

Bermuda works to become first choice

HFM: The increasing number of institutional investors implies greater volatility constraints for hedge fund managers. How can the industry avoid diminishing returns as a result?

Chad Critchley (CC): I think what you will see is the industry offering more multi-strategy funds to investors, involving different share classes with different strategies. An investor can then choose to invest based on the risk strategy and their appetite for volatility. The investor could still invest the same amount of assets but perhaps allocate less to the riskier strategies and still be in compliance with their individual investment guidelines or mandates. If investors have concerns about cross liability between classes and the chance of a significant loss in a riskier strategy, hedge fund managers may want to consider using a segregated account structure, which is offered in Bermuda. This would protect the less volatile share classes from any potentially negative impact, should a riskier share class suffer large losses, and still addresses the volatility concerns of investors.

Andrew Collins (AC): I'm not sure about the point regarding volatility. I think what institutional investors tend to want is more transparency. If they're keeping an eye on their investments on, very often, a daily basis, they want to know exactly what risks they are taking in any particular fund. In that sense, that's more important than the governance. They do a tremendous amount of due diligence on us as administrators, so they're driving the standard of our work higher and higher.

Anthony Whaley (AW): Fund managers are increasingly looking at alternative investment strategies as alpha-generating products. We have particularly seen an increasing use of private investments by hedge fund managers. However, the illiquid nature of private investments raises valuation, compliance and other fiduciary issues. Additionally, in order to ensure hedge fund managers have the opportunity to continue with their investment programme without the need to return

capital to shareholders at an inopportune time, a number of techniques have been developed for managing liquidity, such as the use of longer lock-ups, 'gates', suspensions and in-kind payments and the growing use of special investment accounts, or 'side pockets'.

How has the Bermuda Monetary Authority's (BMA) new regulatory framework fared in attracting a wider range of investors in high-quality funds?

AW: The new Investments Funds Act 2006 (the 'Act') creates a new category of authorised fund, namely administered funds, in addition to the current institutional schemes and standard schemes. There will also continue to be a category of exempted schemes. Such exempted funds will continue to be 'out of scope' for the purposes of the European Union Savings Directive in Switzerland. The new Act brings more clarity and certainty about the process for hedge fund authorisation and continues to allow a high degree of flexibility.

CC: To date we have not really seen much of an impact. The challenge is for interested parties within the industry in Bermuda to educate onshore lawyers and investment managers of the impact and changes, as they usually make the domicile decision. The changed legal definition of a collective investment scheme under the Collective Investment Scheme regulations now includes partnerships and closed-ended funds. This provides a choice of alternative structures for hedge fund managers to offer to their investors, in turn attracting different types of investors to Bermuda funds.

The change to the regulations allowing mutual funds, which meet certain requirements, to apply for classification as an exempted scheme addresses the Swiss authorities' EU Savings Directive concerns. This should allow funds from Swiss investors to continue flowing into Bermuda funds. Lastly, the requirement for fund administrators to be licensed and maintain a minimum amount of net assets, adequate accounting systems,

internal controls and insurance coverage should have a positive impact, attracting investors who require a more regulated but flexible domicile. Bermuda should see the benefits of these changes over the next few years.

AC: I think it's helpful. One of the things that offshore islands are capable of doing – and need to do all the time – is make their legislation as clear and as flexible as is consistent with good governance. Any move at any time to improve the legislation and the regulatory process is good news. To measure the impact is a bit difficult from day to day, but in general it's obviously very important.

What impact has the entrance of companies like Citigroup, BISYS and The Bank of New York had upon the growth of the hedge fund and trust sectors in Bermuda?

AC: I think the overall change is one from where offshore providers were strictly offshore to a position where the administrators are now in many locations and can provide the service and the technology from a variety of places, which gives one flexibility to provide the resources to service and grow the business.

