Service providers co-operation brings investor comfort

Crisis lessons prompt changes in fund structuring

Lehman collapse boosts exchange-traded derivatives
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At the end of September Ifina organised seminars for industry professionals in Zurich and Frankfurt to highlight some of the key lessons to emerge from the events of the past 18 months. Why did we at Ifina, as well as some speakers who flew thousands of miles to take part, undertake this effort at a time when some participants in the offshore fund industry believe it is more prudent to keep their heads down and wait for the storm to blow over?

Bringing together representatives of fund service providers ranging from offshore jurisdictions and law firms to fund administrators and auditors, as well as brokers and exchanges, the seminars sought – we believe successfully – to underline how, far from being a threat to the global financial system, the offshore fund industry can offer high standards of regulation as well as the assurance to investors of independent oversight of the fund manager.

The three themes that ran through the seminars were transparency, third-party administration, and the interlinking and interfacing of all the parties that work together to create and service a fund structure. These issues are crucial to the restoration of faith in the fund industry because it is the absence of these elements that has resulted in serious problems such as frauds and blow-ups.

Obviously Ifina, as a third-party administration firm, has a vested interest in proclaiming to fund promoters the benefits of independent service providers. Nevertheless, the evidence is incontrovertible that arrangements where administration is undertaken or otherwise controlled by the manager have been at the heart of many of the scandals coming to light over the past two years, including most spectacularly the Bernard Madoff case.

Today banks continue to launch funds, sell them to their customers, administer them, provide banking and custody services, and make the investment management decisions. Who is overseeing them? A third-party administrator can monitor the entire fund creation and operation process, offering investors the assurance of independent scrutiny in the event that anything goes wrong.

However, the seminars were not conceived just as a commercial for Ifina and for third-party administration in general. They also highlighted the roles played by other service providers to the fund such as auditors, represented by Baker Tilly. Funds domiciled in the Cayman Islands must have an audit sign-off and the British Virgin Islands are moving toward the same requirement, but in any case Ifina insists that any fund for which it carries out accounting and share registry work should be audited.

The seminars also featured speakers from an offshore jurisdiction, the BVI, offshore and onshore law firms, Ogier and Clifford Chance, a brokerage, MF Global, a provider of banking services, Barclays, and a derivatives exchange, Eurex. All of those providers share our view that it’s no use the offshore industry burying its head in the sand. We have to put our heads above the parapet, acknowledge that mistakes have been made, and point out that it’s not difficult to avoid them in the future with proper organisation and service providers working closely together.

The focus of the G20 over the past six months has been on global tax issues, but there is more to offshore centres than tax schemes and trusts. The world has to be reminded of the role they play in offering regulated mutual funds overseen by licensed providers, a wholly legitimate business serving clients such as institutions and pension funds all over the world.
Introducing a multi-jurisdictional group, providing investment fund administration services.
Service provider teamwork crucial to offshore fund appeal

By Simon Gray

In an environment in which investors are less willing to take the honesty, investment expertise and operational efficiency of fund managers at face value, the interaction and collaboration of independent service providers is more crucial than ever to maintaining the appeal of offshore funds to institutions and other sophisticated investors, according to speakers at recent seminars in Zurich and Frankfurt on the outlook and opportunities for the industry in the wake of the financial crisis of the past two years.

The seminars, organised by international fund administrator Ifina and featuring speakers from service providers including law firms, auditors, banks, brokers and derivatives exchanges, as well as a leading offshore fund jurisdiction, sought to highlight how changes in market sentiment and the global regulatory environment are prompting the offshore fund industry to respond to the new requirements of both investors and supervisory authorities.

The offshore financial sector as a
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BVI embraces new era for offshore centres

By Alicia Green

One of the guiding principles that has made the BVI the globally respected financial centre it is today is partnership between the private and public sectors. A close spirit of collaboration has enabled the jurisdiction to adapt to the requirements of an ever-changing global financial services industry.

This partnership has been all the more crucial following 12 months that have rocked the foundations of the financial industry across the world. Offshore centres have come up against a growing storm of criticism and blame for the wider economic crisis – as opposed to the onshore centres where most of the problems actually arose.

