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OUTLOOK FOR HEDGE FUNDS

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R O U N D T A B L E

OUTLOOK FOR HEDGE FUNDS

Although the first half of 2011 proved promising for the hedge fund industry, the second was one of extreme difficulty, due largely to the sovereign debt crisis in the US and Europe. Continuing concerns about the economic outlook led many to predict stagnation or low growth for 2012. Yet some see an opportunity for hedge funds to take advantage of the widespread uncertainty. Meanwhile, regulation continues to tighten. Fund managers need to meet sweeping reforms head-on, devoting more and more resources to regulatory and compliance matters.

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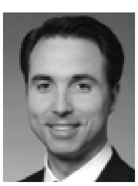

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FW: Against the backdrop of today's economic trends, how would you describe confidence within the hedge funds industry? Are performance levels and returns meeting the expectations of investors?

Memminger: Certainly there is a growing concern as to the economic outlook in comparison to what the situation had been six months ago. Interestingly, however, things have improved slightly in the last four weeks with the confidence that, while we may see a negative impact in 2012 and 2013, the economic outlook will not be as bad and uncertain as it had been in 2007.

Mungovan: Given the size of the hedge fund industry and the wide array of strategies, it is difficult to provide a single, summary characterisation of the industry. From an investment performance perspective, it has been a challenging year for many funds, particularly long-short equity and global macro. The first and second quarters were challenging primarily as a result of the earthquake in Japan and the effects of the tsunami. After that, the third quarter of 2011 was especially difficult for many funds, as the industry as a whole posted one of the worst quarters on record. While some funds and strategies recovered in October, the market remained highly volatile, primarily due to the European sovereign debt crisis. Despite these performance challenges, hedge funds as a group have experienced strong inflows of capital. The most common explanation for the inflows seems to be that institutional investors are reaching for yield in a low rate, tepid growth environment.

Cripps: The economic outlook in Europe and the US is at best uncertain, with many seeing little but stagnation or low growth for a potentially protracted period. The critical issue is a lack of confidence, with fears that the ongoing contraction in the availability of credit will continue or even worsen. As a result, many large corporates are holding significant cash with no appetite for capital expenditure, let alone transactions. This has inevitably fed into the asset management sector, whether traditional or alternative, with the latter affected by a general reduction in credit lines, investor redemptions, and a seemingly never-ending array of regulation and, in the UK, high levels of complicated personal taxation. The performance returns are variable, indeed as variable as the markets are volatile, with one consequence that cautious investors appear almost as concerned that a successful manager's 'run' will end as disappointed if their manager has, for whatever reason, found himself at the wrong end of market volatility.

Harris: These are unprecedented economic times and investors are faced with clearly turbulent market conditions, particularly in Europe and the US. The yield on 10 year US treasury notes sank to below 2 percent and Standard and Poor's announced in December that it will put 15 Eurozone nations on review for a possible downgrading, including six A3 countries. Other economies, however, have fared much better, such as the BRICs, but they too have their own challenges. Investors, however, seem to have preferred to continue investing through alternative investment funds but the reports indicate that 'go anywhere', 'global allocation' funds have increased in popularity allowing investors to move through asset classes as the management team sees fit. Cayman continues to dominate the hedge fund market and its market share has essentially stayed the same.

Devaney: Although the performance in 2011 is hardly producing a rush into the hedge fund sector, both small and institutional investors appear to recognise that, on average, hedge funds demonstrated the ability to manage risk under extraordinarily challenging conditions. This understanding has kept many investors from bolting for the exits. So, although the industry is looking to get out of a rut, it does not appear that there has been a loss of confidence in the ranks of either managers or investors. Despite some notably successful hedge fund managers, 2011 was a year for most of the hedge fund industry to forget. Performance across most strategies was down, significantly, with global macro and quantative driven funds providing the rare beams of sunlight. Despite the sea of red, we are not hearing that investors are unhappy.

> **Many funds have expressed extreme frustration with the markets over the last six months. They believe that the markets are beyond irrational; they are inexplicable.**
>
> TIMOTHY W. MUNGOVAN

FW: From your perspective, how have hedge funds reacted to the sovereign debt crisis gripping certain Western countries? What opportunities and threats does this uncertainty create?

