in servicing their hedge fund clients and adding more value for example with faster, more accurate reporting. Also those FA's with a flexible infrastructure are able to support their clients who are looking to pursue more complex investment strategies using a broader range of instruments.

Head to Head - A discussion on risk, transparency, regulation and back to front office issues

Guy Martell - UBS Global Asset Management's European Head of Business Development & Client Relationships, Hedge Funds Europe

Charlie Woolnough - Fortis European regional director for sales and relationship management

1. Hedge funds are installing more risk managers and risk management systems in their front offices, why was this not done earlier?

Woolnough: Hedge funds have been increasing their risk management practices for a number of years now. The drive for greater resources in risk management is as a result of enhanced monitoring by underlying investors and greater professionalism within hedge fund firms. However, the risk monitoring requirements of hedge funds do undoubtedly vary across the different strategies. For example, you would expect to find a more expansive risk analysis infrastructure within a statistical arbitrage fund than you would for a concentrated long/short equity fund.

That said, whilst a lot alternative investment managers already had expansive risk infrastructures prior to this year, the push for further enhancements may be greater this year due to increasing volatility and stress across financial markets.

Martell: In our view, all employees are to some extent responsible for performing various risk management or risk control functions, rather than it being the sole responsibility of a dedicated risk management specialist. However, it is fair to say that over the last 18 to 24 months, hedge fund managers have become more focused on utilising risk management specialists and/or have invested more in dedicated risk management platforms. Recent events and uncertainty in financial markets has led to the development of even more sophisticated risk management systems and techniques.

2. Is the role of the risk manager now enhanced? Will the risk manager wield more influence across the front, middle and back offices?

Woolnough: The role of the risk manager may not have been enhanced as many will continue to do what they have been doing successfully over the last several years. However, their profile certainly has been. I believe it is always the case where we are operating in a heightened risk environment that prudent fund managers pay more attention to their risk teams. It follows that risk managers will wield more influence. What is interesting is that under previous conditions the influence of risk managers has increased and decreased with market conditions. However, if we believe that the financial landscape has now changed irrevocably it may be that the influence of risk managers will do as well.

Martell: Risk management is currently centre stage and is receiving a significant level of attention. This is the result of a number of factors, one of which is the growing importance of a robust operating framework within which a hedge fund operates. The management of risk has become more effective over the last few years through various risk control initiatives aimed at strengthening hedge fund operating frameworks. Some of these initiatives include increased outsourcing of administration and the range of services offered by administrators, the choice of various offshore domiciles with their differing levels of regulatory oversight, as well as the quality of risk management IT systems implemented by hedge fund managers - both in-house and outsourced.

3. Is more regulation and transparency needed in the hedge fund sector, or is the ever-present threat of regulation enough to ensure good practice?

Woolnough: I think it is important to distinguish between operational transparency as opposed to portfolio level transparency. Operational transparency is always a good thing and shrewd investors should be interested in such things as valuation policies, gating provisions and the internal processes and independence of a manager's procedures. Portfolio level transparency however is not necessarily always beneficial if it compromises a manager's competitive edge and ability to generate alpha. I believe greater regulation is inevitable. However, it needs to be carefully considered to ensure it is not counterproductive.

Martell: Regulation continues to develop and as an administrator we have to be in a position to adapt and respond to these changes. Increased regulation will make our industry more attractive to institutional investors, thereby encouraging a broader investor base. Regulators ultimately decide on the level of regulation they determine appropriate for their jurisdiction. In most jurisdictions in which we operate, the regulator pitches regulation at a level which protects investors while encouraging enterprise and innovation. Different hedge funds are regulated to differing degrees, depending on their risk profile and investor base. Good regulators get the balance right between creating a compliant environment while encouraging business.

4. Does the front office need to be more accountable to the back office?

Woolnough: It is healthy to promote a culture whereby the back office is able to challenge the front office in an open and constructive way. In tandem with this there should be a hierarchy in place which supports this culture and ensures consistent application of the firm's principles.

Martell: As an administrator, we represent the back office to a fund, while our client - the hedge fund manager - represents the front office. The effectiveness of the administration and accounting services provided to the fund is heavily dependent on the quality of the information we obtain from the investment manager. The accuracy and efficiency of the interface between the investment manager and administrator is the basis for how successfully the administrator can fulfil its responsibilities.

5. Perception of hedge fund by the media and the public is still largely negative – does the hedge fund sector need to devote more time and energy to public relations? Does it matter?

Woolnough: It does matter to the extent that public perception can and does lead to regulation. The industry as a whole should devote more time and energy to public relations. The most obvious way to do this would be to increase transparency and understanding of the sector and promote best practice. Indeed, a number of recent initiatives such as the Hedge Fund Working Group have attempted to do exactly this.

