

## **The changing alternative fund infrastructure**

### **1. What have we seen recently?**

- **Demise of Prime Brokers – Lehman – and leveraged products**

**We have seen the collapse of Lehman Brothers and the near collapse, according to newspaper articles and gossip in the market, of Goldman Sachs and Morgan Stanley.** We understand that Prime Brokers may move away from providing leveraged products and we believe there may even be a move away from stock lending, providing borrowing facilities and custody to the more traditional segregated custodian set up. The historic functions provided by Prime Brokers may disappear. There have been too many recent examples of where better segregation of duties would have been more beneficial. And as global liquidity has dried up the Prime Broker is probably not able to provide one of its traditional functions.

- **Alleged frauds on the increase.**

**We have seen the alleged Stanford and Madoff frauds highlight some age old deficiencies.** The most recent high profile alleged fraud relates to the Stanford International Bank in Antigua, the claim centres on the issue of Certificates of Deposit (“CDs”) promising returns above market rate due to Stanford’s “unique investment strategy”. It is claimed these returns were fraudulent and the bank’s balance sheet erroneous for a number of years. Once more a lack of transparency, alleged fraudulent activities and inadequate due diligence now means investors may be left badly out of pocket. There are striking similarities between the facts coming to light in the Stanford and Madoff operating models; interestingly most of the points noted apply in any high profile investment fraud you care to mention from Nick Leeson through to Kerviel and even as far back as BCCI.

#### **No Segregation of Duties**

It appears that only Stanford and a very select few were privy to the investment strategy and trade placement process within the firm. The same is alleged to apply to Madoff and the same did apply to Leeson.

#### **Inadequate independence at board level**

Like Madoff, within Stanford International Bank, the independence at board level came from a family member, namely Alan Stanford’s father who held the position of Chairman Emeritus and who made his own money in cattle ranching. In any industry, but particularly within the regulated fund industry, true independent non executive directors are crucial in the governance framework.

#### **Consistency of Returns**

It was not the level of returns but rather the fact that they were unaffected at all by business cycles. Performance figures should have been benchmarked and excess returns understood and verified prior to investing in such “cash cows”. Both Madoff and Stanford had very consistent returns, albeit that some banks had raised concerns that the return reported was not possible.

#### **Audit Firm**

Stanford used the Antiguan based audit firm, C.A.S. Hewlett & Co for a company with a balance sheet of \$8 billion. The principal is a 72-year-old gentleman who has been auditing the bank for many years (at least ten). Larger internationally recognised audit firms had offices on the island, although in recent times they have not been without their problems, and it could be argued that they would have been better suited. Some suggest that it is good internal control practice to change auditors every few years, but this can be expensive and I am not a supporter of this idea. Although Stanford stuck with his auditor from inception, as did Madoff, so not a good endorsement

#### **Lack of independent administration**

It is arguable that a 3<sup>rd</sup> party administration firm is absolutely critical to ensure the validity of the valuation of investments and that this will also ensure the reconciliation of such holdings to a depositary or counterparty is undertaken accurately. The importance in my mind is the segregation of custody, fund accounting and investment management.

### **Lack of adequate Investor due diligence**

It is again quite obvious that prospective investors were blinded by greed and wowed by Stanford's reputation and charisma, as were the WAGS on that cricket tour. It is obvious that those investors, and in some cases investment managers of Fund of Funds, did not conduct a proper assessment of the proposed investments. I expect those investment managers are hiding under their desks in embarrassment. Interestingly some of the West Indian cricketers, who recently won money from Stanford's high profile Twenty20 winner takes all, invested their proceeds back with Stanford! I guess they thought they would stick with the person who made them rich.

### **Structuring business to avoid Regulatory oversight**

Stanford had offices across the globe but the investment business was primarily conducted through his Antiguan Stanford International Bank. Some of the feeder funds into the Madoff fund were also domiciled in the Caribbean and other less regulated jurisdictions. The case highlights the fact that low cost domiciles may not always have the regulatory structures in place. Given the recent high profile cases, smart investors will look for increased standards of transparency and regulation to help safeguard their investments.

### **Charismatic Central Figure**

Once again it appeared the central figures standing in society meant that those with oversight responsibilities were blinded by reputation. One must remember that in Antigua, Stanford owns the country's largest newspaper, heads a local commercial bank, and is the first American to receive a knighthood from its government making him an "untouchable". Madoff reportedly used socialites to do some of his wowing and gave his investors a feeling of being in a very posh club.

