

## **THE INSTITUTIONALISATION OF HEDGE FUNDS: THE INVESTOR DUE DILIGENCE BAR RISES EVER HIGHER**

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The institutionalisation of hedge funds has been driven by a number of factors over the past two years. The pain suffered by investors following the collapse of Lehman Brothers (“Lehman”) and Bernard Madoff’s ponzi scheme, preceded a market collapse which decimated many institutions and hedge funds.

Many investors had mistakenly considered themselves insulated from such events by virtue of the active management of their portfolios by hedge fund of funds and subsequently withdrew their capital, causing the fund of funds market to shrink dramatically.

We now see a hedge fund market where manager supply exceeds investor demand and in which investors can afford to be more selective about where they invest. Due to a “flight to size”, all but the largest funds are open to new investment. Now the focus of investors is not simply on performance; security of their assets through operational infrastructure and a robust control environment is also critical, as there is no point in making strong returns if all the assets are then lost due to the collapse of a counterparty or custodian. Following the Lehman and Madoff debacles, investors now better understand the importance of having the correct infrastructure and controls to protect their assets.

There has been a gradual flow of money back into the hedge fund industry, but the main sources of investment capital have changed. Despite the extreme market conditions of past years, hedge funds have outperformed, with less volatility than more traditional investment vehicles. This has not been lost on the institutional investor community which understands the benefits of hedge fund strategies, but which also require a sound infrastructure. Such investors are willing to take risk on the investment strategy but not to run avoidable operational risks. Institutional investors are increasingly investing directly into funds rather than through fund of fund vehicles, and are increasing their allocations to alternative investments. They are establishing significant internal operational due diligence capabilities in order to select only those managers which have an appropriate operational infrastructure and control environment.

The combined effect is that both structurally and operationally, the industry has had to mature to try to meet investors’ growing expectations. In a competitive market for new capital, investors now require both a strong alpha proposition and an appropriate infrastructure to protect their investments.

Hedge fund managers have therefore been forced to re-evaluate their infrastructure, the following have been areas of particular focus for potential investors:

- re-hypothecation of assets by prime brokers,
- scrutiny of administrators (commonly known as “check the checker”),
- structure of investment management companies and
- qualifications /calibre of fund directors.

## RE-HYPOTHECATION

Re-hypothecation has become a focus of the due diligence process largely due to its devastating effect on some of the funds which used Lehman as a prime broker (“PB”). Before Lehman failed, little or no interest was shown by investors in the re-hypothecation process operated by PBs. The name recognition of the PB was usually the only factor considered.

Re-hypothecation is a mechanism whereby a PB will take ownership of, then lend out, the stock of a fund through its stock loan desk to earn extra revenue. It has always been argued that this was required to subsidise the other services provided by prime brokers, such as consultancy and capital introduction, as well as enabling the PB to keep its financing rates low for funds which required leverage.

The disadvantage to the funds of this mechanism was that a re-hypothecated asset no longer legally belonged to the fund. The funds simply had a contractual obligation from the PB to replace the stock at a later point. Previously there was no real focus on the implications of a PB failing. As investors now understand, there is a large difference between assets in their account and an obligation from a PB for those same assets. In the former the fund legally owns the assets and can therefore eventually remove those assets if the PB fails. In the latter the fund is left with a claim on a bankrupt entity and may well be treated as a general creditor.

Negotiation around re-hypothecation in PB agreements was historically based on a multiple of the level of “exposure” that the PB had to the fund. Exposure was defined differently depending on the PB but in most cases was drafted to cover any short positions or financing. The multiple typically ranged from 140% of “exposure” up to unlimited re-hypothecation. In the US re-hypothecation of collateral was limited to 140% of “exposure” by regulation (Federal Reserve Board Regulation T, commonly known as “Reg T”).

One major difference in Lehman’s original base model for prime brokerage from that of other prime brokerage models of the time, was that Lehman took legal title of all fund assets rather than holding them in the fund name (the standard prime brokerage model of the time was to hold the assets in the fund name then remove the assets required for re-hypothecation into a separate account in the PB’s name). This was to enable the circumvention of “Reg T” and to allow re-hypothecation of all assets held, maximising revenue for the PB and therefore allowing them to be more competitive with financing. In Lehman’s latter years there

were moves away from this model towards a more standard “limited” model but still some clients/funds continued to use the original model.

Lehman’s model was the worst kind to have in the event of a PB failure. In effect all assets in this model were simply obligations on the PB rather than fund assets held by the PB and therefore further down the chain of creditors when recovering monies in the bankruptcy process.

Another discovery made as a result of the Lehman failure was that even where re-hypothecation rights were limited by the PB agreement, systems and controls were not always in place to ensure the limits were observed. In this scenario, a fund had a case for breach of contract but this was of no real comfort against a bankrupt entity.

