Focusing on oversight in the post-Madoff world

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For the hedge fund industry, the Madoff affair did not so much change the rules of the game, as embed them more rapidly and more deeply.
It has not only helped to enshrine the principle of the independent administrator, for instance, but created a desire for even greater oversight to ensure the quality of the Net Asset Value (NAV) and daily reconciliations.
Jeff Short, a partner in Ernst & Young's Financial Services Office, explains: "In the past, the investment manager may have been involved in the calculation of the NAV either directly or through an affiliate. This has changed so the fund now has their own independent administrator calculating the NAV. Dovetailing into this post-Madoff, is increasing investor demand for Statement on Auditing Standard (SAS 70) reports of the independent administrator."

The reports fall into two categories: Type I focuses on the validity of the controls in operation at the administrator to ensure they complete the specified control objectives; Type II tests the controls.
"Some administrators have had SAS 70 reports in place for several years," says Short, "but there is additional demand for this now." The larger administrators have mainly completed Type II reports, while smaller and mid-sized providers are just now starting to rise to the challenge.
The post-Madoff world also has to contend with greater regulation, not least of which is the anticipated re-establishment of the requirement for hedge fund managers with US-based investors to register with the SEC.
"For some of our clients, it involves considerable work to prepare," says Mike Mannisto, also a partner in Ernst & Young's Financial Services Office., "Some will have to expand their staffing to deal with it." Some funds have more work to do than others in this respect. Notes Mannisto: "Many had fully prepared several years ago when the SEC first required registration, but some later deregistered. The proposed Alternative Investment Fund Managers Directive, whose impact is ostensibly limited to European hedge fund managers, could affect a wider constituency, Ernst & Young believes. "Many of our clients will have to consider this directive because they have global businesses, with operations and clients in Europe, the US and Asia," says Short.

The events of the last year or so have amplified the attention paid to corporate governance issues too. "Investors are asking to what extent independent directors managed difficult situations over the last 12 to 18 months, for instance," says Short.

In addition to hedge funds feeling the effect of the Madoff affair, the lingering after-effects of the banking crisis are also having an impact on the sector. Personal and corporation tax is being raised – or is likely to be raised – in many developed countries as governments rebuild their finances. "We are seeing interest from investment managers considering moving to Cayman," says Mannisto.
There are some investment managers with a physical presence already in the Cayman Islands, while others are considering Cayman because of the potential tax benefits, the existing world-class infrastructure and technology, the island's status as a hedge fund leader, and the overall high quality of life.
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