The *ICFA* Hedge Fund Servicing Panel 2010

ON THE PANEL: Mike Sleightholme and Thomas Zdon

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It has been a tumultuous two years for the hedge fund business, having come under increased regulatory scrutiny and new capital becoming harder to find. *ICFA* asked two industry experts what the impact has been on service providers.

ICFA: **What are the main challenges facing hedge funds and service providers as the business begins to recover from the financial crisis?**

SLEIGHTHOLME: Since the financial crisis, hedge funds have seen unprecedented levels of investor-led demand for independent valuation and more transparency, liquidity and rigorous risk management. This has all occurred in a continually shifting regulatory landscape that is likely to become even more complex. At the same time, the search for alpha has prompted many firms to diversify into new asset classes and to extend their geographic reach. These factors have led to growing degrees of operational complexity.

To be successful in this environment, managers should rethink the way their firms operate. It's important they look at their operating models and consider the options, including how they can lean on strategic partners to help them grow in a sustainable and scalable manner. In turn, service partners need to provide globally consistent solutions across the value chain.

ZDON: The main challenge is to regain investor confidence by implementing improved operational workflows and a stronger service provider ecology, and react faster to impending regulatory to changes.

The aftermath has led to increased efforts to mitigate future risk in each area – both from a regulatory standpoint and driven by investor demand. All of these activities can regain investor confidence.

ICFA: **How have the demands of hedge fund clients changed in the wake of the financial crisis?**

SLEIGHTHOLME: Hedge funds are looking for service providers to offer a broader suite of services than ever before, including middle-office services across multiple asset classes and for funds of funds. In many cases, asset levels are down significantly from peak levels, but costs are not. In fact, costs may be higher due to increased investor demand and more complex fund structures.

Managers are looking for cost-effective ways to re-engineer their operating model to provide more scalability, to move from a fixed to a variable cost model and to provide investors with differentiating levels of customer service. It also helps managers to concentrate on what they do best – generating alpha for their clients.

ZDON: From an operating model viewpoint, hedge funds have become multi-prime to reduce counterparty risk and they have introduced custodians to their field of providers for the perceived safety of assets. Hedge funds have also started evaluating their fund administrators based on the strength of their balance sheet, network of sub-custody services and ability to deliver services around a wide range of products. In order to reduce or remove risk, they are increasing the counterparties and introducing custodial relationships. They simultaneously seek to eliminate redundancy among multiple fund administration relationships – even to merge that with their bank custody relationship.

ICFA: **How is the industry preparing itself for the implementation of the Alternative Investment Fund Managers (AIFM) directive? What impact is the directive likely to have?**

SLEIGHTHOLME: Generally, the new rules of the directive are untested and will require further discussion. However, as proposed, it will impact the risk profile of the depositary business. Contracts may be renegotiated as depositaries seek to manage additional liabilities. Additional due-diligence requirements will exist for depositaries wishing to appoint sub-custodians in a particular market. However, sub-custodians may be reluctant to accept full liability from the depositary. This means certain markets may be locked out when neither party is willing to accept liability.

The increased operational risk capital required to manage the change in 'burden of proof' may result in increased costs to funds and investors.

Ucits is expected to come in line with the AIFM directive legislation, shifting the burden of proof to depositaries across a much wider pool of funds. Citi's large network of direct custody across the globe leaves us well positioned to handle sub-delegation to our own network.

ZDON: Firms are reviewing systems and platforms to ensure they can meet the liquidity, private equity and controlling interest reporting, and perhaps meeting with legal advisers to see if they can benefit from passporting. The speed of repatriation of funds has slowed, which indicates that those interested in being under the AIFM directive have done so, while others may not be required to do so based on their investors and capital.

However, what we are seeing is (general) confusion over the impact of the final directive and how it will play out in the market. The AIFM directive will affect almost 90% of the hedge fund marketplace, which will create a significant impact.

ICFA: **What are likely to be the most promising areas of new-business generation for hedge fund service providers in the next 12 months? Will you focus on particular short-term strategies or geographies?**

SLEIGHTHOLME: With the advent of new regulations, expansion of central clearing and increased usage of derivatives, we see the over-the-counter (OTC) derivative space as a major area of expansion – it is still a very manually intensive space that requires specialist staff. Fund managers are increasingly looking to their service providers to help them achieve scalability and shield them from the need to constantly invest in order to stay current. Closely linked to this drive is the need for solutions that provide efficient margining and use of collateral. Citi has developed a full suite of solutions in the OTC space as well as cross-product margining and collateral management tools.

Another area that is seeing unprecedented growth is the bank debt and distressed space. Hedge funds are again looking for partners to help them build scalability and industrial strength as they look to capitalise on this investment opportunity. They are often employing complex hybrid fund structures to align investor and investment liquidity terms. Citi has developed middle- and back-office capabilities to support clients in this rapidly growing and complex space.

ZDON: Our fund administrator clients talk to us about the extension of services from fund and investment accounting to risk and decision support. Depending on their clients' size, firms are seeking to have many of these services delivered and are looking for providers to do independent valuations of alternatives and illiquids while tracking and auditing these in their systems. More of our service providers are preparing to provide these services to their hedge fund clients.

A clear market definition of the middle-office space is yet to be agreed on. The question is, which bits will be owned by the fund compared to the administrator.

ICFA: How are valuation practices evolving as hedge funds use a wider range of financial instruments?

SLEIGHTHOLME: Fund managers are increasingly looking to service providers to help with independent price verification of complex instruments, including derivatives. Citi has a complex pricing team of highly qualified people who help clients and work with a variety of specialist service providers to offer independent verification.

Investors want to know what percentage of assets have been independently verified. Citi provides an investor transparency report that shows this as well as percentage asset positions independently reconciled.

ZDON: The AIFM directive requires independent valuations and the Financial Accounting Standards Board Statement 157 seeks to ensure a relative sentiment around pricing quality and its auditability. International Financial Reporting Standards compared to US Generally Accepted Accounting Principles enable the use of different types of pricing. This means firms with multinational institutional investors require more flexibility in the use of pricing, but also the ability to store and compare multiple pricing sources. Many of our fund administration clients now offer everything from independent swap marks to independent certified public accountant appraisal services on illiquids and private equity holdings.

ICFA: **What factors are driving consolidation in the hedge fund servicing market? How much scope remains for boutique administrators?**

SLEIGHTHOLME: Service providers such as asset managers are subject to growing pressure to do more to earn their keep. The need to hire specialist staff, to consistently invest in technology and innovation and deliver superior client service at a competitive price makes it difficult for smaller administrators to compete in a meaningful way. There will inevitably be further consolidation in the industry as mid-tier providers seek the scale to sustain the required levels of investment.

The role of the niche provider is unlikely to disappear, but the relevance of smaller players will diminish as the industry undergoes a barbell effect with larger managers and their service providers accounting for more of the industry.

ZDON: Consolidation is primarily driven by liability requirements and hedge funds wanting a single-service provider offering custody, sub-custody and fund administration. Many smaller firms have been subsumed, but there will always be niches where the larger multinationals don't want to go – private clients from a fund's perspective, for example. This will depend on strategy, investors, market-access needs and custody requirements. The regulatory environment and economic conditions may also impact the attractiveness of certain offshore fund administration locales, which could cause hedge funds to re-evaluate existing relationships across functions.