

2008 may prove to have been a turning point for the hedge fund industry in many respects and 2009 is sure to bring fresh challenges, but also opportunities, for Ireland's hedge fund administrators.

The last four months of 2008 and the first two months of this year have seen out-flows of hundreds of billions of euro from hedge funds globally, and administrators, whose fees are linked to the net values of the funds they service, are experiencing an inevitable reduction in revenue in what is the industry's first serious down-turn in recent times. Headcounts at administrators have necessarily been rationalized, some administrators have re-assessed their client book and a certain amount of pruning is taking place. Many administrators are looking at greater off-shoring to facilitate increased efficiency and to reduce costs. The downturn in 2008 also brought with it many challenges to the role of the hedge fund administrator. Illiquid investments and large redemptions saw funds implement liquidity control mechanisms such as gating and suspension provisions, in specie redemptions, spin-outs, holdbacks as well as side-pocketing provisions. Few if any administrators would have previously experienced the scale of these measures or the pace at which they needed to be introduced.

The Irish Regulator announced two policy shifts in its domestic funds regulation in December which will facilitate Irish funds addressing these issues more readily. On 4<sup>th</sup> December, in a letter to the Irish Funds Industry Association, the Regulator agreed to consider the implications and merits of moving from a minimum activities regime for Irish domiciled funds administration to that of a control based environment. Currently, Irish funds are required to ensure that certain activities are undertaken by staff located in Ireland, however, the Regulator acknowledged in this letter that once the appropriate controls are in place in Ireland, there is scope for the activities themselves to be performed outside of the State. Also on 4<sup>th</sup> December, the Irish Regulator notified industry that it would not seek to limit the amount of an Irish fund's assets which might be allocated to a side pocket, partial suspension, or partial redemption arrangement and that the Regulator would not require prior notification of actions taken by the fund, but that the board of directors and the trustee would be required to provide written confirmation to the Regulator that the proposed action took into account the interests of all investors and was in accordance with the fund's rules.

The events of 2008 once again brought the valuation of illiquid assets and OTC derivatives into sharp focus. Looking from the outside in, it often looks as if there is what administrators would probably see as a popular misconception about their role in valuing these assets. At first glance, it would seem that the whole area of valuation falls within the remit of the hedge fund administrator, however, even though fund Boards would probably like for administrators to take more responsibility or at least to provide more guidance in this area, administrators tend not to see themselves as valuation agents, though some administrators provide this service. AIMA's Guide to Sound Practices for Hedge Fund Valuation and the IOSCO Report on Principles for the Valuation of Hedge Fund Portfolios both point towards pricing policies and pricing committees to provide a framework for sound valuation and to the ultimate responsibility of the Boards of funds, however, high level valuation principles are not enough of themselves and where an administrator does not, or cannot, take responsibility for a particular valuation or type of valuation, it would seem that clear and practical guidance should be available to the Board as to the appropriate steps to take, complementing applicable regulatory rules, financial reporting standards and industry best practice where necessary. It goes without saying that there needs to be uniform pricing standards and a uniform approach across the industry in this respect.

Unavoidably, the European hedge fund industry has seen a significant increase in litigation against hedge fund service providers in relation to matters such as fire sales, close-outs, redemption terms and valuations. Hedge fund administrators are not immune to these claims and, as part of the process chain may be victim to the initial approach of most law firms in civil litigation which is to sue everyone in sight when it is not clear where exactly the fault lies. Claims or threatened action will generally emanate from the party appointing the administrator or those having contractual privity, as investors will generally be prohibited under common law principles from suing the administrator directly. Generally, threatened legal action will arise most frequently as a result of error and any uncertainty in relation to the responsibility for the valuation of certain assets and any lack of disclosure by the fund to its investors in this area may accentuate this risk.

It is clear that hedge fund promoters will from now on spend more time choosing their administrators than before and matters such as the administrator's balance sheet, its shareholders and its independence will take on far more significance. We are seeing more managers looking to their

administrators to agree service levels, key performance indicators, and controls on changes to the administrator's services and more administrators are introducing these measures as standard features of their service and not just for their biggest clients. With regulatory changes coming down the line which may bring requirements for greater transparency, we see promoters looking to administrators who can provide a level of reporting and transparency that will satisfy these requirements, and, at the same time, which can satisfy the reporting requirements of institutional investors. It continues to be the case in our view that hedge fund managers ultimately want administrators which are sufficiently flexible to provide a bespoke service to the client and which have sufficient resources and finances to deploy if their service needs to be changed. As a sign of the times, it has also begun to be of concern to promoters whether an administrator will have sufficient resources to settle potential claims or, alternatively, that the administrator's insurance will cover potential claims.

At the risk of sounding naïve, there may be some cause for optimism despite the current market conditions. It is probably fair to say that it is a question of when rather than whether additional regulation will be introduced in Europe and the U.S that will affect hedge fund activity. The global financial crisis has led to what now seems to be an irresistible demand for greater regulatory intervention in the financial markets and it is hard to see how hedge funds will not be affected on a global basis. At the time of writing the European Commission's consultation has just closed on the development of "an appropriate regulatory initiative as part of the Commission's review of the regulatory and supervisory framework for all financial market actors in the European Union" and various state and federal legislative reforms have been proposed in the U.S. requiring either hedge fund registration or hedge fund manager registration among other measures. As perhaps the surest sign of all of where the market is moving, the Cayman Islands Monetary Authority is proposing tighter standards for hedge funds and is clearly seeking to re-brand itself as a more investor-friendly territory. It is not clear exactly what each of these developments will lead to in terms of concrete regulatory rules, though there seems to be a uniform acceptance that there will be greater transparency required of hedge funds, but the fact that hedge funds will be subject to a tighter regulatory regime from now on seems certain.

Increasing demand on the buy side for hedge fund products and service providers that are subject to regulatory oversight should be good for the Irish hedge fund domicile market and consequently Ireland's hedge fund administrators. The preference of investors for greater regulation is not a new development and has not resulted, it must be said, in any major gains by Ireland in terms of overall share of the global hedge fund domicile business relative to Cayman. Recent events suggest, however, that at least for the time being, a regulated offshore fund and a regulated independent administrator are in a far stronger relative marketing position than their unregulated counterparts. There is a growing trend for European hedge fund managers to look to package their strategies into UCITS and top tier hedge fund managers such as Marshall Wace LLP, Brevan Howard and others have already done so in the past couple of months. This trend does not necessarily bring with it the requirement for hedge fund administrators to adapt their skill-sets and processes to the retail fund environment as these funds will still tend to be sold exclusively to the institutional market.

Ireland is well positioned to take advantage of these trends both as an established offshore hedge fund and UCITS domicile and the leading hedge fund administration centre in Europe.

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