



US Hedge Funds 2009

**Experts predict
growth by fourth
quarter**

**Growth of new
alternative asset
classes**

**Investors drive
growth in service
provision**



In this issue...

03 US hedge funds industry: Experts predict growth by fourth quarter

By Suchita Nayar

06 Building a leader among small law firms in financial services

Sadis & Goldberg LLP

09 Investors drive post-Madoff growth in service provision

By Suchita Nayar

12 The life settlement asset class

By Mark Todd, Maple Life Financial

Publisher

Publisher/Editor-in-Chief: Sunil Gopalan, sunil.gopalan@hedgeweek.com

Sales Manager: Simon Broch, simon.broch@hedgeweek.com

Marketing Director: Oliver Bradley, oliver.bradley@hedgeweek.com

Graphic Design (Special Reports): Siobhan Brownlow at RSB Design

Photographs: NYC & Company; freefoto.com; Siobhan Brownlow

Published by: Hedgemia Limited, 18 Hanover Square, London W1S 1HX

Tel: +44 (0)20 3159 4000 **Website:** www.hedgeweek.com

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US hedge funds industry: Experts predict growth by fourth quarter

By Suchita Nayar

Following a dismal 2008, when will the US hedge funds industry show signs of recovery?

This question has steadily made the rounds among fund managers, institutions, endowments, pension plans, and other quarters, especially during the October-December time-frame as things got extremely dire. Losses escalated and

market exits were jammed with investors stampeding to redeem their capital. Some funds have already closed doors and additional casualties are likely this year. Total asset contraction of around USD1trn - USD1.2trn could occur this year.

Bernard Madoff dealt the industry another major blow. The once-famed investor allegedly wiped out some USD50bn of assets



"I expect spectacular growth of hedge fund assets to start during the fourth quarter."

Andrew Lo, MIT

he managed for funds of hedge funds, endowments and others, leaving many wondering if limited partners would return to hedge funds, without which hope for the industry's survival tanked. Some funds are decimated and additional casualties are likely this year.

Investors, meanwhile, fear other Ponzi schemes could be revealed this year amid the continued spate of redemptions. While there's still a fair amount of pessimism to go around, hedge fund practitioners are clear of one thing: what hasn't killed them will make them stronger.

Given the magnitude of market movements caused by hedge funds in 2007 and 2008, whether as a result of deleveraging or investor redemptions, it is now known that hedge funds are no longer a little niche industry for sophisticated investors and have come of age, says Professor Andrew Lo, director of the laboratory for financial engineering at MIT Sloan School of Management, Cambridge, Massachusetts. "The investor backlash against hedge funds has largely been an emotional one. In three-six months, I suspect there will be a backlash against this backlash. I expect spectacular growth of hedge fund assets to start during the fourth quarter."

His optimism is based on the view that the latest wave of deleveraging, asset firesales and corporate restructuring will

present once in a lifetime investment opportunities. And those plays will create the biggest hedge funds of the future, provided regulatory oversight does not get too heavy-handed. "The industry will rise from its ashes this year," adds Lo.

But the turnaround will be bumpy. As a year of continued deleveraging, 2009 will be more complicated than 2008, as managers now begin to sell illiquid positions, especially in credit, convertible arbitrage and fixed income, having already offloaded what they could sell easily. Even a single forced sale could trigger major market dislocation, which will then pose serious repercussions for hedge funds as a whole. "All you need is one burning match and the whole forest can go up in flames. That may not happen, but you never know what may happen when people panic," reckons Lo.

Yet, early signs of revival are emerging. Following last year's financial bust, "a restaging of talent cycle" is now taking place, says Anthony Scaramucci, managing partner of fund-incubator Skybridge Capital, New York. Many portfolio managers and proprietary traders with unblemished records are looking to strike out on their own. Yet, it is taking longer to get things off the ground. Fund-raising is subdued partly because hedge funds are wrongfully being seen as social pariahs, which will take time to burn off. Says Scaramucci: "2008 was a very humbling experience. Everybody ate crow. Everyone was set back. But that doesn't mean the industry can be written off in its entirety. It has a bunch of people determined to succeed."

Moore Capital alumnus Stanley Shopkorn is one such example. Via his newly established Hilltop Park Associates, he launched his fund on 1 October with roughly USD100m. It took grit to set sail amid a raging storm: markets had gone awry following the collapse of Lehman Brothers and the near-brink condition of a few others. Banks, desperate to apply a tourniquet on their wounded balance sheets, were calling back financing lines they'd sold to hedge funds. Managers had to sell assets at fire sale prices to pay back money, further pushing down asset values. In the interim, investors started fleeing in droves, forcing more bargain asset sales.

