NEW TIMES REQUIRE A NEW APPROACH

IAN HEADON OF **NORTHERN TRUST** IDENTIFIES THE FOUR KEY TRENDS THAT HE EXPECTS THE HEDGE FUND INDUSTRY TO EXPERIENCE AS INVESTORS SEEK ALTERNATIVE METHODS TO INCREASE, ACCESS AND RETAIN THEIR HEDGE FUND EXPOSURE

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In a rapidly changing landscape, US investors are increasingly seeking transparency and control while also seeking to retain their hedge fund exposure. The upcoming AIFM Directive and SEC legislation will certainly bring additional change, with investors changing the way they access hedge funds in preparation. Ian Headon of Northern Trust speaks to *HFMWeek* about what these changes will mean for US managers and what they can do to prepare.

HFMWeek (HFM): In what ways are institutional investors seeking to retain or increase their hedge fund exposure?

Ian Headon (IH): Despite the difficulties of 2008 (and to a certain extent 2009) many hedge funds behaved exactly the way they are supposed to: they outperformed markets, provided an absolute return to their investors and acted as a diversification tool. Clearly many hedge funds did not achieve those things, and some hedge funds have struggled to retain investors. Nevertheless, institutional investors are broadly saying that they want to retain or increase their exposure to hedge funds. The key new theme we see, however, is investors looking to slightly shift the way they access those hedge fund strategies. We see four trends:

- First of all, we see investors who are happy with the Cayman hedge-fund route. They do want more transparency, however, and this means seeing the portfolio more frequently, accessing pricing policies and accessing the fund administrator.
- The second trend is a shift into separately managed accounts. The term separately managed accounts covers a wide array of structures and offerings, but broadly speaking we have seen some investors demand much greater control over the activities of the hedge fund manager. This can be in the form of an investor allocating cash directly to a hedge fund purely on a bilateral basis. Alternatively, they can still take exposure to the hedge fund but the fund promoter, the fund owners and the governance structure will be completely removed from the actual investment management function.
- The third trend is a shift to so-called regulated jurisdictions. Even though Cayman and Bermuda funds are not "unregulated", we normally see the world split between so-called regulated jurisdictions, such as Ireland and Luxembourg, and less regulated centres. There is a noticeable shift to the more regulated jurisdictions.
- The final trend we see is the move to Ucits or "Newcits". It still remains to be seen how sustainable and permanent this is, but the best estimates we see are that $69.19bn (€50bn) has been launched in new Ucits vehicles in the past two years or so. While not yet a fundamental change in the way the industry operates, it is a significant shift of capital in a relatively short space of time.

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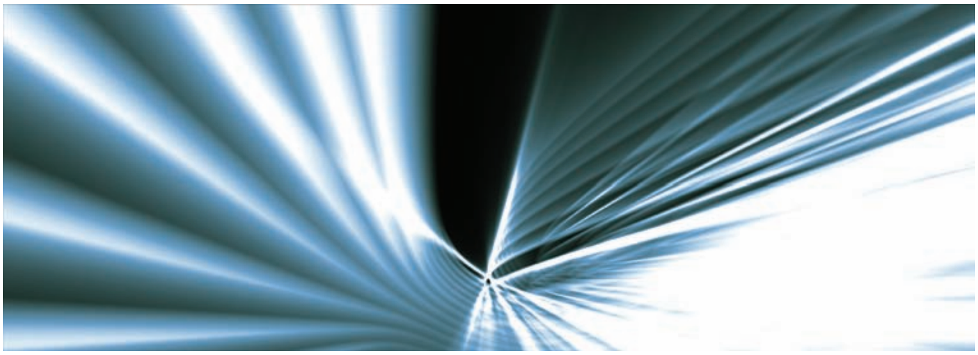
We see these four behaviours driving the way investors want to retain or increase their exposures to hedge funds.

HFM: What is the current demand for Ucits in US hedge funds? What are the factors that have contributed to this?

IH: We see two key drivers at this high level: the events of 2008/09 and new regulation.

Firstly, many investors struggled at the end of 2008/09 with issues like asset safekeeping, asset liquidity or counter-party exposure, with many hedge funds and investors exposed to Madoff and Lehman Brothers. The liquidity issues experienced by many in the form of investment gates, NAV suspensions and side-pockets has driven some investors to demand a Ucits fund, with the expectation being that a Ucits will provide more comfort around asset safekeeping and liquidity.