Martell: As the alternatives industry continues to evolve and allows hedge funds to be distributed on a broader and more mainstream basis - in particular through certain retail-like structures - so public perception, as well as trust, confidence and reputation, become increasingly important.

6. Has the role of the prime broker in regards to the hedge fund sector now changed? If so, how?

Woolnough: The role of the prime broker has changed insomuch as very few funds now have only one prime broker. This trend has been further expedited by the current economic environment which has seen many funds add additional brokers in order to diversify counterparty risk.

In addition to this fund managers are now paying greater attention to the ultimate custodian of their assets, which is not necessarily the prime broker, and the extent to which their assets are segregated and rehypothecated.

Martell: The role of the prime broker is integral to the hedge fund set up. Until fairly recently, the basis for prime broker selection by a manager was driven largely by the markets and asset classes covered by the prime broker. What we are seeing now is that in addition to capability, the appointment of prime broker also takes into consideration the counterparty risk to the hedge fund of appointing that prime broker. This is seen in the increasing numbers of hedge funds appointing more than one prime broker.

7. How key has the role of the hedge fund sector now become in the grand scheme of the financial system? Where does it enhance the system? Where does it detract from it?

Woolnough: One accusation often levelled at hedge funds is that the short term trading nature of some strategies and their ability to turnover positions quickly can create instability in specific stocks. This is especially true in more crowed trades.

However, it should not be forgotten that hedge funds are becoming more and more important to the financial system as providers of liquidity and diversifiers of risk.

Martell: Hedge funds are an important tool used to facilitate diversification of an investor's portfolio risk. Institutional allocations to hedge funds have increased significantly in the last five years with hedge funds becoming more and more recognised as an addition to the usual traditional asset classes.

Head to Head: A discussion of the issues surrounding new technology and hedge funds

Andrew White
managing director, Aquin International.

Dermot Butler
founder and CEO, Custom House

1. What tangible effects will the recent proliferation of risk management technology have on the hedge funds sector?

Butler: There are two questions here – secondly, what effect will the technology have. The first question is will the hedge fund sector use that technology. I think the answer to that question is that larger hedge funds are more inclined to spend the money using risk management tools and particularly outsourcing them because they have a tangible cost to the fund, which, with the clear minimum costs involved, which in turn tends to preclude many of the smaller hedge funds where the costs could amount to 50 basis points or more until such time as the fund grows.

For the larger funds who can afford it, there is no doubt that new risk management technology and systems will be used and will help the investment managers.

White: First of all the usability of risk figures to the end user will be greatly increased. All investment decisions can be monitored and their impact on the risk profile of the fund assessed objectively. It will drive investors (especially institutional investors) to demand more in-depth reports and greater transparency.

2. Will the need to invest in new technology result in the need for more outsourcing? How much outsourcing is desirable?

Butler: The cost of installing some of this technology can be greater than the cost of outsourcing and, in the same way that there are companies out there that provide a pricing service, which can be outsourced, so there are companies and, indeed, have been companies for some time, who are able to provide risk analytics and risk management services. I am thinking of companies like RiskMetrics, who started several years ago under a different ownership and who have now been followed by several other like-minded companies. Thus, the need to outsource may be, initially, a cost factor. However, the advantage of outsourcing to a recognized company that is an expert in its field, is that the manager is, to a certain extent, transferring a risk to that outsource supplier. If the manager purchases the systems and takes them in-house, then, if there is an error, it is the manager's fault. If, however, he outsources to a household name and they make an error, then it is up to them to compensate for that error.

White: Outsourcing is more a question of faith these days. Some companies openly embrace it, others reject it due to various reasons (lack of control, confidentiality etc.). We believe that it is a logical step forward for hedge funds, who find themselves incapable of staffing and maintaining multiple IT solutions and databases. Outsourcing should increase to a level where the investment manager is happy that he/she is concentrating on their core competencies. In fact it will probably come to resemble the world of traditional asset management where the investment manager concentrates on the investment decisions and the fund administrator takes care of all the backoffice processing.

3. Is the development of a standard messaging platform for all types of instruments a feasible possibility for the future? How would this improve efficiencies and could it help with the greater frequency of NAV calculation?

Butler: Given the fact that nobody had dreamed of the Internet twenty years ago – perhaps, in some cases, ten years ago – I would not doubt that the development of a standard messaging platform for all types of instruments is a feasible possibility for the future and, frankly, I think it could be the near future.

It is clear that a standard messaging platform that works would improve efficiencies and could help with the greater frequency of NAV calculation.