CC: I think they've had a positive impact on growth as these are reputable blue chip organisations that have a physical presence in Bermuda, enhancing the reputation of Bermuda's hedge fund industry. This may not be directly seen in the number of funds picking Bermuda as the domicile of choice, but these companies have provided additional resources for the organisations to invest in and enhance their infrastructure. As a result, these administrators have been able to increase the size of their organisations, gain process efficiencies, including timeliness of services, increase the number of funds under administration and offer their clients new and additional services. The combination of these actions has seen the hedge fund expertise in Bermuda rise to a new level. This continues to increase Bermuda's reputation as a quality jurisdiction.

AW: Over the past five to 10 years, Bermuda has seen a growing number of blue chip administrators set up operations and this has had a tremendously positive impact on the hedge fund and trust sectors in Bermuda. The new Investment Funds Act 2006 also introduces a new licensing regime for fund administrators. The proven quality of these first-tier administrators, along with our sophisticated and well-developed infrastructure, is yet a further selling point for our burgeoning hedge fund and trust sectors.

Attracting qualified accountants is a continuing problem in the expansion of Bermuda's financial industry. What is being done to address this important staffing challenge?

AC: I don't think that's true at all. What we've found is that it's simply the time it takes to actually bring someone in the

door that's a problem. Bringing them in the door is not in itself a problem; it's just reacting to a change in business levels that is a problem. The resource issue is one of speed and flexibility in responding to need.

AW: The continued growth of Bermuda's financial industry needs to be serviced by qualified professionals. Bermuda's population is not sufficient to produce the required numbers to fill all of these positions and, on that basis, non-Bermudian workers must be recruited. Many service providers in the financial industry in Bermuda have training programmes in place in order to train Bermudians to fill as many of these positions as possible. In the interim, many companies are able to exempt a number of 'key' employees, including accountants, from the rule which limits the majority of non-Bermudian workers to six years.

CC: Organisations have had to try different

methods of recruitment, including recruiting from countries they would not have otherwise considered a few years ago. Our office has around 25 different countries represented, which is a significant change from a few years ago but makes for a very unique and diverse work environment.

Continuous recruiting throughout the year and using recruiting firms gives organisations the appropriate resources they need in order to take advantage of current opportunities. They have also invested additional resources in technology in order to automate as much of their processes as they can to gain efficiencies and mitigate the staffing challenges. Lastly, you also see organisations looking at setting up offices in other cost- and time-friendly jurisdictions such as Canada and India. These offices may be used to perform some of the routine work, which can then be reviewed by the office in Bermuda.



Has progressive legislation on the part of the Ministry of Finance and the BMA helped Bermuda to counter the Cayman's claim of dominance over the offshore fund industry?

CC: I believe the legislation has helped Bermuda and will continue to help it in the future but Cayman is still the domicile of choice. The 2005 change in the Bermuda incorporation and approval process of establishing a fund was a step in the right direction, as the time it takes to establish a fund in Bermuda or Cayman is now about the same. In order for Bermuda to start catching up with Cayman, the industry participants (service providers such as the lawyers, administrators, auditors and government) need to spend time educating the onshore lawyers and investment managers about the recent changes and increase promotional activities about the jurisdiction. Also, there are many funds that are not domiciled in Bermuda but are administered here due to the quality and presence of the administrators located in Bermuda.

AC: The Bermuda International Business Association (BIBA) and the industry generally have been engaged in developing it with the government. As usual, the industry works with the government to come up with the right legislation, and I think it will be very helpful. I don't have the exact timetable, but it's very close to being implemented.

As far as Butterfield Fund Services stands – and our competitors as well, in the field of administration – we're a little bit agnostic, because we can administer Cayman funds in Bermuda or anywhere else, so we're concerned that our clients should do what they're most comfortable with. A lot of legal firms in Bermuda are in Cayman as well, so they've taken a similar approach. The question of jurisdiction is only of significance in terms of the amount of legal work in the jurisdiction, but otherwise it doesn't impact our business. If the client chooses to incorporate in Cayman, the BVI, or Bermuda it's not a decision that impacts our business as such. We advise on it but we're not pushing Bermuda more than Cayman or anywhere else. We take the client's interests into account – that is the major factor.

