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Decentralisation of trading attracts host of new players

By Phil Davis

A year is a long time in financial markets. Aside from the credit crisis making the transition to a fully-fledged economic downturn, it was a year in which MiFid started to work its magic and trading in Europe began – at last – to decentralise. A whole new crop of platforms, or MTFs (Multilateral Trading Facilities), materialised from the ether to take on the might of the incumbent stock exchanges.

There are now close to a dozen MTFs and their number seem to be swelling month by month. They each claim to offer something unique in the market, with lower costs, faster transactions and reduced implementation shortfall among the main selling points.

Chi-X Europe, for one, which launched in March 2007 and is now the fourth-largest European exchange in the 750 stocks it offers, has already gained traction in the market. Figures from August show it handled 7,319,096 trades, more even than Deutsche Borse, which handled 6,623,281 trades. This is still well behind the 12,000,000 plus trades of Euronext and LSE, but indicates that the incumbents are facing genuine competition.

“There was a level of dissatisfaction with the previous regime,” says Peter Randall, chief executive of Chi-X Europe, “but the lack of competition meant investment banks just had to keep paying.”

Indeed, cost is widely perceived as the Achilles heel of the major exchanges. Randall says: “The challenge for incumbents is that Chi-X has 27 staff and operates out of modest offices outside the City of London while the LSE has a staff of 1,100.” However, he concedes that some LSE staff are involved in other types of activity than pure trading.
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When former Federal Reserve Chairman Alan Greenspan acknowledges that he was “partially” wrong in his belief that some trading instruments, specifically credit default swaps (CDS), did not need regulation, it is time to take note.

Indeed, the subject of regulation and efficiency in the over the counter (OTC) credit derivatives market is now taking centre stage among financial regulators in the US and the EU. Increasingly concerned, New York Federal Reserve officials have recently held a number of meetings with key players in the highly liquid and sophisticated, multi trillion dollar CDS market. Able to offer the right balance between flexibility and the benefits provided by financial regulation, exchanges have proved central in these discussions to bring about a solution.

Growing at an unprecedented rate, there is no doubt that changes need to take place within the CDS market. The key issues in this market that need to be addressed are: reducing operational risk, managing counterparty credit risk, creating real time reporting and improving capital efficiency - quite a challenge.

Whilst clearing houses and exchanges will be key in achieving this, it is not expected that regulators will back any one CDS clearer, preferring instead that there is healthy competition in this marketplace and choice for users.

Liffe, the derivatives business of NYSE Euronext, will be the first exchange to offer a genuine CDS solution to tackle these issues. Launching on 22 December 2008, Liffe CDS will be provided via Bclear, a proven processing and clearing service that is already meeting the needs of the OTC market.

Since it was launched in 2005, Liffe’s OTC derivatives service Bclear has been used extensively by leading investment banks and buy-side firms to process OTC business, helping them to reduce operational risk and manage counterparty risk. Bclear currently offers futures and options on an extensive range of equity derivative products and extending the risk management benefits of this service to the CDS market is a logical next step.

Liffe CDS contracts are true CDS contracts, rather than futures or options, and will offer the market a solution that will tackle some of the concerns related to operational and counterparty risk. CDS on Bclear will allow market participants to enjoy the benefits of doing business on an exchange - clearing, processing and margining facilities - whilst retaining the benefits and conventions of trading OTC.

CDS trades will still be pre-negotiated and agreed anonymously in the OTC market but they will then be processed via Bclear and cleared by the exchange and clearing house, LCH.Clearnet Ltd, who act as the buyer to every selling clearing member and the seller to every buying clearing member.

By bringing together the best elements of an exchange and clearing house with those of the OTC market, Liffe will be able to offer the market a very viable solution for CDS.

Potential users should refer to www.nyx.com/cds which draws their attention to the particular characteristics associated with the contract.
trading. Meanwhile, Euronext employs 5,000 people and Deutsche Borse has 3,000.

And MTFs have more in their armoury than low operating costs to make trading cheaper for users. Many employ the maker-taker model, which offers rebates to users who offer liquidity. “That means, for the first time, the trading community is rewarded for posting liquidity,” says Randall. “At the heart of this rebate pricing model is a lean margin for us of just 0.1bp. Or, put another way, for every million shares traded, we earn E10. This is particularly attractive for high volume participants.”

