SPECIAL REPORT

HEDGEFUNDMANAGER

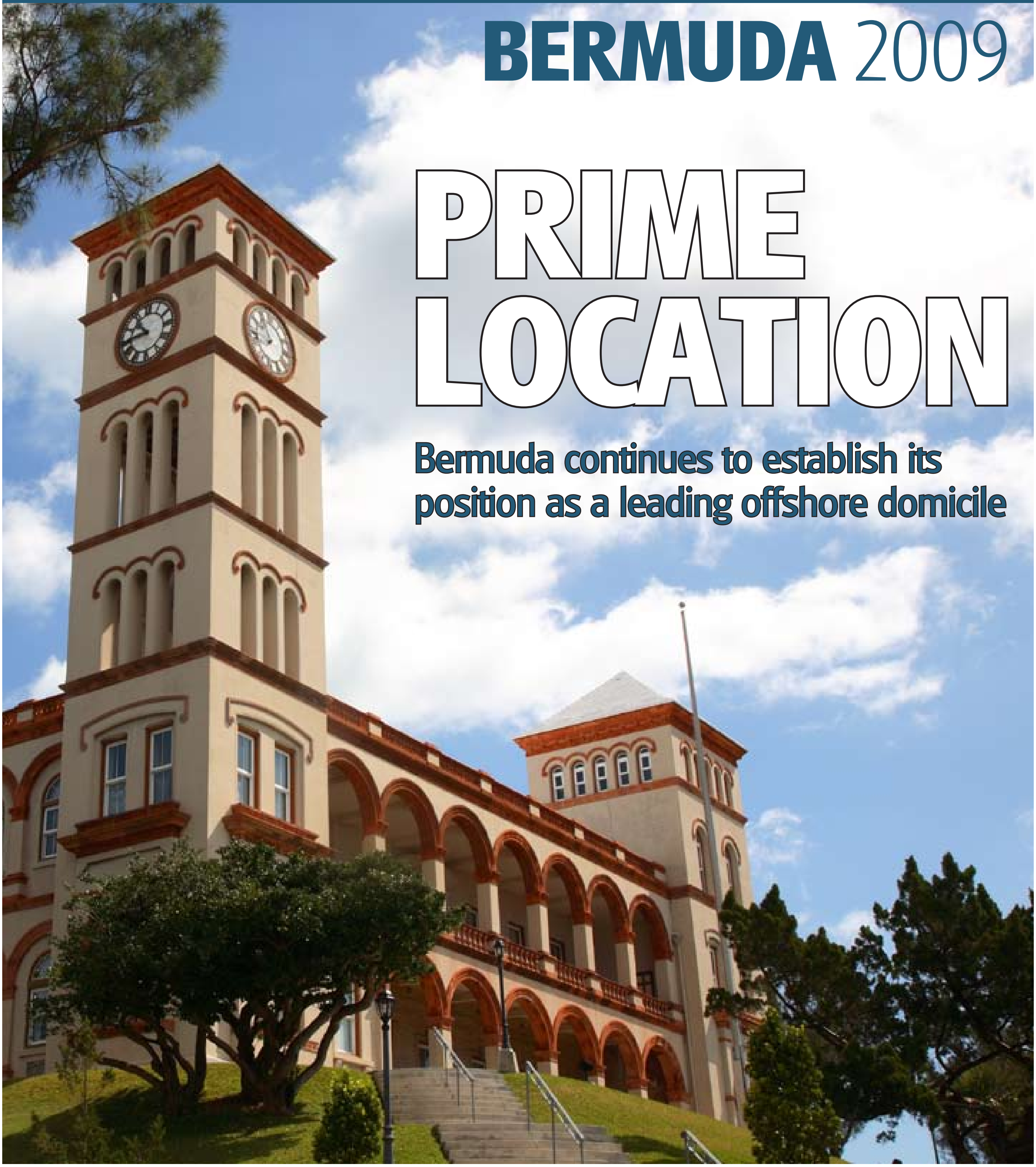
HFMWEEK

The *long* and the *short* of it

BERMUDA 2009

PRIME LOCATION

Bermuda continues to establish its position as a leading offshore domicile



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Weathering the financial storm

In common with financial markets worldwide, the Bermuda market experienced a challenging year during 2008 due to the global financial crisis. Despite the difficult economic environment, the Bermuda market has weathered the financial storm thus far, with all financial sectors demonstrating resilience in the face of the ongoing downturn.

Notwithstanding the harsh market conditions experienced during the past year, the regulation of Bermuda's fund sector remains effective. As the island's financial services regulator, the Bermuda Monetary Authority (BMA) continues to apply a risk-based approach to regulation. This ensures that its regulatory regimes are calibrated to the risk in each sector of the financial services market, including the funds market.

Bermuda's fund industry is predominately wholesale in nature, consisting of institutional, highly sophisticated investors. In line with its risk-based philosophy, the BMA's focus with regard to regulation of this sector remains on proper disclosure and market discipline. This involves initial vetting of the fund prospectus to ensure proper disclosure to investors, as well as a rigorous review of fund owners and senior personnel for fitness and integrity. In the case of investment advisors and other service providers, the BMA seeks to be satisfied that they have the required experience and a sufficient track record to manage funds.

In addition to its strict vetting processes, Bermuda's funds framework requires the separation of funds administrators, custodians and auditors. This particular condition is considered a strong element of the regime and has to date been effective in protecting investors in Bermuda funds from incidents of fraud.

Last year the BMA further enhanced its funds framework by implementing a fund administrators' licensing regime. This regime introduced a list of minimum criteria fund administrators must fulfil at the application stage and maintain on an ongoing basis. Regulating fund administrators in this way allows the BMA to reinforce its effective risk-based regime and ensures the appropriate level of standards apply to funds, without imposing a degree of direct regulation on the funds that might not be consistent with their sophisticated investor base.

Although its funds framework continues to work well for the jurisdiction, the BMA is currently reviewing proposed amendments to the Investment Funds Act 2006, the primary legislation for fund regulation. This review is part of the BMA's continual evaluation of its regulatory frameworks to ensure that they remain practical and effective for the Bermuda market and consistent with international standards.

The BMA is also embarking on a more fundamental analysis of the regulation of hedge funds stemming from the current financial crisis and the concerns of such groups as the G20. It is committed to ensuring that the jurisdiction's legislative and supervisory framework remains in line with international standards and is closely monitoring developments on this front. As with all enhancements to its regimes, any adjustments made to Bermuda's funds framework will be carefully implemented to ensure that it remains consistent with international standards, while at the same time appropriate to the nature of the Bermuda market.

