

SPOTLIGHT

HOPE FOR HEDGE FUNDS

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Hope for hedge funds

BY CLAIRE SPENCER

Although the effects of the financial crisis were not immediately felt by the hedge fund industry, things took a sharp turn for the worse in the final quarter of 2008. The number and size of hedge funds went into sharp decline as values plummeted, credit availability ceased and investor appetite for alternative investments dwindled. Now funds are taking the first steps on a long road to recovery, but are finding it difficult due to the lingering market volatility, not to mention the realisation that their long-standing dependence on leverage needs to be reassessed. This is partially due to the stance of lenders, and also investors, who have become increasingly intolerant of the risks associated with over-leveraging. But, anecdotally at least, interest in the hedge fund industry remains healthy where activity does not, and those involved are tentatively confident that it will weather the storm, given time.

Feeling the aftershocks

While all alternative investors have suffered acutely in the last nine months, it could be argued that hedge funds have felt it more than most. In financial terms, they have experienced a crippling combination of steep losses on their investments and mass redemptions from disgruntled investors. Several have had to realise their investments at the bottom of the

market in order to meet these redemptions, or have sold illiquid securities more slowly, using large holdbacks from distributions or special purpose vehicles. But many others chose a different avenue says James Lonie, a partner at Henry Davis York. "Many investors just wanted to liquidate their investments and buy government bonds. Unfortunately the many were too many, and hedge funds found themselves unable or unwilling to meet redemption requests. Unable if they were fund-of-funds and the underlying fund investments were illiquid, or because of a lock-up or other long term commitment. Unwilling if they realised that the market value of investments did not represent their real value," he explains. As such, many hedge fund managers have taken the decision to freeze redemptions for the time being, but there are concerns that such actions may only delay the demise of weaker funds.

For such funds, the flood of redemptions may ultimately be too much to bear. After all, it was not so long ago that hedge funds were severely shaken by the bursting of the dotcom bubble. "This sent the markets fleeing from techs into advanced growth stocks, like Enron, Worldcom and Dynegy, only to be burned again by the carnage of 'accounting rot', recalls Randall H. Steinmeyer, special counsel to Murray Frank & Sailer LLP. "In response, investors fled to

quality securities such as Citi, Bear, Ford and GM, only to realise more losses as their balance sheets were shredded by the recession. Most funds and investors sought refuge in their banks and accepting menial rates, but not even they were the panacea that investors had hoped." He adds that today, investors have lost faith in the markets, and the uncertainty created by government bailouts of financial institutions, dilution of equity stakes and the shifting status of creditors has also subdued investment, even from those that can afford it.

Their guarded attitude is hardly surprising. Hedge fund managers promised investors that they could make money in both rising and falling markets, but ultimately failed to 'hedge' against their riskier investments. The declines in investment values have, naturally, had a profound impact, but that is only one part of the story. "With credit markets frozen, fund managers also faced difficulties valuing debt securities," recalls Jill R. Whitelaw, of counsel at Montgomery, McCracken, Walker & Rhoads LLP. "Model pricing was also hobbled by unusual market conditions. Rating agencies and monoline insurers came under fire respectively for the ratings assigned to the issues and the credit support behind the ratings, and in what seemed like a waterfall, debt was widely and drastically downgraded." She adds that these ►►

effects were compounded by an ever-increasing distrust between market players, which led to an intense focus on counterparty risk.

Then came the media backlash. Almost overnight, previously unheard-of hedge fund trading strategies such as short selling and over the counter trading in credit default swaps and other derivatives became common concepts in the wake of the AIG collapse and subsequent bailout. Regulatory and general government scrutiny intensified, short-selling was suspended, and hedge fund managers found themselves at the centre of a heated global debate. “Even though hedge funds did not cause the financial crisis, the financial crisis has brought regulation of hedge funds to the forefront,” observes Nora Jordan, a partner at Davis Polk & Wardwell. “Policymakers around the world are concerned about systemic risk, and they want to ensure that risks posed by hedge funds are addressed by systemic risk legislation they are crafting. In addition, the financial crisis exposed many frauds that weren’t necessarily hedge fund frauds but have been mischaracterised as involving hedge funds.” Ms Jordan believes that enforcement officials have consequently set their sights on hedge funds to bolster public confidence in their ability to safeguard investors. Whatever their reasons may be, it is clear that the days of light-touch regulation are now over.

