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## ADDRESS FROM THE CEO



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### No hedge fund should be designated a ‘systemically important financial institution’

By Andrew Baker, Chief Executive Officer, Alternative Investment Management Association

You may recall that back in early 2009, at an important moment for our industry, AIMA came out in support of several measures including improved transparency to regulators and the registration/authorisation of all hedge fund managers globally. This made clear that the hedge fund industry was neither opaque nor uncooperative, and it helped to create a spirit of constructive engagement that marked our subsequent discussions with policymakers.

We recognised that, by having managers register with and report to the likes of the Securities and Exchange Commission (SEC) and the Financial Services Authority (FSA), more data would be available to allow better monitoring and assessment of markets.

As such, hedge funds would be able to contribute to a more effective global systemic risk monitoring system.

However, we also were quick to add an important caveat – I recall our Chairman, Todd Groome, making this point in an article for the *Financial Times* in early 2010 – that it was important that managers were not forced to supply too much unnecessary information for regulators to have to process.

As Todd wrote, “the data gathered need to be relevant to the risks we seek to mitigate, and it must be understood that neither the public nor the private sector can draw on infinite resources”.

I am reminded of this as we wait to hear whether any hedge fund firm will be designated as a “systemically important financial institution” (SIFI), and thus subject to further regulatory scrutiny, including additional oversight by the Federal Reserve.

As the Financial Stability Oversight Council (FSOC) in the US considers and is expected to clarify soon the criteria by which it will determine which non-bank financial companies may be deemed

systemically important, it is our strong contention that no hedge fund firm today should be designated as a SIFI.

We believe that no single hedge fund firm today is sufficiently large, leveraged, complex or interconnected that its failure or financial stress would cause a “market disruption sufficient to destabilise the financial system” – the basic definition of a SIFI.

It should be remembered that the FSA has stated that, based on its risk reporting framework, none of the large hedge funds it examines (currently) poses “a significant systemic risk to the financial system”. It is also significant that the FSA’s most recent hedge fund survey found that major hedge funds do not pose a potentially destabilising credit counterparty risk, and that the levels of leverage employed remain relatively low, which in the words of the FSA suggests a “contained level of risk”.

The key issue, of course, is whether a hedge fund firm is “too big to fail”. Casting our minds back to 2008, more than 1,400 individual hedge funds were closed or were liquidated, almost all in an orderly manner. It has been acknowledged by many regulators and policymakers that those closures had virtually no impact on hedge fund firms’ counterparties nor the stability of the financial system at large. This difficult period provided a very up-to-date and significant stress test concerning hedge fund risks to markets.

Sebastian Mallaby of the Council on Foreign Relations has a memorable way of describing this – he says that hedge funds are “safe to fail, even if they are not fail-safe”. We are not suggesting that hedge funds do not fail, only that when they do, they do not bring the rest of the financial system crashing down with them.



## ADDRESS FROM THE CEO

Size matters in this debate. In our discussions with policymakers, we always stress that hedge funds collectively represent a relatively small group of extremely heterogeneous and often small businesses.

The global hedge fund industry is dispersed – approximately 9,500 hedge funds manage a combined \$2 trillion in assets, according to Hedge Fund Research – whereas a small number of financial institutions' balance sheets are on their own much larger than the entire global hedge fund industry. Those are the true SIFIs.

Even hedge funds' collective positions and exposures are not such that individual failures pose a risk to financial

stability. And hedge fund firms employ significantly lower levels of leverage than banks and some other financial institutions. Moreover, hedge fund activities do not typically contribute to pro-cyclical market dynamics; they tend to be contrarian or to look for market inefficiencies and, through their investment activities, they tend to make markets more efficient.

As such, hedge funds enhance diversity of market behaviour, and thus contribute positively to financial stability.

We hope that the FSOC and other authorities recognise this, and that common sense will prevail.