Matthew Elderfield,
Chief executive
BMA

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Cheryl Packwood of the **Bermuda International Business Association** believes Bermuda's experience in hedge funds has placed it in prime position for returning investors

A history of excellence

Cheryl Packwood is the chief executive officer of the **Bermuda International Business Association.** In Bermuda, Packwood has held senior positions at Digicel Bermuda and the Bermuda Monetary Authority.

There is no doubt that the effects of the economic downturn are still being felt with full force throughout the global hedge fund community. Declining market values have led to mass redemption and liquidation, and managers and investors alike are struggling to navigate their way through the financial crisis. However, Bermuda's continued focus on efficiency, regulation and transparency has meant that it is weathering the storm better than many other jurisdictions.

This is the view of Cheryl Packwood, chief executive officer of the Bermuda International Business Association, who argues that Bermuda's gradual ascent as a domicile has paved the way for a more meaningful position within the industry.

"It's a bit like the tortoise and the hare scenario," she explains. "Previously, we were the tortoise in the funds sector while others were the hare, but in the end we, like the tortoise, will win the race by being persistent, patient and consistent."

The analogy certainly seems an apt one, as Bermuda continues to surpass other offshore centres in terms of meeting the challenges of an increasingly demanding financial environment, Packword points out.

"The history of Bermuda focuses on quality over quantity," she says. "This means that we have seen the closure of far fewer funds, unlike other jurisdictions which have seen literally thousands of funds close and investors clamouring for their money."

The Bermuda International Business Association comprises of service providers working in a number of sectors, including accountancy, risk management, technology and law.

"Our professional services are state-of-the-art and set the standard in the offshore world," says Packwood. "We are very much known for the quality of our service providers – they are the best in the world."

The infrastructure of the Association is one that encourages the growth and continued performances of funds. "For example, we have segregated accounts leglisation, which allows one cell to invest in another," explains Packwood. "This is not possible in many other jurisdictions."

Bermuda's emerging status as an integral part of the global economy is apparent in a recent economic impact study, which examined the role that Bermuda plays in the US economy across a variety of different sectors.

"We've always known that our insurance-reinsurance sectors are important – we are the number one provider of insurance and reinsurance to the US," asserts Packwood, "but the study has also found that we deliver real value in our realms like energy, shipping and in funds."

A significant financial centre

Over the past ten years, Bermuda has evolved into a significant financial centre which plays an invaluable role in the US economy.

According to Packwood, in 2008 Bermuda had 1,300 domiciled and regulated investment funds with almost $200bn in net assets and, although exact figures are difficult to confirm, it is estimated that US-owned corporate and tax exempt funds accounted for $70bn of these assets, while US individuals accounted for another $30bn.

The majority of Bermudan investments are US offshore funds established by US money, as Bermuda provides key advantages to US money managers to attract non-US investors. Such advantages include its proximity to the US, lower costs, sophisticated infrastructure, favourable tax structure, and effective and respective regulatory framework.

"Looking forward, Bermuda will continue to provide the capital that stabilises and sustains the US economy over the near and long term," asserts Packwood, "and, as a result of the global recession, this is a vital role to play now more than ever."

In turn, Bermuda is now the tenth largest portfolio investor in US securities, and its portfolio investment doubled to $209bn between 2000 and 2008. This bilateral relationship is likely to significantly impact the ability of both the US and Bermuda to meet the challenges presently facing them.

With the hedge fund industry still experiencing the repercussions of the Madoff scandal, the importance of strong regulation and transparency have never been greater, and this is an area in which Bermuda has historically excelled.

"The Bermuda Monetary Authority (BMA), which is the sole and independent regulator of the financial sector, is highly professional and experienced," says Packwood.

“We are confident that we are going to see the return of investors to hedge funds and the fund industry”

Bermuda’s current Know Your Customer (KYC) policy dates back to the 1930s when it was termed Know Your Enemy, and was established to prevent Nazi funds being hidden in Bermuda.

Meeting Bermuda’s standards

Today, Bermuda continues to ensure that only those individuals or businesses whose reputation and business ethics meet its high standards will be given access to the jurisdiction. According to Packwood – unlike many other offshore centres in the Caribbean – in Bermuda the vetting of principals is the first step to registration, not the last.

“We have a long history of regulatory excellence,” says Packwood. “It is risk-based and focuses on the investor and not just the fund and its goals. As a result, we have the kind of appropriate regulation and transparency that funds and investors are now looking for.”

The Organisation of Economic Co-operation and Development (OECD) recently included Bermuda on its ‘white list’ after the jurisdiction signed its 12th Tax Information Exchange Agreement (TIEA) with the Netherlands.

“However, we’re not just resting on the 12 treaties,” explains Packwood. “We’re going forward, signing with Germany, Japan, Canada and Mexico and negotiating with a series of other countries as well.”

According to Packwood, Bermuda also surpasses many other jurisdictions in terms of financial prudence.

“It is important to note that we are competitive on cost,” says Packwood. “For example, we don’t require the local auditor sign off that other jurisdictions require. We accept the primary auditor as long as they are on the approved auditors list. Also, many are surprised to know that experience and efficiencies have made Bermuda the least expensive in terms of cost for setting up and registering a fund.”

This ensures that the sign off occurs in a timely manner as well as saving an extra layer of expense.

With the performance of hedge funds up relative to the market in the first quarter of 2009, Packwood is confident that a turn in the market is on the horizon.

“We are confident that we are going to see the return of investors to hedge funds and the fund industry,” she asserts. “It’s already begun and it never really stopped.”

Packwood is equally confident that Bermuda will continue to play a significant role in the global economy – and the hedge fund market in particular – in the future.

“We have always had transparency, KYC regulations and top-notch regulation,” says Packwood, “and we are very optimistic that this history of regulatory excellence, transparency and focus on costs will benefit us in the near and long term.”

Bermuda’s substantial experience in hedge funds and fund management means that, as the market begins to stabilise, it will be in a prime position for attracting returning investors.

“We are well positioned in that we know what we are doing and we have been doing it for a long time,” concludes Packwood, “and that is why funds will continually come to Bermuda.” ■

Going forward, **Greg Wojciechowski** sees huge opportunities in the global stock exchange industry for the Bermuda Stock Exchange

Uniquely positioned

Greg Wojciechowski is the chief executive of the **Bermuda Stock Exchange**. He was previously its chief operating officer, responsible for the development of regulatory and operational infrastructure, as well as the day-to-day running of the exchange.

