FIRST DEGREE GLOBAL ASSET MANAGEMENT

Smaller Hedge Funds:

Why Do We Continually Reinvent the Wheel?

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1. Introduction

When we started First Degree Global Asset Management in 2011, a fairly standard retort was that “there are 500 hedge funds in Singapore and three-quarters of them are less than USD 30 million … so are you sure that you want to do it?”

Putting aside either the masochism or delusions of grandeur of the Principals of First Degree, such a statement does indeed make one pause, not only for the obvious fund raising challenges.

The website of the Monetary Authority of Singapore notes at the date of this paper, there were 119 holders of a Capital Markets Services Licence for Fund Management (CMSL) and 564 Exempt Fund Managers (who are generally restricted to dealing with Accredited Investors) operating in Singapore (1). While it is more difficult to determine the number of hedge funds managed by these entities (many are not registered for retail distribution locally), most of those entities could legally act as the manager of a hedge fund.

Multiply Singapore’s experience globally and you quickly arrive at the total of 10,000 hedge funds in existence around the world (2).

What struck us was that, despite the number of hedge funds in existence, beginning a hedge fund seemed to be an operation of starting from near scratch. There appeared to be little in the way of standard documentation or operating procedures in the industry and very much in the way of variation. This matters for three key reasons: (i) the process is more cumbersome, time consuming and expensive for managers than it needs to be (ii) the variations in documentation, back office, compliance and risk management processes makes the due diligence effort for investors unnecessarily intensive and (iii) arguably, those same variations impose unnecessary burdens on regulators in fulfilling their oversight functions.

We believe that the best practice approach for the industry would be to adopt common standards on as many of these issues as possible, thereby standardising the fund set-up procedure, making the due diligence process for investors and intermediaries more efficient and enabling regulators to identify outliers. This should enable effort to be spent in the areas that are most important to the stakeholders in our industry.

2. Why Standardisation of the Plumbing Matters

The top 100 hedge fund managers globally manage approximately USD 1.4 trillion (70% of hedge fund industry assets) (3).

The traditional side of the industry is equally concentrated, with the top 20 global asset managers managing approximately USD 25 trillion (40% of industry assets) (4) and the top 10 Sovereign Wealth Funds (SWF) managing approximately USD 3.7 trillion (77% of total SWF assets) (5).

Generally speaking, these investor and industry behemoths have the resources and expertise to build products with customised terms, to undertake very customised due diligence on each other and to negotiate bilateral agreements and deal-specific terms.

For the rest of the investors and the hedge fund industry, that is much more of a challenge and is, arguably, an unnecessary impediment to building, offering and investing in quality products.

Why this matters is because smaller and newer hedge funds provide a key source of returns to investors. In 2011, PerTrac, one of the leading global providers of hedge fund analytics concluded that, generally speaking, smaller hedge funds had outperformed larger hedge funds and newer hedge funds had outperformed older hedge funds over the 15 year period to 2010 (6). The performance differentials for the smaller and newer funds were material, being in the order of +150 bps p.a. over the period.

With the exception of parts of the investment management process, the bulk of what most hedge funds do in the non-investment management areas is relatively generic: the back office function, the establishment of compliance and risk management policies and oversight and (the bulk of) the fund constituent and offering documentation. An industry move to standardise these activities should not only ease the process by which smaller managers can bring product to market but also bring significant efficiencies, with the cost savings being passed to the end investors: the Mutual Funds Law of the Cayman Islands, for example, allows set up costs to be charged to the relevant fund and recovered by a manager over five years. Lower set up costs will lower those charges, which are ultimately borne by investors.

Equally, on the investor side, facing investors and intermediaries with relatively standard operational and compliance practices, as well as with standard constituent and offering documentation, should help to reduce the due diligence costs of the investor. This was brought home to us recently with the receipt of two thirty-plus pages due diligence questionnaires from potential investors. Each questionnaire went into about the correct level of detail, but each then asked more-or-less the same due diligence questions in slightly different ways. The amount of resources necessary to design such a checklist, for the manager to complete it and then for the investor to analyse the results was very significant indeed. Multiply that across the 10,000 funds in the industry and the entire investor class and you have an industry in itself.

Finally, having standardisation in these areas should also be a net benefit to regulators: regulators could then focus on exceptions or variations from standard practices – outliers in industry parlance - in determining where key regulatory risks lie.

3. Where the Plumbing Could be Improved

There are five key areas that lend themselves to standardisation:

1. Back office procedures;
2. Fund documentation;
3. Know-your-client procedures;
4. The investor due diligence process; and
5. Oversight procedures and practices.