But Frederic Ponzo, managing director of NET2S, a consultancy, points out that the cost of trading is not everything. “The bulk of the cost of a transaction is in the back office. Lower costs are less important overall than getting an order filled quickly and fully,” he says.

The big question now – 18 months after the first new platform was launched - is can MTFs win sufficient market share to justify their existence? Well, according to a study by Tabb Group, a US-based consultancy, the new entrants will win 21 per cent of market share over the next three years before consolidation occurs.

Chi-X, the European pioneer, says it has already broken even and is better positioned for a downturn than the incumbent exchanges. Says Randall: “We have a strong balance sheet to weather a period of extended slow markets for 18 months or more. With share prices down across the board, the imperative for investors to pay lower costs will be all the greater and this plays to our strengths.”

So far, Chi-X has achieved its launch targets. Last April, it said it wanted to go above the 25 per cent level in FTSE 100 trading within a year, and take more than 15 per cent of volumes in the CAC 40, AEX 25 and the Dax 30. It achieved that by the end of the summer.

So despite the increased complexity caused by fragmentation in the market, investors appear to be warming to MTFs. Phil Allison, head of client trading and execution at Chi-X, says: “Last August, clients would have been cautious but they have seen how it is working and are more positive. They want us to be more active.”

“**For the first time, the trading community is rewarded for posting liquidity.**”

Peter Randall, Chi-X

Others have yet to be convinced. Richard Muckle, COO of Blue Oar Asset Management, a new company which runs two equity-based funds, says: “Although we take an active interest in the new trading systems such as Turquoise and Chi-X, we feel it would be too early for us to use them before seeing how larger funds with greater volume fare. For newer operations, the best course of action is to observe from a safe distance until you’re sure that teething problems have been ironed out.”

This is music to the ears of incumbent exchanges. They are keen to exploit any initial uncertainty over the MTF model and are fighting back hard. NYSE Euronext, for example, has launched a “global incentive programme”, rewarding traders for using more than one of the group’s trading platforms. The scheme is aimed at high-frequency traders - such as hedge funds, asset managers and banks. Similarly, Nasdaq OMX says it will offer users of its new pan-European equities trading facility fee discounts if they also trade on Nasdaq in the US or on OMX, the group’s Swedish equities platform. And the LSE has unveiled a radical shift in its fee structure to attract algorithmic traders. However, Chi-X is sceptical about the LSE’s move. Randall says the net effect for traders will be neutral because the LSE is putting its prices up in other areas. “Its three largest customers will get lower fees and that’s about it,” says Randall.

Crucially, the incumbent exchanges have a strangle-hold over market data. The LSE, for example, is the only “reference market” in the UK for pricing purposes. The Investment Management Association, the trade body for UK fund managers, warned in June that investors were unable to judge whether UK equity trades were being executed at the best price, blaming the proliferation of price-reporting mechanisms. The issue was highlighted last month when the LSE’s trading system failed. Ponzo says: “The
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RMS: the antidote to information overload

By Mark Rice

The investment industry today is more information intensive and data dependent than ever. Investment professionals must be able to manage all the information they gather on their investment ideas effectively, and then locate and retrieve any single piece of research quickly and easily. However, in recent years, the industry has struggled with a massive influx of investment information – sell-side research, email, independently produced analysis, news, internet content, earnings calls and more.

In addition, the marketplace today demands greater transparency, objectivity, and accountability. An organised approach to investment research is a competitive necessity, and potentially compliance imperative.

But the problem is not just the sheer volume of data and its rate of acquisition, but also the lack of structure to that data. A firm’s information is typically scattered across multiple systems and applications that are not designed to support the research process. Firms and fund managers need a systematic, integrated approach to organise and analyse the detailed information that shapes their investment ideas.

Portfolio managers of fundamentally driven strategies generate alpha through the way they discover, research and evaluate ideas and many of them have their own unique investment decision making workflows. The explosion of information, statistics, and opinions on companies, sectors, and markets – and the challenge of managing it all within a well defined workflow – has focused attention on the emerging field of research management solutions (RMS).

Advent, through its recent acquisition of Tamale Software, is now offering a product specifically designed for this research process – Advent Tamale RMS. It creates a centralised information hub where firms can easily aggregate, track, store, search, and access data from a variety of sources. It helps investment teams collaborate more effectively and, ultimately, make timelier and better informed investment decisions.