There is a huge attraction to having a daily NAV from a risk management point of view and, obviously, if investors are able to get access to the daily NAV from a liquidity point of view. However, there is also the school of thought that says that the recent turmoil in the markets has demonstrated that there is too much liquidity in the hedge fund market already and that investors should be tied up for two or three years. I don't think that either of those arguments fly, because many hedge fund managers will not accept daily liquidity because it puts their investment programme at risk and many investors will not accept a three-year lock-up because they want liquidity in times of stress, therefore, the answer to the question is yes – an efficient standard messaging platform could help with greater efficiency of NAV calculations.

White: It is most definitely feasible, but the problem remains that illiquid assets will always be difficult to price. For plain vanilla instruments and exchange traded derivatives frameworks are already in place, in the near future it will also be available for some types of OTC derivatives. Whether it will spread to all instruments is debatable.

4. As quant funds continue to use ever more complex algorithms and learn how to better incorporate factors such as news, will they come to dominate the hedge fund sector?

Butler: I have my doubts that quant funds will come to dominate the hedge fund sector, regardless of the evermore-complex algorithms that they have and how they better incorporate factors such as the news. In my mind, there is no doubt that the majority of hedge funds will continue to be long short listed equity or security funds.

As the quant funds become more sophisticated, if they wish to dominate the whole hedge fund sector, they are going to have to persuade the majority of investors that their black box is better than anybody else's black box and that their programme is better than more transparent programmes and programmes that are easier to understand.

White: They will very likely gain in significance, but they will not come to dominate the space as diversification will always be necessary.

5. In the past have hedge funds ignored the advantages that technology can bring in terms of risk management, valuation and communication? Are the days of three men in Mayfair coming to an end?

Butler: I don't think that it is fair to suggest that hedge funds have ignored the advantages that technology can bring. The problem has been that the hedge fund managers, who are, by nature, very sophisticated and highly intelligent boffins, if you like, tend to bring out products and technology has to catch up. Many of these managers develop their own risk management valuation systems using their own models. We have seen the weakness of that strategy over the past year or so, but, nevertheless, at the time they did it, it was a perfectly valid exercise. As technology catches up with the marketplace, so I think hedge fund managers use them. I think for the second part of this question, I am not convinced of that either. Somebody who decides that they wish to leave the prop desk of a major financial institution has to start somewhere and, if they are going to run their own capital or that of family and friends, then there is no reasons why three men in Mayfair should not do a good job on that. I am involved in a fund which was recently set up and has probably not more than four employees, all of whom are involved in the investment management. Every other aspect of the operation of the business has been outsourced and this has meant that the managers can concentrate on the job of managing the money and they haven't had to install massively expensive systems and massively expensive staff to run those systems, because all the work has been outsourced to entities that can provide the middle and back office, the banking, margining, administration, accounting, etc., etc. Therefore, those three men in Mayfair will continue to thrive, providing they get the market right. Where the three men in Mayfair fail and have consistently failed over time, has been where they have set up a hedge fund knowing about the markets, but having absolutely no idea how to run a business from buying paperclips to employing staff and complying with labour laws, etc., etc., etc. More hedge funds fail because they are unable to run their business, than from so-called "blow up". Indeed, the likelihood of start-up hedge funds making a disproportionately high amount of money is recognized by the seed capital merchants who base their business on the belief that a successful hedge fund will make more in the first two or three years of the life of the fund and before they get big enough to be cautious.

Finally, on this topic, I think that one thing we have learnt is that technology becomes more affordable over time and, therefore, the likelihood is that, five years time, three men in Mayfair will be able to afford the sort of sophisticated technology systems that today are very high ticket items.

White: The days are probably numbered, the main factor being the uptake in outsourcing and the quality of services provided by outsourcers. It is theoretically possible that a small team can use service providers to do all non-core tasks, so they can concentrate on making wise investment decisions. But it is more likely that hedge funds will take a mixed approach, insourcing the most vital processes (and therefore requiring more staff) and outsourcing all other tasks.

Guy Martell - UBS Global Asset Management

As the financial system remains in flux, change is afoot in the hedge fund sector. Joe Corcos talks to Guy Martell, UBS Global Asset Management's European head of business development and client relationships for hedge fund services.

ISJ: Where does the administrator fit into the risk management side of operations, and how can one best integrate with the front office risk management operation?

Martell: As the back office to the fund, the administrator acts as the independently appointed third party keeper of the fund's books and records. This forms part of the risk management framework that the directors of the fund would be responsible for overseeing.

By virtue of using an outsourced fund administration solution, the fund manager is able to take advantage of the risk management framework that the administrator has in place.