Once investors began to understand the effects of the above they quickly realised the importance of re-hypothecation, the limitation language and the systems and controls in place at the PBs. There was a flurry of activity to determine their exposure to each of the PBs and to push the investment managers to protect the funds’ assets. The focus on PB exposure strengthened in line with the fear of other institutions failing and was further intensified by the experiences some managers had when trying to remove their assets from certain PBs.

In the aftermath of the failure of Lehman, due to investors’ demands, the PBs had to re-evaluate their models and change their offerings to satisfy concerns of a Lehman scenario recurring. The PB landscape changed rapidly as investors drove managers to evaluate and manage their fund’s exposure to PBs.

There are now a variety of products and models available, provided by the PBs to satisfy investors’ demands. There are also some new participants offering “Prime Custody” to meet the demand for models which focus on the requirement for the security of assets. As a direct result of the need to diversify exposure it is now extremely rare to see a fund with only one PB.

Re-hypothecation is still an important element of the PB landscape. It is an important revenue stream for PBs, especially with low levels of leverage, restrictions on short-selling and trading volumes down in many strategies; all key drivers of PB revenue. Without re-hypothecation many PB models would not be viable and the financing rates attainable without the subsidy of re-hypothecation would not be attractive to managers.

Investors now also look through the PB model to the quality of the custody services provided and the liability of the sub-custodians. There is focus on where the assets are held, in whose name and where the liability sits for the safe-keeping of these assets.

The combination of PBs and models used is in part driven by the strategy of the manager and in part by the risk appetite of the investor base. The more institutional the investor base, the less tolerant of unnecessary exposure to PBs and the greater the security of assets required.

**The majority of current PB models fall into one of the categories below:**

**1. Prime Custody**

This is arguably the safest available model and is an extension of the global custody product used by institutions to safe-keep assets. In global custody re-hypothecation is not usually used, though some clients may opt to engage in a securities lending programme. Fees are paid for custody services, unlike in the standard PB model where custody is subsidised. Custody is sold on the reach, quality and security of the custody network, whereas in the historical PB model, custody was often of variable quality and in many cases outsourced to a separate global custodian. The traditional PB model placed little focus on where the actual assets were held and in whose name. Custodians typically limit liability where the assets are held by a non-group sub-custodian. Therefore custody networks utilising group entities to provide sub-custody are generally viewed as offering greater security of assets.

Under the prime custody model, a core custody product is supplemented by standard PB services such as stock borrowing, FX hedging and financing. When the custody model is used as a starting point, assets are held in the name of the fund at the custodian as a default, with no re-hypothecation.

Financing can be arranged either by way of a charge on the fund's assets or by using a combination of charge and re-hypothecation. The main difference in the use of re-hypothecation here is that positions have to be actively opted into re-hypothecation and often need to be physically moved to a different account to be re-hypothecated, thus allowing for greater control and transparency.

This infrastructure tends to be available only for larger funds. It has been claimed that it is not appropriate for funds requiring large amounts of leverage due to the increased financing costs involved where there is no re-hypothecation subsidy. The providers will argue that this should not be the case as re-hypothecation is in fact available, it is simply not the default position. In addition the main providers of these services are custodian banks with internal cash funding and should therefore be competitive on financing. Such providers do tend to be more risk averse, so not all funds will satisfy the terms of their credit teams for approval as a new client.

**2. Prime with fully outsourced custody**

A model some larger PBs have adopted is to sweep unencumbered assets out of the PB account into a custody account in the fund name at an independent custodian. A re-hypothecation limit is agreed upon with the client and a charge is put in place over the fund's assets to cover any financing. Assets outside of the re-hypothecation amount are then swept to a third party custodian account to be held in the fund's name. In some cases a "charge account" is held separately to the unencumbered account at the custodian to keep the assets legally in the fund name and outside of the PB account.

### **3. Prime with legally “outsourced” custody**

Once again, this is a model utilised by a number of PBs which have created a “bankruptcy remote” new entity to custody assets. This is not a fully outsourced custody solution as the custody entity has been created solely for bankruptcy remote purposes rather than to provide a full custody service. The upside of such a solution is that it is usually cheaper as there is no third party to pay for a custody solution. The downside is that the solution may not offer the same quality of custody network as may be provided by a major global custodian. As with the previous model, a re-hypothecation level is agreed and a charge created for financing. Some models have an automatic sweep for the remainder of positions plus the ability to negotiate which positions, within reason, are left for re-hypothecation. Other models rely on the manager to instruct positions to be moved to the custody account, which can be more operationally challenging.