Regulation has become a focus of the debate. At the London G20 summit in April, the world’s leading powers called for a stronger, more globally consistent supervisory and regulatory framework for the financial sector, and implied that offshore centres were the weakest link.

Yet independent experts say the root of the problem has been much closer to home. In 2008, the International Monetary Fund noted that compliance and regulatory standards in many offshore jurisdictions were better than those in leading onshore centres such as New York and London.

The great importance placed on maintaining high standards by the independent regulator, the BVI Financial Services Commission, enabled it two years ago to become the first member of the International Organization of Securities Commissions to be admitted through Iosco’s Multilateral Memorandum of Understanding Concerning Consultation and Co-operation and the Exchange of Information. An extensive review concluded that the BVI’s legislative and institutional regimes on international co-operation met Iosco’s standards.

The Caribbean Financial Action Task Force has also highlighted the tremendous efforts undertaken by the BVI to ensure compliance with international anti-money laundering principles.

The G20 also highlighted the need for increased transparency in tax matters, and invited the Organization for Economic Co-operation and Development to assess the progress of international standards for the exchange of information. Today the BVI is on the OECD’s white list, having signed 15 tax information exchange agreements, and is committed to meeting future standards as they evolve.

The quality of its regulation is a key reason why the BVI plays host to so many fund managers and administrators, as the world’s second largest hedge fund domicile with clients from the US, UK, Europe, the Middle East and Asia.

The BVI’s forthcoming Securities and Investment Business Act will further enhance the regulatory regime applicable to the fund industry, enhancing its ability to serve alternative investment clients in Europe and elsewhere and maintaining an attractive environment not only for fund managers but administrators, lawyers and custodians.

The past 12 months have seen an unprecedented challenge for the global financial sector, and a new era has dawned not just for offshore centres but for the financial services industry as a whole, but we embrace the challenges and opportunities.

The government and the BVI Financial Services Commission led by Robert Mathavious will continue to foster a spirit embracing both robust regulation and co-operation with the private sector. By standing firm together, meeting international standards and staying ahead of the curve, the BVI will continue to succeed and prosper in the years to come.
whole has found itself on the defensive amid moves by groups such as the G20 countries and the European Union that have insinuated – arguably quite wrongly – that it was at least partly to blame for the recent market turbulence and demanded greater transparency and better regulatory oversight of the industry.

In tandem, the Organization for Economic Co-operation and Development has led a drive to achieve global compliance with its standards of transparency and exchange of information on tax issues, to which offshore jurisdictions have responded by signing co-operation agreements with key onshore markets.

Yet offshore funds and the jurisdictions where the industry has made its home continue to appeal to managers and investors alike because of the tax neutrality that facilitates the pooling and deployment of capital by investors from different countries and subject to different tax regimes, a regulatory environment geared to the needs of sophisticated rather than retail investors, and the accumulated experience and expertise of offshore service providers.

“The tax neutrality of offshore funds is one of the most compelling factors,” says Simon Schilder, a partner with offshore law firm Ogier in the British Virgin Islands. “It means that the funds themselves pay no tax in their home jurisdiction, providing a level playing field for international investors.

“Another factor prompting the choice of an offshore jurisdiction is an appropriate level of regulation. Investors in offshore funds are typically institutions and high net worth individuals that are big enough and experienced enough to look after themselves. They don’t need the heavily regulated products that are typically set up onshore but prefer offshore products with a lighter regulatory touch. Finally, as a consequence of these factors, the expertise and sophistication of local service providers tends to perpetuate the use of offshore vehicles.”

According to Ifina director Derek Adler, the decision to highlight the qualities that offshore funds bring to the global investment market to professionals in two leading European financial centres was prompted by the scapegoating of the industry by politicians onshore. “There was a lot of wailing and gnashing of teeth directed particularly at offshore centres and hedge funds – blaming others in order to divert attention from being focused on some of the real issues,” he says.

“We decided that all of us had a duty and a responsibility to stand up for the offshore fund industry by organising a forum to review what went wrong during 2008 and how to avoid some of the obvious errors in the future. In addition, we wanted to give serious thought to some of the current proposals that might affect our industry. Some of the ideas under consideration make good sense, but others are clearly satisfying political imperatives without any real knowledge or understanding of the industry.