**Andrew Baker**  
Chief Executive  
Officer, AIMA

A handwritten signature in black ink that reads "Andrew Baker".

## AIMA NEWS

### AIMA'S INVESTOR STEERING COMMITTEE PUBLISHES NEW GUIDE FOR INSTITUTIONAL INVESTMENT

AIMA launched a new paper by our Investor Steering Committee, [A Guide to Institutional Investors' Views and Preferences Regarding Hedge Fund Operational Infrastructures](#). Our Investor Steering Committee is composed of various leading institutional investors, several of whom are full members of AIMA. The paper details the preferences of institutional investors about operational matters. It is intended to be helpful to managers, rather than being prescriptive, and is not a set of standards. The paper stresses that even though smaller managers may not operate on the same scale as larger managers there are nevertheless operational measures that they too can consider in order to be more attractive to institutional investors. The work also is meant to complement rather than displace our existing Sound Practices and DDQ work.

### AIMA CREATES SMALLER MANAGERS' GROUP

A meeting to establish an AIMA Smaller Managers' Group was held at AIMA's head office in London. The attendees, who included a number of smaller managers,

agreed that such a forum would be of benefit on an ongoing basis. A number of potential areas which a working group could cover were proposed, including regulatory issues; sound practices; due diligence; interactions with service providers; and business pressures. The group's Chairman is Jim Kandunias, of Esemplia Emerging Markets. It is open to AIMA manager member firms in Europe with \$250 million or less in assets under management.

### AIMA AUSTRALIA FORMS INVESTOR ADVISORY COMMITTEE

AIMA Australia has announced the creation of a standing Investor Advisory Committee (IAC). The committee's membership is comprised of senior investment executives from large superannuation and endowment funds, and will be expanded over time to include charitable foundations and family offices. The objective of the committee is to form an open communication channel between the Australian institutional investor community and the local hedge fund industry. This important two-way dialogue will act as a means to incorporate investors' views into the industry as well as acting as a learning mechanism for large Australian investors wishing to know more about all aspects of the hedge fund industry. The founding members of the AIMA Australia IAC

are: Bruce Tomlinson, Portfolio Manager, SunSuper (Chairman); Craig Turnbull, Chief Investment Officer, Local Government Super; Jon Glass, Chief Investment Officer, Media Super and adviser to University of Sydney endowment fund; Tom Gillespie, Senior Portfolio Manager – Risk, Aust. Reward Inv. Alliance (ARIA). Ex-Officio: Kim Ivey, President, AIMA Australia.

### US MEMBERS MEETING HELD IN NEW YORK

The AIMA US members meeting was held on 10 June 2011 at the Harvard Club, New York. The event drew one of the highest ever turnouts for a US members' meeting. It featured an update on AIMA from our CEO, Andrew Baker, as well as a regulatory and policy discussion involving our Chairman, Todd Groome, and our Director of Government and Regulatory Affairs, Jiri Krol. The event was generously sponsored by Ernst & Young.

### STRONG TURNOUT FOR AIMA JAPAN HEDGE FUND FORUM

The annual AIMA Japan Hedge Fund Forum was held on 3 June 2011 and attracted more than 150 attendees – the highest turnout in the event's history. The Forum was originally due to be held in March, but was postponed until June because of the devastating earthquake and tsunami.

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bear on a very small company (say, under 50 people) seems to him to be a wrong use of resource and that it is far better to find other ways of making sure that that small company knows how to operate ethically. The SFO will look for the most difficult cases, namely “those involving companies (whether UK or foreign) operating in a range of challenging environments that want to continue to use corruption in order to undermine ethical companies”.

### PROCEDURES FOR PREVENTING BRIBERY: THE SIX PRINCIPLES

The MoJ Guidance sets out six principles which should inform a business’s procedures for preventing bribery being committed on its behalf. It is required reading for all companies wishing to reduce their exposure to Section 7 prosecutions. It provides commentary and guidance to accompany each principle and also contains a series of case studies.