### **4. Traditional Prime Brokerage model**

Some PBs have stuck to their original model, or run the original model in tandem with one of the above models. This entails an agreed re-hypothecation limit ranging from 140% of exposure up to an unlimited level. All assets are held at the PB in its custody network on an omnibus basis (as a default) with the potential to be held in the fund’s name in some scenarios.

The benefit to the traditional model is that it is the most cost efficient and easiest to manage operationally, both for the PB and for the fund/manager, although it can be argued that many PBs using the above three models have reduced much of the operational “sting” for their clients of moving and tracking the assets. Some say that for funds with higher trading volumes and higher levels of leverage, the traditional PB model is the easiest and most economical model to use. This is also the hardest model to justify to institutional investors as it can be difficult to prove to their satisfaction that re-hypothecation has been restricted only to the limits agreed at any given point in time. Even if a PB produces a detailed report of what is being re-hypothecated, the liability on the accuracy of the report will be limited and recourse could be limited to suing a potentially bankrupt entity. Some PBs have taken additional insurance coverage to protect such assets and to provide more comfort to investors.

Determination of the optimal model involves a balance of price versus both current and potential investor comfort. The most suitable model will depend on various factors including the strategy and size of the fund and the liquidity of the assets, credit rating and market reputation of the PB, financing requirements of the fund plus the future capital raising plans of the fund.

The PB market has moved a long way from the generic models available prior to the Lehman implosion. No two options appear quite the same. The need to have at least two PB relationships for diversification of risk means that selecting the right combination of services to efficiently run the business, and satisfying current and future investors’ requirements for security of assets has become a major challenge.

## SCRUTINY OF ADMINISTRATORS (“CHECK THE CHECKER”)

One of the current focus areas of the due diligence process is on the quality and oversight by the manager of service providers. There is no longer an automatic presumption that service providers are fit for purpose. The fact that a provider is paid to perform a process does not necessarily mean a manager can always rely on it to perform that process without oversight.

Investors want to see evidence of an organised and documented process to both select service providers and to monitor and review providers. Investors want to understand why each provider was selected. In addition, Service Level Agreements (“SLAs”) are now required for all major relationships.

The latest providers to face increased scrutiny are the fund administrators. The historical model, common in the United States, of managers performing administration internally is now unacceptable to institutional investors. The administrator must be independent and appropriately sized for the fund. If the administrator is too small then it may be perceived that the manager has power over the administrator. If, on the other hand, the administrator is too large, then it may be perceived that the fund will not be a priority for the administrator. It has to be remembered that the administrator is engaged by, and paid for by the fund and should therefore prioritise the interests of the fund investors. In reality the managers’ input in the choice of administrator, and working relationship with them on a day to day basis, can result in the lines becoming blurred. The outsourcing services provided by some administrators to managers for middle office solutions can also create issues regarding the identity of the real beneficiary of those services.

In recent times, due to a number of hedge fund failures, there have been a series of accusations and legal claims against administrators, alleging that they have not discharged their duties to the investors of the fund and that the appropriate checks and balances were not in place.

The downstream effect of this is an increased focus on the choice of administrator, scrutiny of any SLAs agreed with the administrator, focus on the quality and longevity of individuals servicing the fund, and a flurry of questionnaires and meeting requests from investors directly to the administrators.

The latest development in this increased scrutiny involves investors pushing for validation and oversight of the prices and data provided by the administrator. This is known in the industry as “check the checker”. No part of the processes within the fund should be without review and oversight. Many managers would argue that the administrators are paid to provide oversight of the fund for the investors but the question now is: who provides oversight of the administrators?

**There are three main solutions available to evidence the required oversight:**

**1. Documented scrutiny of administrator's reports by the manager**

This is the most commonly used solution where the manager will have a documented process to review and sign off all reports and data provided by the administrator. The main issue some investors have with this solution is that managers experience a conflict of interest, as they are rewarded on the basis of the administrators' NAV and performance calculation. The reaction of investors to this depends on the size of the manager, the size of the manager's operations and the details of the process employed. While acknowledging the conflict, managers certainly have the expertise and motivation to undertake this role. Portfolio managers should be signing off on the P&L figures and all accruals should be checked and signed off by the CFO. All reconciliations should be checked and prices should be validated.

**2. Use of shadow accounts at the manager**

This solution is really an extension of solution 1 above and involves the use of a recognised accounting system by the manager to validate the accounts provided by the administrator. If operated properly, this will provide a systematic check of the administrator's results. There can still be investor concerns based around the potential conflicts of interest at the manager and investors may want to see proof of the controls built around the system.