“It’s ironic that politicians in the US and Britain should complain about offshore centres and fraud in the industry when most of the scams and fraud have occurred in the US, because there are far less stringent rules in the first place and little monitoring thereafter. Moreover, it’s very irritating that offshore centres are portrayed as being just about tax and trusts. For example, the BVI runs a highly regulated and very efficient financial services centre. If anyone thinks that licences for mutual funds are just handed out on a plate, they are very much mistaken.”

One of Adler’s central themes is that the offshore fund industry can defend its international standing by emphasising the key elements that ensure probity and protection of investors, transparency, control and interfacing between the various...
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Transparency in the new environment

By James Rowsell

The financial crisis and the Madoff scandal have subjected the fund industry to unprecedented scrutiny. Following record outflows, fund closures and collapses, investor confidence is very low. Optimal relationships between brokers and administrators can help managers provide the transparency to meet regulatory obligations and to restore investor confidence.

MF Global, the world’s largest futures and options broker, enjoys a major market share on the world’s leading derivatives exchanges, including CBOT, CME, Comex, Nymex, Liffe and ICE. With 3,200 staff and offices in 14 countries, we trade with more than 150,000 clients every day, we transact more volume than anyone else, and two-thirds of our business is on-exchange.

Our leading market position gives us transaction volume and very substantial client balances, we seek to offer best in class risk management, and our predominantly agency-only model means we are unconflicted. All this makes us a very attractive venue to transact business.

Through our business worldwide, we have the opportunity to work with many fund providers in various jurisdictions, and have observed a range of governance structures. Ideally a fund’s governance structure should be spelled out in its prospectus or articles of association, clearly defining the roles and duties of the broker, the independent administrator and the fund manager. This model ensures that the administrator can monitor all the fund’s actions.

We’ve all seen the problems that can occur when funds are losing money. We have more comfort where rules are already in place on the maximum amount of leverage a fund will accept, and that require trading to be stopped or curtailed automatically when a fixed proportion of the capital is lost. The independent administrator should manage this process and have the power to stop trading if necessary.

Before opening an account, we ensure that a fund’s beneficial ownership is transparent. We will only deal with legal entities incorporated in OECD countries or recognised offshore jurisdictions, and we will only deal with entities from jurisdictions where we are less comfortable doing business if certain conditions are met.

What red flags do we look for? A change of administrator may be a signal for us to investigate. We monitor trading – if the fund buys thinly-traded instruments toward the end of a month, could this mean manipulation of the valuation? We will also scrutinise sudden changes of ownership, of authorised signatories or management, as well as unusual fee structure. We are unlikely to accept accounts where the manager and administrator are the same legal entity, and unknown providers cause us concern. We prefer to deal with administrators with which we have established relationships and confidence in their professionalism.

We in turn can provide administrators and funds with a range of services, including daily account summaries configured to individual requirements and online access to account statements and open positions. We use Risk Informer to provide administrators with real-time risk monitoring of all trading activities and margin requirements for the funds they service, aggregating trades on a real-time basis with data from exchanges and in-house, and we can also give an administrator a view-only trading platform.

Transparency is as much part of the new environment as performance. The long-term winners will be managers that employ sound governance and can demonstrate the safety of their clients’ assets.
third-party providers that serve the fund. One of the core elements is third-party administration, long a staple feature of the offshore world but which is only now being recognised as the ideal in North America.

"Many of the problems that have occurred with funds would never have happened had they been policed by a third-party administrator like Ifina," Adler says. "This is being recognised by some of the larger banks, which now accept that administering their own funds can be somewhat incestuous and might cause problems at a later date.

“We are already undertaking administration for very large institutions, which is the sensible approach and demonstrates outside control for the protection of investors. Ifina reconciles the fund’s trading every day with the investment manager, the broker and the bank, and co-ordinates every aspect of the fund’s operations. We cross-check everything on a daily basis and are also the counter-signatory to the fund’s bank account.