Investment managers are constantly barraged with investment research information from a variety of sources – broker emails management conference calls, online subscriptions, market data feeds, as well as internal proprietary research. Advent Tamale RMS helps them manage and make sense of it all, while making sure they don’t miss any critical piece of data. They can coordinate their research process with their daily workflow much more efficiently. Portfolio and fund managers can easily and quickly produce a tear sheet of key company data. This functionality gives them a high degree of visibility into their research analysts’ activity and a clearer picture of investment opportunities. Thus, they can deliver the right guidance and direction more quickly and with a higher measure of confidence to individual analysts and teams.

In an uncertain economic environment, these solutions can bring an efficient structure to large volumes of unstructured data. This not only significantly reduces the cost of managing information, but also increases the productivity and effectiveness of the investment professional.

Advent Tamale RMS provides a structured, transparent way to centralise and evaluate research, and provides investment professionals with instant access to all historical research ideas, trades, and performance.

When you look at RMS from every angle –competitive advantage, client relations, cost control, efficiency and compliance–it is clear that RMS is now a mission critical component of the front office infrastructure.
MTFs gloated and said the technology was not up to scratch. But there was almost no trading on Chi-X and Turquoise because LSE prices are still used to calculate NAV. Without reference prices, everything else is meaningless. This will take years to change.”

Chi-X, Turquoise and Nasdaq OMX have in recent weeks joined an informal working group formed by Plus Markets, a London-based exchange, to help tackle this issue. Bob Greifeld, Nasdaq OMX chief executive, says: “We certainly want to take a leadership role on that. We think it will not be too difficult to come up with a market-based solution.”

But it’s a long road for the MTFs to travel to compete with incumbent exchanges. Each MTF will also need to differentiate itself from its peers as the battle for market share intensifies. “In a bid to differentiate their products, the MTFs will invest in new matching functions, targeting different audiences and offering a variety of business models, technologies and pricing models,” Tabb says.

Certainly, anyone coming into the market now must have distinct edge. Ponzo says: “They need something much more than a technical gimmick or gadgetry.” He judges that Chi-X has first-mover advantage, while Turquoise has critical mass because of its investment bank backers. Meanwhile, Equiduct has a smart half-exchange, half-aggregator model and BATS, the latest MTF to go live, is the Walmart of order matching. It is far from clear, though, which one or ones will win out. Ponzo says: “Like gravity, the bigger you are, the more liquidity you attract. No single ECN has yet to pull away from the rest.”

And no single MTF is likely to kick down the final straight until it is clear that technology solutions can keep pace with the new marketplace. For instance, the use of algorithms, which are increasingly important for fast and efficient trading, has been complicated by the advent of the MTFs.

Simon Nathanson, chief executive of Neonet, says traders need to know they can reach all the venues, - or at least the relevant venues - get the necessary market data and be able to process it. “Direct market access, viewed in the last couple of years as a commodity, could now be a complex and niche service where issues such as the speed at which orders are executed, becomes a key issue.”

The difficulties are likely to intensify in the future, says Nathanson. “Next year we may see 30, 40 or even 50 new execution venues if you count MTFs, dark pools and systematic internalisers. It will be too expensive for everyone to build connectivity to all those places and this presents opportunities for providers like us.” However, as in the US with the Electronic Communication Networks (ECNs), consolidation is likely to take place. “The traditional exchanges eventually bought up many of the ECNs and this is likely to happen to the MTFs in Europe,” Nathanson says.

But, before this happens, MTFs are likely to bring huge changes to the marketplace. Latency for instance, is improving fast and attracting innovative approaches. Nathanson says: “Thirty years ago, everyone traded together at an exchange. Then with electronic trading they all went back to their own offices to trade. Now, speed of light down cables is the key, so servers need to be close to the order book machine. So you end up with servers instead of people inside the exchange buildings. You could say we have come full circle.”

“Without reference prices, everything else is meaningless.”

Frédéric Ponzo, NET2S
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Hedge funds have always had an interesting and diverse relationship with IT: from mission-critical, proprietary systems and prime broker-sourced systems to creating ad hoc spreadsheets – or ignoring IT altogether.

