SECURITIES INDUSTRY NEWS

Small Firms Wary of Efforts to Fortify Fund Industry

June 2, 2008
By Janice Fioravante

Can two traders with a Bloomberg terminal still start a hedge fund? That question was on the mind of at least one small fund manager at a recent roundtable on best practices.

On April 15, two private-sector committees selected by the President's Working Group on Financial Markets (PWG) issued proposed guidelines for fund managers, enhancing investor protection and mitigating systemic risk by implementing controls and infrastructure. The investor committee included representatives from labor organizations, endowments, pension funds and consultants, while the asset management committee was made up of hedge fund executives.

The names of the buy-side committee members "are familiar--all front very large funds," said the fund manager at the gathering sponsored by Boston-based technology provider Eze Castle Integration (ECI). Eton Park Capital Management CEO Eric Mindich chaired the committee, which included Kynikos Associates president James Chanos and Cantillon Capital Management founder William Von Mueffling, among others. "How will this affect smaller funds like mine? How expensive will it be to attempt compliance?" he said.

While adherence to the guidelines would be voluntary, many attendees said they see the writing on the wall. They suggested that following the elections a new administration may look more closely at regulating the alternative investment industry.

ECI managing director Bob Guilbert, who pointed out that the comment period remains open until June 15, said that smaller funds need to understand the scope of the PWG recommendations. Even in a four-man office, resources and capital will need to be committed to compliance.

"Complexity isn't needed or wanted," said Brian Tsai, COO of New York-based Equinox Partners. Funds must exercise "creativity to pull resources together without the need to spend lots of money--plans and systems can match the size of your firm." According to Tsai, the most important thing is being prepared to answer investors' questions.

The PWG has called for funds to establish policies and procedures for disclosure, valuation, risk management, and trading and compliance. The recommendations stress accurate documentation and improved transparency, which could pose problems for less organized funds. "There's no specific time when you should decide to tackle documentation, but once a year is a good idea," said panelist Ephraim Lemberger, associate at law firm Bingham McCutchen in New York.

What should funds be looking for? "Uniformity, consistency throughout all documents, including marketing material," said Tsai. Inconsistencies not only draw attention from the Securities and Exchange Commission, but also state attorney generals' antifraud staff.

"Be sure not to be doing things differently than what you say you're doing," advised Mark DiMaio, principal for global financial services risk management at Ernst & Young in New York. DiMaio added that funds should also be more open with investors: "If you have a new general ledger system, set up a succession plan, start a private equity fund--let people know."

Independent Valuation

Panelists stressed the importance of segregating a fund's valuation functions, an area that has been subject to increased scrutiny. DiMaio said hedge funds should look to traditional investment banking as an operating model. "Make sure the traders' P&L is an independent function," he noted, adding that there need to be clear duties and reporting lines, with someone looking at the source data from trading models and independently performing valuations.

Institutional investors, who are increasingly putting their money into hedge funds, "are looking at compliance in terms of an absence of conflicts of interest as exemplified in separation of duties," said Equinox's Tsai.

For a start-up, it's understandable that the pricing person handles an array of tasks, observed ECI compliance manager Mark Kenney, but as a fund grows, responsibilities have to be segregated, with oversight in place to make sure procedures are followed. "Bigger institutions need more infrastructure, based on risk and size, which affects the compliance method," he said. For sizable funds, Tsai suggests having a chief compliance officer sign off on valuations.

Larger funds can have an evaluation group that prices portfolios of illiquid assets, noted Tsai. How fund managers price illiquid instruments affects net asset value calculations for subscriptions and redemptions and helps determine managers' fees. Undervaluing the products can be unfair to current or redeeming investors who need to know the true value of their investments, and overvaluing may inflate subscription prices.

Appetite for Risk

The PWG recommends that managers have a "comprehensive and integrated risk management framework" that is tailored to the fund and communicated to its investors. Panelists were eager to discuss firms' appetites for leverage and risk.

Large funds should make risk decisions by committee, asserted Tsai. "There are tons of things that operations needs to be aware of," he said, such as "the risk of the biggest issues' margin being withdrawn or shrinking, about auction rate securities' fluctuations, about an investment becoming suddenly illiquid." Funds should stress-test risk, said Tsai, adding that they should "budget in terms of software and other resources."

Technology was cited as an area where operational controls are needed. Funds need to have access policies, Tsai said, and passwords should be required to perform certain functions.

Business continuity and disaster recovery plans also have to be in place, noted Tsai, and a fund's staff must know what to do in a crisis. Processes need to be established for everything from an Internet line going down to a steam pipe explosion. "Make sure your business continuity/disaster recovery plan becomes rote," Tsai cautioned, "that anything that can't be replaced is redundant. Test your plan on weekends, do it in stages, phases."

To discover interdependencies between systems, Ernst & Young's DiMaio suggested "running for two days on your disaster recovery site."

Ethics Guidelines

Among the PWG recommendations is that fund managers have a code of ethics to promote "professionalism" and "require a certification by each employee that they have read and understand the code and will comply with its contents."

"Any fund's professionalism chafes against the pretty ugly behavioral issues of some hotshots acting up and getting themselves into the papers," noted Bingham McCutchen's Lemberger. "It can be very embarrassing to the brand and to the organization." Funds should have a gift policy and detailed trading rules, and their procedures and policies should be reviewed quarterly, according to Lemberger.

A firm with only two or three people on staff should be careful to outline common-sense steps, he added. "For example, for a more than $50,000 transfer, make sure there are two signatures so no one worries that the money will end up in Tahiti."

Some see the guidelines eventually leading to fewer small funds. "The proposals are cost-prohibitive because we don't all have the same amount of resources," said the manager of the smaller hedge fund. "The cost of entering the business is too high now. Where will the money for compliance and infrastructure come from? Returns, of course. It's the investors who pay. You need a larger base of investors."

Hedge fund founders are often investment banking veterans who want to get away from the constraints and are willing to take on more risk, he noted. "But with a greater level of infrastructure needed, they won't want to be caught up in an arms race."

While another fund manager attendee supported the concept of best practices, he didn't want to see young firms smothered. The hedge fund industry is evolving, he noted, and it's normal to attract compliance issues as it grows. "I don't think that this is a barrier to entry as yet," he said, "but it could potentially be a barrier depending on what regulators do."