“If something seems about to go wrong or seems at all out of the ordinary, Ifina will be the first to know. In that event, we will investigate and if necessary ring the alarm bell. We also insist that our calculations are audited. If a prospective client does not want to accept these conditions, we will not accept the client.”

For years the Cayman Islands have required that funds domiciled in the jurisdiction have a local audit sign-off, and the trend is spreading to other offshore jurisdictions. At present the BVI imposes an audit requirement only on public funds destined for the retail market, but this may be extended to professional and private funds, the categories into which most alternative funds fall, when the Securities and Investment Business Act replaces the existing Mutual Funds Act, possibly next year.

Already many new funds are opting to be audited even without the legal requirement, according to Nigel MacPhail, audit director at the BVI’s longest-established public accounting firm, Baker Tilly. “Transparency is the theme of the moment,” he says.

“If you look at recently-uncovered frauds perpetrated by the likes of Bernie Madoff and Arthur Nadel, either they weren’t audited at all, or the auditors were compromised in some way. In several cases the frauds only came to light when independent audits were demanded by other members of the board.

“All these scandals have highlighted the benefits of another set of eyes that understand the numbers, but the need is also greater than ever to pick up accidental accounting errors. It all ties in with the way the industry’s going in its attempt to become more transparent in using third-party service providers wherever possible, including
Being the oldest established public accounting firm in the British Virgin Islands, Baker Tilly (BVI) Limited has a wealth of experience in providing auditing and business solutions to a variety of offshore investment funds.

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The importance of independent audits

By Nigel MacPhail

The economic meltdown of the past two years has seen unprecedented redemptions from funds and other investments and a rush to liquidity - bringing to light a string of scandals including frauds, Ponzi schemes and other types of embezzlement that had been hidden during the boom years. A common denominator in many of these scandals has been the absence of a reputable independent auditor.

Take Arthur Nadel, whose Scoop Capital investment business was run from a high-street storefront in the beach resort of Sarasota, Florida. Nadel took as much as USD350m from clients, but six funds that were supposed to have USD300m in assets in fact were found to hold less than USD1m remaining when the business collapsed. Nadel had rejected his partners’ requests to hire an independent auditor for the funds until the discovery of Bernie Madoff’s fraud last December forced him to go on the run.

Albert Hu helped to raise more than USD5m for the Asenqua and Fireside hedge funds by falsely claiming several prominent international law firms as legal counsel and forging the signature of a purported chief financial officer who in fact had no association with the funds. Hu also provided investors with supposedly independently audited financial statements, in reality from an entity he set up with an address in San Francisco’s financial district.

Samuel Israel III was a third-generation trader respected on Wall Street, whose firm Bayou Management apparently had generated steady returns of 10 to 15 per cent since 1996 by taking short-term equity positions and at its peak claimed to manage USD440m. Israel told investors that the funds were audited by independent public accounting firm Richmond-Fairfield, which in fact was created by Bayou’s CFO to help conceal the fraud.

One of the red flags that caused some experienced investors to avoid Madoff was that the independent auditor of his multi-billion-dollar investment management business was a three-person firm located in a strip mall. Similarly, the investigation into Allen Stanford’s Antigua affiliate identified as its auditor a small firm in a quiet, largely residential neighbourhood of the island, an unlikely auditor for a USD8bn enterprise.

Just as important is the financial relationship between auditor and client. Arthur Andersen was accused of being reckless in its audit of Enron because of the conflict of interest represented by the consulting fees it earned from the company. In 2000 the relationship earned Andersen USD25m in audit fees and USD27m in consulting fees, around 27 per cent of the Houston office’s total audit fees from public clients.

All these frauds were aided by the lack of a properly independent audit - which is not only a deterrent against fraud but provides protection against casual errors arising from failure to follow proper procedures or honest accounting mistakes. Independent audits lead to increased trust, an enhanced reputation and financial credibility, increasing funds’ ability to raise additional capital as well as highlighting aspects of processes and controls that could or should be strengthened.