Bermuda is home to a thriving and dynamic offshore financial services industry. For many years, Bermuda has been the leader in creating and implementing the business and regulatory models that have become the standard for other jurisdictions to follow.

It is located within two hours flying time from most US East Coast hubs and is a short flight away from Canada. Daily air service to the UK and Europe make Bermuda the gateway between Europe and North America. Proximity to the world's largest capital markets and global business centres has been a key ingredient in Bermuda's success, and it has carved out a niche in the global financial services industry which is well known and highly regarded.

Bermuda's pragmatic commercial approach has created an operational, technical and regulatory infrastructure focused on clients' needs which is the result of a collaborative effort between the private and public sectors of the jurisdiction. This model ensures jurisdictional policies remain in line with or ahead of market developments and keeps Bermuda's regulatory oversight at prudent levels, while also maintaining support and appreciation for the entrepreneurial spirit that drives innovation.

This approach has driven the development and success of Bermuda's insurance and global financial services industries.

Bermuda has been transformed from being a tourist destination in the 1950s to holding the enviable position of being one of the most significant insurance and reinsurance centres in the world. At the end of 2006, the Bermuda Monetary Authority (BMA) reported over 1,400 insurance and reinsurance companies on its register, with over \$100bn in assets and capital and surplus of over \$110bn (for the year ending 2005).

Historically, Bermuda was seen as a captive insurance jurisdiction. However, over the last 15 years it has evolved to become a global leader and is supplying 40% of the US and European market property catastrophe reinsurance coverage. Bermuda reinsurers rank 13 out of the top 40 in the Standard and Poor's reinsurer rankings and 15 out of the top 35 AM Best reinsurer rankings. Bermuda's foundation for success in a global market has been its support of the capital markets, a centre of excellence with a diverse and talented underwriting pool and an effective and appropriate regulatory regime.

Household names such as Citigroup, The Bank of New York Mellon, Nomura Securities, HSBC, Ace and XL Capital have established a presence in Bermuda.

Early pioneer

The mainstays of Bermuda's strength as a leader in the offshore financial services industry can easily be traced to the jurisdiction's longevity in the business. As one of the early pioneers in the offshore financial services business, Bermuda has developed a commercially sensible level of regulation based upon years of experience, and has created products that meet the needs of its sophisticated client base. Bermuda's experience has produced a deep and knowledgeable infrastructure of service providers, which extends to services provided by global fund administrators, attorneys, banks, auditors and the Bermuda Stock Exchange. Bermuda has evolved to offer a sophisticated product to a sophisticated and selective client base.

A recent example of this innovative approach is the 'Launch 'n' List' product made available to the global hedge fund industry. Launch 'n' List is the result of a collaboration between the Bermuda International Business Association, the Bermuda Monetary Authority (BMA) and the Bermuda Stock Exchange (BSX). It was developed as a result of industry feedback which indicated a growing frustration among practitioners with the length of time they experienced when creating, domiciling and listing a structure. Launch 'n' List is a direct response to this frustration, as the procedure seeks to reduce and eliminate duplicate effort, which in turn reduces the amount of time to market.

The BSX has been in existence since 1971 and has carved a niche in the global stock exchange industry, with nearly 550 listed issuers with a combined market capitalisation of around \$330bn. Offering a complete stock exchange solution in one of the world's most respected and sophisticated offshore financial centres, the BSX trades and settles stock and cash transactions daily through its electronic trading, settlement and depository systems.

The development and success of the BSX has helped the growth of Bermuda's capital market and has provided opportunities for international clients. The BSX's commercially sensible regulatory approach dovetails with that of the jurisdiction, and is based

> **“The development and success of the BSX has helped the growth of Bermuda’s capital market and has provided opportunities for international clients”**

Bermuda Stock Exchange (BSX)

Established in 1971, the Bermuda Stock Exchange (BSX) is now the world’s leading fully electronic offshore securities market, with a current market capitalisation (excluding mutual funds) in excess of $330bn.

There are nearly 550 securities listed on the BSX, of which nearly 300 are offshore funds and alternative investment structures.

The success of the BSX lies in its innovative approach to new products and markets and its ability to offer a ‘commercially sensible’ regulatory environment. The Exchange specialises in the listing and trading of capital market instruments such as equities, debt issues (including specialised debt structures), funds (including hedge fund structures) and derivative warrants programmes.

The BSX is a full member of the World Federation of Exchanges (WFE) and is located in an Organisation for Economic Co-Operation and Development (OECD) member nation. In addition, the BSX is a Recognised Investment Exchange (RIE), as set out by the Bermuda Monetary Authority (BMA).

The BSX has been granted Approved Stock Exchange (ASE) status under Australia’s Foreign Investment Fund (FIF) taxation rules and Designated Investment Exchange (DIE) status by the UK’s Financial Services Authority (FSA).

In recent developments, the BSX was designated a Recognised Stock Exchange (RSE) by the UK’s HM Revenue and Customs.

upon currently accepted international regulatory and operational standards. It seeks to achieve an appropriate balance between providing issuers with access to the market at the earliest opportunity, and providing investors with certain safeguards and timely information to enable them to make informed decisions on the value, risk and merit of listed securities.

The BSX’s regulatory approach has been embraced by the global fund industry. Of the nearly 550 BSX listed vehicles, over 100 are hedge funds or have hedge fund attributes. Recently, the BSX has seen interest growing in the listing of fixed income products and derivative warrants, with over 100 derivative warrant structures listing in 2007 alone.

Location of choice

The BSX’s international regulatory recognitions and longevity in the stock exchange business has resulted in the BSX becoming the location of choice in the offshore world for those entities wanting a superior level of support and distinction from their listing. In fact, over half of the funds listed on the BSX originate from other jurisdictions.

Going forward, Bermuda will continue to drive innovation in its core financial services industries. The stakeholders in Bermuda have always embraced change in anticipation of the potential opportunities that may follow.

From the BSX’s perspective, we see huge opportunities in the global stock exchange industry for the Bermuda Stock Exchange. Our unique approach in respect of our regulatory infrastructure, coupled with our strategic geographical location and internationally recognised electronic stock exchange platform, places the BSX in a very exciting position to take advantage of rapidly changing and expanding global capital market opportunities.

Paul Thorne tells *HFMWeek* how **The Bank of New York Mellon** and Bermuda are leading the way in finding a prosperous solution to the present global financial crisis

Partners in prosperity

Paul Thorne is vice-president in Alternative Investment Services for **The Bank of New York Mellon** and manages the company's Bermuda operations centre. He oversees a staff of 70 fund administration professionals including investor relations representatives, fund accountants and various support personnel.

