Service providers take on enhanced role in era of regulation

By *Anonymous*
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The efficient structuring and ongoing operational efficiency of hedge funds is very reliant on a group of supporting professionals, the services providers, and in South Africa as elsewhere most hedge funds carry out their operations with assistance from prime brokers, independent administrators and other firms. With the hedge fund industry looking to emphasise its adoption of operational best practice and the use of third-party providers as a source of added reassurance for regulators and investors, the importance of these specialists can only grow.

The quality of independent service providers is seen as one of the reasons for the resilience of South Africa's hedge fund industry in the face of the global economic and financial crisis. 'Having third-party fund administration as strong as it is in South Africa has shown its merit in that there have been no Ponzi schemes or untoward failures,' says Ian Hamilton, chief executive of administration firm Investment Data Services Group and the former chairman of Aima's South African chapter.

The adherence of South African managers to international best practice has ensured that the majority of the funds are serviced by independent administrators. While this is not a regulatory requirement, as a rule institutional investors and funds of hedge funds will not invest in a fund unless it uses a third-party administrator. Fund administration firms themselves are regulated, as are prime brokers.

Carla de Waal, a portfolio manager at fund of hedge funds manager Novare Investments and the Aima board member for media and education, says: 'Self-regulatory practices include the use of third-party administrators and prime brokers. Last year, independent administrators oversaw more than 88 per cent of local hedge fund assets, with prime brokers servicing 76 per cent of industry assets.'

Novare produces the annual South African Hedge Fund Survey that offers the most widely-followed statistical analysis of the industry. In its most recent survey, covering the 12 months to the end of June last year, Novare reported an increase in total assets under management to ZAR30.3bn in mid-2008 from ZAR25.9bn a year earlier, despite a decline in net industry inflows from ZAR7.1bn to ZAR6.3bn.

The period under review saw the launch of 20 new funds with total capacity of ZAR5.4bn, mostly created by established companies including large asset managers, boutique hedge fund firms and niche managers. According to de Waal, the potential for the industry to expand is evident from the open capacity within existing funds - an estimated ZAR34bn at the end of June 2008 - and the fact that even after a year of 17 per cent growth, the industry's total assets still represented just 0.7 per cent of the capitalisation of the country's equity benchmark, the FTSE/JSE All Share Index.

The survey also emphasised the continuing decline in the preponderance of equity hedge strategies among South African managers, with the proportion of assets managed in long/short and market neutral strategies falling from 72 per cent in mid-2007 to 64 per cent a year later, as well as the vital role that funds of hedge funds continue to play in the market, accounting for 64 per cent of all industry assets.

An important factor in the growth of the industry, say professionals, is the role played by prime brokers not simply as service providers but long-term partners to hedge fund managers. The better the relationship and the higher the standard of service offered by brokers, the easier the fund manager's day-to-day operations.

Prime brokers operate on two models in the South African market, as either principal or agent in securities lending transactions. The principal approach intermediates hedge fund credit risk in the securities lending market and can offer protection to the fund against changes in lending requirements.

'Maintaining a level playing field in terms of credit extension to the hedge fund market during extreme market volatility is a critical success factor for the prime broker,' says Brett Thornton-Dibb, head of prime finance for South Africa at Deutsche Bank.

'The agency basis, on the other hand, moves hedge fund credit exposure into the securities lending market. While limiting exposure to the prime broker, it can be difficult to assess the hedge fund's ultimate credit counterparty. In the South African market, which is dominated by single prime broker relationships, the burden of operational risk rests significantly on the shoulders of the prime broker.'

Prime brokers also play an important role in protecting hedge fund investors. Most funds will trade through a prime broker under a written agreement that authorises the broker to close positions if they believe that the risk involved in the hedge fund is liable to expose the prime broker's balance sheet to undesirable or irregular risks. This gives the firm the contractual right to close out risky positions and, in certain situations, to enforce risk limits similar to the manager's own mandate.

Hedge funds have partnered with prime brokers to provide custody and settlement for many years, but Thornton-Dibb says: 'As due diligence within the hedge fund investment process increases, the prime broking community must continue to invest in the industry that has grown out of this partnership.'

Fund administrators also help to protect investors in South African by providing unparalleled levels of transparency. Says De Waal: 'It is common for funds of funds to be able to calculate a 'soft price' on a regular basis because we receive daily performance updates from the majority of our underlying funds, and we also receive portfolio holding information on an equally regular basis. This makes it so much easier to measure systematic risks. The move toward increased regulation is thus a mere formalisation of the high levels of self-regulation already employed by the industry.'

Nevertheless, the global financial crisis has posed new challenges for fund administrators. One is that new fund launches are no longer valued in hundreds of millions of dollars but tens of millions or even less, and their managers are often struggling to find administrators willing to take on smaller clients. 'The bigger the administrator, the less inclined they are to serve smaller funds,' Hamilton says. 'At this point, brand-name administrators hold prime position in the market as brand name is considered more important than service delivery.'

However, administrators in countries where third-party fund servicing is the norm may benefit from the new insistence, post-Madoff, that US-based hedge funds employ independent administrators. Hamilton points out that Investment Data Services Group is offering its services to a wider market through various European offices that rely upon the South African engine room and its 100 staff to provide cost efficiencies. 'This means lower minimum fees, thereby supporting the launch of smaller funds in the international market,' he says.

Overall, assets under management, trading volumes and leverage were all casualties of last year's market collapse, but Thornton-Dibb notes that for service providers, technology and platform costs did not shrink in line with the markets' dramatic downturn.

'The first half of 2009 has seen low trade volumes and cautious positioning, with market volatility a hallmark of this period,' he says. 'Hedge fund credit exposure to their prime brokers became a key topic following the Lehman collapse and investment mandates were revisited, particularly with regard to over the counter derivative exposure. Locally, credit exposure was highlighted by the default of contracts for difference provider Dealstream.

'This had no direct impact on hedge funds, since Dealstream offered CFDs to private clients, but the resulting fallout in the Safex futures clearing market certainly did. Market participants re-evaluated the leverage offered on illiquid stocks and the subsequent ramping up of margin requirements by clearing members brought an end to many small-cap illiquid strategies, as these leveraged positions were sold down. Even traditional leverage, enjoyed by virtue of short extension in the market, suffered, with lenders tightening their list of acceptable scrip to lodge as collateral.'

Another issue has been the potential for mis-selling of hedge fund products, with all the attendant risk of damage to the jurisdiction's reputation. De Waal advocates more stringent fit and proper requirements for advisers that sell hedge fund products to ensure that they are not mis-sold. 'It could be very damaging for the industry if investors did not fully understand the attributes of these investment products and then were shocked when the funds did not behave as they initially thought,' she says.

Greater regulation, both self-imposed and from outside, is a key factor in the maturing of South Africa's hedge fund market, and it is liable to entail higher costs for hedge fund managers. This could prove a barrier for smaller managers seeking to enter the market, but de Waal believes it is not necessarily a bad thing. 'In order to be able to attract money from institutions such as pension funds, an institutionalised industry will have to demonstrate proper financial soundness,' she says.

Service providers will be closely involved as product regulation is put in place, but the rewards are likely to lie in clarification of many uncertainties for potential investors, especially for pension funds that may in future be permitted to increase their allocations to hedge funds to levels comparable with those in other developed markets.

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