But in recent years a new alternative has emerged: broker-neutral technology from independent software vendors that take the best elements from systems designed for asset management firms and create lighter weight packages for hedge funds. The broker neutrality of these systems is attractive to hedge funds trying to prevent information leakage, and is an efficient, cost-effective replacement for disparate applications. They also help address investor pressure for robust technology that meets the demands of today’s complex – and recently very volatile – market.

The functionality of these systems – particularly their asset-class coverage and strategy support – has really raised their profile. What we have seen is a large-scale intelligence swap in which institutional investors have adopted more exotic financial instruments and occasional high-risk strategies traditionally employed by hedge funds, while the hedge funds have taken on the technology developed to support this new approach.

This is why the software now available has become much more interesting to hedge funds. This is most noticeable in the field of derivatives trading, which has seen three key stages of development.

The first was the creation of systems that could model and manage derivatives as part of a diverse portfolio. The next was to overcome the previously prohibitive complexities of measuring exposure to underlying instruments, so that an end-to-end investment management workflow, powerful, real-time P&L and pricing analysis, validation and reporting could be realised.

That opened up a new range of opportunities in terms of modelling and portfolio management, so the third stage of the technology’s development offers the ability to calculate accurate and comprehensive exposure and with it truly interactive hedging.

To illustrate interactive hedging, consider a trader who holds bonds plus interest rate, credit default and inflation swaps. Historically, he would have to buy and sell several bonds with different lengths of maturity to change the duration on his exposure numbers.

But with full, interactive hedging capabilities he can highlight a number of bonds that need duration management and ask the system to propose the most appropriate swap. With that single swap he can change a portfolio of 20 bonds. The same technique can be applied equally successfully to inflation and credit management, or even to long-term LDIs.

The same functionality can also be used for interactive speculation, by using it to look at the impact of using derivatives on a multi-asset portfolio and act accordingly. In effect, it gives hedge fund managers the tools to test theories, look at portfolios from a modeling point of view, and then implement strategies only when satisfied that they will work and deliver expected results.

There is little question that hedge funds will benefit from the execution and order management capabilities initially developed for institutional asset managers. Interactive hedging and speculation will radically alter the way funds are able to respond to market moves, and are one example of how innovations on the buy-side are now matching, if not outpacing, sell-side systems.

The trend for more vendor-supplied solutions is set to continue for some time yet.
It is fashionable to blame hedge funds for the world’s ills, and politicians have not waited long before pointing the finger at them over the credit crunch and the subsequent recession. It would be tempting for hedge fund managers to laugh off the often absurd attempts to pin the blame for everything on them were it not for the fact that political posturing could soon be backed up with new regulation of the industry.

Crackdowns have been threatened on everything from short-selling and the use of derivatives to leverage and capital requirements.

This is not the first time such threats have been issued. As Meredith Jones, managing director of US-based PerTrac Financial Solutions, says: “In 1998, we had LTCM and the industry made the trip to Congress to testify. Then in the high-tech downturn of 2000-2002 it was asserted that hedge funds had taken down the Nasdaq and we had a similar process.”

Jones is not convinced that the current threats will be carried through. After the problems in 1998 and 2000-2002 there was little substantial change, she says. “What did change, however, was oversight by investors. Before 1998, few hedge funds reported numbers and there was zero transparency. Afterwards most provided information on holdings, exposure and returns. So there was little real regulation but plenty of self-regulation.”

However, Jones accepts that the current environment is of a different order of magnitude and regulation is more likely to result.

Manny Roman, co-chief executive of GLG Partners, the New York-listed multi-
They say information is power, and nowhere is that more true than in the investment world. But these days, accessing information isn’t the problem — it’s figuring out how best to use all the information we have.

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Information is Power.
Unlock its Potential.
Changing the way investors communicate

By Meredith Jones

The flow of information between hedge fund managers and investors has historically been challenging for both parties. Investors have struggled for more than a decade with manual data entry of qualitative and quantitative information they receive monthly, weekly and even daily directly from managers. Even today, you can walk into multi-billion-dollar funds of hedge funds or family office to find a cadre of analysts and even the portfolio manager entering data. Not only is the process error-prone and time-consuming, it delays more important analysis and reporting.

