Service providers come to grips with new investor requirements

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At the end of last year it was possible to believe that the hedge fund industry might be drastically reduced in size over the next couple of years, and that the Cayman Islands, home to the vast majority of the world's offshore funds, would be in deep trouble too. However, confidence has recovered quickly, and sentiment has turned.

While most service providers have had a lean year, few have thrown in the towel. In fact, according to the Cayman Islands Monetary Authority, the number of administrators on the island with full licences rose from 99 to 100 over the difficult 12 months beginning in September 2008.
There are a number of reasons for this, not least the amount of restructuring and liquidation that has taken place, but most of the process is now complete, according to Gray Smith, a partner at legal firm Appleby. "The restructuring of funds that went wrong has nearly worked its way through the system now," he says. "However, a few funds failed to meet the terms of the arrangements they made with shareholders and are having to restructure again."

Nevertheless, the emphasis is now on new funds, and this is likely to keep the service provider industry busy for the best part of 2010. Ingrid Pierce, head of the Cayman hedge fund practice at law firm Walkers, says: "Interest in launching new funds was somewhat patchy in the summer, but over the past couple of months this turned into solid instructions for the end of 2009 and early 2010."

The new funds are either restructured versions of funds that suffered large redemptions and falls in net asset value and are offered to existing clients under more attractive terms, or brand new funds seeking to take advantage of market inefficiencies thrown up by the credit crisis and ensuing economic recession.

The strategies of the latter group are often highly targeted, according to Pierce. "Few funds these days try to be all things to all people," she says. "Strategies are often targeted at a specific asset class with a specific set of investors in mind. More managers are prepared to send out draft documents to significant clients and potential clients to determine whether a strategy works for them, and then refine it depending on the feedback."
A track record is essential for managers of new funds. Says Pierce: "We are mainly seeing break-out managers that used to be with good shops. We suspect the bankers are coming too but we haven't seen them yet."
Appleby reports that fund launches are considerably smaller than previous vintages. "USD50m is the new USD500m," Smith says, adding that a portion of the invested capital is often sourced from the management team itself. "They are injecting their own money while they get back into the game and establish a track record, so if the big money returns next year they can show the strategy works and raise third-party funds."
Managers from the UK, the European Union and the Middle East have been first to take up the opportunity. Says Smith: "European and UK managers seem to be livening up more quickly than their US counterparts. I thought the US would have been off the mark quicker, but I expect it to catch up soon."

Service providers are being asked to deal with different structures from the past in order to address the hot issues of liquidity, transparency and fees. Many new funds now offer greater liquidity, sometimes daily. Others have gone to the other extreme and are asking for longer lock-ins, but with performance fees based on longer timeframes too.

"The ability to impose lock-ups depends very much on the strength of the individual manager," Smith says. "Many are frankly desperate for cash and are taking their chances by offering monthly liquidity with the possibility of losing their whole fund if performance drops off for more than a month or two. The days when hedge fund managers considered whether they would accept a client or not are gone."

Smith says some investors are still pushing for side-letters, which is a sensitive issue given the more stringent guidelines issued by organisations such as the Alternative Investment Management Association. Investors that allocate large amounts of money more frequently ask for their own class of shares.

Transparency is also concentrating the minds of investors and managers. Most investors now demand that hedge funds are clearer about when and how gates will be imposed in times of distress. Says Pierce: "Many complained that they didn't really know what they were signing up for."
She reports that Walkers is also getting a lot more requests for due diligence work, so that investors fully understand the liquidity terms, how they operate and whether the manager actually has the power to implement liquidity restrictions at short notice or whether the power actually lies with the board. Fund directors and managers also require advice on this issue. "Diligence work is trickling in at the moment, but I wouldn't be surprised if this becomes a much bigger part of the work we do for our clients," Pierce says.

Fees at new and existing funds are under review, with the management fee now mostly ranging between 1 and 1.5 per cent rather than the traditional 2 per cent, while performance fees are typically around 15 per cent rather than 20 per cent as in the pre-2007 world. There has also been an increasing shift to variable performance fees, with lower levels in the early years of a fund increasing as the fund matures and proves it can deliver sustainable returns.