Back Office Procedures

Having worked for more than a decade with an international bank with a world-leading back office/custody operation and now been the client of a leading fund administrator and an international bank with a leading custody operation, I am amazed at the areas in which, with relatively little effort, activities could be standardised between industry players to create significant efficiencies.

Consider the following areas:

- *Foreign exchange price feeds*: Some custodians take FX feeds from Reuters, some from Bloomberg and others from proprietary inhouse systems (with data from a dealing desk);
- *Non-exchange traded securities pricing*: Some custodians take the last reported price, some take the bid price and others take the median of the bid-offer spread; and
- *Accounting methodology*: Generally-speaking, the manager may elect whether to use series or equalisation accounting (without going into mind-numbing detail, each of these methodologies is a more-or-less different way of arriving at the same account result).

In my experience, rarely do these issues result in material differences to the portfolio valuation over time, but they do lead to numerous near term reconciliation items, particularly where the manager/custodian and the end investor conduct detailed ongoing due diligence upon each other. Many fund-of-funds, for example, operate mirror systems to their managers: these variations mean that those are mirrors can be unnecessarily opaque.

Fund Documentation

The Private Placement Memorandum (PPM) for the First Degree Long Horizon Absolute Return Fund (Fund) was prepared by a leading law firm, and reviewed by another leading law firm, and is 92 pages long. Just 10 pages of that document contained information that is truly-Fund specific. The remainder of the PPM contains boilerplate descriptions of regulatory, tax and risk issues.

Beneath the offering documentation are generally the articles of association of the fund (34 pages in the case of the Fund), the subscription agreement (26 pages), management agreement (18 pages), the fund administration agreement (16 pages) and the custodian agreement (12 pages).

So, we have 198 pages of documentation, probably not much more than 10 of which are Fund-specific. All of this documentation has to be drafted and agreed by the Fund, the manager and the various service-providers and then reviewed and understood by investors and intermediaries, let alone monitored by regulators. Multiply that number of pages by the 10,000 or so hedge funds in the world and you get a sense of the scale of the issue.

There are precedents for standardised documentation, both at the industry and legislative level: The various Australian State Law Societies, for example, publish a standard form contract for the sale of land that is adopted for the vast majority of property transactions in Australia. The Law Society of Singapore has a similar standard agreement that is used almost exclusively for local residential property transactions. These standard agreements contain terms that are widely understood and accepted, leaving the parties free to focus on exceptions to the standard provisions in a particular transaction.

Equally, from the legislative side, Schedule 1 to the Corporations Act 1989 of Australia and the Fourth Schedule to the Companies Act of Singapore each contain a standard form memorandum and articles of association that may be adopted by local companies. Again, these documents are widely adopted and common interpretations of their provisions have been established.

Know-Your-Client Procedures

Each time that an investment manager accepts a new client or enters into an arrangement with a regulated service provider (such as a custodian, bank, fund accountant, auditor or law firm), the two parties must go through a cumbersome practice to establish the other's identity (KYC). This may sound straightforward, but it can be anything other than that.

There appears to be no common approach to the steps to establishing a person or entity's identity, and even less to the manner in which the "necessary" documentation is to be provided.

At is base level, for individuals usually a copy of the person's passport, some proof of address and an indication as to the source of funds will suffice. However, again there is no consistency as to the requirements of the manner of production of the documentation. Some firms require citing original documents, some will accept copies certified by a professional (for example, a lawyer), while others require documents to be notarised or consularised. Complexities arise when the individual is out of the local jurisdiction and his or her home country certification processes are not recognized: for example, we had an instance where, due to some local quirk, a Notary Public in the Czech Republic would not notarise a passport copy (apparently it is not the local practice) and the individual had to fly to London to have it done. These are not trivial issues when they ultimately hold up, or prevent, investors coming on board.

On the corporate side, some counterparties undertake only basic identification procedures requiring the production of copies of lodged documents that can be provided from the local companies office. However, others want to go back through corporate histories, requiring historical documentation on activities, shareholders and officers. Similar certification issues arise with these documents, to those of individuals.

It is not that these processes are particularly onerous, and most individuals and corporates have accepted them as the price of doing business in the twenty-first century. It is more that there is no consistency: regularly are we told "but our other manager did not ask for that", which leads one down the slippery slope of either defending your own practices or rubbishing someone else's.

This process has to be gone through each and every time that a new relationship is established. In the case of First Degree and the Fund, we have three banking relationships, three broking relationships, a custodian, an auditor, two sets of lawyers, a tax advisor, and a back office provider. For each, we had to go through a similar, but different, KYC process.