However, the situation is not without hope. The pace of investor withdrawal has slowed markedly, and it is thought that asset values will soon bottom out, if they have not done so already. Anecdotally, investors are starting to return to the market now, encouraged by the slow evaporation of volatility from the stock markets. “The key to return to confidence is the proper corporate governance of all businesses and specifically investment funds,” asserts Paul Christopher, a partner at Ozannes, an offshore law firm. “Along with an increased and more visible level of corporate governance there is a resurgent interest in jurisdictions with appropriate and meaningful regulation of hedge fund vehicles, such as Guernsey and Jersey.” Those investors willing to invest are closely focusing on the terms and conditions, particularly with regards to investment structures, in minute detail. Indeed, they are in an excellent position to negotiate better terms, such as shorter lock-ups, lower fees and clawbacks. Ultimately though, transparency is key to confidence, and hedge funds and their investments must be subject to the highest standards of corporate governance in order to maintain it.

All in the details

Until this is accomplished, hedge funds are likely to find the fundraising process to be somewhat arduous, and growth will be a

struggle for even the best of them as institutional investors reconsider their allocations to alternative investments. But participants are now grimly aware that change is inevitable, and both investors and managers are working through their problems together to forge a new, better normal. “Specific issues for the hedge fund industry are the level of hedge fund manager fees and the pressure from investors to reduce these from the traditional sums that have been charged,” notes Mr Christopher. “There is also the challenge of dealing with the lack of liquidity in underlying assets and the creation of structures to fairly deal with those particular issues.” However, and perhaps unsurprisingly, there has been a notable decrease in the number of investment products being created. As such, those that remain have had to adapt. “The types of funds being launched in this environment have changed from the most recently preceding markets. With debt being sold for pennies on the dollar, distressed debt funds and bank loan funds are more popular. High yield debt funds are also being launched more frequently as investors willing to take on risk demand higher risk premiums, increasing the yield on these securities,” says Ms Whitelaw.

Of course, not all of the change has been organic. Rightly or wrongly, the recent spate of high-profile frauds has caused regulators to act swiftly to ensure that such events are not repeated. “The Madoff fraud in particular, while shocking in its scope and the sophistication of the investors, was perhaps the most instructive and far-reaching in its consequences,” explains Ms Whitelaw. “The involvement of prominent funds-of-hedge funds and other intermediaries led many in the industry to reinforce and recommit to stringent due diligence policies. When it became clear that people and organisations from all walks of life had been Madoff investors, including a variety of charitable organisations, public and political pressure for regulatory reform became intense.” This inspired US Senators Chuck Grassley and Carl Levin to introduce the Hedge Fund Transparency Act (2009), which would amend the Investment Company Act of 1940 by requiring all private investment funds with \$50m or more in assets under management to register with the SEC.

It has also been top of the agenda outside of the US, and the European Union (EU) has also sought to strike while the iron is hot. But the process has been anything but smooth, warns Killian Buckley, a member in the corporate advisory consulting team at Kinetic Partners. “The EU’s regulatory response to the role of hedge funds in the financial crisis – the Alternative Investment Fund Directive – was published last month amid controversy. While the aim of the Directive is well intentioned – transparency and systemic risk aversion – it

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appears hurried and vague in places. In some areas it will add a layer of unnecessary regulation to other directives such as Markets in Financial Instruments Directive.” In addition, he warns that some of the suggested requirements may considerably shrink the industry. This would be economically unhelpful by anyone’s standards, and may not even be for the right reasons. Indeed, the main criticism from the hedge fund managers and other alternative investors is that the Directive may be politically motivated, given that the European elections are so close.