If the administrator represents the back office and the asset manager the front office, the degree to which we can successfully provide our administration services depends on how efficiently, accurately and timely the front and back offices are able to interact with each other.

ISJ: When a fund chooses an administrator, how much of a deciding factor is the technology that they use and the integration of the incumbent technology?

Martell: Technology is a critical factor when it comes to a fund selecting an administrator. What we are selling, in its plainest form, is leading edge technology with experienced, qualified people wrapped around it. This is a key distinguishing factor in being able to win business.

ISJ: How important is fostering a culture of risk management to go alongside the technology?

Martell: Fostering a culture of risk management is increasingly important, particularly in the current volatile economic environment. This is something that asset managers are certainly focussing on in terms of their due diligence of administrators and can be a key deciding factor when making appointments.

ISJ: How are hedge funds perceived? Is this perception changing?

Martell: The perception of hedge funds varies depending on who you talk to. For example a lay investor might make reference to the current financial crisis possibly being down to the actions of hedge fund managers or parts of the hedge fund market. When you look at hedge funds across the broader investment community there can be a lack of real understanding as to what they do and what they are for and that can lead to misperceptions.

As hedge funds are vehicles which operate in an environment where there is a low level of regulation imposed on them, they are intended to be used as a sophisticated investment tool for sophisticated investors.

The regulatory environments in places such as Ireland and Luxembourg are starting to permit structures which are more diverse as to investment type and restrictions and which are able to be distributed on an increasingly broad basis. With the changing nature of these distribution channels it has, and will continue to become far more important for hedge funds to manage their public perception.

ISJ: It seems that there has been a certain amount of consolidation in the hedge funds sector – will this affect administrators?

Martell: There has been a certain amount of consolidation and I think there is nothing to suggest that this will not continue. Consolidation implies that larger hedge funds will buy smaller hedge funds. Large hedge funds usually seek administration services from the larger providers who offer a wide service range and are able to support the significant levels of investment required to stay at the leading edge of an industry which is continually evolving and advancing.

While opportunities will always remain for boutique and niche administrators, this consolidation may imply an opportunity for larger hedge fund administrators.

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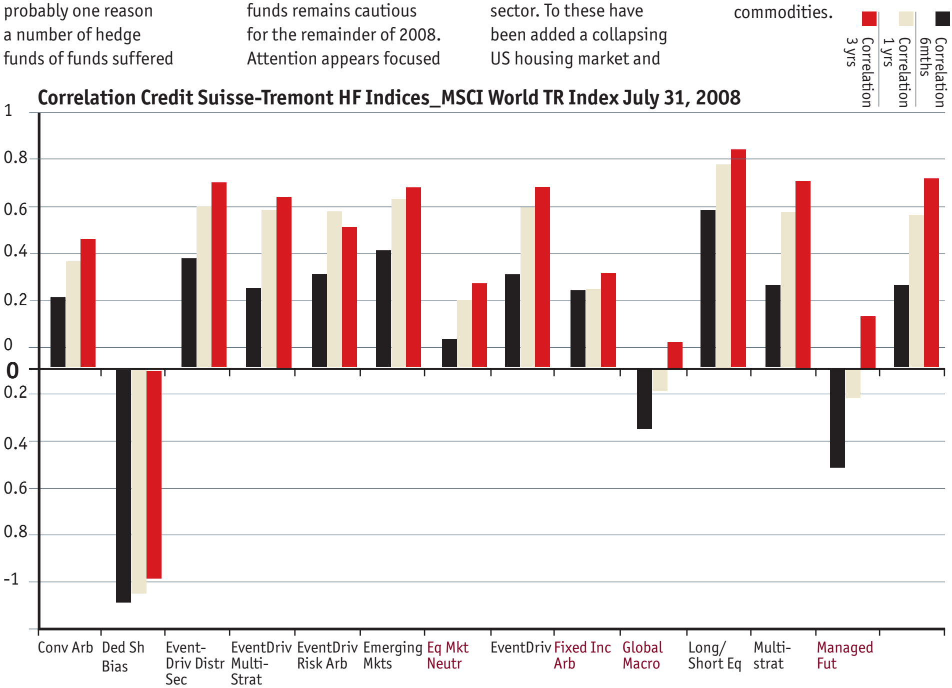
Hedge fund statistics 2008 - Lipper Hedge Funds Insight Report

The degree to which apparently diverse strategies such as Event-Driven, Equity Market-Driven and Long Short Equity increased their correlation exposure to commodity prices was probably one reason a number of hedge funds of funds suffered performance issues as the Reuters/Jefferies CRB Index fell. Certainly, it made construction of a well-diversified portfolio of noncorrelated strategies more of a challenge.