AW: The pre-approval process recently introduced by the BMA means Bermuda can now point to a number of examples and boast that funds can also be incorporated in Bermuda within 24 hours. There is no longer a requirement for prior approval by the Minister of Finance for the formation of a hedge fund.

On the private equity side, changes in partnership legislation have resulted in



Chad Critchley began his career with Ernst &

Young in 1988 and was promoted to partner in the Assurance and Advisory Business Services Group in 2002. He is the office's country director of audit and accounting and country independence leader.

the removal of a requirement to make the register of limited partners available to the public, as well as certain other procedural requirements. New legislation was also introduced that provides an option for limited partnerships to become legal persons by registration.

The Companies Amendment Act 2006 will be one of the most flexible and simple vehicles to operate in international transactions. Of particular interest to the hedge fund industry are the provisions which make the Companies Act 'E-friendly'.

The previous minimum share capital requirements have been abolished. Written resolutions may now be effective when the same majority as would be necessary for a physical vote have signed the written resolution – unanimity is no longer necessary.

Bermuda was one of the first jurisdictions to pass segregated accounts legislation, enabling companies to legally separate and therefore 'ring-fence' the assets and liabilities of one account or portfolio from the assets and liabilities (and creditors) of the other accounts or portfolio within the same company.

Bermuda's flexible, user-friendly regulatory framework facilitates the convergence of hedge funds and the Bermuda Reinsurance Market – several sidecar reinsurers have been established in Bermuda by a variety of hedge funds and private equity funds wishing to participate in the property catastrophe market.

In the face of increased scrutiny by the UK Financial Services Authority (FSA) and the Securities and Exchange Commission (SEC) and greater demands from institutional investors, what steps towards

corporate governance have been taken by the industry?

CC: We have observed that directors are taking a more serious look at the responsibilities they must fulfil. This has resulted in some administrators resigning as directors in order to minimise their business risk. Other administrators have continued as directors, believing the more involved in the fund they are, the more influence they have on governance and viewing this as a method of reducing their business risk. There are some recently formed organisations that offer independent director services. These directors generally have good offshore experience and industry knowledge and are a significant step towards enhancing the governance of a fund. Some funds have formed audit committees and are following the best practices of audit committees for public companies. Also, investment managers who are registered with the SEC have employed chief compliance officers, internally enhancing the overall compliance of the fund in meeting applicable regulations and laws. As institutional investors' money in hedge funds increases, along with greater scrutiny by regulators, the importance of good corporate governance will increase.

AC: I think there are two elements to it. One is corporate governance and one is taxation for the onshore locations – the Inland Revenue in the UK certainly. Interest in that aspect of scrutiny is not so much driven by governance as by the need to maximise tax revenue. In terms of governance, it's like compliance and everything else



Anthony Whaley joined Conyers Dill & Pearman

in 1991. He has been a partner in the Corporate Department since 1995. His practice includes all aspects of corporate and commercial law with specialist expertise in securities law and the establishment of mutual funds, unit trusts, partnerships and other investment funds.

– it's an ever-changing scenario. If you look at institutional investors then of course the most lightly regulated place might be said to be Cayman, but it's also the one with the most institutional investors. So, institutional investors obviously make themselves comfortable with the governance of the funds they're investing in. I think it's driven that way. There's no evidence that I'm aware of that they're dissatisfied.

AW: In the UK the FSA has warned hedge funds about the use of side letters, indicating that, if they are used at all, they should be disclosed to all investors. The SEC is also said to be focusing on whether appropriate disclosure of these arrangements and related conflicts are being made to investors. As a firm, Conyers Dill & Pearman has for several years been urging the exercise of caution by our clients when entering into these arrangements. However, we now see hedge fund managers taking greater care to review existing disclosure relating to side letters and ensure that conflicts are properly disclosed.

Greater caution is now being exercised with respect to provisions that purport to give certain investors enhanced liquidity rights or transparency to portfolio holdings. Hedge fund managers are putting increased time and effort into reviewing their compliance procedures on issues relating to valuation of portfolio investment, the fairness of valuation procedures being used, the use of soft dollars, insider trading and disclosure within the funds' marketing materials and offering memorandum.

