



CHRISTOPHER MILLER on the need for the EC to tread carefully with the AIFM Directive

“The risk of regulatory moral hazard is actually increased with products that people think are safe, simply because they are regulated. As we learned from Madoff, regulators are not perfect”

For most of my adult lifetime, politics and economics have been largely separate, as financial markets were left to their own devices. But now, they are entwined like warring octopi, and it is hard to see who is besting whom.

At least with the EU AIFM Directive we know who instigated it. The extent and tone of the proposals caught us all by surprise. And most people in the hedge fund industry are more interested in numbers, trading and perhaps a bit of poker than they are in political

intrigue and horse trading. So there has been a whole new skill for the industry to learn in a very short space of time.

The industry's trade associations have led a coordinated opposition effort, in an unprecedented spirit of co-operation. Let's face it; getting a group of hedge fund managers together to agree on anything is like herding cats. The very thing that makes hedge fund managers 'alternative' is that they think for themselves and avoid following the crowd. I think that quality is one reason why hedge fund managers are so misunderstood by the general public. It's a personality thing.

But regulation is not all bad, and there is much promise in the AIFM Directive that could turn out to be positive for the industry, providing that the final implementation is proportionate, and doesn't restrict hedge funds more than other players in the market, such as banks, companies, family offices, sovereign wealth funds, private equity and of course mainstream regulated products such as Ucits III funds. Also, there's no doubt that with increased regulation behind them, hedge funds will become more socially acceptable. Soon we may even be able to tell people at dinner parties what we do for a living.

However, there are still pitfalls for the EC team to watch out for. The risk of regulatory moral hazard is actually increased with products that people think are safe, simply because they are regulated. As we learned from the SEC's horrifying internal investigation in the wake of Madoff, regulators are not perfect, and are certainly not a substitute for engaging your own brain as an investor. The report even notes painfully that Madoff used the fact that the SEC had investigated him and found nothing in his marketing pitch. Equally, Ucits vehicles are seen by some people as safe investments that need minimal due diligence. Yet risk management based on VaR is what brought both Long Term Capital Management and the investment banks down.

The smaller manager is where innovation and investment diversity can be incubated without any systemic risk at all. As the Directive stands, smaller firms won't be able to afford to set up shop. The EC would do well to avoid stifling such managers; beyond basic registration and reporting, and providing the investors are professional, there should be little need for intrusive or restrictive regulation.

Another hot potato is the retailisation of hedge funds. While the man in the street should not be denied access to the superior risk-

adjusted returns that hedge funds can bring over time, it is clear that some of the carnage of 2008 was compounded by retail investors who, failing to understand what they had, rushed for the exit and tarred all hedge funds with the same brush.

The changes made to stop such a stampede happening again should be a guide for future reform of the hedge fund industry. I think that harmonisation of liquidity provisions such as gates, side pockets and in-specie redemptions would be an excellent step. Good liquidity and fair treatment of all investors can sometimes be incompatible, and harmonisation could reduce the ability of managers to compete for client favours using unrealistic liquidity.

But the most obvious pitfall to avoid is overkill, pure and simple. In the US, hedge fund regulation is light years behind the EU and especially the UK, but they are probably still smarting from the over-reaction to Enron that turned into Sarbanes-Oxley, and demolished much of New York's position in the global financial markets. They won't make the same mistake again, and the EU shouldn't either. ■

Christopher Miller is CEO of Allenbridge HedgeInfo, a hedge fund consultancy firm

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Published by Pageant Media Ltd
London
14a St Cross Street, London EC1N 8XA
T+44 (0)20 7269 7575
F+44 (0)20 7269 7570
New York
1375 Broadway, 11th Floor, NY 10018
T+1 (646) 278-9961
Dubai
502 La Riviera Tower, Dubai Marina,
Dubai, UAE T +971 (55) 6959773

EDITORIAL

Editor
Gwyn Roberts +44 (0)20 7269 7573
g.roberts@hfmweek.com
News editor
Zaki Abushal +1 646 278 9962
z.abushal@hfmweek.com
Senior reporter
Elana Margulies +1 646 278 9960
e.margulies@hfmweek.com
Investment correspondent
Kapila Gohel +1 646 278 9964
k.gohel@hfmweek.com
Reporter
Tony Griffiths +44 (0)20 7269 7591
t.griffiths@hfmweek.com
MENA correspondent
Antony Ireland +971 (55) 695 9773
a.ireland@pageantmedia.com
Data manager
Indira Peters-DiDio +1 (646) 278 9961
i.peters@hfmweek.com
Design/Sub-editor
Matt McLean +44 (0)20 7269 6402
m.mclean@hfmweek.com
Production editor
Melanie Rockett +44 (0)20 7269 7594
m.rockett@hfmweek.com