Bermuda celebrates the 400th anniversary of its founding this year, and the story of the island nation's origins and subsequent development can provide valuable insight into the challenges being faced by the hedge fund industry – challenges that, if confronted, endured and eventually overcome, can lead to a more promising and prosperous future.

In 1609, a flotilla of supply ships and settlers en route from Plymouth, England to Jamestown, Virginia encountered stormy seas while sailing across the infamous Bermuda Triangle. One of those vessels, the Sea Venture, became shipwrecked off the coast of Bermuda, and the stranded settlers claimed the islands for the British Crown.

Those first "accidental Bermudians" not only survived and effectively founded Bermuda, but went on to build two ships to complete the original rescue mission to Jamestown. The early going was rough, but from such inauspicious beginnings both nations ultimately prospered and Bermuda grew an economy that today ranks among the top five in terms of per-capita GDP. In fact, Bermuda had a per-capita GDP that was approximately 50% higher than that of the US in 2008.

Today, the hedge fund industry finds itself in much the same predicament as that struggling group of Bermuda settlers so long ago. Seemingly shipwrecked due to the global economic crisis, the hedge fund industry is seeking ways to survive and eventually prosper amid much uncertainty. The going will likely be rough, but as those early Bermuda settlers showed, the future offers bright prospects to those with a willingness to adapt to new realities.

The global economic crisis has exposed the flawed business models of some hedge funds which were not apparent during the boom years earlier this decade. During the bull market, many hedge funds cashed in on the rising tide and were able to post strong returns despite poorly managed businesses. But once the tide moved out and market volatility set in, these models were unable to effectively respond to the mounting financial crises and the search for new solutions began in earnest.

The Hedge Fund of Tomorrow: Building an Enduring Firm

The hedge fund industry's current predicament and future prospects are effectively presented in The Hedge Fund of Tomorrow: Building an Enduring Firm, a groundbreaking new white paper published by The Bank of New York Mellon in conjunction with Casey, Quirk & Associates, an independent consulting firm. The white paper shows how the industry must address key shortcomings in its business and operating models to position itself as the future of active asset management.

The Hedge Fund of Tomorrow: Building an Enduring Firm is based upon rigorous research that involved interviewing over 150 industry leaders, including institutional investors, hedge funds, fund of hedge funds and service providers. These interviewees were geographically dispersed across North America, Europe, Asia, Australia and the Middle East, and were asked questions on a wide range of topics regarding operational infrastructure, risk management, fund transparency and hedge fund fees.

One of the white paper's most important findings was the need for better alignment between hedge funds, their investment team and their investors. Integral to this alignment is an objective administrator that provides clients an honest and independent view of where the business stands. When asked if having an external administrator was a key operational requirement, a staggering 82% of hedge funds surveyed answered "yes".

Historically, the hedge fund industry benefited from having prime brokers subsidise hedge funds' operational infrastructure. The severe turmoil affecting prime brokers' parent organisations has put a sudden end to this lifeline, forcing hedge funds to bear the full cost of operations. From the managers' perspective, the combination of multiple factors, including poor investment returns, unexpected liquidity, rapid market deleveraging, major counterparty failures and unprecedented fraud, has caused investors to redefine standards for transparency and business risk, forcing hedge funds to restructure their operations. Our findings point to a future operating model for hedge funds which will be characterised by:

> **"Shipwrecked due to the global economic crisis, the hedge fund industry is seeking ways to survive and eventually prosper amid much uncertainty"**

- A greater reliance on non-conflicted third parties for a growing range of operational and administrative functions.
- Stronger in-house operations and controls to shadow and verify these third parties.
- Deeper and timelier reporting to investors and regulators demonstrating robust and segregated compliance.

A forecast for growth

The hedge fund industry's assets under management (AUM) have taken a steep fall from the high-water mark of $1.9tn in 2007, to approximately $1tn in 2009. The Hedge Fund of Tomorrow: Building an Enduring Firm, however, presents a strong glimmer of hope for the hedge fund industry. Central to our forecasts for industry growth is the fact that hedge funds will indeed address their alignment and transparency challenges and regain investors' trust.

Given recent market uncertainty and the severe contraction in hedge fund assets, the white paper presents three scenarios against which to model future demand. In the Base Case scenario, hedge funds will have an estimated $2.6tn in assets under management by 2013. In the Bull Case, that amount rises to $3.25tn, where as in the Bear Case, AUM is only projected to rise to approximately $1.9tn, about what it was at the height of the bull market in 2007.

There are also big changes in store regarding geographic regions and investor types. In the white paper's findings, North America will make up a larger share of hedge fund assets, accounting for almost half of all hedge fund AUM by 2013. Europe and Asia, meanwhile, will make up a smaller share. As far as investor types are concerned, private banks' share of hedge fund assets will fall from approximately 30% in 2009, to about 20% in 2013. Institutional investors such as pension funds, meanwhile, are projected to make up a much larger share of hedge fund AUM going forward.

While each market participant will view and respond to challenges differently, there is one thing that they can all count on: The Bank of New York Mellon is committed to helping hedge funds and investors alike through this challenging market environment. As hedge funds and their investors evolve, grow and mature, The Bank of New York Mellon has the experience, scale and scope to provide the diverse range of services that they need now and in the future. ■

Jason Bibb of **ISIS Fund Services** tells *HFMWeek* how the appointment of an independent administrator can vastly reduce investor risk and improve confidence in the hedge fund industry

Independent thinking

Jason Bibb is an executive director and managing director of **ISIS Fund Services,** a specialist hedge fund administration company. He has over 15 years' onshore and offshore fund investment management and hedge fund administration experience in developed and emerging economies.

Many hedge funds are self-administered. This means that a hedge fund manager's front, middle or back office employees can trade investment positions, move cash, monitor investment guidelines, value investments and compute net asset value calculations without any third-party validation of the process or independent oversight. Therefore, the investor has no guarantee that their investment is being managed in accordance with the fund's offering memorandum and that the valuation of that investment is being accurately recorded. This has led to devastating results. The alleged Ponzi scheme run by money manager Bernard Madoff had neither an independent administrator nor a custodian.

In Europe, which has a much younger hedge fund industry than the US, it is standard practice for hedge fund managers to use independent administrators. While some US funds also use independent administrators, it is much less common, particularly among larger, long-established funds.