Although the BVI’s current Mutual Funds Act requires only public funds to be audited by an approved auditor, it is anticipated that the regulatory requirement will soon be extended to professional and private funds. In an environment where due diligence, transparency, segregation of duties and reliance on independent third-party service providers is of utmost importance, investor confidence can only be boosted by the independence and objectivity of a third-party audit by an experienced public accountant.
MacPhail notes that auditors themselves are under pressure to ensure that they uphold the highest professional standards. “The International Ethics Standards Board for Accountants has issued a revised code of ethics for professional accountants that tightens the independence requirements for auditors,” he says. “These include the extension of partner rotation requirements and strengthening rules restricting the provision of other services by public auditors to their clients.”

Banks are also part of the new networks of co-operation required of independent fund service providers. “Now more than ever, there must be a more collaborative, proactive approach to ensure that banks and administrators deliver added value to clients and investors,” says Steve McCafferty, head of the Isle of Man-based intermediary and institutional wealth solutions team at Barclays Wealth.

He stresses that good communication between the respective specialist teams in banks and administration firms is critical: “It’s attention to detail that makes us both look good to our clients.” McCafferty adds that the banks also need to have confidence in their fellow professionals. “Barclays sees the biggest issue in the market as reputational risk, and we go through very thorough money laundering and due diligence assessments on the administrators,” he says.

“There are many crucial counterparties and professionals involved with new and existing fund structures, but the banker-administrator relationship should be a key long-term partnership that adds value to the business. Managers should be asking themselves whether this is the current experience they are getting from their banker and administrator, and if not, why not?”

James Rowsell, managing director for Europe at MF Global, the derivatives brokerage that spun out from Man Group two years ago, argues that many of the changes being pushed by organisations such as the G20 are already taking place not as a result of legislation or regulatory fiat but because investor expectations are driving best practice among industry participants. “A lot more transparency is required, involving not only fund managers but administrators and broker, which actually supply the real-time information required for functions such as valuation. The events of the past two years have led to the realisation that this was best practice, rather than it being mandated.”

A common factor in many of the problems that have come to light over the past couple of years, Rowsell says, is the weakness of governance structures – an issue that he argues should be addressed at the start, when a fund is being set up.

“Ideally funds’ governance should be spelled out in the prospectus or articles of association,” he says. “The governance structure should clearly define the roles and duties of the broker, the independent administrator and the fund manager, to ensure that the administrator can monitor all aspects of the fund.”

MF Global is more comfortable dealing with funds that have rules in place setting a maximum level of leverage and stop-loss mechanisms to halt or curtail trading beyond an agreed level of losses, and that this should be in the hands of an administrator with which the broker enjoys a good working relationship. “We deal with many new managers,” Rowsell says. “If we can talk with them about governance early on in the process of setting up a fund, we have a lot more comfort about taking the business onto our book.”
The offshore fund sector, from managers and their service providers to the world’s leading offshore domiciles, has not been left in disarray by the economic and financial crisis that began more than two years ago. Although performance issues and redemptions have seen total assets of hedge and other alternative funds decline appreciably – a trend that now seems to be reversing – members of the industry are already responding to the new environment with changes in the way they do business, the development of new products and fresh initiatives to publicise and market their products, services and infrastructure.

“In the future, offshore funds and funds in general will differ from the kind of funds we’ve seen in the market up to this point,” says Simon Schilder, a partner with law firm Ogier in the British Virgin Islands. “How they differ will very much depend on how things end up playing out [in the regulatory environment]. What is for certain, though, is the continuing role of offshore funds and...
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The bank and fund admin partnership

By Steve McCafferty

For fund managers and promoters, banking and administration are key functions that impact directly on the day-to-day administration of the fund. Often, the service delivery of these providers can make the difference between a successful, well-managed fund – or in the worst case it can undermine investor confidence through poor service levels and a lack of engagement.

A correct approach to this key relationship can deliver tangible benefits for promoters, and indirectly investors, where banks build a business team with expertise in the sector and focus specifically on this market, ensuring understanding of sensitive issues such as critical timelines and processes, especially the operations surrounding the launch of a fund.

The early engagement of banker and administrator is vital in order to clarify timelines and structure and to ascertain the likely requirements for the promoter. A collaborative partnership approach to due diligence can significantly ease the administration burden for clients and save them time when they are more focused on launching their fund – or indeed, as has been the case over the past couple of years, when existing funds are undergoing restructuring.