Mungovan: In general, hedge funds are well-positioned to take advantage of market dislocations. That said, many funds have expressed extreme frustration with the markets over the last six months. They believe that the markets are beyond irrational; they are inexplicable. This frustration with making sense of the market is reminiscent of 2008, on the way down, and 1999, on the way up. The current market makes it difficult to produce positive returns with strategies that have 'worked' in more stable or typical market environments, and it is difficult to predict when the markets will return to 'normal'. Specifically regarding the European sovereign debt crisis, it certainly presents investment opportunities, but they are not for the faint-hearted. The clearest example of the embedded 'threat' in these opportunities is the collapse of MF Global, due to a bet on European sovereign debt using substantial leverage.

Cripps: There has been a steady trickle of inquiries as to the form a sovereign debt default might take and the legal consequences, both in terms of the impact on existing contracts denominated in euro and sovereign and private debt in affected currencies. These have increased in recent weeks into something of a stream, and now include major corporates planning for possible contingencies. However, we have seen little direct activity from the hedge fund sector at the legal level outside certain CDS interpretational and governing law issues. The situation as to threats and opportunities is very uncertain as so much depends on where and how a debt or membership change occurs, or whether France and Germany can instil enough confidence for the current system to survive, notwithstanding the seemingly inevitable storms.

Harris: Amid the economic crises is an increased push to introduce regulation in Europe which seems more geared toward pushing revenue onshore for taxation purposes than ensuring proper regulation of the industry. Ironically, those within the industry have warned that such measures will only serve to hurt investors by driving up costs and limiting business opportunities onshore, especially for US investors. KPMG recently reported that there will be an increase in 'co-domiciliation' – clone or feeder funds onshore together with the offshore funds – in response to the Alternative Investment Fund Managers Directive. The statistics to date support this. The feedback that we hear from investment managers that feel forced to relocate onshore is that the quality of infrastructure declines in comparison to the Cayman Islands and the cost goes up.

Memminger: Actually this is the perfect environment for hedge funds and other opportunistic investors to take advantage of the widespread uncertainty, and in some part even hysteric reaction, to even minor new developments in the debt crisis. General investor confidence is low, which means that prices to acquire assets have already started to drop again. From that perspective the current turmoil actually offers many opportunities for opportunistic investors, which hardly existed at the end of 2010 and beginning 2011. Whether these advantages are in fact 'advantages' will however only be seen in two to three years from now, and hence this is also the biggest threat: that the debt crisis will continue much longer and with a much higher impact than the general market currently expects.

FW: What investment strategies are proving popular among hedge funds in the current market? Have you seen fund managers utilising particular financing and leverage techniques to take advantage of conditions?

Cripps: We have little direct knowledge of the strategies being deployed as these rarely lead directly to legal questions beyond the ever growing regulatory restraints and notifications. The general lack of availability of bank lending has seen prime brokers remain the main source of leverage, but there is a general feeling, if only based on anecdotal evidence and discussion, that leverage is less available as the brokers increase costs and reduce risks. However the overwhelming message seems to be of increased market volatility combined with low turnover, with very low levels of borrowing and leverage as part of a steady decline that has persisted since the summer.

In 2011, global macro appears to have been the best positioned strategy, but even within that class of funds performance appeared to hinge on well timed decisions.

THOMAS M. DEVANEY

Devaney: In 2011, global macro appears to have been the best positioned strategy, but even within that class of funds performance appeared to hinge on well timed decisions. European and emerging market economic shifts, and currency adjustments appear to have presented lucrative trades, despite the general uncertainty. Funds focused on credit trading seem to continue to enjoy better fundamentals and investors continue to be strongly attracted to this strategy.

Harris: We have not seen fund managers utilising any particular financing or leverage techniques to take advantage of recent market conditions. Cayman funds are generally set up with a lot of operational flexibility built in and perhaps that is proving a useful tool for managers in the current market conditions. Fund managers appear to be utilising the same financing and leverage techniques they have always done. However, as credit is harder to obtain at the moment, from a practical perspective, some managers may be more limited in the amount of financing and leverage that they have been able to deploy.