With many private and institutional investors facing significant losses as a result of reported Ponzi schemes, they are now threatening to pull billions of dollars of investments from large US hedge funds because they do not use a full-time independent administrator. Clearly, an investment manager has two options: appoint an independent administrator; or add new protections, controls or procedures to his in-house operations. It could be argued that the latter will fall short of meeting the due diligence requirements of private or institutional investors. Many investors and other industry specialists believe that independent administrators help guard against fraud or other irregularities by serving as a third party responsible for confirming that the hedge fund has the assets it says it does and adheres to the investment policy and guidelines defined in its offering memorandum.

Administrators perform many day-to-day duties associated with operational aspects of a fund, such as handling money from new investors, screening investors, processing cash movements, observing risk and compliance tolerances and calculating the value of the fund's assets. An administrator calculates the asset value based on data it receives directly from the hedge fund's custodian or prime broker, such as a bank, which physically holds the shares and other assets owned by the hedge fund, independent of the hedge fund manager.

Transferring risk

There are limits to the safeguard an independent administrator can provide. An administrator may not detect a fraud or irregularity, for instance, if the custodian or prime broker is working with the fund manager and sending the administrator fictional data. The administrators of the funds that invested with Madoff did not detect the alleged fraud as they relied on statements from Madoff's brokerage business, which held the assets. However, the administrator has the ability to assess whether the information received is accurate, complete and robust before independently investigating any irregularities. It should be highlighted that appointing an independent administrator transfers the risk, and resultant liability, arising from expensive administrative errors from the hedge fund manager to the administrator – a further benefit for the hedge fund manager.

Larger hedge fund managers argue that they have spent millions of dollars employing staff and building internal technology platforms to manage such tasks as administration and that some independent

"Making sure that all company secretarial duties are performed correctly will keep the fund, the board of directors and the hedge fund manager out of trouble"

administrators are not able to administer the complexity or volume of trades performed by the hedge fund manager. Furthermore, they suggest that having an independent custodian and auditor is sufficient protection against fraud. But the response to these arguments is that independent administrators have the ability to administer a multitude of domestic and offshore fund structures which deploy a variety of investment strategies, from long/short to the over-the-counter environment, in a daily, weekly or monthly operational environment within a controlled environment. This is what gives investors assurance that their investment is being administered by an independent third party with the capabilities, skills and expertise to safeguard their interests.

Not all funds that are self-administered are being accused of being dishonest. However, investors have made it quite clear to the hedge fund community that they are no longer prepared to take any risk associated with a self-administered fund. Therefore, the hedge fund manager is faced with a difficult conundrum: re-engineer their in-house back office operation and outsource the fund's administration to an independent administrator; or risk losing investment capital from risk-averse investors. Market sentiment seems to suggest that 'independence' is getting a vote of confidence.

Corporate governance

Independent administrators and hedge fund managers are accountable to the fund's board of directors, who in turn are accountable to investors/shareholders. The application of good corporate governance in the management of any hedge fund is very important as it is a key element in enhancing investor confidence, board leadership, management oversight and accountability.

Much of the recent emphasis on corporate governance has arisen from: high-profile corporate scandals – due to a number of circumstances including financial reporting irregularities leading to a lack of investor confidence and public trust; globalisation – developing markets in particular need to demonstrate good corporate governance to instill investor confidence; and increased investor activism – when managing long-term investments.

Recent new legislative and self-regulatory corporate governance requirements have helped to instill global market confidence. This includes: improved integrity and oversight of management; scrutiny over board composition and independence; effective use of internal and external audit functions; higher levels of disclosure and transparency and greater engagement with investors.

There is evidence that investors value investment funds with good corporate governance and established board of director structures.

Independent administrators typically domiciled offshore offer company secretarial services to hedge funds that assist in the application of good corporate governance standards. ISIS Fund Services has a team of qualified company secretaries that can guide a hedge fund, and its officers, through the obligations imposed by statute and regulation in the jurisdiction of incorporation.

These professionals add value to the board of directors and the hedge fund manager in a variety of ways such as: assisting in the fund's formation; advising on the appropriate legal procedures to change the officers of the company; change shareholdings; amending the accounting reference date; declaring a dividend, dealing with late subscription or redemption requests; advising on directors' responsibilities; maintaining statutory registers and minutes; attending board and general meetings to advise on procedure and to take minutes; and filing all necessary accounts, forms, returns and resolutions with the local regulators and government associations.

These are just a few of the tasks performed by an experienced company secretary which can add significant operational value to the board of directors and management team, as well as giving investor greater comfort that the fund is being managed properly and within the legal and constitutional guidelines in which it was formed.

Making sure that all company secretarial duties are performed correctly will keep the fund, the board of directors and the hedge fund manager out of trouble with the authorities and other related parties. Therefore, the provision of corporate secretarial services should not be taken lightly.

Taken together, the appointment of an independent administrator and the application of good corporate governance principles will ultimately reduce investor risk and develop more confidence in the hedge fund industry. Whether each factor is working independently or in combination with each other, the expectation of future capital inflow and the growth of assets allocated to hedge funds would certainly look brighter. ■

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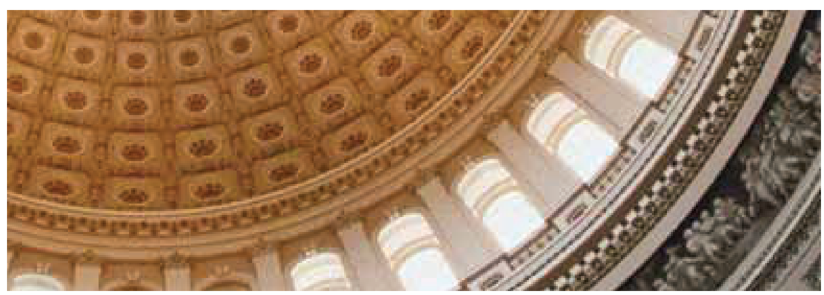

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Stuart Drake and **Stephen Castree** of **Equinoxe** look forward to the opportunities that will arise as it strives to satisfy investor demands in an increasingly scrupulous environment

Ready to meet the challenge

Stephen Castree is chief executive officer of **Equinoxe**. Prior to joining Equinoxe, his previous roles include global head of strategy and product development and global business head for hedge fund administration at JPMorgan in Ireland and director and operations manager at Tranaut Fund Administration in Bermuda.

Stuart Drake, chairman of **Equinoxe,** was a managing director of JPMorgan Hedge Fund Services (previously Tranaut Fund Administration) until late 2007. He set up Tranaut in late 1999. Prior to Tranaut, he joined Hemisphere Management Limited in 1993 and progressed to become a member of their executive management team in 1997.