With so many balls in the air, it is clear that the extent to which hedge fund managers on both sides of the Atlantic will get a say in their fate remains to be seen. It is technically still early days, but many hedge fund managers and investors are already feeling the pressure of the government intervention – particularly those that invested heavily into the US’ distressed automakers, says Mr Steinmeyer. “GM plans to all but wipe out the holdings of remaining shareholders by issuing up to 60 billion newly minted shares in a bid to pay off debt to the US government, bondholders and the United Auto Workers union. The unusual plan would only need the approval of the US Treasury to proceed since the US government would be the majority shareholder of a new GM,” he says. As such, hedge funds have sustained heavy losses in this area, and will continue to do so as the distress plays out.

Hope for the future

Most hedge funds are now focusing on what they have, as opposed to what they would like to have. Many have taken the previously unusual step of holding fund assets in segregated accounts in order to please investors. This is a wise step, as growth will not return until security does, but the journey will be slow. "The hedge fund industry has definitely gone backwards at least five years and possibly 10," asserts Mr Lonie. "Those who invested heavily in hedge funds, especially those who used their own leverage on top of the leverage with the hedge funds, have suffered badly. The value proposition that a hedge fund could provide a hedge against falling markets has been fundamentally dented," he warns. Ron S. Geffner, a financial services partner at Sadis & Goldberg LLP agrees, saying that "the alternative investment industry will revert to trends which developed shortly after 2000. Barring a regulatory attack, we expect many new products to be developed and launched with fewer assets. As the products are incubated with fewer assets, the new tranche of managers will arise."

Ultimately, the outlook will be more certain when lending conditions improve. However, experts are concerned that the measures designed to achieve this have been largely ineffective to date. "The Federal government has been going to great lengths to prime the pump flooding it with liquidity, guaranteeing bank deposits and dropping interest rates to record lows," says Mr Lonie. "But the banks aren't passing all these benefits straight on. Credit margins have been spreading. Banks respond that they hadn't been pricing in risk because of the competition for

business and that a spread is inevitable." Nonetheless, these measures have been ongoing for some months now, and it is thought (or hoped) that they will soon begin to bear fruit.

Nonetheless, it is important that hedge fund managers realise that lending may not occur at the levels seen during the M&A boom for the foreseeable future, says Mr Geffner. "Two material variables will influence banking and financing institutions, such as the requisite assets that will be required to be maintained by regulators which will enable those institutions the ability to ride out and survive further economic volatility as well as the amount of leverage they may employ or finance either through their own investments or that they may lend to borrowers." He adds that the US government will seek to influence these controls by virtue of having provided the capital necessary to maintain these institutions. In the near term, this could ultimately be to the benefit of the hedge fund industry.

Furthermore, governments will continue to have a generally instrumental role in the hedge fund industry going forward, and this may not be to the tastes of its participants. "The hedge fund sector will continue to be on the political agenda," maintains Mr Christopher. "This could well lead to an increase in regulatory burden and therefore an increase in costs of operation of hedge funds. Also, the continued remuneration of hedge fund managers is likely to be a matter of further concern, all of which lead to an unpredictable environment in which to carry on the business." Of course, the fact that many hedge funds are biding their time at the moment may mean that this unpredictability will pass, if

not the difficulty of operating per se.

Things may seem like an uphill struggle from this vantage point, but the global market is changing all the time. While globalisation may have exacerbated the effects of financial crisis, it will also ensure that the recovery process does not begin and end with the developed markets. It is clear that the emerging markets will play a significant role in the recovery of the markets, and therefore of the hedge fund industry. "Many Asian pension funds have recently received mandates to push a certain percentage of their funds into the US and European markets," reveals Mr Steinmeyer. "The Asian mandates are primarily restricted to fixed income, but this trend in combination with the flight to liquidity will remain for the next 6 to 12 months. When the enormity of cash on the sidelines begins to slowly move back in the markets, provided the catastrophic liquidity crisis ends, the market should start return to normal," he adds.