There is little doubt that Cayman providers have huge experience in setting up funds, and the jurisdiction is a hub for innovative structures, but there is some concern that funds are paying too much for access to these services, particularly now that fund sizes are smaller.
"There is a long-held perception that Cayman is cheap for fund formation and servicing, but this situation has reversed over the years," says Peter Hughes, managing director of Apex Fund Services. "It costs USD30,000-USD40,000 to set up a simple fund in Cayman, but in Bermuda the same structure costs just USD20,000 to USD25,000."

However, many Cayman service providers insist clients are satisfied with overall cost levels. Says Pierce: "There are variations between firms, but many of our clients use providers in Cayman and they don't feel that it has become too expensive overall."

The satisfaction of clients will be of paramount importance as the Cayman fund industry prepares for battles ahead. The first has already arrived in the shape of the EU's Ucits III directive, which was modified in ways that allow these retail-authorised funds to encompass many hedge fund strategies. Following the liquidity problems at the end of 2008, Ucits III funds – with their strict liquidity rules – have become more popular.
However, the liquidity requirements and investment restrictions of Ucits III funds affect their appeal to certain investors. Andrew Edgington of ICG Management, which provides independent non-executive directors to funds, says: "Many strategies favoured by institutional investors will not be fully deliverable within Ucits funds. Also, the set-up and operational costs involved with Ucits funds can be higher than for funds established solely for sophisticated investors."

Edgington says there is a need to understand the liquidity traits of a hedge fund's strategy. "Ucits funds now can follow a strategy which has a significant exposure either directly or indirectly to illiquid assets. This could create considerable future problems if the need to satisfy investor liquidity outstrips the strategy's liquidity at the time of receiving redemption requests."

Others believe that Cayman and Ucits structures can exist happily side-by-side. Peter Heaps, managing director of Carne Global's office, says: "With changes to the Ucits regime, 60 to 70 per cent of the world's hedge funds can now be deployed in a Ucits. In one way that's competition, but in another it's complementary."

He argues that in Asia and the US, the Cayman vehicle is firmly entrenched via the master-feeder structure, but for European distribution Ucits funds are likely to dominate. Ucits are also popular

among retail investors in Asia, and to a lesser degree in South America and Africa, Heaps says, and the right structure for the right investor and environment is important to help oil the wheels of the global hedge fund industry.
Perhaps the greater threat to the offshore fund industry stems from the EU's proposed Alternative Investment Fund Managers Directive. Peter O'Dwyer, a director of Trinity Fund Administration, says: "EU alternative funds may in future be able to get a Ucits-style EU passport, which may enhance their competitiveness versus Cayman funds."
However, the directive is likely to undergo a number of changes that could, at the very least, prove chaotic. "Fund managers are confused about whether to domicile in the EU or go to Cayman and Bermuda," Hughes says. "At the margins, offshore will lose business to onshore under the current proposals."

Cayman will come under particular pressure from well-regulated jurisdictions in Europe, he believes, such as Luxembourg and Dublin, and Malta could also benefit. "Malta is well-regulated and is practical in how it applies its rules," Hughes says. "It is also low-cost and usually cheaper than Luxembourg and Ireland, and it is tax-efficient, too."
However, many observers believe the European directive cannot achieve its aims. Says John McCann, managing director of Trinity Fund Administration: "It does not address systemic risk. They have clearly stated that hedge funds did not cause the crisis, so they are spending a disproportionate amount of time looking in the wrong places." He points out that hedge funds are leveraged on average just 1.4 times, compared with as much as 70 times for major banks, and that to date no hedge fund has looked for a taxpayer bailout.

"This represents a protectionist move," McCann says. "The directive will have to be changed or watered down before it is passed if it is to have any chance of achieving its publicly stated objectives of allowing the industry to operate, yet offering greater investor protection and improved operational risk management." He and other Cayman industry professionals hope that wiser counsel will prevail in Brussels.

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