### **Prior Warnings**

In November 2007, the Financial Industry Regulatory Authority (FINRA) fined Stanford Group for distributing marketing materials that "failed to present fair and balanced treatment" of the risks and potential benefits of a CD investment. Harry Markopolos wrote to the SEC several times with suspicions that were not followed up upon in the Madoff case. Complaints about alleged corruption should be a "tell tale" sign that maybe compliance is not considered so important.

It is no coincidence that these themes are consistent in each of these two recent scandals. They are the primary areas where fraudsters in investment firms may be able to take advantage. Independent oversight and a strong governance framework are necessary tools to avoid being a victim of such ploys and everyone within the asset management industry must look to these points and ensure robust systems of control are in place to avoid massive monetary and reputation loss occurring.

- **Global Banking Crisis has lead to Nationalisation of major banks.**

We have seen a global banking crisis of proportions not seen before that has lead to some household banking names nationalised. Northern Rock being the first and a number of other banks with a high proportion of ownership held by HM Government. Nationalised by any other name.

This quote provides an amazing foresight albeit 142 years earlier than the current banking crisis. I guess most predictions come true given enough time.

"Owners of capital will stimulate the working class to buy more and more expensive goods, houses and technology, pushing them to take more and more expensive credits, until their debt becomes unbearable. The unpaid debt will lead to bankruptcy of banks, which will have to be nationalised, and the State will have to take the road which will eventually lead to communism". Karl Marx, Das Kapital, 1867.

- **FSA being branded a "light touch" regulator.**

We have seen politicians and reporters get on the bandwagon branding the FSA as a light touch regulator. The FSA would say that it regulates based on assessing the senior management of a regulated company and deciding whether it can be trusted. If they can be trusted they can be left to get on with running their business. Now it is alleged that many of the management teams the FSA

thought were trustworthy and competent have actually proven to be far from it. Therefore the FSA, and other regulators who have adopted a principle based approach to regulation, will robustly challenge more activities; especially the corporate governance and risk framework around management going forward.

## 2. What trends do we expect to see from what we have seen

We believe there will be a rethink on a number of regulatory and business fronts.

- **Moving to higher regulated offshore domiciles**

We know there is discussion in the market place about the domicile of funds and we can see that some traditional hedge funds domiciled in the Caribbean might move to Dublin or Luxembourg to use the UCITS “badge of honour” and therefore become a regulated product. The UCITS brand is universally known and its objective of spreading investment risk is well known to regulators globally. The UCITS 3 product has significant flexibility and allows for a lot of the investment strategies only previously available in hedge funds. Additionally a Professional Investor Fund or a Qualifying Investor Fund could be used to give further investment diversity, albeit in a regulated environment.

Whether traditional Caribbean Hedge Funds will move to another jurisdiction – possibly the Channel Islands or the Isle of Man - because such jurisdictions have been around for a long time and provide tax sheltering for specific products I am unsure. I consider if the fund is more retail by nature then for distribution purposes a Dublin or Luxembourg UCITS would be preferred over the Channel Islands or Isle of Man Fund.

However, we may see new fund structures being set up in the Channel Islands or the Isle of Man if the investor is more institutional based or a listing on the UK AIM is required. I know a number of AIM listed funds are domiciled in the Isle of Man. **It goes without saying that these domiciles do provide tax benefits to fund structures and have become popular for various categories of alternative funds.**

However moving to a higher regulated offshore domicile does not resolve all issues and it is not to say that the more regulated offshore centres will not have issues with the governments of the OECD countries in the future.

- **Better Corporate Governance**

The recent period has been one of bleak financial data and economic news generally. Ireland in particular has been affected by negative news in relation to the behaviour of senior executives within the major Banks, major failings in the general governance structures of those financial institutions, a prevailing culture of rule breaking and the implication that unfavourable practice were conducted to the benefit of a “Golden Circle” of privileged clients.

I do not wish to dwell on what has been written about ad infinitum recently and it should also be said, in Ireland’s defence that it has moved up the rankings as an offshore fund domicile because of the high standards of administration services it provides, but the whole Irish episode has put corporate governance once more in the spotlight and it is evident that there will be pressure on Ireland’s Director of Corporate Enforcement to deal with Directors not acting in the best interest of their investors harshly – this applies as much to the funds industry as it does the banking sector.”

- **Fund Promotion Requirements**

Appropriate disclosure requirements are the corner stone to accurate Fund Prospectus. Investors are scrutinising Fund Prospectus in the current economic climate to see if there is any possibility to reclaim losses from investment managers and promoters. We see this trend continuing and the legal profession being busy.