### CONCLUSION AND ACTION POINTS

Fund managers which are authorised by the UK Financial Services Authority will already comply with its rules relating to their systems and controls and to inducements, which address some of the same

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5. Speech by Richard Alderman, Director, SFO on 30 June 2011 on Anti-Bribery Compliance Solutions

concerns as the Act. However, it is likely that most fund businesses will need to take at least some steps given the wide scope of the Act. In summary, fund businesses should consider, while using a risk-based and proportionate approach, the following steps:

- Ensuring they have top-level management commitment to preventing bribery;
- Conducting an internal and external bribery risk assessment;
- Having appropriate anti-bribery policies and procedures;
- Updating contractual terms with counterparties and employees to include anti-bribery provisions;
- Applying due diligence procedures on existing and potential associated persons;
- Providing communications, training and avenues for “whistle-blowing” and feedback; and
- Monitoring, evaluating and reviewing anti-bribery policies and procedures.

In addition, as discussed above, multinational fund businesses companies with UK operating companies seeking to minimise risks under the Act should consider implementing protective measures.

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## A pragmatic approach to investor protection: Better fund structuring and the use of series entities

By Dominic Lawton-Smith and Philippa-Lucy Robertson, JP Fund Administration

It will come as no surprise to market participants that there has been increased worldwide demand for better, more conflict-free corporate governance of investment funds; a primary objective being improved investor protection. One approach to addressing this objective has been a wider role for regulators; while many believe stronger regulation is vital, other observers identify inefficiencies and failures of such an approach.

This article focuses on another (somewhat less debated) approach

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1. For example, the European Commission proposed its original draft of the Alternative Investment Fund Managers Directive (AIFMD) on 30 April 2009. After years of negotiations and around 2000 amendments to the original draft, the Directive will final enter into force at European Union (EU) level on 21 July 2011 and member states of the EU will then have a further 24 months to transpose the Directive into national law.

2. For example, with respect to the implementation of the AIFMD, it has been reported that the directive will cost the private equity and hedge fund industries in the EU between €1.3bn and €1.9bn in the first year, with an annual recurring cost thereafter estimated at between €689m and €985m ([www.ft.com/cms/s/0/251c682e-a63d-11de-8c92-00144feabdc0.html#axzz1Rsaptew7](http://www.ft.com/cms/s/0/251c682e-a63d-11de-8c92-00144feabdc0.html#axzz1Rsaptew7)).

3. For example, the Luxalpha fund, a feeder for Bernie Madoff’s fraudulent operation, as well as several others, had been certified as a UCITS fund. Despite being subject to rigorous EU regulation, the lack of harmonisation across member states concerning the role of the depositaries meant that the Luxalpha fund generated losses of approximately €1.4 billion through its custodian, the Swiss bank UBS (see further Weber, R. And Gruenewald, S. “Fraud - UCITS and the Madoff Scandal: Liability of Depositary banks?” (2009) 6 *Butterworths Journal of International Banking and Financial Law* 338).

that may run in parallel to regulatory provisions, tackling industry demands at the source; namely, at the fund structuring and corporate governance level.

Regulation should offer a demonstrable value in keeping with the costs that are created through its existence.

### INVESTOR PROTECTION THROUGH REGULATION

Recent history demonstrates that regulation alone is slow to produce<sup>1</sup>, cumbersome to live with, expensive<sup>2</sup> and regularly fails<sup>3</sup>. Even now, the next fund/regulatory meltdown is within sight based on the investment from unqualified investors into what would normally be considered ‘qualified investor’ strategies; ‘NEWCITS’ circumvent established law and one can only guess how long it will be before the next media and politically driven uproar occurs following vulnerable investors’ loss of money in investment schemes which they didn’t understand. It would therefore seem that no level of regulation will ever, or should ever, be considered as being ‘fraud proof’.

