Service providers shift gears as fund launches take off

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After a sometimes nervous period of retrenchment and consolidation, service providers to the hedge fund industry in the British Virgin Islands such as administrators and law firms are moving up the gears as the upsurge in new business that has been taking shape since the middle of last year turns from expressions of interest into concrete deals to establish new funds.

Not that the past 12 months have been barren territory for the BVI's array of law firms, a sector that includes most of the biggest specialists in offshore financial services business. The firms, which have experienced dramatic growth over the past five or six years, have continued in the main to prosper despite a relative dearth of new fund set-up work and a fall-off in new incorporations for their corporate business departments.

The first half of 2009 saw an avalanche of restructuring work for fund lawyers as management companies sought to balance the conflicting pressures of investors seeking to redeem their capital and assets that suddenly became illiquid and impossible to value accurately. In addition, their colleagues in litigation have been busier than ever, although litigation between managers and investors has been less common than the problems might suggest.

Overall, funds work for BVI law firms has held up relatively well considering the difficulties in the market, according to Ross Munro, a partner and head of investment funds and regulatory business at Harney Westwood & Riegels, the BVI's most venerable international law firm. "Lawyers have been kept busy with a lot of distressed fund work," he says. "There have been redundancies across the law firms, but not in the funds area - we're actually recruiting at the moment."

He is echoed by Rob McIntyre, head of investment funds at Maples & Calder, who says: "It's no secret that some lawyers have left the firm this year, as has been the case with other law firms and financial sector businesses, and we haven't recruited heavily this year. Historically our corporate department has been the largest, and for obvious reasons that business has dipped, but litigation has gone up and we did recruit two new litigators last year. We expect that area of business to continue to grow. If you think about the number of BVI companies set up over the years, the law of averages says there will be disputes, albeit not necessarily fund-related."

According to Richard May, a partner and BVI head of funds at Walkers, apart from a small number of relatively high-profile cases, such as BVI funds connected with Madoff, the volume of litigation regarding hedge funds has been "surprisingly small".

He says: "It was certainly difficult in the first part of last year, but there was very little justification for those minded to litigate because you could effectively be going after your own money. I can't think of many scenarios where there was anything you could consider actionable anyway, and even if there were, there weren't many cases where it would have been worthwhile to pursue such a strategy.

"In a distressed scenario you want everyone focused on fixing things and getting money back to investors. You don't really want your investment manager caught up in litigation just because you feel a bit aggrieved about the situation. In our experience investors were not happy when they couldn't get money out, but were resigned to the fact that it wasn't the manager's fault, it was the market, and they just had to grin and bear it."

Instead, May says, the first half of 2009 saw a continuing flow of fund restructuring work, following a rush at the end of the previous year as managers sought to get their arrangements in place before year-end.

"There was a lot of spill-over into the first few months of last year with managers still trying to decide what to do with illiquid assets such as imposing suspensions of redemptions and gates," he says. "Later on investors were called on to vote for or against the restructuring plans, and for the most part hedge funds had a high success rate in getting through their proposals because investors didn't have a lot of options except to sit and ride the market out."

For managers that did not have well-defined arrangements to deal with illiquid assets, synthetic side-pockets were a popular option, according to May. "They were trying to isolate the illiquid assets in a way that would assist them in carrying on the fund," he says.

"They would create an SPV underneath the fund and transfer the illiquid assets into the SPV, or if they weren't transferable, there would be an agreement between the two entities to allow the SPV to participate in the proceeds of the sale of those assets when they became liquid. Shareholders who had put in redemption requests would get a portion of cash and a portion of shares in the SPV.

"This was a rather neat structure for resolving a problem where everyone wanted to get cash out as quickly as possible, but where funds were restricted from doing that because of the share of illiquid assets and where they did not already have authorisation to create side-pockets.

"If they could redeem in part by giving investors a stake in an SPV, they could also return cash. That went down quite well among investors because it was a speedy way of getting as much back to them as possible. Although the SPV was effectively managed by the investment manager, for the most part no fees were charged because it was treated as a redeemed asset."

The success of these efforts has been welcome to administrators in the BVI, most of which have as clients both local and non-BVI funds, especially those from Cayman. Derek Adler, whose International Financial Administration (Ifina) business has offices in both jurisdictions (as well as operational functions in the UK), notes that some of his competitors have struggled, cutting costs and staff, but Ifina's diversification of clients and focus on smaller funds have served it well through the crisis.

"Some of our competitors have been growing rapidly, but we've been very reluctant to take on funds of funds," Adler says. "We've always been nervous about accepting NAVs from other administrators that have a poor record for getting them out on time. Like the BVI, we've remained fairly stable. During the catastrophic period we must have lost five funds, but we replaced those pretty quickly.

"During the first six months of this year, not many people were looking to set up new funds, but now we are seeing a lot more enquiries coming from new funds, as well as new money coming into existing funds. Over the past few months we are starting to see start-up funds launched by people that have left the bigger banks to go it alone. Although many existing funds are now recovering, in some cases managers are not earning any performance fees because they haven't reached their high water mark yet. A few managers have closed their existing funds and started new ones to accelerate the process."

Adler believes that in the post-crisis environment, administrators can play a much greater role in oversight of the hedge fund industry. "Some people are trying to offer more transparency, but we've a way to go yet," he says. "This is an issue I have raised with the regulators in both Cayman and the BVI. The fund administrator is in the front line, and therefore regulators should looking more to us because we are the first to know if something goes wrong. That will only work with an arm's-length, third-party administrator at, it won't work if the administrator is part of the same group as the investment manager."

Mara Alido Spencer, managing director of Ace Fund Services, believes that the implementation of the long-awaited Securities and Investment Business legislation will have a positive impact on the jurisdiction and its international image, which should in turn help to attract new fund domicile and servicing business.

"The act will cover not only mutual funds but a new investment business licensing regime, regulation of the public issue of securities, and the targeting of market abuse offences, all of which should inspire increased confidence among users of the BVI. It's really good news, together with the fact that the new legislation is accompanied by developments such as the Commission's implementation of electronic filing last year, which makes it easier to access statistical information."

Spencer, like other members of the industry, regrets the departure of Fortis from the ranks of the island's administrators. "The BVI could certainly use bigger players coming into the market," she says. "We are second in the global offshore hedge fund market" with a total of 2,923 funds at the end of September 2009, up from 2,781 a year and a half earlier, according to the BVI Financial Services Commission.

"It wasn't good news that Fortis came in and then had to leave, but the past two years were difficult, and it's no different from what's happened in other jurisdictions. Now that things are starting to stabilise in terms of the market and of hedge funds and offshore vehicles in general, I wouldn't be surprised if in a few years we saw new players coming in."

Says Munro: "Fortis had already pulled back a lot of what they were doing in the BVI – a lot of the more high-level work was being done elsewhere, as far as I could see, for some time." He adds that banking and custody is another area in which the BVI would benefit from an influx of new blood. "It would be great to see a name bank here offering funding and custody services," he says. "HSBC does quite a bit of business with the BVI, and undoubtedly it would be good to have a name like that to refer people to, even though the fund industry has flexibility with the recognised jurisdiction regime."

Adler also acknowledges that the BVI lacks a wide range of institutions offering high-quality banking services – something that appears to be due at least in part to the regulator's wariness about the reputational dangers that can result from the activities of an offshore banking sector. "We used to do banking with Chase in the BVI because it was a household name and a global bank," he says. "Having more top-name banks would raise the credibility of the jurisdiction."

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