The outlook for hedge funds remains cautious for the remainder of 2008. Attention appears focused on identifying the cause of the current equity bear market, with the breaking of the subprime crisis, its associated unique securitization issues, together with an overleveraged banking sector. To these have been added a collapsing US housing market and rising energy prices. Many talk about the solution appearing to be the recapitalization of the banking sector, the cutting of real interest rates, and steps to address the issue of institutional investments in commodities.

Correlation Credit Suisse-Tremont HF Indices_MSCI World TR Index July 31, 2008



Ten Top-Performing Hedge Funds July 2008

Name	Lipper Global	Performance TR USD 1M 30/06/2008 To 31/07/2008	Performance TR USD 1Y 31/07/2007 1Y To 31/07/2008	Volatility TR USD 31/07/2007 To 31/07/2008
IKOS Financial EUR	Hedge/Managed Futures	19.68	17.38	25.25
Ebullio Commodity	Hedge/Managed Futures	18.19	NA	NA
DL Partners LP	Hedge/Multi Strategies	15.79	9.60	38.82
Mercury Mult-Strategy A	Hedge/Fund of Funds	15.24	NA	NA
Caduceus Capital LP	Hedge/Long/Short Equity	14.35	4.26	19.95
Caduceus Capital Ltd	Hedge/Long/Short Equity	14.33	4.22	19.88
Caduceus Capital II LLP	Hedge/Long/Short Equity	14.14	4.70	19.25
Hillis Partnership	Hedge/Long/Short Equity	13.86	-22.15	39.71
Melkart Diversified EUR	Hedge/Fund of Funds	11.79	23.44	16.18
Clay Capital LP	Hedge/Long/Short Equity	11.53	52.65	14.24

Roman Harbich COO

Company Brief:

Aquin is one of the leading solution providers for the international asset management and fund industry.

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Company Brief:

Fidessa LatentZero is an international technology firm that specialises in developing complete, full asset class, front-office solutions for the buy-side community. Our products are used by over 180 buy-side companies, including nine of the world's largest ten global asset management organisations, through to smaller specialist managers and hedge funds.

Richard Jones, CEO, Fidessa LatentZero

Richard Jones has been CEO of Fidessa LatentZero since its incorporation in 1999, working with Dan Watkins to create an agile, profitable business with a compelling proposition.

Richard has two decades experience of working in both the financial services and IT industries. As IT Director of Jardine Fleming Investment Management in Asia, Richard was responsible for all aspects of IT strategy, implementation and support across the region, managing a team of 80 IT staff.

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Capstone for Hedge Funds

Capstone for hedge funds is a broker neutral, pre-packaged and easy to implement application that supports hedge fund investment and trading workflows for all asset classes, including OTC derivatives.

The hedge fund solution includes position analysis by fund, strategy, sub-strategy, etc, with cross-asset class real-time exposure and P&L, and integrated market data. Orders can be easily created to open or adjust positions, and trading connectivity is provided to global brokers, algorithms, DMA venues as well as ECNs/alternative trading systems. The system supports pre-and post-trade allocation by fund and strategy, and workflow controls with integrated compliance reduce trading errors.

EMS Workstation

The EMS Workstation is a broker-neutral, low-latency trading application for equities and equity derivatives for global markets. The Workstation is ideal for any asset manager, from small hedge funds to larger institutional managers, requiring out-of-the-box access to a comprehensive set of brokers, algorithms and DMA venues, with integrated real-time, full-depth market-data with broker IOIs, news, charts and fundamentals.

The fully hosted ASP solution is quick to deploy and requires minimal or no technical support. The Workstation can also receive orders from and send executions to any third party OMS via FIX.

Connectivity

Fidessa LatentZero's front office solutions are supported by the proven Fidessa network, which provides connectivity to the DMA, Algorithmic, Program and Care order execution destinations of 310 brokers across 100 markets worldwide. Connectivity to numerous ECNs, crossing networks and ATSs is also available, providing you with all the global execution destinations you require in your continual search for liquidity.

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Company Profile - BIBA

Cheryl Packwood CEO

Company Brief:

The Bermuda International Business Association is a membership organization of leading firms serving and working in the international business community in one of the world's preeminent financial centers. It provides access to world leading fund administrators, legal and accounting firms, insurance and reinsurance companies and investment banking and trust service providers.

