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SPONSORED Q&A

Marina Lewin, global head of business development at BNY Mellon Alternative Investment Services, discusses the challenges and opportunities facing the international hedge funds industry

Challenges and opportunities emanate from regulation

HEDGE FUNDS REVIEW: How will European Union regulation affect the hedge funds industry?

Marina Lewin: The AIFM directive is impacting the industry in a number of different ways. It will have a significant impact on the area of valuation and the definition of roles and responsibilities within the valuation process.

The second major area of impact is how the definition of the role of the depositary will be changing, how that role needs to be played, the liability definitions around that, who can play the role and the responsibilities in the process. These are all very significant.

On the flip side, the passporting abilities offered by the AIFM directive will be significant in how European managers can eventually navigate the number of countries and regulations within Europe.

The impact on service providers will be defined by the new obligations for them – for example, as a depositary bank. It will also impact on how they monitor cashflows, how they monitor processes, what their level of liability will be, what the role of the manager will be and the type of strategy they have. Building data flows from the manager to the service provider and the multiple prime brokers with whom they work will also be a challenge and an opportunity.

HEDGE FUNDS REVIEW: In the US, regulation for the hedge funds industry is contained in the Dodd-Frank Act. What impact will this have?

Marina Lewin: We have noticed some concerns that industry participants are currently voicing in relation to Dodd-Frank. Firstly, from a spin-out perspective, some of the rules of proprietary trading have forced the spin outs of many of the proprietary desks, or the ending of those desks. That has had an impact on businesses in that we have seen a lot of launch activity from those former proprietary desks of

investment banks. There have been some healthy new ventures coming out from former proprietary traders, so there is good opportunity. I believe we may see an impact on earnings of investment banks in the future.

We are also seeing and hearing increased discussion about the Securities and Exchange Commission registration and 'Form PF' that goes along with it. We are going to hear a lot more about that between now and June, when the first of those obligations needs to be reported.

This regulatory environment is evolving constantly, but the industry also has many positives. With the volatility in equity markets, the instability in many of the emerging markets and the debt conversations all over the developed and emerging markets, there has never been a better opportunity for hedge funds. Investors have an appetite, in the right circumstances, for that style of investing. It is an interesting interplay between the constraints of the changes in regulation and the industry's emergence from the deep recession that started in 2008.

The global hedge fund manager has successfully evolved due to changing regulation. The question now is: how will the regulation impact the global nature of our business? Investors and managers may pick their customers and providers based more on geography.

HEDGE FUNDS REVIEW: How will the Foreign Account Tax Compliance Act (Fatca) impact the hedge fund manager and investor?

Marina Lewin: In addition to Dodd-Frank, US legislation such as Fatca is changing the dynamic, particularly for non-US investment managers with a US client base. It changes the dynamic of the reporting they have to carry out and the level of look-through they have to achieve in order to comply.



BNY Mellon Alternative Investment Services
Marina Lewin, global head of business development



Fatca will be an interesting factor in terms of how investment managers choose their investors. They will have to do reporting for an entire client base where only a percentage may be US investors. Will that change their views and to whom they target their funds? Do they have additional funds targeted to US investors that will have to do this reporting? Do they have the ability to look past nominee names into the individual investors for reporting purposes?

That, combined with the needs of the institutional investor market, which is very attractive to the global manager, means that managers will have to build those look-through capabilities and work through their providers for reporting because the nature of the investment community will require it.

HEDGE FUNDS REVIEW: With record new launches in 2011, what can you do to help start-ups cope with regulatory requirements and investor demands?

Marina Lewin: From a manager's perspective, it is important to have the right distribution channels in place from the beginning to help achieve target growth. There is a multitude of providers that can help them get through some of the reporting requirements and investor demands. Service providers are stepping up to assist them.

HEDGE FUNDS REVIEW: What are the biggest reporting and compliance challenges?

Marina Lewin: One of the biggest challenges is defining roles and responsibilities in relation to reporting and compliance. We need to see how we can assist our customers in a way that allows them to fulfil their obligations as an investment manager, and for us to be able to provide them with the information and services to support them in running their business.

It is very important to define who is responsible for what aspects, what a provider can and cannot do – or will and will not do – in support of the regulation. Nobody should make assumptions about who is doing what. There needs to be a clear communication channel so that all parties involved understand what the impact of the regulation is going to be and ensure that there is a clear designation of roles and responsibilities.

HEDGE FUNDS REVIEW: What are the trends in reporting?

Marina Lewin: More frequent valuations and reconciliations are a fact of the industry. We assume every customer, irrespective of liquidity, needs a daily process. We follow a daily process, whether it is just a soft portfolio evaluation reconciled to counterparties and custodians or a full gross asset value calculation or, in some cases, even a full net asset value calculation.

HEDGE FUNDS REVIEW: What are the main danger points for hedge funds and service providers?

Marina Lewin: The first risk I see is entrepreneurial innovation being reduced. While there have been multiple launches over the last year, the size of the launches has become smaller. It will be a challenge to find service providers and partners that want to make an investment in resources to facilitate all of the data feeds that are now required. It is not insurmountable, but it will be harder for investment managers to start out.

There is also the danger of increasing cost. Increasing data flow obligations and taking on additional liability and functions are going to add significantly to the costs of the investment manager, which will accelerate in an environment where returns have been inconsistent.

One other thing that is not often talked about is the area of data confidentiality. There are increasing amounts of data being circulated to multiple parties. Service providers and investment managers worry where the data is going, who is going to look at it and who is going to protect it? For this reason, data security is emerging as a major global concern.

HEDGE FUNDS REVIEW: What are the trends you see in the industry?

Marina Lewin: We are seeing the emergence of credit funds. It makes complete sense as there is a lot of debt overhang globally, and some of that is being bought out at lower prices. That creates opportunities to recognise some value in the long run for quality holdings and arbitrage.

We are seeing continued use of the private equity structure to facilitate that investment. Investing in distressed securities globally, utilising a private equity structure, requiring a custodian and requiring an administrator but leveraging a



private equity structure because it is closed ended. Using that structure, managers can call capital when they have found investment. They are also less impacted by the monthly variations in valuation that a hedge fund would hold. As it is closed ended, there is a longer time horizon to recognise some of the value of this debt.

HEDGE FUNDS REVIEW: Do you see Asia as an area of opportunity for growth for yourself and the industry?

Marina Lewin: The growing Asian economies hold terrific ongoing opportunities for investment in the region. Many of the largest managers have offices in Asia. From an investor perspective, you have the sovereign wealth funds in Asia – among the world's largest institutional investors – that are trying to understand how they manage their operational flows, how they manage their data and how they manage the whole process of making investments into alternative managers.

A regulatory infrastructure is also emerging – definitions of what is domestic, what is global, what can be invested offshore or what domicile is preferred.

You also have the challenges of great distance. Nevertheless, the opportunities are tremendous.

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