The bank can support the administrator by ensuring that the electronic banking platforms and basic critical functions such as account opening are fit for purpose, as well as monitoring lending facilities and addressing cross-border foreign exchange and other requirements by engaging specialist expertise in fields such as treasury and capital markets.

The crisis of the past two years has brought the issue of liquidity to the fore, and it remains a big issue within the industry. One of the benefits that banks such as Barclays can offer is the strength of its balance sheet and the availability of capital within it to support structures such as hedge funds, private equity and real estate vehicles.

At all times it’s essential that robust lines of communication are in place between the banking and administration teams. Collaboration on areas such as compliance and due diligence can add huge value to the manager and save time and money for all parties.

The current crisis has thrown up a myriad challenges for fund professionals, including unprecedented levels of redemption requests and the imposition of gates, suspensions and side-pockets, in turn posing risks such as litigation, reputational and regulatory threats. Over the past two years, working alongside the administrators on distressed structures and investing time at the outset, we have been involved in a number of workout situations, effectively working on behalf of the investor.

In the current environment, it is not enough to play a passive role in this relationship. It is incumbent upon the banking partner to understand the manager’s strategy and the planned marketing and distribution approach of the promoter at the outset in order to be able to support key operational requirements such as hedging share classes or provision of liquidity lines.

Amid changes in the markets and in investor appetite, it’s crucial for the key service providers to maintain their commitment to learning and to take steps to remain close to their clients in order to maintain and enhance these relationships as well as to understand how they can continue to add value. Consistently facing the market, and engaging with managers and promoters as well as other sector professionals, is central to the success of the banker-administrator partnership that is so vital to the fund industry.
their importance in both the fund industry and the broader financial community.”

Schilder notes that major legislative measures are afoot on both sides of the Atlantic that will certainly increase oversight of the offshore fund industry, at the very least. In Europe, the European Union’s proposed Directive on Alternative Investment Fund Managers is likely to have a significant impact on non-EU funds and managers, although its extent is still unclear as the legislation makes its way through a protracted process of revision and amendment.

“The AIFM Directive will cover onshore and offshore funds of EU-based managers as well as offshore funds with EU investors,” says Anja Breilmann, an associate with law firm Clifford Chance in Frankfurt, who notes that the legislation may be subject to further input along the way from the European Parliament, Council and Commission, and that it may well not come into force before 2013. “However, we expect a lot of changes.”

The Private Fund Investment Advisers Registration Act, which would require hedge fund managers to register with the Securities and Exchange Commission, was approved by the US House of Representatives’ financial services committee in October, while the Hedge Fund Transparency Act, first introduced to the US Congress in January, seeks to regulate funds as opposed to their investment advisers.

The Congress is also considering two other pieces of legislation that would directly or indirectly target offshore jurisdictions, the Stop Tax Havens Abuse Act that President Barack Obama originally supported as a senator and which targets tax avoidance by US corporations, and the Foreign Account Tax Compliance Act, which would require institutions seeking to access US capital markets to provide details of US account holders.

Says Schilder: “In this brave new world, transparency is the key, particularly tax transparency. The OECD has made entering into tax information exchange agreements the criterion according to which jurisdictions are white-listed, grey-listed or black-listed. The BVI is a white-listed jurisdiction with 15 Tieas currently in place. We recognise that the criteria for being white-listed will change, and the BVI continues to discuss further Tieas with OECD member states.”

Alicia Green, a senior research analyst with the BVI International Finance Centre, which promotes the islands’ financial industry globally, says the regulator, the BVI Financial Services Commission, offers a secure and robust regulatory regime that encourages high-quality fund business. “We’ve pretty much held our ground in funds over the past year,” she says. Noting that this year has seen the arrival of another international law firm, Withers, Green adds: “It’s been a challenging time for everyone but the BVI still seems to be attracting business.

She believes the forthcoming Securities and Investment Business Act will further enhance the regulatory regime applicable to the fund industry and make the jurisdiction more attractive to managers, administrators, lawyers and custodians. Says Schilder: “Siba gives the BVI the opportunity to put in place a legal and regulatory framework attuned to requirements onshore among institutions, managers and investors for the regulation of funds and the kind of fund platform these participants want.”