BUSINESS

Managing director Charlie Kerr
Operations director Sebastian Timpson

ADVERTISING

Commercial Manager
James Blanche +44 (0) 20 7269 7596
j.blanche@hfmweek.com
Senior publishing executive
Lucy Guest +44 (0) 20 7269 6404
l.guest@hfmweek.com
Senior publishing executive
Sally Boyle +44 (0) 20 7269 6411
s.boyle@hfmweek.com
Circulation manager
Fay Muddle +44 (0) 20 7269 7590
f.muddle@pageantmedia.com
UK subscriptions
Rhianon Ebsworth +44 (0)20 7269 7577
r.ebsworth@hfmweek.com
Events
Beth Gill +44 (0) 20 7269 6410
b.gill@pageantmedia.com

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MY LIFE IN HEDGE FUNDS

ANDREW SAUNDERS, managing director, Hedge Connection

HOW DID YOU FIRST GET INVOLVED IN THE HEDGE FUND INDUSTRY?

I was aware of the growth of the industry through my previous position in corporate IR, where I was confident that the skills that I had could be transferred to helping hedge funds market more efficiently. Hedge Connection brings together intelligent investors targeting tools, events and marketing consulting services.

WHAT WILL CHANGE ABOUT YOUR AREA OF BUSINESS IN 2009?

Investors are beginning to allocate capital again, so the ice sheet of the last year is starting to break. I am having much more interesting conversations with both managers and investors.

WHAT ARE YOUR OWN BUSINESS PLANS FOR THE YEAR?

Partnership: what the last year has taught us is that it is hard to go it alone. Service providers need to be part of networks of proven, high integrity firms. There are a fair amount of unsavoury characters that play in this space and protecting reputation by affiliating with high-quality firms is the only way to go.

WHERE WILL THE HEDGE FUND INDUSTRY BE IN FIVE YEARS TIME?

Still around, that is for certain. I see a lot of growth over the next five years, but growth that is measured, professional and driven by demands of sophisticated institutional investors.

WHO DO YOU MOST ADMIRE AND WHY?

I admire the hundreds of hedge fund managers that have started funds, treated their investors fairly, delivered returns and done it in a highly respectful manner, despite tremendous odds. They largely fly under the radar and receive virtually no exposure in the media. I speak to these individuals daily and tip my hat to them.

WHAT WOULD YOU DO IF YOU WERE IN PRESIDENT OBAMA'S SHOES?

Toe a careful line between populist rhetoric and acknowledging that creating hedge fund managers is one of the few things that America does well anymore. I am not sure that vilifying managers and talking generally about greed resonates that strongly with the American people, and only serves to turn an entire industry against you. ■

THE WEEK IN QUOTES

“I think hedge funds are incredibly useful tools for diversification purposes – and most outsourced models will recognise that”

Outsourced CIOs could be a great source of new investment, according to Lee Partridge, founder of Integrity Capital.

“Behind the scenes seeding movements are afoot that will make for an interesting 2010 – with smaller deals and harder bargains driven by those in the seeding business”

The seeding business is down, but not out, according to ACG's Ian Tracy

“The new government that came in place in September is corporate-friendly and that is something we need in Germany”

HSCA's Alexander Jacobse predicts a thaw in German hedge fund relations.



EDITOR'S VIEW

g.roberts@hfmweek.com

If the SEC wanted just one post-Madoff crack at proving its effectiveness, it's finally got it.

The current allegations against the Galleon Group and its cornered chief exec, Raj Rajaratnam, involve a list of characters straight from the 'G20 protestor guide to modern business demonology': hedge funds, software executives, rating agencies and bankers. Judging from the coverage, it's already proving a heady mix for the media, which has heralded the case as a new dawn for the US regulator.

It also shows that despite the fairly low-level noise surrounding increased hedge fund regulation in the US, the Feds really do mean business. Sanctioning wire taps for the first time has lifted white-collar crime to Mafioso levels. It effectively means that managers, who regularly shoot the breeze about the markets, will have to bite their tongues in future.

Previously, proving insider trading was almost impossible, without the most complex of algorithms. Now it can be sniffed-out just by getting your microphone levels right and picking up the sort of picaresque language where hardened traders compare themselves to "Martha F***ing Stewart."

If the allegations are proved to be true it certainly is a blow for justice, but equally, the ensuing taint is unjust for the large number of hedge fund managers who have worked tirelessly to get their shops in order. With regulation being discussed on both sides of the Atlantic, the whiff of a new scandal could be enough to push the EC or Congress in a more onerous direction.

It's also bad news for innocent parties caught in the maelstrom. UBP has worked hard to rebuild its credibility post-Madoff and has been responsible for a slew of sensible measures. It's a great shame that its new Ucits III product, now perhaps one of the shortest-lived funds ever, was managed by New Castle, a firm at the centre of the allegations.

Severing all ties with the manager was the only option for UBP, but whether this convinces investors is another matter. Even if the current allegations don't hold water, Galleon is likely to make waves for us all.

Gwyn Roberts, editor