For hedge funds and other alternative investment managers, the challenges are different, but no less disruptive. Managers must produce more frequent qualitative and quantitative updates for investors than ever before, but the methods of transmission (PDF, fax, email) are not secure or automated at either end. Managers must typically create separate documents for different distribution groups (investors, prospects, third-party marketers, etc.) and, increasingly, investors have begun to require daily, weekly or monthly updates to proprietary data-collection templates or web sites to obtain specific performance, risk and due-diligence information.

The hedge fund industry may have grown enormously in the past decade, become much more open and transparent, but the communications workflow between managers and investors and prospects hasn’t changed at all – until now. PerTrac Financial Solutions has just launched PerTrac P-Card, an electronic communication mechanism that allows managers to privately, seamlessly and securely share information with investors.

A PerTrac P-Card is a secure, lightweight email attachment generated by a fund manager that, when opened with the PerTrac Reader application, automatically deposits the data it contains (including daily, weekly and monthly returns, AUM, and even sensitive fund risk and exposure information) into the appropriate fund record in the recipient’s PerTrac Analytical software. Think of it like an electronic business card you might send or receive – only instead of contact data, it transmits all the critical performance and qualitative information on which our industry relies.

Managers decide in advance which pieces of information they wish to distribute. Then, when they enter updated fund information, the free P-Card Generator automatically creates P-Cards that contain that fund’s information, which the manager can then email directly to their distribution lists. Managers can update their funds’ P-Cards and send them out as often as they wish, and customise the data distributed in the P-Cards for specific recipients or groups with just a few mouse clicks. Managers can also attach monthly letters and ancillary spreadsheets, which provides an extra layer of security for sensitive information, since P-Cards are encrypted.

P-Cards will revolutionise the information distribution workflow of the alternative investment industry because it automates a critical process without fundamentally changing the way managers and investors interact. P-Cards are sent directly from manager to investor, just like the letters, faxes, PDFs and emails sent today. Yet in one simple application, the data distribution and collection dilemma is solved for both managers and investors – no more manual entry, increased productivity for both parties, improved communication and transparency. Given events of the last few months, communication between managers and investors has never been more important. With investors hungrier than ever for information and even once reticent managers increasingly willing to provide it, P-Card aims to fix their antiquated communication system and further bolster transparency. P-Card is an idea whose time has come.
strategy alternative asset manager, says he expects the industry to have to face a severe regulatory clampdown. “There needs to be scapegoats, and they are going to go hunt people,” he says. He believes regulation is “long overdue”, adding: “Someone can leave college on a Friday and start a hedge fund on Monday.”

The larger US hedge funds are likely to choose to be regulated to avoid closer scrutiny down the line, reckons Carmel Peters, an Asian equities specialist at RWC, a USD 2.5bn multi-strategy hedge fund firm based in London. “The SEC may register more firms and more firms will voluntarily choose to do so,” she says.

Leverage, widely perceived to have exacerbated systemic financial problems, is a potential target area for rule-makers. But Peters argues against new rules in this area, arguing that leverage will reduce naturally as the structure of prime broking changes. “There appears little reason to legislate. Funds will still lever, of course, but less so.”

And RMF, a Swiss-based seeding firm and fund of hedge funds company, points out that leverage, at least in the short-term, will not be necessary for many funds to make money, given market volatility and distressed asset prices. Hans Hurschler, head of RMF Hedge Fund Ventures, says: “There is ample opportunity for funds to make excellent unlevered returns in this environment.”

Short-selling is another likely regulatory target, following crackdowns in just about every world economy over the last few months.

Tom Brown, head of investment management at KPMG, says: “Personally, I think the rules will be temporary.” On the other hand, he thinks the uptick rule, where investors can only sell a stock short if the last movement was up, may stick. “This is sensible since it avoids a vicious downward spiral in a single stock,” Brown adds.

New rules on the use of credit derivatives, widely viewed as the root of recent problems, are most likely of all. Moves to regulate the USD 62,000bn credit derivatives market escalated last month, with New York State planning to bring parts of the sector under the control of its insurance supervisors from January. “The absence of regulatory oversight is the principle cause of the Wall Street meltdown we are currently witnessing,” said David Paterson, governor of New York, last month, adding that credit derivatives were a “major contributor” to the crisis.