Equally, each of our investors had to go through the KYC process with us, together with (presumably) all of the investor's other investment managers. Just think of the obligations on a moderate investor that had half-a-dozen mutual fund accounts, a couple of broking accounts and a couple of bank accounts. It gets to the point where the process is a disincentive to opening new commercial relationships.

My pet want – and I know that this is a long shot – is for the industry or a regulator to establish a body to oversee a common KYC and certification process. Individuals and corporates could then go through the process once, and provide – notarised if necessary! – documents to support a KYC qualification. The individual or entity could then be issued with a code valid for a period (say, three years) stating that it had gone through the process, the documents had been produced and – hopefully – avoid going through it on a repeated basis with any new relationships. Couterparties could rely upon the certification provided, with the onus being on the certified party to update the central registry if his circumstances changed. The efficiencies from such a scheme would be enormous, and it could presumably be operated on a commercial basis.

Interestingly, India has implemented such a scheme for mutual fund investors in that country. CDSL Ventures, a wholly-owned subsidiary of Central Depository Services (India) Limited, which acts as the depository for the various Indian stock exchanges, undertakes a one-time certification of mutual fund investors for KYC purposes and then records that certification on a publicly available register. Managers of mutual funds are then entitled to rely upon that certification for their own KYC purposes, without being required to repeat the KYC process. This is not only hugely efficient for managers, but it also makes the investment process for investors much more friendly.

The Investor Due Diligence Process

Most institutional investors and intermediaries conduct preliminary due diligence on managers and hedge funds by way of a checklist to be completed by the fund and the manager. As noted above, such checklists are generally comprehensive (usually more than 30 pages) and involve significant resources on the part of the investor/intermediary to compile and then review, and on the part of the manager/fund to complete.

In 15 years in the industry, I have not seen two identical checklists.

Standardising the fund documentation and procedures as well as the due diligence checklist should bring much in the way of efficiency. It should also enable investors and intermediaries to focus their efforts on exceptions – areas in which the manager/fund does something different and which deserves attention. Equally, it should encourage managers and funds to bring their procedures and documentation into line with industry standards, or be prepared to defend the rationale behind variations that will now stand out.

Oversight Procedures and Practices

Risk management and compliance is a critical feature of a fiduciary business. In my experience, most investment managers – and investors - take these functions very seriously indeed and commit considerable senior resources to identifying and managing risks and regulatory compliance.

However, these processes are often established in the face of regulatory environments that are deliberately vague. The typical regulation reads something like this:

2.1.1 An institution should have comprehensive and sound policies, approved by the Board, for prudent management of significant risks arising from its business activities and operations. The approved policies should be consistent with the nature, complexity and materiality of the institution's activities. (8)

One can have much sympathy with Regulators who will argue that the better approach is to lay the responsibility for developing a compliance and risk management framework on the participant, for that participant should not its business – and its risks – best. This is a very sensible approach. However, this means that if there are 683 holders of a CMSL and Exempt Fund Managers in Singapore, for example, there almost certainly will be close to 683 different versions of compliance and risk management policies.

Without wanting to abrogate the responsibility of Directors and Officers for risk management and compliance control of their organisation, surely it cannot be efficient (other than for law firms and compliance consultants) to have so many different versions of what should be fairly standard policies on relatively routine issues such as staff dealing, soft dollar commissions, best execution, KYC, AML, proxy voting, gifts and entertainment and complaints handling. Again, if common policies on these issues, for example, were put in place that reflected broad industry standards, managers, investors and regulators could focus on exceptions, where there time may be better spent.

4. Should Standardisation of the Plumbing be Compulsory?

Given the myriad of regulatory and tax regimes – let alone languages and legal systems – it is probably unreasonable to expect compulsory standardisation of plumbing matters. Indeed, that process should not take away from the fundamental fiduciary responsibility of Directors and Officers to manage their businesses and to act in the best interests of their clients.

However, the plumbing process clearly could be made more efficient and less fund-specific, to the benefit of the community as a whole.

Whether this is done by an industry body for the hedge fund community or by a Government institution in one of the leading hedge fund hubs taking the lead, the opportunity is open for someone to design a standard platform that should be much more efficient for managers and investors alike.

FOOTNOTES

1. http://www.mas.gov.sg/fi_directory/index.html

2. Source: Hedge Fund Research, reported in The Economist 31 January 2012

3. *Financial Markets Series: Hedge Funds* May 2011 by The City UK

4. Pensions & Investments/Towers Watson *The World's 500 Largest Asset Managers, Year End 2009*

5. Sovereign Wealth Fund Institute

6. PerTrac, Inc. *Impact of Fund Size and Age on Hedge Fund Performance* September 2011

7. *Fund Management 2010* by The City UK

8. Internal Controls Guideline February 2006, The Monetary Authority of Singapore