He argues that the difficult market environment and the problems faced by hedge and other offshore funds over the past two years have proved to be an educational process for members of the industry, and particularly lawyers. “The lessons learned will influence how funds are structured in the
Managed futures strategies prove value

By Florian Wagner and Philipp A. Pölzl

The economic slump and financial market turbulence of the past two years has focused the attention of investors on the benefits offered by managed futures strategies, which have not only delivered impressive performance at a time of poor – if not disastrous – returns by other asset classes and alternative strategies, but demonstrated their value in providing diversification and reducing volatility in broad-based portfolios.

Managed futures strategies have consistently demonstrated low correlation with equities as well as other hedge fund strategies, and are able to generate positive performance in both bull and bear markets.

Managed futures lends itself to quantitative strategies determined by computer algorithms. This ensures a disciplined approach that avoids the vagaries of the manager’s emotions and discretion and enables strategies to be tested against historical price data to model future movements. Using a single system to invest across a broad range of sectors and markets shows its robustness, quality and stability. By contrast, optimising systems to patterns occurring in different markets in the past can lead to substantial problems if the markets’ behaviour changes.

It was to meet demand from investors that Qbasis Fund Management launched the Qbasis Futures Fund in April 2008. The fund contains two systematic managed futures strategies that have been available separately and combined as managed accounts since 2006: Qbasis MF Trend, a trend-following strategy that represents 70 per cent of the fund’s investment, and Qbasis MF Plus, a swing-reversal strategy that seeks to capitalise on periods of market consolidation or trend reversal.

The Qbasis Invest group, which operates from the Cayman Islands, Austria and Liechtenstein and offers products domiciled and administered in Cayman, consists of Qbasis Fund Management, which is responsible for investment management, system development, risk management and compliance; Q-IT, which handles the group’s technological requirements, research and implementation of mechanical trading systems and trading support; and Systrade Asset Management, which deals with marketing and sales in Europe.

Qbasis MF Trend is a breakout trend-following strategy that trades a large and globally diversified portfolio of liquid and actively-traded exchange-traded futures, and aims to profit from medium- and long-term trends plus an additional strategy element designed to capture intra-day movements.

By contrast, Qbasis MF Plus aims to boost performance during periods where no trends are apparent and avoid losses when trends exist. Investing mainly in highly liquid stock index and interest-rate futures, it displays low correlation not only to other asset classes but trend-following strategies. Like MF Trend, it does not trade options or any OTC derivatives, nor calendar or inter-market spreads, and it has no arbitrage or relative value aspects.

In February 2009 Systrade Asset Management launched the Liechtenstein-domiciled Sysmatic Fund of Funds, incorporating the two Qbasis managed futures strategies and strategies from other systematic managers to offer increased diversification, especially for retail and high net worth clients.

Qbasis Managed Futures manifests low correlation to traditional portfolios and to other managed futures products, but is widely diversified across stocks, bonds, currencies and liquid commodities. Its ability to profit from short- and long-term movements up or down, and even from periods without much movement, makes it a great financial product.
positions or interests in an SPV. There is also the question of whether the transfer takes place on the redemption date or later, to avoid a mismatch between NAVs on the redemption day and the date on which they actually receive the asset. We recommend a full exposition of what kind of assets can be paid out, which could include short positions.”

Schilder says side-pockets are another feature of fund structuring that has required re-examination in the light of experience during the crisis. “Traditionally side-pockets have been set up to enable managers to acquire positions that are illiquid at the time of acquisition and hold them until such time as they become liquid, when that position can be moved into the main body of the fund. The current environment has highlighted the importance of drafting side-pockets broadly enough to capture not only investments that were illiquid at the time of acquisition but also those that become illiquid because of market conditions.”

Drafters of fund documentation are also having to pay attention to court decisions, such as a case involving the suspension of redemptions by a Cayman-domiciled fund called Strategic Turnaround. According to Schilder, the Cayman court’s decision in the case will be considered persuasive – albeit not binding – in the BVI and other offshore common law jurisdictions.