Cheryl Packwood, CEO

Ms Cheryl Packwood joined the Bermuda International Business Association (BIBA) on October 9th, 2006 as the chief executive officer. In Bermuda, Ms. Packwood has held senior positions as general manager at Digicel Bermuda and also, the Bermuda Monetary Authority where she was general manager, corporate services and secretary to the Board of Directors as well as director, legal service, enforcement and international affairs. Internationally, she was managing director of CORA for Western Wireless International Corporation and director of international development for N'Goan, Asman & Associes, both in Abidjan, C te d'Ivoire. Prior to moving to the C te d'Ivoire, Ms. Packwood also practiced law at Shearman & Sterling in New York City and taught at the Martin Luther King, Jr. High School, also in New York

Key Services & Products:

Legal
Accounting
Trusts
Telecommunications/Technology/e-Commerce
Investments
Fund Administration
Insurance
Bankingw

Key Locations:

Cedar House
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20 Victoria Street
Hamilton, HM 12

Tel: 441.292.0632
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Email: info@biba.org

Company Brief:

Hassans was founded in 1939, and is the largest law firm in Gibraltar. It was the first to structure itself as a modern international law practice, with separate departments for different fields of specialisation. The firm has an international clientele, which it continues to develop. It has global links with major international law firms and a presence in Spain.

The majority of the firm's work is related to international clients.

Gibraltar's status as part of the EU is a significant factor in attracting, such institutions and businesses.

Languages spoken: English, Spanish, French, Hebrew, Portuguese, German and Chinese (Cantonese and Mandarin).

Key Services:

Corporate and commercial: the firm provides a full range of legal services for clients ranging from small businesses to major multinationals. It advises corporate clients working in or through Gibraltar on a wide variety of cross boarder transactions and financing structures. Other matters handled include: international corporate restructures, joint ventures, M&A, Corporate franchising, tax and e-commerce.

Litigation: the department handles most aspects of litigation, with a niche focus on international commercial and trust litigation. The firm's litigators practice as both barristers and solicitors, and provide a full range of litigation services at all levels for both local and international clients.

International finance and banking: The firm has particular experience in banking and financial markets.

Funds: the firm has helped the Government of Gibraltar modernise the fund legislation in particular enabling experienced investor funds (EIFs) to be set up quickly and effectively. The fund team is by far the largest and most active in what is a rapidly expanding market in Gibraltar.

Telecoms: the firm advised on the privatisation of the Government of Gibraltar's telephone services and advises on all aspects of telecoms, including: broadcasting and wireless telegraphy, and was instructed by the international Telecommunications Union to report on telecoms legislation in the Caribbean region.

Private clients: the firm has specialist lawyers who regularly advise on all aspects of private client matters, including: asset protection trusts, domiciliation and taxation.

Drafting: the firm advised the Government on the transposition of EU Directives into Gibraltar law. This work has concerned legislation relating to financial services and telecoms. Contacts have also been established with a number of other Governments requiring assistance in this area.

Maritime: The firm has strong links with major English shipping firms.

Property: the firm acts for most of the major local and international developers and builders.

E commerce: the firm has advised some of the major online betting operators on setting up their operations in Gibraltar.

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Web: www.gibraltarlaw.com

Senior Partner:
James Levy QC.
Number of lawyers: 60

Spanish office:

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Email:info@hassans.gi
Web:www.gibraltarlaw.com

Dermot Butler CEO

CUSTOM HOUSE
THE SPECIALIST FUND SPECIALIST

EQUITY TRUST

Custom House is authorised and regulated by the Maltese Financial Services Authority (MFSA) and the Dublin office, Custom House Fund Services (Ireland) Limited, which is SAS 70 Type II compliant, is authorised and regulated by the Irish Financial Regulator under Section 10 of the Investment Intermediaries Act of 1995
(which authorisation does not extend to any other Custom House office).

Company Brief:

Custom House Global Fund Services Ltd. ("Custom House") offers a full "round the world" and "round the clock" service out of its various offices in Amsterdam, Chicago, Dublin, Luxembourg, Malta and Singapore. Custom House, which merged its business with Equity Trust's Fund services business on 1st September 2008 has approximately US$50 billion of assets under administration. Custom House's administration services cover all aspects of day to day operations, including maintaining the fund's books and records, carrying out the valuations, calculating the NAV and handling all subscriptions and redemptions, as well as over-seeing payment of the fund's expenses. Reporting can be effected through CHARIOT, Custom House's secure web reporting platform for managers and investors. Custom House is the only hedge fund administrator in the world to have been awarded a Moody's Management Quality Rating.