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SadisGoldberg LLP

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NEW YORK
551 Fifth Avenue, 21st Floor
New York, NY 10176

Ron S. Geffner
(212) 573-6660
rgeffner@sglawyers.com

Douglas R. Hirsch
(212) 573-6670
dhirsch@sglawyers.com

CALIFORNIA
50 California Street, Suite 2320
San Francisco, CA 94111
(415) 490-0561

Building a leader among small law firms in financial services

In troubled times, many financial services companies are finding it hard to focus on boosting their business, while dedicating time and resources to complying with legal requirements. Hedge funds, for example, would rather focus on what they do best – seek alpha, and leave the legal and compliance requirements to other, experienced firms.

Hedge funds and to a lesser extent, private equity funds, have dramatically proliferated over the past 10 years. Given the growth of the industry and recent market events, impending regulatory reform is prompting hedge funds and financial services companies to rethink their legal strategy and representation. Although there are many law firms servicing the financial services industry, only a handful of those firms stand out.

One law firm that has been constantly hitting the news of late is Sadis & Goldberg LLP. Sadis & Goldberg, established in 1997, is internationally recognized for its financial services practice and represents over 600 hedge funds, private equity funds and fund of funds in the United States and abroad. The company was recently ranked fifth in Alpha Magazine in the Top Onshore Law Firms category for 2008. The firm provides a wide range of legal services to those clients, including compliance, regulatory defense, tax planning, civil litigation, labour and corporate formation and restructuring. The firm's extensive experience in representing the financial community provides it significant economies of scale and the background to respond to most legal issues without time-consuming or costly research and analysis. By regularly monitoring state and federal regulatory developments, the company keeps its clients well advised.

Sadis & Goldberg Partner Ron S. Geffner,



Ron S. Geffner, Partner, Sadis & Goldberg LLP

who oversees the Financial Services Group and is a former enforcement attorney with the US Securities and Exchange Commission, is a familiar face on Fox Business News, CNBC and Bloomberg. Geffner's broad background with federal and state securities laws and the rules and regulations of the National Association of Security Dealers, Commodities Futures Trading Commission and various other regulatory bodies, enables him to provide strategic guidance to a variety of clientele. "Our success can be attributed to the expertise and hard work of all the members of our firm," says Geffner.

An additional attribute of Sadis & Goldberg is its very diverse business portfolio. The firm's clients include domestic corporations and financial institutions, venture capital and buyout funds, and corporations and entities that conduct commercial and financial activities. Geffner notes: "We have a very diversified portfolio of clients that operate in a number of different industries, including manufacturing, communications, consumer and luxury products, hospital management, information processing, insurance, investment banking, textiles, new media, software, wireless, brokerage, hedge funds and venture capital."

Geffner regularly structures, organizes and counsels investment entities, including hedge funds, private equity funds and venture capital funds in connection with regulatory investigations and actions. "Given all the turbulence in the financial services industry and the upcoming regulatory changes being mandated from Washington, the firm will adapt and continue to be responsive to the needs of our clients. I would describe Sadis and Goldberg like a football team – young and fast-paced and constantly changing our plays to win in the game..." adds Geffner. ■

- 4 ▶ “We knew going in unless we had significant commitment and confidence to build our business over time, it was not worth the brain damage,” says Jason Siegel, Hilltop Park’s partner and chief operating officer. In the current financial climate, hedge funds have become a “high conviction” business. Barriers to entry have “rightfully” skyrocketed and some other changes are afoot.

For example, it’s no longer sufficient for a manager to possess a performance history; prospective investors now want to dig deeper to verify what percentage of those is directly attributable to the manager. Additionally, prime brokerage is no longer the main way to raise capital; a start-up should either have a large network of prospective clients or be willing to launch with a smaller purse. And be prepared for more operational due diligence from investors, who are now rolling up their sleeves to peer under the hood, says Siegel.

He reckons the hedge fund marketplace will become stronger as a result of the ongoing upheaval. It posted positive “absolute return” in January, versus a loss of over 8% for the S&P500 benchmark index. More months like January will remind investors of the main rationale behind hedge funds being an integral component of a diversified asset allocation program.