Market manipulation is a further area of contact for legislators. The Securities and Exchange Commission has pledged to obtain statements - under oath - from hedge fund managers, broker-dealers and institutional investors with significant trading activity in financial issuers or positions in credit default swaps. Richard Jones, chief executive of Fidessa LatentZero, says similar measures should be unnecessary in Europe where trade reporting rules have already been tightened under Mifid. “Smaller funds delegate this to their prime brokers,” says Jones. “This should not be an issue for most hedge funds.”

However, the greatest likelihood of genuine regulatory action exists in capital requirements rules. The European parliament’s economic and monetary committee has passed a resolution calling on the Commission to make “all relevant actors and financial market participants, including hedge funds and private equity” subject to mandatory capital requirements. In response, the Alternative Investment Management Association (AIMA) in October updated guidance to its members on how to implement an Internal Capital Adequacy Assessment Process. Andrew Baker, AIMA’s deputy chief executive, says: “The hedge fund industry has embraced the capital adequacy debate proactively.”

Yes, all the putative measures represent a somewhat desperate response by

“We need more supervision and enforcement of the existing regulations, not new rules.”

Tom Brown, KPMG
policymakers to a desperate economic situation and KMPG’s Brown, for one, is sceptical about the potential benefits. “What we need is more supervision and enforcement of the existing regulations, not new rules,” he says. “I would expect regulators to look at hedge funds with greater resources, greater frequency and depth of probing.”

PerTrac’s Meredith Jones agrees. “It is not very useful to impose industry-wide sanctions on an industry that is so diverse. They could put restrictions on leverage but 30 per cent of hedge funds don’t use leverage. There is no panacea from a government point of view.”

Nevertheless, regulators are starting to gather the firepower to enforce existing regulation, according to Fidessa LatentZero’s Richard Jones, who says “Regulators will be able to recruit a higher calibre of person than in the past with the job losses in the financial services markets.”

Whether existing regulations are tightened or new ones introduced, it is clear that the industry needs to act to protect itself. Says PerTrac’s Meredith Jones: “The introduction of additional real regulation will depend on how well the industry responds and educates people. Hedge funds must get out and dispel the myths. That is the only way can they avoid knee-jerk official reaction.”

There has already been a marked trend towards greater transparency – the main concern of politicians and rulemakers – with most hedge fund managers providing weekly or even daily numbers, she says. “This is a natural evolution of the business,” says Jones. But there are technical difficulties involved in providing the numbers that not all hedge fund managers had yet overcome. She adds: “We still see many hedge fund managers provide a PdF of the information to investors, who then have to go through it and type in the relevant bits and then do their analysis. Many hedge funds have the information but don’t have the ability to share with it a large group of investors.”

And the more complicated the strategy, the more challenging the reporting requirements become. Exotic instruments aside, there is even complexity with plain fixed income funds, which tend to use plenty of leverage to magnify small movements in prices. “Reporting on the leverage and explaining counterparty risk is no easy matter,” says Jones.

Indeed, counterparty risk rose to the very top of the agenda for hedge funds following the collapse of Lehman Brothers, and is now an essential part of the risk jigsaw alongside operational controls, performance measurement, compliance and order flow control. Fidessa LatentZero’s Richard Jones says: “If you are a single prime-broker hedge fund, you are much more likely to run into trouble.”

But even operational controls – being able to produce a snapshot of all positions and all exposures at all times – are not always in place. Neither are order controls, which enable managers to track whether an order has been placed, executed and settled correctly. Smaller hedge funds often don’t have these systems in place even though explicit checks and balances are crucial in exercising control, Jones says.

There is, however, some doubt whether better systems actually solve the problems funds have faced in the recent past. Simon Nathanson, chief executive of Neonet, a specialist technology broker, says: “I’m not sure if better compliance and performance tracking tools will work. In exotic products you have hidden risks and I don’t think people can start to know how to address them.”

Nevertheless, many in the industry believe if hedge funds can get the majority of operational, compliance and risk issues right, they can expect a healthy future. PerTrac’s Jones says: “Hedge fund performance overall is better than the markets or mutual funds. If you are in an index-tracker you are down 40 per cent this year, if you’re in a hedge fund you’re down 10 per cent or so. It is Darwinian that there will be fewer hedge funds next year, but the groups that get out in front of operational and regulatory issues will do well. Money will definitely flow into this industry again.”

“More hedge fund firms will voluntarily choose to register.”

Carmel Peters, RWC