We are also seeing greater steps being taken towards the appointment of independent directors to hedge fund boards.

How has the adoption of the Financial Accounting Standards Board's (FASB) fair value exposure framework affected the valuation methodology of hedge fund managers?

AC: From the discussions I've had – I attended a seminar at the GAIM conference in Boca Raton (Florida) last week – it's still being developed. I think it will be very helpful and there are some interesting questions raised by it. It will continue to develop the processes by which valuation is arrived at, so it does pose a number of questions, but I wouldn't say that anyone has addressed them yet. It will certainly result in a lot of activity – and work – for managers and administrators, with them having to work together even more closely in resolving them.

The auditors will take the view that it is the managers' and administrators' responsibility to come up with categorisations for valuation. At the same time, I always take the approach of trying to ask the auditors what position they're going to take when it

comes to the audit at the end of the year, so we're not valuing something on a basis different from what they would insist on as being fair value for the annual accounts.

CC: I think it is too early to assess. FAS 157 does not need to be adopted until year ends beginning after November 15 2007. Therefore, it is effective for 2008 calendar year end. Over the next year, there will be much discussion among investment managers, auditors and administrators about the challenges regarding valuation methodology, assumptions used and supporting documentation. For example, in situations where, historically, a manager or administrator may have been able to set fair value at cost, due to the absence of readily available market inputs and/or it being a recent purchase, they will instead need to perform a rigorous analysis to justify the fair value with the best available information they can obtain. The standard also requires certain disclosures from the beginning of

'The Investment Funds Act 2006 should greatly enhance Bermuda's competitive edge in the global industry'

Anthony Whaley, Conyers Dill & Pearman

the year in which it is adopted, so if the fund has a calendar year end, management should be taking certain actions at the 31 December 2007 year end to ensure they capture the information they will need to meet the disclosure requirements for the fund's 2008 year end.

Will the Investment Funds Act 2006 further advance Bermuda's competitive edge in the global fund community? What regulatory/other advantages does it offer?

CC: I think the changes to the Investment Funds Act continue to demonstrate and reinforce Bermuda's claim that it is a high-quality jurisdiction. Industry participants were given the opportunity to have input into the changes and, as a result, overall they are very positive about the changes. The enhancement of the BMA's powers to intervene with a fund, should problems arise, is in line with other global regulators. The requirement for administrators to be licensed is also similar to other jurisdictions and should provide additional comfort to those investors who are looking to invest in offshore hedge funds. Overall, I think it is another very positive step forward for Bermuda in the global market.



Andrew R Collins is managing director of

Fund Services (Bermuda). He is responsible for fund administration and corporate trust services provided by the bank in Bermuda. He is also a director of the bank's fund administration service companies in Guernsey and the Bahamas.

AC: It's a continuous process and obviously the more you keep your legislation up to date, the more you rationalise it and clarify it, the better. I don't think it's a dramatic change from one day to the next. It's an update, an improvement, and that's a continuous process. The commercial demands of investors on a day-to-day basis are more relevant, I think. Nevertheless, it's essential that you do update your legislation in order to not have disadvantages or bottlenecks compared with other jurisdictions. Because this kind of business is important to them generally, the advantage that offshore places should have over onshore locations is that their legislation is up to date. In the USA and the UK there are lots of other issues to deal with, other than the funds industry, whereas in Bermuda it should be higher up the list.

AW: It should greatly enhance Bermuda's competitive edge in the global fund industry. It is no secret that the Cayman Islands is the leading offshore jurisdiction but the importance of Bermuda cannot be underestimated. There are over US\$180bn of fund assets domiciled in Bermuda, with over 2,000 collective investment schemes registered here. The new Act is consistent with our risk-based approach to regulation and should simplify and add more clarity to the authorisation process. The fee structure introduced by the new Act is extremely competitive. Any readers who want a summary of the changes that the new Act will effect can visit our website at www.conyersdillandpearman.com or contact me at anthony.whaley@conyersdillandpearman.com. ■