Memminger: The techniques I have seen are pretty straightforward – be it debt to equity swaps, as in the case of Pfleiderer, or acquiring debt significantly below par with a later repayment than above the entry price. They are basically the usual techniques for these circumstances.

Mungovan: Leverage – or more specifically the lack of it – and maximum liquidity are among the most popular 'strategies' that I have seen over the last couple of years. Many hedge funds were hurt in 2008 by excessive leverage, which hindered their ability to meet redemption requests. In response, several clients are now offering separate accounts that use no leverage and provide daily liquidity. While these products have proved popular with investors, their staying power is in question because they can constrain alpha.

FW: What advice would you give to fund managers on selecting the right location to establish a hedge fund? To what extent have offshore locations come under pressure from foreign regulators in recent years?

Devaney: Nothing occurred in 2011 that changed the fundamental, standing advice on selecting the location in which to establish. For US based managers looking to set up an offshore vehicle, Cayman and BVI continue to be the most popular fund destinations. Europeans have new considerations to bear in mind, but the options within the EU have not changed in a meaningful way – Luxembourg, Ireland and The Netherlands. Although politicians, and to a lesser extent regulators, have been making unsettling statements about the offshore fund-friendly jurisdictions for a number of years, nothing concrete has materialised in the US. The impact of the new EU alternative investment fund manager directives, although not immediate, provides the clearest instance of a shift in jurisdiction selection for managers with a presence in the EU. In the US, the FATCA (Foreign Account Tax Compliance Act), although not targeted at tax havens, will have an affect on how on-US vehicles operate, in terms of back office burden.

Memminger: In day-to-day interaction with the management team of the potential target the hedge fund wants to invest in, but also in terms of general market recognition, having at least the general partner, or its advisory entity, being incorporated and regulated under the supervision and laws of the authorities of the countries of the EU or the US is certainly a big plus. But of course, that goes along with a rising level of reporting and disclosure obligations, and scrutiny by applicable authorities.

Mungovan: Fund managers have to consider carefully whether to establish funds in traditional offshore locations such as Cayman or BVI. Several large institutional investor clients have indicated that they have reservations about making new investments in an offshore – Cayman/BVI – fund. These reservations are driven by a perception among many institutional investors that these jurisdictions are 'unfriendly' to investors. This perception seems warranted based on the liquidation of Madoff-feeder funds and subsequent litigation.

Harris: Whilst I might be naturally biased towards the Cayman Islands, it is not without merit. Cayman has been a predominant leader in the industry, aided by proportionate regulation since the mid-1980s. The Cayman Islands continue to host the majority of the world's investment funds due in no small part to its renowned infrastructure of top accounting and top law firms located in the jurisdiction. The Financial Stability Board, a supranational body composed of the OECD and other organisations, has made a finding that Cayman has a sufficiently strong regulatory and supervisory standard with cooperation and information exchange, and cleared Cayman of the long standing myth of being a tax haven. Moody's reviewed the Cayman Islands and maintained its A3 rating, whilst Standard and Poor's looked to downgrade 15 European countries.

Cripps: If a hedge fund manager has established relationships with providers based in a jurisdiction, then this is not the time to change, although the ever-growing regulatory burden means that this is an area which must be kept under review, in particular given the changes being introduced in the US and Europe over the next 18 months or so. If a manager is looking to establish a new business, my advice would be to be very sure of the seed capital before proceeding in what is an increasingly hostile market to new entrants.

FW: Reflecting on the last 12-18 months, have you seen an emphasis placed on any particular fund types and structures?

Harris: Using Segregated Portfolio Companies (SPCs) to set up umbrella funds with sub-funds with varying strategies is gaining in popularity. The cost savings of using an SPC versus setting up focused standalone funds for each investment strategy could be the driver. We are also seeing an uptick in interest in administered principal office funds which allow managers to set minimum initial subscriptions lower than US$100,000 in funds. On types of funds, our Cayman office is involved in setting up a number of FX funds at the moment, whilst in Zurich we have been seeing increased requests to set up commodities funds – gold, for example – and emerging market funds. Generally, the use of derivative instruments and techniques such as short selling and arbitrage remain popular.