For fund administrators, especially, the catastrophic events of 2008 brought with it momentous change. The weight of declining assets, redemptions and restructuring across the hedge-fund space led to increasing pressure in various forms. Heightened investor scrutiny brought calls for independent oversight and transparency and, as the market condensed and revenues dropped, competition among administrators increased, causing fee levels to decrease despite raising expectations and heavier workloads.

According to Stephen Castree, chief executive officer of Equinoxe, the economic crisis condensed a reasonably well-segmented market into one ridden with administrators competing for similar business.

"Originally larger funds worth $200m plus in assets had the capital to opt for a large institutional household name, while smaller funds of around $50m did not have that option," explains Castree. "This lent itself to a basic three-level market segmentation, larger institutions would seek to service larger clients; some boutique providers would service medium-sized simpler clients and more complex larger clients; and some administrators that competed purely on price for the smaller manager."

However, in today's altered landscape, the picture is very different.

"In those days managers were naturally picking from a different pool of administrators," says Castree. "Today, however, there are few $200m start ups; many more are around the $40-50m mark; so competition is far greater, as the larger institutional players are now looking to take on lower fund sizes for lower fees, and service model offerings are more diverse."

Choosing the ideal model

According to Castree, there are currently three core business models available to managers: the large institutional model that functionalises every component over a large team of individuals; a cheaper model off-shored in a location in a different time zone; or a boutique-style service model offering a single-point-of-contact management team performing all duties for the client situated in the same time zone as the manager. The latter approach is most aligned to Equinoxe's model, Castree explains.

"Our model focuses on flexibility and high touch," he says. "Going forward, I believe that this model – a boutique-style approach that can provide assurance through its institutional flavour – will have a lot of resonance as the industry re-emerges."

According to Stuart Drake, chairman of Equinoxe, market volatility coaxed managers to more established, brand-name administrators with the belief that this limits their counterparty risk. However, in reality, the additional pressure from staff downsizing coupled with increased workload in large organisations has translated into increased operational risk, he believes.

"Historically, managers who made decisions based on an organisation's reputation or its perceived counterparty risk found, as pressure increased, that they were not receiving the high-touch service they wanted," he says. "Going forward, the challenge is for managers to choose an administrator that can provide an affordable service that satisfies investors and is personal."

According to Castree, Equinoxe holding a Fortune 500 institution as a significant minority shareholder is one factor that validates it with institutional credence. Castree is equally keen to point out that taking an institutional functionalised model and simply wrapping it with relationship management components is not a suitable approach in an industry that should not be commoditised.

"Many institutional players are unable to provide a boutique-style service because they have to scale quicker," he explains, "and, in turn, boutiques with legacy issues usually have not acquired the required institutional components. That is what separates us from our competitors."

As a relatively new player that built its business to an institutional level over a two-year period, Equinoxe can provide scalable technological solutions within a client-centric model in a way that other administrators cannot, Castree explains.

"We selected a technology platform with $12tn of assets on it, coupled with a leading edge transfer agency platform," he points out. "A boutique service without the benefit of starting afresh and selecting a new technology platform would suffer significant migration costs – as well as having to re-write its procedures manual and hire the additional staff needed to punch at an institutional level."

"Ultimately if you do not pay the right amount, you are not going to get the right person doing the job, and you are not going to get the right quality of service"

"If we had started our business five years ago rather then two, however, it would be a very different story, with challenges of reduced revenue and high-fixed costs that we are fortunate enough to have avoided," Castree admits.

Resisting adversity

According to Drake, another reason for Equinoxe's relative stability is its resistance to asset downturn due to its business mix. The blows dealt to larger institutional players facilitating a larger asset base were in many cases cushioned by the sheer size of their pockets, whereas the middle-tier boutiques coping with the loss of 30-40% of its revenue base have found cashflow very strenuous.

"Because we do not have any legacy issues, we have not been as badly hit by asset downturn due to the fact that our clients are predominantly minimum fee clients or their seed capital is more stable, therefore allowing them to side-step suspensions or liquidations," Drake confirms.

Those not so fortunate have been forced to compete by taking on business at a loss as a last resort, Castree points out.

"Some administrators have had to offer a service at a loss-making price just as a way of grabbing business," explains Castree. "And this has allowed the manager to push an administrator's price down. This model is not expected to be successful in the long term."

In this scenario, the challenge for the manager – and ultimately the investor – is not to drive the fee so low that it prevents the work's completion, especially as the products become increasingly complex during a period of widespread illiquidity.

"Ultimately if you do not pay the right amount, you are not going to get the right person doing the job, and you are not going to get the right quality of service," Castree acknowledges. "So there is a conflict between choosing a cheaper mode of service and one that satisfies investors."

In today's environment, where third-party oversight has become the modern pre-requisite for any fund, a discrepancy has arisen. Investor calls for transparency have combined with the demand for more frequent, accurate reporting, and all at a cost-cutting price. According to Castree, somewhere along the line this dynamic needs to be addressed.

"The reality is that there is a minimum price that has to be paid to get that quality of service," asserts Castree. "Over time, once the industry has consolidated a bit and demand has increased, price will stabilise at an appropriate level."

In light of this, both Drake and Castree have become aware of a significant opening for fund administrators in this area. Those strategically positioned – nimble enough to respond to a manager's demands passed down from a generation of choosy investors – will prove most successful. And ultimately there will be an opportunity to fashion niches in a segmenting industry going forward.

"As the industry rebuilds and liquidity returns, what we will begin to see is more hedge fund managers opting to define their own best-fit model of business," concludes Castree. "The challenge for administrators will be to meet bespoke requirements by defining their own product offering and targeting it at a particular client."

So for Equinoxe, conveniently positioned as an institutionally flavoured administrator offering a high-touch service, opportunities will arise as it strives to satisfy investor demands in an increasingly scrupulous environment. Going forward, as liquidity returns and the pool of administrators consolidates, managers may well find themselves in a position to hand-pick an administration service that is carefully tailored and suitably priced, but with robust institutional components to satisfy the demands of heightened due diligence – and, as suggested by Drake and Castree, Equinoxe is ready and waiting to meet that challenge. ■

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Bermuda's strong fund services history and wilingness to accept ever-changing regulations has stood it in good stead in the recent global turmoil, according to **Peter Hughes** of **Apex Fund Services**

Leading from the front

Peter Hughes is the founder and managing director of **Apex Fund Services**. Between 2000-2003 he was chief financial officer of FMG Fund Managers and has been a qualified chartered accountant since 1994.