The remainder of this article will thus consider ways in which better corporate governance and oversight could be achieved within the fund industry’s existing infrastructure, beyond the separate debate centred on increased regulation.

### CONFLICTED DIRECTORS

An area of fund governance often overlooked is the effective control of



the corporate vehicle itself; a straightforward review of the position of the fund's principals and those of the investment manager may be one of the most under-considered and yet important issues for investors. Such a review may be extremely productive as a means of minimising non-market based risk.

It has long been the case for many investment funds that the principals and directors of an investment manager control the board of both the investment manager and the fund itself.

Such structuring creates a significant conflict of interest given that the directors of the investment manager have a fiduciary obligation to act in the interests of the shareholders in the investment management company whereas the directors of the fund have a fiduciary obligation to act in the interests of investors.

Although conflicts of interest are normally disclosed in the fund's offering documents, removal of a conflict is better than disclosure. Removal of conflicts such as drafting of balanced agreements between investors and investment manager or the extent to which a manager can devote time to other projects is key; as soon as subjective factors exist, there is greater pressure on everyone, not only to act in accordance with their fiduciary duties, but also to be seen to have done so. An independent fund enables the manager to focus on what it does best.

Whilst the appointment of independent directors to the board of the fund is undoubtedly part of the solution to this conflict, it is still rare to see a fund board comprised exclusively of independent directors. Moreover, where this does happen, it is normal for such independent directors to be capable of being 'hired and fired' by the same individuals or entities that control the investment management company. It is therefore reasonable to conclude that whilst the use of independent directors is a valuable step it may not present a complete solution.

The ongoing conflict raises two other points:

1. A consideration of the extent to which Director liability can be limited within the law (i.e. how much flexibility a fiduciary might have in a conflicted situation where a duty is owed to different parties with very different interests); and
2. How to create and operate fund structures that grant independent directors greater freedom and demonstrable independence from the investment manager to exercise their authority in favour of investors.

Whilst a detailed consideration of fiduciary liability and the extent to which it can be limited for professional fiduciaries is beyond the scope of this article, readers can gain some insight into this issue with reference to the leading case of *Armitage v Nurse*<sup>4</sup>.

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4. (1997) EWCA Civ 1279. Readers should bear in mind the normal definition of 'Gross Negligence' now requires some form of bad faith which has generally changed since the case was ruled upon.

5. In order to safeguard segregation there are a number of key 'rules' to follow, it is crucial that the holder of voting shares understands these considerations and sticks to them; the authors can be contacted to discuss them.

In summary, so long as a fiduciary acts in good faith they can limit liability very substantially through express words in core documents (and, in some cases, by obtaining evidence of informed consent). Whatever one's views on the 'rights and wrongs' of the extent to which liability can be minimised, it stands to reason that enabling a director's interests to remain as unfettered as possible when acting in the interests of investors is key.

Given the regulatory challenges and conflict of interests, we're left in search of a more pragmatic approach to improving investor protection, namely by structuring investment funds in such a manner to address the conflict of interest without adding to the regulatory burden.

### ONGOING PROGRESS

Although not compulsory in many cases from a regulatory perspective, many investors (particularly institutional) are demanding the appointment of an independent, properly regulated fund administrator (a 'Qualified Administrator').

As a result of having the right systems and the right employees, a Qualified Administrator is often in the best position to provide services that are accurate, independent and conflict free. Inevitably, greater independent oversight increases investor confidence and helps funds to raise money. Independent Directors are also now largely appointed for similar reasons.

It is now time that the industry take the next step towards better corporate governance through the wider use of independently held funds (for the purposes of this article, 'Independent Funds'). In doing so, the conflicted position of the investment manager's principals exerting control over the fund and its service providers is eliminated and the fund operates with a range of service providers with independent systems and focus according to the law, the offering documents and the interests of investors.