Mungovan: The Achilles heel of most hedge funds has been the inability to hold permanent or semi-permanent capital. As we saw during the financial crisis, redemption gates and side pockets are not a substitute for longer-dated capital commitments from investors. The single biggest change that we have seen since the financial crisis relates to redemption liquidity. Most investors are looking for substantially greater liquidity than historical norms of 30, 45 and 60 day redemption rights. Because daily liquidity requires that funds focus on highly liquid investments, it narrows the set of prospective investments and can constrain positive returns. Funds and managers that have created structures to provide same-day liquidity have attracted substantial capital. At the other end of the spectrum, funds have been pushing for longer-dated capital in exchange for reduced fees.

If a manager is looking to establish a new business, my advice would be to be very sure of the seed capital before proceeding in what is an increasingly hostile market to new entrants.

JAMES CRIPPS

Devaney: We have seen continuing interest in business development companies, and renewed interest in CLOs and funds that invest in CLOs.

Cripps: We have seen little appetite for new structures at the fund level, where the traditional limited partnership and open-ended vehicle remain predominant, combined with intermediate special purpose vehicles between the fund and underlying portfolio designed to minimise tax leakage, with some complex acquisition vehicles for acquisitions in new target areas for investment. Jurisdictions used for traditional cross-border routes have seen some new business, using Mauritius to access Africa for example, while other jurisdictions have been keen to promote themselves as still, or newly, open for business.

FW: Where does the balance of power currently lie between fund managers and investors? What key issues arise when negotiating fund terms, management fees, and so on?

Cripps: In an environment where new investors are a very rare commodity and the fight is increasingly to retain existing investors and their levels of commitment, the balance of power is undoubtedly with the investor rather than the manager. However, there has been less of a shift in terms in favour of investors than might have been expected, perhaps reflecting that many investors are seeking much higher levels of portfolio transparency and more regular reporting and updating, so that this, when combined with the increasing administrative and regulatory burden, means the slight fee reductions reflect a more severe reduction in manager profitability. So far the talk of periodic fees not themselves generating profit does not seem to have affected existing businesses, although there is some indication that this is a feature in funding negotiations between putative start-ups and seed investors.

Harris: I think the balance of power currently lies with the investors, especially those who are sitting on large pools of cash or liquid assets. Such investors are in a position to request, and in many cases obtain, discounted fees and structures designed to ▸▸

enhance their objectives. The amount of the proposed investment, the minimum duration of the investment, agreement on the level of fees and rebates, liquidity terms are potentially negotiable, and in some cases, large investors have sought to dictate who their custodian, administrator or other third parties should be. Generally, fund raising is hard in this environment and for new startups in the current market conditions, the demands of larger or wealthier investors are taken seriously.

Devaney: Entering 2012, institutional investors clearly have a greater degree of leverage over fund managers, relative to historical norms – which range from being fairly to strongly manager advantaged – but they do not appear to be pushing too aggressive an agenda. The tide is certainly turning on investor lock-ups, with a shift towards redemption fees as opposed to hard lock-ups, withdrawal terms, with reduced notice periods being a continuing trend, and matters of 'transparency'. Modest reductions to management fees are being negotiated for large investments. But no sea change has occurred. A potential external stimulus, that would have a big impact on investor leverage, could be more assertive SEC action on side letters. If the SEC seeks to force fund manages to disclose all side letters, and further requires that investors, including smaller investors, be offered withdrawal rights if they are not permitted to benefit from terms being made available to larger investors, the effect of empowerment of smaller investors could result in more significant changes to fundamental terms and conditions.

Mungovan: The balance of power currently lies with institutional investors, perhaps with the exception of the biggest funds with the best reputations. Investors have been demanding – and receiving – greater liquidity, transparency and fee concessions than ever.

Memminger: The balance of power is still in favour of the investor. This can be explained by the reduced level of funds that need to be, and are to be, invested by investors, reduced allocation ratios to that type of asset class because of risk-averseness in the current environment and still in quite a number of hedge fund providers.

FW: What challenges are associated with releasing funds back to investors, such as liquidity control, redemptions and clawbacks? What steps have fund managers taken in this area?