“In the case of Strategic Turnaround, the Cayman court considered the redemption process a three-stage process that began at the time the redemption request was submitted and ended when the investor received the proceeds. In the court’s view, a redeeming investor became a creditor of the fund on the redemption date, but the point at which the investor ceased to be a member of the fund, and thus entitled to membership rights such as voting at a shareholders’ meeting, depended on the drafting of the documents. The redeeming investor might cease to be a member when his name was removed from the register of members, or when he received the redemption proceeds in full.”

“Other considerations include whether the investors will actually take custody of the asset itself or participate in a special-purpose vehicle or trust set up by management, as well as the kind of assets being transferred, whether underlying

18 future,” Schilder says. “One example is the use of gates, which enable managers to control how much money is coming out on any given redemption day and which can be structured on a class-by-class basis or for the fund as a whole.”

Another, he says, is the sudden surge of redemptions in kind, which until recently were relatively unknown even where they were authorised by a fund’s prospectus and articles. “For many years, the in-kind redemption provisions were boilerplate clauses in fund documentation that no-one really looked at,” he says.

“However, in the current environment their importance has become such that the drafting of such clauses requires expert attention. Among the points to consider from a practical perspective is the importance of providing investors with prior notice of intentions to pay out interests in kind, for no other reason than that for redeeming investors looking to realise cash, the fact that they will receive an in-kind redemption instead may prompt them to withdraw their redemption request.

“Other considerations include whether the investors will actually take custody of the asset itself or participate in a special-purpose vehicle or trust set up by management, as well as the kind of assets being transferred, whether underlying
and a new investor that subsequently invested in the fund. Also, if a redeemed investor can continue to exercise his rights as a member, a situation could arise where redeemed investors that are creditors could vote on resolutions requiring shareholder consent. There could be a mismatch between the interests of continuing investors in the fund and the interests of creditors.

“To remove these anomalies and concerns, it’s important that the funds documents state that on a redemption date, redeeming investors shall cease to be a member of the fund in respect of shares being redeemed, and they shall forthwith be removed from the register of members and the shares cancelled. The articles should also state expressly what rights a redeeming investor has in his new role as a creditor of the fund.”

Schilder says that another structuring lesson drawn from the current market is the importance of retaining flexibility in provisions regarding the suspension of redemptions. Historically, suspensions have imposed a total lock-down in the funds, covering redemptions, NAV calculation and the issue of shares.

“In many cases that will be necessary, but on other occasions when the purpose of the suspension is to control liquidity, the fund wants to keep operating, taking in money - assuming there is demand from investors - and importantly, keep striking NAVs. In the future it’s important that funds draft suspension provisions with sufficient flexibility that if it needs to, it can suspend just the redemptions.”

He adds that the search for increased transparency toward investors is prompting initiatives such as the establishment of valuation committees, either at the structuring stage or if a fund subsequently runs into problems. “A further aspect of transparency I expect to see more and more going forward is the use of independent boards of directors that are all functionally independent of the investment manager,” Schilder says.

The collapse of Lehman Brothers in September 2008 has prompted a new focus on the relative merits of exchange-traded and over-the-counter derivatives, according to Peter Noha, a senior consultant with derivatives exchange Eurex in Frankfurt. “September and October last year saw a surge in trading volume because every investor was coming back to the exchange and refraining from trading over the counter,” he says.

“Since then we had a lot of customers who wanted to transfer their bilateral positions to our on-exchange platform in order to enjoy the benefits of the central counterparty. If they had bilateral positions with Lehman, they would have lost all their money. The benefits of on-exchange trading include not only mitigation of counterparty risk but pricing transparency at all times and 24-hour risk management. We offer delivery management and control the fulfilment of obligations on both the buy and sell sides.”

Noha’s colleague in Zurich, executive director Markus-Alexander Flesch, adds: “Eighty-six per cent of derivatives are still traded OTC, on a bilateral basis. If one crucial bank fails, there is a danger that the whole financial system will fail. With a clearing house in the middle, all positions are collateralised, and if one bank defaults, the others are not affected and there should be enough collateral to cover losses from closing positions. When Lehman defaulted, all positions on Eurex were closed and there was collateral left. There was no damage to anyone who traded with Lehman on our platform.”