The hedge fund industry is currently experiencing dramatic changes: the effects of the global financial crisis are ever present, while new regulatory measures proposed by the EU look set to have a dramatic impact on all offshore domiciles.

In addition, the fallout from the Madoff scandal has meant that fund regulation and transparency have never been so important, as fund managers are being prised away from self-administration in favour of more transparent third-party solutions.

Drawing upon his own substantial experience, Peter Hughes, managing director and founder of Apex Fund Services, explains how these changes are impacting the global hedge fund industry and why the flight to outsourcing will be a significant part of all fund management going forward.

HFMWeek (HFM): How has recent economic turmoil impacted on the services you provide funds?

Peter Hughes (PH): It has clearly had a significant impact across all types of funds. In particular, the lack of liquidity over the whole financial system has meant that many of the bigger credit-based funds have had to close. Fortunately Apex has serviced none of those, but the financial crisis has meant that our funds have had to manage their liquidity better due to an increased volume of redemptions.

In order to best serve our clients, we have raised their awareness over best practice for fund management to ensure that shareholders still have a decent structure to work with and can get liquidity as soon as possible. We have focused on adding value by discussing redemptions gates, lock-ups and restructuring, and this is something we have had to do more than ever before over the last year. We service a cross-section of funds and apply our diverse knowledge gained from experience to add value to all our clients.

HFM: How well is Bermuda placed to respond to the changing expectations of the fund industry?

PH: Bermuda, as one of the oldest fund jurisdictions, has acquired a lot of experience and the pre-eminence gained from this exists within our flexible regulator, the Bermuda Monetary Authority (BMA), as well as within the services provided by law firms, auditors and the administrators. I believe that having strong service providers is a pivotal aspect of any jurisdiction.

There has been a strong fund industry on the island for many years and this has harvested a quick and efficient environment that can respond to changing regulatory regimes. Such flexibility was demonstrated recently through Bermuda's placement on the Organisation for Economic Co-operation and Development (OECD) 'white list' – I don't think Cayman or the British Virgin Islands are on that list.

HFM: Amid a changing industry, what can be done by a fund administrator to help entice investors back into the market?

PH: Fund administrators can add value and give investors confidence, especially with regards to funds that have not had a fund administrator before. Prior to the economic crisis, particularly in the US, many funds were self-administered, however today, amid investor calls for transparency, there is a flight towards third-party administration.

For example, one benefit of a third-party administrator is that you can provide web-based reporting to investors and independently check the pricing of a portfolio.

Moreover, third-party oversight can add substantial value to the fund manager through its credibility, and in turn attract investors. What we are seeing in today's climate is that the absence of an independent administrator is proving a major hindrance for a fund regardless of its performance, as the industry comes to terms with a newfound institutional acceptance that self-administered funds will no longer satisfy investors.

In an era post-Madoff, people recognise that what was acceptable in the past is no longer a viable approach. Even UBP and Bank Mirabeau, who are institutional investors in Switzerland, have announced that they will redeem any investments from a fund that doesn't have an independent administrator unless one is acquired.

The industry is clearly being steered in the right direction, which is going to give investors more confidence and, as liquidity comes back into the market, money will come to well-structured funds with the right service providers.

"Third-party oversight can add substantial value to the fund manager through its credibility, and in turn attract investors"

HFM: How do you expect the jurisdiction to be affected by changing regulation?

PH: Following April's G20 summit in London, the EU published a draft directive which, in its current format, would be quite damaging for all the offshore jurisdictions outside the EU. The state of its final format will be critical to how regulators in Bermuda can strengthen its regimes in line with what is happening onshore.

In its current form it is fairly protectionist for the EU, outlining the prohibition of fund's promotion into the EU if it is not domiciled in the EU. In effect it will close the boundaries to offshore jurisdictions, relegating the fact that well-run funds set up at low-cost with excellent service providers are not a risk to regulators.

Currently there is a lot of lobbying from organisations such as the Alternative Investment Management Association (Aima), who argue that, although changes do need to be made, some of these requirements – put together in a two-month period without industry consultation – may not be suitable.

Although the final format of the directive will have a bearing on Bermuda, it is clear that regulators do need to bring stronger regulation into the jurisdiction in order to converge with what is available in mainland Europe. A convergence between offshore and onshore domiciles will mean that in the future, possibly in the next couple of years, it is likely that offshore domiciles will no longer be termed as such – they will simply be treated as individual nations.

There are a lot of changes happening and, while the industry is in a state of flux, it is difficult to make predictions. However, one thing is certain; Bermuda is very forward-thinking and its ability to adapt quickly will ensure a competitive advantage over rival jurisdictions.

HFM: In terms of performance, what do you expect for the industry in the near future?

PH: Despite rising markets across Europe and US over the past two or three months, there are still signs that there will be more bad news to come over the summer. In my opinion, Q4 is when we will see more positive results as some of the Middle Eastern sovereign-wealth funds put money back to work.

The world's growth is still coming from the emerging markets: China, India, Africa, Russia and the Middle East. I think that a lot of money will move towards those jurisdictions and those markets and they will do very well over the medium term.

Essentially, from October onwards, I think performance should improve across the board with a particular bias towards the emerging markets.

HFM: Going forward, what benefits does Apex have over its competitors?

PH: The fact that we are a global, niche administrator is a huge selling point for us. It means there is a lot of cross-selling between offices; clients get a global solution rather than a local solution. Our clients will not have to use different administrators for different jurisdictions – they can do everything through Apex, outsourced over multiple time zones.

Today, this is very important because fund managers now want a faster, more responsive service – they want an answer within an hour as opposed to a day and, with our model, that is what we can deliver.

In contrast to some of our competitors, who want funds of a particular size or amount of revenue per client, we take on clients of all sizes – no matter how big or small – with an aim to build long-term relationships. Because we take on all different types of strategies, in all jurisdictions and of all sizes, we are attracting a lot of clients – it is very rare that we cannot offer a solution. ■

Bradford Rowley of **Pacific Fund Systems** tells *HFMWeek* how fund administrators are responding to a changing environment

Trends in fund valuation

Bradford Rowley is a senior business analyst for **Pacific Fund Systems** and is based in London when he is not visiting clients.

As fund administration continues to play an increasingly important role in the hedge fund industry, the need for secure and efficient systems built to support the fund administration process is becoming ever more vital. For companies wanting to ensure they consistently provide a high-quality service to their clients, Pacific Fund Systems provide flexible, adaptable and scalable software solutions which enable fund administrators to work with both increased speed and cost-efficiency.