There is the increasing emergence of the institutional investor as a dominant force; they have demanded greater due diligence rather than onshore domicile, which is an attributing factor to funds remaining offshore rather than relocating.

SOPHIA-ANN HARRIS

Harris: Following 2008, investors have emerged more sophisticated after hard learned lessons, and have brought about the increase in consulting companies whose mandate is to advise the investor before he enters into a fund to conduct due diligence on the fund or to negotiate the provisions of the fund for the benefit of the investor. There is the increasing emergence of the institutional investor as a dominant force; they have demanded greater due diligence rather than onshore domicile, which is an attributing factor to funds remaining offshore rather than relocating. For their part, institutional investors had not to date reallocated significant sums away from offshore investment funds to other funds. Investment managers ensure adequate due diligence and the placement of professional and effective independent directors to meet the investor demands.

Memminger: Those who were fortunate to have respective provisions in their fund documentation postponed payments to their investors upon respective clawback requests. Others were forced into fire sales of their assets and even to close funds. At least from my perspective, these points were hot topics 24 months ago, but are no longer so pressing as either respective repayment requests have already been satisfied, or the respective fund went out of market. Further, improved investor communication and a more conservative approach to risk-taking helped to avoid running into similar problems so easily again.

Mungovan: In the US, clawbacks on investor redemptions are driven almost exclusively by fraudulent conduct on the part of the fund manager. In the last two months, there has been a substantial development in the law in the US on clawbacks. The US Court of Appeals for the 11th Circuit, in a case of first impression, ruled that investors in a fraudulent hedge fund that was operated as a Ponzi scheme are not subject to clawbacks for redemptions of principal where the investors acted in good faith. The name of the case is *Perkins v Haines,* 2011 U.S. App. LEXIS 22659 (11th Cir. 2011), and it involved the liquidation of the fraudulent hedge fund, International Management Associates. The bankruptcy trustee sued investors who redeemed principal, claiming that all redemptions are subject to clawback regardless of whether the investors acted in good faith. The bankruptcy trustee's theory was that redeeming investors did not give 'value' even when they redeemed principal. The 11th Circuit rejected the trustee's theory, and concluded that redemptions of principal constitute 'value' because investors in a Ponzi scheme are defrauded at the time that they made their initial investment, which gives rise to a claim for rescission. That claim for rescission has 'value' and the claim for rescission is reduced, dollar for dollar, upon a redemption of principal.

Cripps: The period since the 2008 crisis began has seen many techniques deployed in an attempt to cater for the mismatch between investor perceived redemption rights being exercised and portfolio realisation, which cannot produce the funds necessary to meet redemption demand. In the main, the potential mechanics are well known and have been set out in prospectus and information memoranda for many years, even if rarely deployed and often far from popular when they are. The conflicts of interest between continuing investors and those seeking to depart are particularly acute in a market where realisations are often only possible, in the short term, at depressed prices to opportunistic purchasers.

Devaney: Over the past few years fund managers seem to be more cautious about liquidity, including in some instances sitting on sizeable cash positions. Although shifts in lock-up periods are working their way through term sheets now, with many managers opting for more 'soft' lock-ups such as withdrawal fees, investors and fund managers appear to continue to agree that gates and sensitive suspension event parameters are appropriate for a pooled investment vehicle. However, the proliferation of separate accounts and 'parallel' funds within a single strategy are creating challenges to equitable treatment of clients/funds in the event of requests for liquidity, especially when a separate account customer has the ability to require liquidation at a time when the fund manager is not looking to pursue liquidity for all clients simultaneously. These facts recommend careful navigation. Ultimately, the most significant adjustments that we are seeing are in operational matters, with fund managers being more sensitive to balancing illiquid holdings and limiting leverage that would create an impediment to redemptions. Fund managers seem to be putting themselves in a position from which they can demonstrate that the likelihood of triggering a gate are low.

FW: Would you say that fund managers are more focused on risk management and mitigation than they were in past years?

Devaney: Risk management and risk mitigation have become extremely high priorities. Funds are facing many new regulatory requirements and will be required to devote more resources to regulatory and compliance matters going forward.

Memminger: It is hard to generalise but I would say fund managers are more focused on risk management. Also, in that asset class which is, per se, subject to a greater risk exposure, people are increasingly careful about what kind of risk they are willing to take and to what level.