If practitioners have learned anything from the financial crisis, it is that the correlation between hedge fund performance and the global markets is much closer than had been assumed. But the stirrings of activity suggest that hedge funds are still a compelling investment vehicle, regardless of the trouncing that their reputation has taken in recent months. However, all positive action should be tempered with caution. The legal and regulatory environment is still in flux, and although the outlook has stabilised, it would be premature to say that this constitutes a recovery. Nonetheless, those that wrote off the hedge fund industry after Madoff were sorely mistaken – it will recover, and it is here to stay. ■

Fiduciary duties of a hedge fund that are often neglected

BY RANDALL H. STEINMEYER

Ofentimes a hedge fund with large losses in a stock as a result of fraud or misrepresentation will ask what its fiduciary duties are with regard to such losses, and in particular ask if it can or should 'actively' participate in the case. In such circumstances, there are a variety of matters to be considered, including maximising the recovery to the class, and thus to the fund; ensuring the fund receives its fair share of the settlement proceeds; minimising the risk of the company committing fraud again; and the fiduciary duties to pursue such a claim. Absent taking an active role, a fund limits its ability to influence the outcome and perhaps minimises rather than maximises its recovery.

A fund manager is a trustee of the assets it holds for the benefit of the fund's investors. As

such, it is under a duty to maximise the financial interest in claims it holds for the benefit of its investors. Some state officials view the lawsuits as their duty to be publicly accountable to fund-holders and to try to recover losses in cases where they believe fraud occurred, and this thinking should be applicable to public as well as private institutions managing other people's money.

Regardless of the jurisdiction, it is black letter law that "a trustee has a duty to investigate relevant facts, to explore alternative courses of action and, if in the best interests to pursue claims". As a fiduciary, fund managers have a fiduciary responsibility to consider the merits of participating in the litigation. Failure to investigate a valid claim may breach the fund's

fiduciary responsibilities to its investors and may expose them to liability. As stated by one federal court, it may not only be prudent to initiate litigation, but also a breach of fiduciary duty to not pursue a valid claim.

A fiduciary has a duty to "take reasonable steps to realise on claims that are property of the trust, including claims in tort". When a tort is committed against a fiduciary, the trustee has a duty to take reasonable steps to compel the tortfeasor to redress the injury. Moreover, fiduciary (i.e., a hedge fund manager) cannot properly abandon claims affecting the trust property unless it reasonably appears that a suit would be futile or the expense of the litigation or the character of the claim would make it reasonable not to bring suit. In 1998, the United States ►►

Secretary of Labor stated:

“[A] fiduciary may have a duty to serve as lead plaintiff where no single individual has sufficient interest or resources to serve in such capacity or where, as a large stakeholder, the fiduciary has an interest in assuring that an alternate class representative with a less substantial stake in the outcome does not unduly compromise the interests of the class in settlement, fail to vigorously prosecute the actions, or fail to protect the interests of the class vis a

vis its attorneys.”

The lesson here is twofold: First, if the your fund takes a large loss in a security associated with fraud (and the shares trade on a US Exchange where the fund can engage counsel without incurring a scintilla of risk or costs and pursue a class action) ask the fund manager what the fund is doing to recover the losses. If you're the fund manager, make sure you have an answer. Avail yourself of your rights by associating with one of the 20 or so firms in

the US that practice exclusively in the area of shareholder class actions and open a dialogue. This way, when the next Enron, Worldcom, Parmalat or Lehman hammers your fund, a simple phone call to US counsel will not only protect you by demonstrating you're attempting to comply with your fiduciary duties, but enhance your returns as well. ■

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Regulate sensibly and with care

BY RON S. GEFFNER

President Obama, Congress and the US Securities & Exchange Commission (SEC) seem intent on increasing the regulation of the alternative investment industry. The government appears concerned that the alternative investment industry may pose serious risk to the broader economy. The government has proposed legislation seeking to regulate the alternative investment industry in a manner that both gathers more information and seeks to control behaviour which the government believes may cause systemic risk to the US markets in the future. The government's current proposal is the Hedge Fund Transparency Act of 2009 (HFTA). As currently written, the HFTA requires, in part, the registration of private investment funds with \$50m or greater in assets.