For example. in light of the turmoil with regard to the money market asset class in the last year or so, the Irish Financial Regulator now requires confirmation from Fund Promoters of new money market funds that the promoter does not envisage that the fund will require liquidity support. In addition, the Fund’s prospectus must include a risk warning drawing the investor’s attention to the differences between an investment in a money market fund and a deposit

- **UCITS IV Ratified by European Commission**

However, the one silver lining in the big black cloud over the financial services industry was the EU Commissions approval of the UCITS IV proposals which it is hoped will add impetus to the UCITS brand when introduced. We consider this a positive trend but are not holding our breath. On January 13<sup>th</sup> the European Commission approved the proposed changes to the UCITS Directive, including the controversial full Management Company passporting arrangement. It is expected that the actual agreed detail and implementation across Member States will occur in late 2010 / early 2011. However, the two offshore centres in Europe will probably be slow to implement and continue with their protectionism attitude.

If this is implemented it will be good for investors and should lead to a rationalisation of the number of funds.

- **Banking qualitative guidance**

Due to the global banking crisis Banking supervisors have produced detailed qualitative guidance setting out more detail on individual liquidity assessments and noting issues relating to intra-group cash flows. This will be a major compliance related issue during 2009.

### **3. IMPACT ON OFFSHORE CENTRES OF RECENT EVENTS AND TRENDS**

So what has been the impact on the various offshore jurisdictions of recent events and trends?

- **Recent scandals / bleak news**

It is difficult to say what the full impact of the recent Stanford and Madoff scandal in the Caribbean and the well publicised Irish issues will have on offshore centres. These two centres are perceived to be very different offshore centres and they are certainly not the only jurisdictions that have "skeletons in the closet". I believe after a period of time and an improved economic climate that the scandals will, like previous scandals, fade into the distance. Greed will still exist.

- **Political awareness**

I hope that these issues do not lead to knee jerk changes in regulation as was the case after the Enron collapse. However, it has been well publicised that President Obama has a stated mission to reduce the Caribbean and other tax havens as a jurisdiction of choice for funds for US citizens. I'm not sure whether he will do this with legislation or tax penalties, but it is on his agenda. So this is something to look out for, however, I suggest he looks in his own back yard first, namely Delaware, before he starts criticising other jurisdictions.

The UK government have suggested that a campaign could see Britain targeting some of its own overseas territories such as the Cayman Islands and the British Virgin Islands. The blacklisting threat comes as the British government calls for a review of Channel Island domiciles such as Jersey and Guernsey. Offshore centres that refuse to participate in tax agreements may face economic sanctions from the US and EU governments according to initial reports from the G20. The British government made clear that enacting economic sanctions for failing to comply with requests is a possibility and requested that this be discussed during the forthcoming G20 meeting. The G20 is believed to be drawing up its blacklist from three overlapping groups of centres which still have no double taxation conventions;

- those which allow nations to swap information on taxpayers in each other's jurisdiction;
- those which have refused to accept the idea of new Tax Information Exchange Agreements which allow one nation to require another to find extra information on a suspect; and
- those which agreed in principle to Tax Information Exchange Agreements but have failed to sign them.

France and Germany also proposed earlier this month a fresh crackdown on tax havens and offshore financial centres, insisting that banks that use them be forced to put aside higher capital to offset the risk to the financial system. The French Finance Minister and her German counterpart said they wanted leaders meeting at the G20 summit on April 2 to sign up to the idea that banks

and insurers should be forced to disclose their use of tax and regulatory havens in their annual regulatory filings. They would have to provide regulators with general information about the size and nature of their transactions with these jurisdictions, data that could be used to trigger higher capital requirements.

- **Knee jerk regulatory changes**

We have seen the wasted time, energy and effort that went into Sarbanes Oxley as a result of poor thinking by the US Congress. However, it did make the big four accounting firms richer albeit with little impact on financial control or controlling fraud. In my opinion there is no need to increase regulation in the regulated offshore centres, the issue is to enforce and monitor existing regulations. That together with good business controls, assurance of segregation of duties and strong corporate governance is what a successful offshore jurisdiction should be aiming for.

- **Segregation of duties**

One criticism that has been forthcoming on some offshore jurisdictions is the lack of Governance required and the requirement to segregate duties; such as custody, investment management and pricing. A good offshore centre should require appropriate segregation of duties as a minimum.

I believe the offshore centres that will survive will be those that continue to look to sound business principles to attract future fund sponsors and investors.

#### **4. CONCLUSION**

- **Will investors be more aware of where and how their money is invested?**

**Will investors be more aware of where and how their money is invested?** I doubt it very much. But they might shy away from those offshore jurisdictions that have had bad publicity in the most recent past. The sound of a regulated product as opposed to an unregulated product in these current economic conditions may persuade investors to choose the jurisdiction of the fund they invest in more wisely.

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