

Offshore Services - Cayman Islands

Investors urge hedge funds to shape up

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Background

Since early 2008 a significant discourse has emerged in response to the economic crisis on the need for increased governmental regulation in the hedge funds industry. Numerous investor rights groups, governmental, non-governmental and supranational organisations have called for an increase in the regulation of hedge funds. Much of this discussion has centred around how hedge funds should be better governed, monitored and held accountable to their investors. However, none of this discourse has taken into account the impact that investors, especially institutional investors, have had in making hedge funds shape up.

In the current post-crisis economic climate, investors are becoming increasingly demanding of hedge fund managers and administrators. Lessons have been learnt from the recent collapse, which has led investors to pay more attention to the operational aspects of their investments. Two specific ways in which this new investor awareness has impacted upon investment funds include the requirements that investors now have for increased transparency and independent valuations.

It is more likely that changes made to the way that investment managers and administrators operate hedge funds will be driven primarily by the demands of institutional investors rather than the pontification of policy makers, ministers or regulatory bodies.

Increased transparency

Although return rates will always be an important factor in comparing investment opportunities, hedge fund managers are increasingly also seeing investors consider transparency as a comparative measure. Investors want greater information on the business dealings, arrangements and agreements between the investment fund and its service providers. There is a growing demand for more transparency on fees, especially those fees linked to performance, and to the payment of any 'soft dollar' items.

An important agenda item for investors in considering investment opportunities is whether there are any 'soft dollar' items included in the fees paid to custodians or prime brokers. Despite usually being glossed over in the relevant offering document, soft dollar items can range from computer software to office facilities and are often not capped. The availability of soft dollars allows administrators and investment managers to charge what would otherwise be standard operating costs to their business to the relevant custodian or prime broker providing the soft dollar items. The lack of transparency on the type of soft dollar items cover and the frequency and their availability represent a serious concern for investors, causing many to require that that no provision for soft dollar items be included in hedge fund documentation.

The concept of transparency also applies to the extent of communications between investment managers and investors. The type, method and frequency of communications play a central role in alleviating investor concerns. Most importantly, investors want clear and regular communication on any changes in the methods and processes used for the valuation of investments, especially illiquid investments. There is also an increasing requirement for third-party confirmations of financial positioning and regular updates on basic financial information such as net asset value, leverage

and long-short risk.

Improved communication to investors on fund performance and financial information and a greater understanding of the relationship that hedge funds have with their service providers such as custodians and prime brokers are becoming standard demands of astute investors.

Independent valuations

Historically, valuations of investments that could not be easily ascertained from a third-party source such as a stock exchange were delegated to investment managers. Valuations of investments such as over-the-counter, hard to value or illiquid investments were often made by the administrator based on information provided by the hedge fund's investment manager. Who better, it was thought, to ascertain the value of investments which had no public trade value?

However, these days investors are cautious of the relationship between the valuation of investments and the payment of performance fees and seek a more independent source of valuation. Many industry bodies have responded by publishing best practice guidelines on valuation practices which call for greater transparency, disclosure and the elimination of conflicts of interest in the valuation process by way of utilising multiple valuation sources.

This new investor requirement for independent valuations backed by industry bodies has given rise to a sub-industry within the investment sector of third-party independent valuers. These independent valuation agents provide an avenue for investment managers to reassure investors and the general community of the integrity of their investment managers and their pricing and valuation mechanisms.

Additional measures being required by investors include the provision of well-documented and understandable valuation and pricing policies. In some instances investors require copies of, or input into, these pricing policies prior to considering investment into the fund.

Comment

The increasing demand by investors for improved operational standards, higher levels of communication, greater transparency and more appropriate and independent valuation methods will lead hedge funds out of the current crisis and into a more stable and sustainable investment era. This demand, more than any proposed government regulation, will be the driving force behind improvements in the hedge funds industry.

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