As drafted, the HFTA is flawed and capable of deepening financial and market crises, and has many unnecessary and unintended consequences. The HFTA in its current form casts a far wider net than necessary to accomplish the government's stated goals, and with relatively modest adjustment could be much more effective and cause far fewer negative results.

It has been estimated that near the end of 2008 roughly 8000 hedge funds were in existence (Reuters, "Number of hedge funds could halve in 2009", October 14, 2008. By Svea Herbst-Bayliss). There is somewhat inconsistent infor-

mation as to the number of these hedge funds which have assets in excess of \$50m. However, there appears to be somewhat better information concerning the concentration of assets with larger funds within the alternative investment industry. According to Institutional Investor's Alpha Magazine (May 2007), the top 100 hedge funds control 68 percent of all global hedge fund assets. For the purposes of this discussion, we shall assume 25 percent of the hedge fund universe has assets in excess of \$50m. Relying on these assumptions (and presuming the population within the hedge fund industry does not materially increase or decrease), under the proposed version of the HFTA, the SEC would be required to collect information from and routinely monitor 2000 hedge funds.

The HFTA needlessly requires too many private investment funds to register and could accomplish the government's goals with the registration of far fewer private investment funds. The HFTA should be revised to require the registration and monitoring of private investment funds with assets in excess of \$500m. By requiring the registration and monitoring of a few hundred private investment funds rather than thousands, the SEC's staff will be able to spend more time monitoring fewer funds. By avoiding this dilution of its monitoring efforts, the SEC regulatory reach should be far more focused

and effective.

Setting the regulatory bar for private investment funds at \$50m to register will substantially worsen the distress in the financial services job markets. It is almost certain that many future managers will forgo the creation of private investment vehicles under the weight of greater organisational and maintenance costs, and the complexity of running a more regulated enterprise. Existing funds will also be forced to shutter rather than comply with the regulatory regime. Experience suggests that investment firms with such a small asset base are not typically profitable enough to justify the costs of maintaining reporting, registered investment entities. One of the negative results of the regulation will be perversely anti-competitive: investors will have fewer options, and the competitive status of the larger fund managers will be bolstered at the expense of startups. Perhaps more importantly, the securities and commodity markets may experience meaningful negative implications from the legislation. Fewer market players means less liquidity in the markets, with obviously negative ramifications for market pricing. ■

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On-site SEC exams: practical tips

BY JILL R. WHITELAW

With a long-time regulator now leading the SEC and a former prosecutor at the helm of the agency's enforcement division, hedge funds should be prepared to receive an

examination letter in 2009 from the SEC's Office of Compliance Inspections and Examinations. SEC staff members have stated publicly that hedge funds are a key regulatory focus of

the agency this year and that both registered investment advisers and unregistered advisers running hedge funds will be reviewed.

Most importantly, remain calm and business- ▶▶

Registered advisers can expect a thorough exam on all areas of the business and compliance with Adviser's Act requirements.

like at all times. With only a week or so to prepare (for a standard, not a 'cause' exam), you may feel rushed, or you may be dreading the SEC's microscope, but don't give into those feelings – they will undermine your efforts. If you had any past SEC exams, review the related exit or deficiency letters and ensure those items have been corrected. Being cited a second or third time for the same issue will invite enforcement action against you.

You will do best by treating this like a thorough due diligence visit from a new and im-

portant client. Make sure your entire staff is respectful and polite. As with a new client, the more organised, responsive and straightforward you are in your presentations and discussions, the better the audience will understand your business and how you run it.