Mungovan: There is certainly a heightened focus on risk management today than there was five years ago. Whether that focus results in fewer catastrophic losses remains to be seen.

Cripps: The experiences of 2008, combined with the significant increase in the regulatory burden and the enhanced expectations of investors, have inevitably meant much greater concentration on risk management, both in response to compliance requirements and investor expectations. Indeed, some older managers have decided to give up third party management to concentrate on 'family and friends', so enabling them to focus on investment decisions rather than administration and investor reporting. Those continuing require a significantly enhanced back office as well as an increased willingness to engage with investors and discuss portfolio content and plans for the future.

Harris: Fund managers that came through the financial crisis are more wary of potential liquidity issues and want more than just the traditional NAV suspension option to deal with them, such as the right to side pocket; the right to suspend redemptions in isolation; and the power to end the fund via 'wind-down' rather than formal liquidation. We have not seen anything to suggest they are necessarily more risk averse in terms of investment and trading strategies, but that may be the case.

FW: In what ways are fund managers addressing internal governance issues? In your opinion, should they be doing more to enhance oversight, independence and accountability, for example?

Generally my recommendation would be to continue the path of an information exchange with investors, regulators and the public, which started as a result of the crisis in 2007.

PETER MEMMINGER

Cripps: The larger the manager the greater, generally speaking, the internal governance issues, with many of the larger hedge fund managers increasingly resembling an old-fashioned merchant bank, albeit one with the enhanced capabilities available because of technological advances, especially in electronic communication. A feature of a number of recent transactions has been an investor acquiring a minority stake in a fund manager while at the same time providing a significant increase in funds under management such that the enlarged business becomes attractive to a wider range of institutional investors. This typically leads to complex negotiations as to the minority rights to intervene in the business, which can extend to de facto control if the business falters and falls outside carefully drawn and negotiated business plans.

Harris: We have seen an increase in independent director appointments, perhaps fuelled by Justice Jones' statements in the non-binding Asset Based Lending decision that independent directors were 'best practice' for hedge funds. We have also seen instances where funds that have got into difficulty have appointed an independent director or an insolvency practitioner to sit on the board as an investor representative and report back to the participating shareholders.

Memminger: I think the industry has already taken a good step in the right direction during the last few years. One has to balance the benefits– higher investor satisfaction, reduced risk of clawbacks, improving public recognition – with the disadvantages that go along with it, mainly increased costs. Generally my recommendation would be to continue the path of an information exchange with investors, regulators and the public, which started as a result of the crisis in 2007.

FW: How well are hedge funds coping with external demands for improved reporting and disclosure? With regulatory requirements set to increase in the years ahead, what impact might this have on the industry?

Mungovan: Regulation is driving the two biggest changes in the hedge fund industry: transparency and institutionalisation. The increased reporting requirements of both regulators and institutional investors will provide greater transparency into trades and trading strategies. It will be more difficult than ever for managers to develop and protect 'proprietary' strategies and trading models. As a result, the shelf-life of any particular trading strategy will shorten, and competition will increase. Ultimately, only the truly gifted managers, who are capable of repeatedly identifying and exploiting new investment opportunities, will separate themselves from the pack. Regulation and transparency will drive up the costs of operation, which in turn will drive institutionalisation. Fund managers will need larger, more comprehensive compliance teams and research teams, the costs of which require greater assets under management. The costs to compete effectively will end, for now, the era of hundreds of new launches of emerging managers each year.

Devaney: We anticipate that for the next year or two funds will be required to devote significant time and attention to their IT systems in order to be able to address new reporting requirements, including Form PF requirements. In addition, many funds will have to add compliance personnel, or contract with outside compliance providers, in order to meet other registration and reporting requirements. For example, some funds may be considered 'large traders' required to register and comply with new reporting requirements. For non-US funds, compliance with new tax reporting requirements under FATCA also will prove burdensome and expensive. In the short term, this will mean increased expense. Over time, funds may be able to adjust to this new, more regulated environment.