The second driver we see is the AIFM Directive which is aimed at non-Ucits funds and creates a degree of uncertainty over the way those non-Ucits funds can behave. One obvious way to remove the uncertainty created by the AIFM Directive is to create the investment



strategy in a Ucits vehicle. This said, I think it is also important not to over state this trend.

Even if the AIFM Directive comes into being before this side of 2011, there is still much discussion to be had over the details. I think investors in this space are sufficiently sophisticated to know that if they take exposure to a non-Ucits fund, the AIFM Directive will eventually have an impact.

HFM: How can investors improve the transparency of their Cayman fund?

IH: The most obvious response to the question of transparency is additional reporting into the portfolio valuation. However, we see two other dynamics.

Firstly, we see transparency into the valuation process being popular, and the second is what we can refer to as compliance.

In terms of valuation process, we have seen large institutional investors and fund of funds spend a lot more time in working through the valuation policy of the hedge fund. We have also started to see investors expressing just as much interest in the process as in the price. There is an acknowledgement and acceptance that there will be illiquid and other hard to price assets in most hedge fund portfolios and a key focus for investors is in understanding how that valuation process works – including governance, control, decision-making authority, stale price procedures, involvement of the asset manager etc.

From a fund administrator point of view, we have certainly seen institutional investors of fund of funds come into our office to see how we work with the fund board and the fund manager in implementing pricing policy.

The second dynamic is investors seeking transparency into the investment compliance of their hedge fund investment We are starting to see our fund of fund clients who have secured some of the transparency we talk about, or indeed our hedge fund clients on whom these demands are being made, starting to look to us to add extra value in terms of demonstrating compliance with investment strategies. We are certainly starting to see the shift to investment compliance, in addition to legal compliance.

HFM: What are the advantages in switching to a separately managed account?

IH: There are normally two ways this is structured. One is a bilateral agreement between the investor and the hedge fund: the investor gives the hedge fund money to manage on their behalf and only on their behalf; they do not want to be comingled with anyone else. This arrangement is normally known as a separately managed account. The second option is a managed-account platform, which in many ways is a comingled fund where the governance structure is quite different. The owner of this platform effectively creates a governance structure and then selects investment managers' independent from that structure. Investors tell us one advantage to this arrangement is that transparency and control are separated from the investment-management process, which can provide comfort to many.

Many hedge funds will, however, claim that managing separate accounts can sometimes be an operational hassle because there are extra governance protocols, extra reporting, different investment mandates and you are managing two or three pools of money instead of just one. Some hedge fund managers will look at the balance between obtaining the extra capital versus the extra operational difficulties. There is also a view that the bilateral contract between investor and hedge fund manager may end up being exempt from the AIFM Directive.

HFM: In what way do you expect the upcoming AIFM Directive and SEC legislation to affect US hedge funds? How is Northern Trust preparing for this?

IH: The AIFM Directive is aimed at non-Ucits managers, so it specifically doesn't cover some of the Ucits funds I mentioned earlier.

Notwithstanding some of the uncertainty on the final terms of the AIFM Directive, we can say with confidence that it is going to have an impact on any non-Ucits fund seeking EU investors. If the management is based in the EU, if the fund is domiciled in the EU or if you have investors in the EU there is going to be an impact on your business. Precisely what that impact is remains to be seen, although we still want to give some direction to asset managers.

US managers with Cayman funds who want to distribute to EU investors via passive marketing or reverse solicitation will probably have to comply with aspects of the AIFM Directive which are loosely bundled under the heading 'operational'. This may include remuneration policy, leverage, and creating investor communication, in a similar way to the creation of a Key Investor Information Document (KIID) for Ucits IV. It is also highly likely that the US manager will have to register under the SEC Dodd-Frank Act, if they wish to distribute to the EU. At the most extreme, to secure an EU Passport, it may include a significant change to the way the fund is structured and the non-EU AIFM may need to undertake the appointment of a depository. In preparation for this, we are keeping clients up to speed, in terms of the negotiations at EU level. We have also commenced workshops with all our clients to go through what we believe the AIFM Directive will say, and start to sketch out what impact we expect that to have on our clients' business. Precisely what the changes are remains to be seen, but US managers can certainly expect change. ■