The examiners will be on-site for a limited period of time and as a result, want to *efficiently* review the materials you have prepared and collected based on the SEC's request letter. Be sure you collect documents needed from third parties, such as fund administrators and auditors. Reserve an empty office, conference room or other quiet area for the examiners. They will arrive with laptops, so make every effort to have a healthy chunk of the relevant documents on disk by Day 1 of the exam, and label the docs (or the disk itself) with the corresponding item numbers from the request letter.

Designate a contact person for the examiners to ask for additional information and have your compliance officer or other principal review and approve the response. The contact person should keep a log of all these requests, with copies of everything given to the examiners and the date and time provided. To the extent you are uncomfortable with a particular document request, discuss with the examiners alternative ways to provide the information. For example, consider allowing the SEC to review and take notes on a sensitive document

while on-site but restricting them from taking copies. Or, depending on the circumstances, you might consider redacting sensitive but irrelevant parts of documents and providing copies of the redacted version to the SEC.

Registered advisers can expect a thorough exam on all areas of the business and compliance with Adviser's Act requirements. When asked about key compliance issues you are dealing with, don't say you have 'no issues'. A compliance program that detects no violations or has not been tweaked in some way is a weak program. For unregistered advisers, exams will likely focus on documentation supporting the unregistered status (e.g., number of advisory clients) and your hedge fund's compliance with applicable exemptions and anti-fraud rules.

As the SEC's team wraps up its on-site work, the lead examiner will let you know whether they will conduct an exit interview or will follow-up with a deficiency letter. Nearly every exam results in some deficiency or suggestion for improvement. Your prompt and complete response to the deficiency letter, and implementation of the promised changes or corrections, will position you well for the future, including future regulatory exams. ■

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Hedge fund: bad dog

BY JAMES LONIE

Give a dog a bad name and you may as well hang him, goes an old saying.

Well, in Australia at the moment, rightly or wrongly, offshore hedge funds have a pretty bad name. The corporate watchdog (ASIC) is particularly down on them.

As are executives of, and shareholders in, companies that believe they have been targeted by hedge funds short selling their securities.

The conspiracy theorists have found plenty of fodder.

What if I was an executive of Acme Ltd with a large holding of Acme shares acquired using a loan from Big Bank. Say Big Bank required that the shares be registered in the name of Careful Custodian who then on-lent the shares (for a princely couple of basis points).

Imagine further that the borrower was Bad Dog Hedge Fund who dumped the Acme shares on the market along with a bit of rumourage ("Pssst, want to hear the latest? Acme is in bad financial trouble").

Down goes the market price, triggering a

margin call from Big Bank and forcing me to sell my Acme Shares (now worth a lot less than what I bought them for), wiping out my equity in the Acme shares and, in the process, pushing their market price down even further. Bad Dog Hedge Fund then goes into the market and scoops up Acme shares for a song to hand back to (Not So) Careful Custodian.

ASIC has had a three-pronged response: a ban on short selling securities; disclosure of margin loans of key executives; and investigations into rumourage.

On short selling, the local hedge funds have defended the practice as a legitimate investment and risk management strategy and a useful tool for settlements. Meanwhile ASIC has said it doesn't like it because it makes everyone nervous and the market price of securities go down (which we've all had enough of now). (Pity if you're a long/short fund because if you can't go short, you can't go long.)

I've got no issue with the disclosure of margin loans to directors (or of short selling).

The final one, the offensive against rumourage, is a difficult subject. Rumour-mongering is what brokers do. It's like legislating against breathing for the rest of us. Spreading false information about securities is one thing but is it false or misleading to tell someone that you've heard a rumour? Very hard to prove you haven't. ASIC had a crack at it though and issued notices to a number of traders and brokers seeking information. So far it has banned only one broker after it found that he had sent dozens of emails to clients with false information about Macquarie Bank.

The Australian market has been well and truly spooked. It was just getting used to hedge funds and then the GFC had to pop up. I think it'll be a few more years until it'll start calling hedge funds 'good puppy' again. ■

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