Harris: Funds are generally improving their disclosure and reporting, not only to investors, but to regulators and tax authorities. Recent case law has highlighted the importance of timely accurate disclosure and reporting, and directors are actively taking this on board with service providers' help. In places, investor perception is that more regulatory oversight is better, and in this market, this thinking may cause some fund migration. We believe that any increased regulation will increase compliance costs to funds. Where regulation has a 'global' impact, we anticipate that funds which can bear the increased cost pressures will adjust, adapt and survive. Where there is scope for regulatory arbitrage, managers may opt to avoid the additional costs and move elsewhere or shift focus. Think FATCA. Some managers would rather divest US holdings and US investors than comply. Where funds can no longer bear the costs of regulation they will be wound down.

Cripps: There is no doubt that investors are increasingly inquisitive and demanding of detailed information concerning portfolio content and strategies. Some managers complain that more than half their time is now occupied by administration and investor queries, leaving too little time available for the investment decision process that is the key to portfolio management. At the same time, the seemingly never-ending waves of new regulation, sometimes inconsistent or unworkable, has led to significantly increased regulatory reports, often combined with enhanced queries and inspections, not always well focused but frequently involving very significant resources and senior management time. Ultimately this trend is reflected in a significant increase in compliance and administration, and of increased fixed costs, which in turn can be absorbed much more easily by larger managers.

FW: Regulating the alternative asset class has been a major item on the political agenda in the aftermath of the financial crisis. What do you believe will be the long term effects of new developments such as the US Dodd-Frank Act and the European AIFM directive?

Memminger: Increased regulation will mean that the industry will become more mature with the effects that can be usually seen in this process. More regulation will mean more rules and information and publication requirements to be observed, which will result in increased costs impacting returns, particularly for smaller providers. Hence I would expect that we will see smaller hedge funds that market themselves to the general public start to disappear. This will not be true for those funds that are either so small, so limited, or so specialised in terms of their investor base, that they are outside of the scope of applicable regulation.

Cripps: The major impact of the waves of new regulation seems likely to be increased costs, further contributing to anti-competitive trends. The market for investors is to some extent already split, for tax and regulatory reasons, between the US and the rest of the world, with the managers themselves concentrated in New York and London. It is possible that this will be further split, in terms of investors, into three – the US, Europe, and the rest of the world – with different levels of regulation leading to separate products being made available in each, and some managers deciding there is insufficient demand in one sector to justify the entry costs. While there are concerns that high levels of taxation and regulation will see managers move out of London, the trend seems to be for existing businesses to stay but for any growth to be offshore and the principal individuals increasingly visiting London rather than becoming UK resident for taxation purposes.

Harris: At this stage AIFM has had minimal impact in Cayman and this is largely to remain the case. In fact the uncertainty during the drafting and negotiating process was worse than the actual law, which still allows non-EU funds to market in Europe via the private placement regime. If that is phased out, which would be after 2018, there could be challenges at that point. Dodd-Frank introduces requirements for hedge funds and private equity advisers to register with the SEC as investment advisers, and increases the asset threshold for the requirement of federal regulation from \$30m to \$100m. The US regulations mean that any funds with US investors come to us through US counsel who manage those compliance issues, dramatically increasing set up costs for US managers. We have seen a further increase in funds that completely prohibit US investors, depriving them of access to a large number of alternative investment strategies and managers.

Devaney: We expect to continue to see additional regulation. The Financial Stability Board continues to focus on the 'shadow banking system'. Moreover, it is not clear how regulators will be using the wealth of new information available to them, and whether we will see new enforcement initiatives as a result.

Mungovan: The Dodd-Frank Act is not the 'final piece' of regulation in the US. Rather, it is the end of the beginning of a new wave of regulation and regulatory enforcement in the capital markets both in the US and abroad. With respect to hedge funds and other private investment funds, the key characteristic of the Dodd-Frank Act is transparency. Regulators have wanted to introduce greater transparency to the industry for years, as much to understand it as to control it. Presumably, regulators will utilise the data that they receive to fashion new rules and regulations, particularly around the use of leverage and the disclosure of leverage to investors, lenders and other counterparties. I expect a wave of new regulatory initiatives in the capital markets in the coming decade that will be reminiscent of the regulatory initiatives in the US in the 1930s. ■