In light of the changing economic climate, Bradford Rowley, a senior business analyst for Pacific Fund Systems, explains how the fund administrators are responding to changes in the market and why effective and efficient software solutions are now playing a crucial role in the administration industry.

HFMWeek: In what ways does the application system provided by Pacific Fund Systems differ to other applications in the industry?

Bradford Rowley (BR): The core strength of PFS-Paxus lies in its integration. From the outset, our objective was to build a single system to support administrators to cover the breadth of their business. The functions of an administrator can be supported by a single system without having to build interfaces between various standalone systems that were not designed to talk to each other.

To my knowledge, there are few systems out there that can offer the same breadth of functionality for administrators on a single platform, and the advantage of this is that it maintains consistency of data throughout the fund administration process in a single database. This increases the efficiency of the fund administration process and gives administrators a single point of reference. Helpful side effects also include reduced IT costs and reduced training costs, due to the consistent interface. It is easy to make system selection far more complicated than it need be by having various competing systems under the same roof. An integrated system also allows for rapid recalculation of valuations. This is particularly relevant for the fund of funds sector where underlying asset prices are subject to regular revision and performance estimates are often demanded with each change in underlying asset price.

As one of the 'original' offshore fund administration centres we see Bermuda as a repository of high-quality fund administration knowledge and skills. We have been working with the Bermuda fund-administration community for 10 years, and feedback from that community has contributed to our product offering significantly. In my opinion, what makes the Bermuda community unique is the entrepreneurial approach they bring to their clients, and the boutique offerings they strive to provide to each of their clients. In turn, this has required us to be able to add functionality at short notice to provide for all manner of nuances – for example, there are a surprising number of different ways to calculate a management fee.

As specialists in the hedge fund administration industry we understand the demands of the industry and can respond appropriately to new requirements. When an administrator approaches us with a new requirement they do not have to explain it twice and, if for some reason the request cannot be rapidly built into PFS-PAXUS, we are in a good position to advise on how best to accommodate it until permanent changes can be made to the application.

HFM: How has the changing financial climate affected market performance and what impact is this having on administrators' business?

BR: Many administrators saw very substantial reductions in assets under administration (AUM) in the third and fourth quarters of 2008. Given that their revenue is largely basis point derived this had a direct impact on revenue. We have seen encouraging signs of growth in the last three months, with many of our clients reporting that AUM are increasing again. The global financial crisis has also led to the creation of a significant number of side pockets which complicate administration and require highly skilled staff to oversee.

Despite the return to some form of normality in the markets, at least in terms of asset class correlations, many hedge funds are still below their high water marks (HWM). For those funds with annual HWMs, many missed their HWM at the end of 31 December 2008 and so the performance losses have been carried forward to the following performance fee period.

This has a significant effect when hurdles are involved and it is likely that some managers may attempt to change the way hurdles are calculated to incentivise them. In these cases the pertinent variable becomes the hurdle capital date. Where a fund is below the HWM, is the hurdle calculated upon the original HWM or is it reset at the date the HWM is tested?

For example, let's say a fund starts on 1 January 2008 at Net Asset Value (NAV) 100 and falls to NAV 75 at 31 December 2008. If the HWM is tested on 31 December 2008, does the hurdle apply to the starting price of NAV 100 or upon the 31 December 2008 NAV price of 75? This can have a material impact upon the future investment returns required for the manager to achieve a performance fee.

If the hurdle rate is 5%, then under the first approach the effective investment returns require to achieve a performance fee becomes 6.6% (for example Hurdle Rate 5%/ NAV75 = 6.6%) which is obviously a more challenging target.

We are also seeing an increasing trend to change the way in which hurdles are applied as a result. Traditionally once the performance exceeds a hurdle, the performance fee is calculated upon the 'out-performance' (for example the performance above the hurdle). For example, if the hurdle is LIBOR (London Interbank Offered Rate) +1% spread, and the LIBOR is 4%, then the performance fees will only be calculated upon returns exceeding 5%, and so if the performance is 8% the performance fee will be calculated upon the excess return of 3%.

More recently we are seeing an increased use of an alternative method where the performance fee is calculated upon the 'total performance' so long as the hurdle rate has been achieved. Using the same example, if the performance is 8%, the performance fee will be calculated upon the total 8% performance, but if the performance is 4.9%, the performance fee will be zero.

These calculations can be automated in Paxus under the multi-series or the performance fee equalisation models.

"As the changes to the regulatory environment unfold, we believe the resulting trend will see an increasing demand for transparency and independence of valuation"

HFM: How do you feel the fund industry is changing in terms of investment methods?

BR: The need for side pockets has become apparent as a result of the continued market volatility. Side pockets can be the best solution to enable the normal entry and exit of investors into the fund whilst ring-fencing distressed or illiquid investments to the group of shareholders who were invested at the time the issue manifested.

In this way the fund can continue normal operations and the NAV can be struck without the encumbrance of having to value illiquid or hard-to-value assets before finalising the NAV. By creating a side pocket, those specific assets can be owned by specific shareholders without affecting the performance of new shareholders who have entered the fund after the creation of the side pocket.

The calculation of both profit allocations and performance fees in the presence of side pockets can become considerably more complex as it is not equitable for the shareholder to pay performance fees on their original shareholding if the side pocket is bearing a performance loss.

In PFS-Paxus, any profits and losses arising from the side-pocket investments can be automatically allocated to the side-pocket shareholders. This is an example of where integration of portfolio, general ledger, fee calculations and share registry brings real benefits.

HFM: Going forward, what is the outlook for the fund-administration industry?

BR: We believe the future is bright for fund administration in Bermuda. As the changes to the regulatory environment unfold, we believe the resulting trend will see an increasing demand for transparency and independence of valuation driving demand for the services of fund administrators. There is also an increasing call for separation of duties, which may impact large institutions that offer both prime brokerage and fund administration services thus creating opportunities for boutique administrators.

As a result these trends will manifest in increasing investment in private equity-style investment vehicles (to avoid regulation), managed accounts (for transparency) and alternative investment managers will begin to step into the traditional manager space (due to regulatory supervision).

Much has been said recently about the likelihood of institutions pushing for managed account vehicles, although the push may be tempered once institutions consider the increased costs and potential unlimited liability that can arise from these vehicles in some circumstances.

Traditional hedge fund administrators in the offshore market need to be able to offer private equity in their suite of administration services, so we recently invested in PFS-Paxus to provide functionality to support private equity-style vehicles.

This is part of our commitment to support Bermuda administrators; we want to become business partners in helping entrepreneurs grow their fund administration business to share mutual success. ■