A simple way for managers to demonstrate the utmost good faith to their investors is to seek a structure within a well-managed series-entity company where the voting/management shares (i.e. the non-economic shares) are held by a company affiliated to the fund administrator or other party that is independent of the investment manager.

Legislation concerning series entities (identified by a number of different names such as 'Segregated Portfolio Companies', 'Protected Cell Companies', 'Segregated Accounts Companies' or informally as 'umbrella companies') is now well established in most fund jurisdictions. Within such structures, numerous strategies ('portfolios') can exist while each portfolio's assets and liabilities remain entirely segregated; there is no recourse to the assets held by other portfolios under the same umbrella company<sup>5</sup>.

Umbrella companies can offer a cost-effective solution, as well as potentially reducing the compliance burden. While the due diligence procedures for the founding portfolio of a new umbrella company may be as substantial as for a 'standalone' fund, further portfolios of the same umbrella company often have a far smoother account opening process where the same bank/custodian/prime broker etc. are used, even though entirely separate accounts are created.



Similarly, in cases where the ‘independent structure’ is sought, but a series entity is not appropriate or perhaps where substance for the fund in a given jurisdiction is required, there may be potential for a trustee to hold the management shares as an independent fiduciary.

**CONCLUSION**

Whatever one’s view on the efficiency of regulation (existing or planned), a fund supported by as many independent service providers as possible adds substantial safeguards for all parties to it. All other things being

equal, a more independent fund will be less contentious and easier to attract investors to. Moreover, umbrella companies play an increasing role in enabling Independent Funds to be established. Independent Funds are not a change in direction, rather a natural evolution of the efficient and positive progress that the industry continues to make alongside the demands of the prevailing regulatory environments in which we all operate.

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**Investor assurance**

*By Neil Griggs, Partner – Audit and Assurance, Kinetic Partners*

**R**obust internal processes and an effective control framework has always been a vital factor in a successful firm – as a differentiator to raise capital and/or because it reduces operational / business risk. As an industry we’ve recently seen a huge increase in asset allocation from institutions, pension funds and endowments most of whom are expecting more from managers in terms of due diligence and demonstrating sound infrastructure.

This article looks at various options managers could consider in order to deliver on the investor assurance agenda but also balance cost and the value they can derive from the process.

**CONTROLS ASSURANCE REPORTS**

These reports provide users of the reports with an overview of an entity’s control environment and a reporting accountant’s opinion over the design and operating effectiveness of those controls.

The frameworks for controls assurance reports are outlined below:

- AAF 01/06 is the UK framework for controls assurance reports.
- SSAE 16 is the recently issued replacement to SAS 70, the US framework.
- ISAE 3402 is the recently issued international reporting standard. This standard is very closely aligned to the SSAE 16.
- Bespoke controls assurance reporting - for many organisations the established frameworks above are not consistent with the size and nature of the organisation and so tailored external assurance reports can be produced to meet specific needs.

We are often asked which of the above frameworks are the most appropriate and the answer is – it depends. The following factors are the key matters that need to be considered:

- Nature of the your business operations;
- Demands of the investor base;
- Intended distribution of the document; and
- Intention to use the document for broader marketing purposes.

However, the process to achieve a report under any framework is similar and cost differentials are often marginal. It is not uncommon for organisations to utilise the same processes and produce either combined reports covering different frameworks or distinct reports under different frameworks but based on the same underlying processes and testing.

The pros and cons of controls assurance reports are set out in the following table:

Advantages	Disadvantages
Demonstrates an entity’s commitment to maintain an externally verified strong control environment and provides direct comfort to existing and potential investors.	Incurs a significant initial and ongoing annual cost this can be both financial and in terms of deployment of internal resources.

*(Table continues on next page)*



**Would your firm like to write for the AIMA Journal?**

We encourage all our members to write for the AIMA Journal. If you are interested, please contact AIMA Communications Manager Dominic Tonner at [dtonner@aima.org](mailto:dtonner@aima.org).