Dermot Butler, who is Chairman of Custom House, the international alternative investment and hedge fund administrator, has over 40 years experience in the financial services industry. Butler has worked variously as a stockbroker and stock jobber (specializing in South African mining stocks), before becoming a commodity broker and market maker in metal options on the London Metal Exchange (LME). Butler was a member of the Options Sub Committees of the LME, liaising with the Bank of England, the UK Department of Trade and the US Commodity Futures Trading Commission (CFTC) on option regulation.

Key Services:

Full hedge fund administration service, to include: fund accounting and NAV calculation shareholder services corporate secretarial services fund formation services

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Guy Martell, Head of Business Development & Client Relationships, Hedge Funds Europe

UBS Global Asset Management

Investor Services Journal | Hedge Fund Services Market Guide 2009

Company brief:
UBS Global Asset Management - Fund Services is a dedicated fund administrator providing customized and flexible services for traditional and alternative investments. With more than 50 years of experience, we understand the importance of fund administration to your business.

Fund Services holds a leading position in the area of hedge fund administration with specialized teams around the world. We offer a complete range of services including accounting, NAV calculation, shareholder services, banking and credit facilities. With specialist expertise in both single manager and fund of hedge fund administration, services can be provided for both onshore and offshore funds.

Through our comprehensive range of services and products, leading edge technology platforms and superior client service, we work in partnership to offer the solutions you need. For more information, visit www.ubs.com/fundservices.

Guy Martell is responsible for business development and client relationship management for hedge funds based in Europe and the Middle East. Guy began his career at UBS in 2004 as a business development manager with Fund Services in the Cayman Islands. Prior to joining UBS, Guy worked in the risk advisory services division of KPMG in Australia and the Cayman Islands, and before that worked in fixed income with JP Morgan in London. He is a member of the Institute of Chartered Accountants in Australia.

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Bill Salus, chief business development officer

PNC GLOBAL INVESTMENT SERVICING

Company Brief:

PNC Global Investment Servicing is a leading provider of processing, technology and business solutions to the investment industry. We service onshore- or offshore-domiciled funds, trust vehicles, limited partnerships, and commingled investment products from service centres in Luxembourg, Ireland, Poland, and the United States. Our multi-jurisdictional, multi-fund capability allows us to process complex fund structures-from hedge funds, fund of funds, and private equity funds to master/feeder and multi-managed funds. We cover all legal structures including UCITS, PIFs, QIFs, SIFs, VBFs, corporate, trust, open- and closed-ended.

Key Services:

As one of the world's leading third-party fund administrators, PNC Global Investment Servicing has over 30 years of experience delivering personalised solutions to the global marketplace. Our services include:

Securities Services:

- Fund accounting and administration
- Custody
- Securities lending
- Middle office
- Corporate secretarial services

Shareholder Services:

- Transfer agency
- Trustee and depositary services through PNC International Bank Limited
- Foreign Exchange

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THE DOWNTURN & LENDING

TIME WARP TO THE 1970s.

With the economy expected to slow dramatically and inflation worse than it has been in over two decades, we maybe in for a bit of a time warp back to the days of polyester shirts, when spiraling inflation joined forces with economic stagnation - slow to no growth, combined with rising unemployment - leading to a stagflation.

Status Quo

Oil and other basic commodities are surging in price to new heights, with double digit growth rates. At the same time the growth picture is just as bleak. Now that consumer power has been weakened by the credit crunch some economists are predicting anemic growth for 2008, and a growing number of experts are even predicting a recession. Sectors like automotives, airlines or retail which are sensitive to oil prices, consumer confidence and – due to high leverage – to interest rates, are facing fresh downgrades by analysts.
How will the future look?
Slowing economic growth and the insatiable need for liquidity has been triggering the Federal Reserve's policy of lowering interest rates but it seems as if this time is now over. Bernake could not be in a worse position. The Federal Reserve now has to fight inflation and at the same time stabilise the deeply disturbed financial markets, which means that the liquidity drain will stay and asset values should face more write-downs at least until next year.

Custodian banks are the winners Global custody banks have experienced unprecedented

growth in their securities lending businesses in the past year thanks partly to the global credit crunch. The explosion in revenues can be put down to the impact of the credit crisis, which has pushed up collateral reinvestment returns. This anomaly has not only affected returns but also inherent risk profiles have changed significantly. On top of this, we have learnt from clients that some banks have earned the best margins by lending cash internally.

THE IMPORTANCE OF FINANCIAL TUITION

FinTuition as a leading provider for securities related training programs and offers a variety of courses covering today's challenges:
Collateral management
Post credit crunch custodians face new challenges. Is my counterparty engaged in Alt-A or leveraged loans? Do my assumptions concerning the probability of default differ from the rating or models? How can I improve my collateral position and how will collateral be affected in a continuation of the downward spiral?

