

Peeking through the hedges

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By Jacob Geiger

Though legislation aimed at ramping up regulation and registration of hedge funds remains stalled in Congress, many funds are increasing transparency, formalizing compliance procedures and hiring third-party administrators, industry experts told SNL.

The changes are being driven by nervous investors, especially on the institutional front, who want assurance that their investments will not be caught up in the next trading scandal.

"Many alternative firms that were self-administered are either moving to full third-party administration, or they're doing something to bolster their position in the meantime, and they are talking about full outsourcing to a third-party administrator," Brian Ruane, the recently appointed CEO of Bank of New York Mellon Corp.'s alternative investment services unit, told SNL. "But there are very few of the larger third-party asset managers that aren't doing one of those two things. That probably is both an outgrowth of the credit crisis and an outgrowth of some of the issues that emerged post-Madoff."

Ruane noted that Bernard Madoff did not operate a hedge fund, but he said clients across the alternative investment universe are demanding more information. In light of this trend, Ruane said his division, which serves as the administrator of funds with more than \$200 billion under management, has seen very strong demand in the past year.

"Demand in the U.S. is very strong as companies migrate to the third-party administration model," he told SNL. "Brazil is becoming a stronger market, and we're getting significant growth in Asia."

Most U.S. funds, Ruane said, started off with in-house administration, with companies like BNY Mellon typically brought in as the funds become bigger. Asian and European funds, in contrast, have shown a desire to have outside administrators from inception, meaning much of the growth in those regions is driven by rising AUM.

"Asia is taking the third-party model early," he told SNL.

Questions of transparency have been more difficult to resolve, as some funds have fought ferociously to protect their investment formulas from the eyes of investors, according to Chip Arvantides, executive vice president at FrontLine Compliance.

"Hedge funds are very protective of their strategies and investments, and disclosure worries some," he told SNL. "But others say [disclosure] is necessary to determine the risk component for investors."

Another element of this new business formula is stronger compliance procedures. Arvantides said hedge funds have started to prepare for possible regulation or registration rules by instituting their own compliance systems before they are mandated by the government. He, like Ruane, said institutional investors are driving the changes.

"I think the institutional investor is taking a firmer stance with hedge funds to determine that their house is in order," Arvantides told SNL.

Many FrontLine clients, he noted, have set up compliance procedures that would be required before a fund registered with the SEC, even though they have no immediate plans to go through with the registration. In some ways, he added, the slow pace of reform efforts in the House Financial Services Committee has allowed funds to start meeting proposed requirements before they become law.

"People thought things would happen sooner, but the positive is that it gave firms a chance to understand what they need to do," Arvantides told SNL. "For a new firm or one without formal compliance, there is a learning curve."

Formal compliance and conflict-of-interest rules at hedge funds are often distrusted by fund advisers because they see it as a curtailment of their independence and power, according to Arvantides, who said the biggest challenge is establishing a system that does not compromise the "hedge funds' free-wheeling spirit."

But at the same time, FrontLine is seeing increased awareness of administrative and compliance issues, he told SNL. Even firms that are delivering strong results and have not faced substantial investor pressure are eager to show investors that relationships between funds and administrators are vetted and formalized. He said more and more fund managers are approaching the company for details, anxious to prepare for possible regulatory changes.

"The trend is to get a basic program in place to show investors your house is in order," said Arvantides. "People want to get the process started before new rules kick in." *i*