**3. Independent verification of the administrator's work**

This involves a third party provider running shadow accounts to validate the administrator's results. To make this an economic solution, providers usually suggest reducing the frequency of the NAV calculation by the administrator if possible (hence reducing the administration cost for the fund) and then using the new provider to provide oversight by performing their own daily process (and in some cases undertaking middle office functions from the manager). In this scenario, the cost to the fund does not increase a great deal but the fund has two providers providing accounting services. The appeal of this varies amongst investors with some seeing this as a way of having a true oversight over the administrator, but others find the reduction in calculation frequency by the administrator a concern. As with all these alternatives, choosing the optimal solution becomes a question of creating comfort with the oversight process for the fund's current and future investor base.

We will continue to see movement in this area as investors push managers to demonstrate the controls and processes which provide effective oversight of their funds' administrators.

## FOCUS ON THE MANAGEMENT COMPANY

Another area of increased due diligence focus is on the management/investment management companies and their infrastructure. Previously it was often sufficient to prove that an investment manager was registered with an appropriate regulator and that appropriate compliance oversight was in place.

Increasingly, investors review the financial statements of management companies to gain an understanding of how the management company is being run, looking for insights on compensation, borrowings, cost of infrastructure and the revenue streams of the company. They will try and estimate a “break even” amount of AUM for the company to run.

Investors now wish to understand how all key staff at the manager are incentivised and retained. They request to see growth plans to ensure that these plans are viable in order to try and gauge the long term viability of the company. The structure of a company provides an insight into the quality of the management skills behind the manager. It is no longer a presumption that good alpha generation skills are enough to set up and efficiently run a management/investment management company.

In terms of regulatory compliance, investors now demand access to compliance oversight reviews and access to the compliance oversight practitioners to ensure that the investment manager’s regulatory obligations have been met.

## FUND DIRECTORS

Fund Directors have become another focus of due diligence given their fiduciary responsibilities to investors. Historically, many boards had a combination of members of the investment management company, friends of the investment manager, and perhaps a “paper” director or two.

After a variety of restructures and blow-ups from the end of 2008 onwards, investors now recognise the importance of an independent board of directors which understands its responsibilities and has demonstrable experience that enables it to discharge its responsibilities in difficult circumstances. A mix of professional expertise is desirable amongst a fully independent board. Increasingly directors need to be able to assure investors as to their abilities to provide the appropriate required oversight and their understanding of the fund’s activities.

It is important to ensure a mix of applicable disciplines so the individuals can offer real oversight for the fund. Examples can be lawyers, ex-administrators, accountants, ex portfolio managers, ex custodians or those with many years’ experience as a corporate director. We have also seen a movement towards having Irish resident

directors for those offshore funds with a Dublin based administrator. This is partly to have demonstrable experience of the market in which their administrator is based (which ties in with the previously mentioned “check the checker” requirements).

As part of the increased due-diligence on fund directors, investors will actively run checks on the backgrounds of directors to confirm the existence of professional qualifications, look for character references and ask for examples of them acting for other similar funds.

Increasingly, investors ask for board minutes to check that board meetings are held and properly structured, and that all required matters are addressed regularly. Many see this as an intrusion into the confidentiality of the board and may therefore provide a schedule of items covered rather than full board minutes. Evidence that the directors have actively contributed is also sought and that any required outside parties have also participated when required, such as auditors, administrators or valuation providers.

It is also now expected to have an active valuation committee, again with proven experience, to report to the board of directors. This should not only be for problem valuations; there should be a periodic review of the valuation policy to ensure the administrator is in compliance. Such meetings should be documented with minutes provided to the board of directors.

Many Offering Memorandums/Private Placement Memorandums provide significant power to the directors to determine when it is in the best interests of the fund to enforce gating provisions or suspensions, as well as discretion on valuation issues. Investors now understand the significant implications if these powers are not discharged properly so we expect to see even more scrutiny of board compositions and individual directors.

## **SUMMARY**

The above areas of focus are in no way a complete list of investor due diligence concerns, but are indicative of how investors have pushed hedge funds to develop and become ever more institutional. Investors do not wish for hedge funds to lose their entrepreneurial spirit, but do want their risk to be purely related to the investment strategy of the fund.

A challenge for many fund managers is keeping up with the current trends and areas of investor focus. Investors do not usually share with managers the reasons for not investing in their funds, as they consider their investment process to be proprietary. Given the current choice of funds available, investors can afford to look elsewhere if they find an area of concern or “red flag” in their due-diligence process.

Investor due diligence is a fast developing area which has seen a substantial amount of change in a relatively short period of time. There are no signs of the development slowing down, so managers require mechanisms to keep up-to-date and ensure that they do not get left behind.

These developments make it even harder for start-up managers to meet investor requirements. Trying to make sure all the potential investor requirements are met is becoming a mammoth task for an established fund, so a new manager with limited resources has a hard task ahead. The fear is that as the bar rises, it could leave behind many high quality managers and squeeze some of the entrepreneurial spirit out of the hedge fund space. The hope is that managers and investors can work together to find the right balance.

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