Securities Lending

Understanding the mechanics of a securities loan is challenging. You have to understand the relationship between the risks and returns and the risks are complex. We all know the devil is in the details. These are two simple examples how a small mistake can corner you in these volatile markets:

- Using the wrong day-count convention trading with a foreign counterparty will probably delay the settlement.
- Marking to market every month or week can prove lethal as collateral fluctuates and the longer the period of time you mark to market you are more exposed to risk.

Collateral margining is a common way to avoid mishaps but the question of whether counterpartieties
under these circumstances will do business with you is a different matter. Understanding you and your counterparties' collateral can give you better risk- adjusted returns.

Hedge funds are your clients

Understanding the motivations, strategies and needs of hedge funds, trading desks and asset managers is key to improving your products and processes and to maximising your fee income.

New experts need fresh courses

As market conditions are changing we are adapting our courses to ensure that they are practical

FinTuition
Securities Finance Training

and relevant. We have also expanded our trainer pool with Jens Ebinger, head of short term products structuring and sales at Dekabank, Grant Saunders, head of short term products trading at Dekabank, and Alex Krunic, senior sales custody client services at citigroup.

Global Collateral Management

15-16 October 2008 – London
Trainer: Alex Krunic /Kathleen Tyson-Quah

This course explains the rationale and current best-practice functioning of collateral management programmes for financial institutions. It is designed to build up a sufficient level of expertise to give attendees a good grasp of the legal, technical, process and economic issues and drivers affecting the profession. It is therefore suited to individuals who are either starting up a collateral management function or seeking to improve their unit's capability to add value to the front and middle offices through adoption of more efficient collateral management processing.

International Securities Lending

9-10 September 2008 – London
18-19 September – Hong Kong
7-8 October 2008 – New York

Trainer: Walter Kraushaar / Jens Ebinger
This course explains the mechanics of securities lending as well as the motivations of the various market players. The focus is on how the economic benefits of securities ownership are retained even as legal title is transferred. Lending and collateral options are outlined and assessed. We then examine the borrowers perspective and the trading strategies that drive securities lending. Why borrowers reward lenders for collateral flexibility will become clear. Following a review of the risks incurred in a securities lending programme, and the protection offered by good documentation, the course explains the different routes to the lending market and provides a comparative review of the main electronic securities lending exchanges and their impact on the industry.

FinTuition Upcoming Courses

Equity Finance & Structured Products
23-24 July 2008 – London
16-17 September 2008 – Hong Kong
9-10 October 2008 – New York
5-6 November 2008 – London
Trainer: Grant Saunders

Moving on from plain vanilla stock borrowing and lending, this intermediate-level course examines the expanded product range that comprises equity finance, including collateral swaps, repos, structured repos, and derivatives. The course explains how these structures are used to reduce dealer funding costs and enhance yields through tax and balance sheet management. Ample hands-on opportunities are provided through the use of exercises and case studies to develop participants' understanding of how and why trades are structured using various economically equivalent derivative instruments.

Bond Financing (REPO)

8-9 July 2008 – New York
12-13 November 2008 – London
Trainer: Paul Carroll

This course provides a comprehensive overview of the fixed income repo product. You will be introduced to the economic motivations of market players and learn the main trading structures, delivery methods, risk elements and documentation. As part of a small group, you will employ alternative trading structures in an extensive case study using SunGard's Personal Martini trading software. You will gain an understanding of the role of the repo desk as the 'hub' of the fixed income trading floor. You will learn what factors drive demand to borrow specific securities and create 'specials' in the market through a review of the main bond trading strategies.

Charlie Woolnough - Regional director for sales and relationship management

Company Brief:

At Prime Fund Solutions, the part of Fortis Merchant Banking dedicated to servicing the alternative and traditional investment community, we are committed to building strong and asting relationships within the global investment industry.

Focusing on the future needs and opportunities in all type of investment funds, ranging from traditional through hedge funds to funds of hedge funds, we deliver cutting-edge services and invest in state-of-the-art information technology. These services are provided from key locations, supported by representative offices around the globe. Providing a first class package of fund administration, cash management, clearing, custody, securities borrowing & lending, risk management and bridge and leverage finance, we are ready to support our clients' challenges.

Charlie has over 8 years experience in the hedge fund industry having previously worked for HSBC (formerly Bank of Bermuda) before joining Fortis Prime Fund Solutions where he is European regional director for sales and relationship management. Previous to this he has worked in a variety of hedge fund related roles including fund trusteeship, client relations, strategy and business development.

Charlie is a member of AIMA's Investment Management Research Committee and holds a degree in Business Law and an MBA.

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