Siegel notes that the faucet of fresh capital could get turned back on this year just as quickly as it was turned off last year, provided funds stay in the black even if overall markets stay bad. And leverage will eventually return to the market, albeit at conservative levels for now. Even so, he thinks those managers who produced unleveraged returns during 2008 will be among the top beneficiaries of future capital inflows.

But foremost, all managers have to prove their business model still works. They must demonstrate an ability to generate uncorrelated returns in down markets and with diminished asset bases, says Karim Leguel, investment chief at advisory firm Rasini in New York. He expects most managers will lower fees and give more concessions on capital they’ve frozen. Even so, a handful of high calibre managers may still be able to draw in longer-term capital



for particular investment opportunities and charge premium terms, Leguel adds.

In 2008, the HFRI Fund Weighted Composite, which contains around 2,200 constituent funds, declined 18.7%. Historically, research on the industry’s five worst declines shows that funds post average gains of 16% during the 12 months following the bottom of the decline, says Kenneth Heinz, president of Chicago data provider Hedge Fund Research. By extension, the losses in 2008, the worst in the history of the industry, could be followed by improved performance this year. But for now, even the best performing strategies, namely global macro and managed futures, continue to see capital outflows, notes Heinz.

Most hedge funds seem to have raised sufficient liquidity to meet redemptions. For example, Daniel Och’s Och-Ziff Capital Management is holding as much as 40%-50% cash in some of its funds to capitalize on new investments and meet future redemptions. Och-Ziff’s AuM of USD22.1 billion as of 1 January 2009 reflects USD5.7 billion in performance-related depreciation and USD5.4 billion in net outflows during 2008.

“Most hedge funds seem to have raised sufficient liquidity to meet redemptions,” says Michael Hennessy, managing director of Morgan Creek Capital Management, a fund



of funds firm based in Chapel Hill, North Carolina. "While investors are still a bit skittish, it seems that the worst is behind us. Likewise for funds of funds for the most part."

Madoff and other failed managers have proved that the true fund of hedge funds model is needed more than ever - to provide the identification and access to top managers, to conduct rigorous due diligence, to provide intelligent and sufficient diversification, and to have strong risk management embedded throughout the process. "This is difficult, time consuming and expensive - not to be tried at home by the average investor," Hennessy says.

Congress is also taking action. Prompted

by last year's financial meltdown and Madoff's fraud accusation, senators Charles Grassley of Iowa and Carl Levin from Michigan proposed the Hedge Fund Transparency Act, which calls for, among other things, for funds larger than USD50m of assets to register with the Securities and Exchange Commission and annually provide key data such as current valuation of assets.

Treasury secretary Timothy Geithner and Mary Schapiro, the new SEC Chair, also want hedge funds to be regulated. This is the lawmakers' third attempt to police the industry since 2006. The proposed bill transforms certain exclusions in the Investment Company Act of 1940 into exemptions and imposes filing and other requirements. "The Bill's theory is that the SEC will have more information about managers to detect and perhaps prevent fraudulent activity," says Mitchell Nichter, a partner in the Investment Management practice at international law firm Paul Hastings.

But some large managers aren't convinced about the possible benefits of opening their books in front of the SEC, says Matt Simon of research firm Tabb Group. They are concerned about how the SEC would safeguard their trade secrets. Moreover, things could fall through the cracks despite additional regulation because that's how fraud works. And the fact remains Madoff could operate all these years before getting caught not because of lack of information at the SEC. As evidenced by whistleblower Harry Marcopoulos in recent Congressional testimony, the SEC didn't take any action even after being repeatedly told that Madoff's operation was a fraud. "The SEC is taking it on the chin with the Madoff case. To protect themselves from foul play, investors must be their own lifeguards," Simon says.

So far, regulatory proposals have addressed the issue of investor protection, which was easier for politicians to push for, but have left a lot to be desired on the side of systematic risk, says MIT's Lo. "The Federal Reserve may have to be given oversight of liquidity issues of hedge funds. With proper safeguards and regulatory oversight, hedge fund growth anticipated later this year would be positive for the global economy." ■



Investors drive post-Madoff growth in service provision

By Suchita Nayar

During the era of easy money, the prime brokerage arms of Wall Street titans thrived by lending money to hedge fund clients. Many managers used the leverage to amplify the returns they made on conservative plays and to make large bets in far-flung places. But things came unglued pretty rapidly last year.

Laden under the deadweight of bad mortgages that triggered the ongoing financial crisis, the U.S. banking industry remained on extremely thin ice for most of 2008. Following the initial eruption of the credit bubble in the summer of 2007, problems exploded during the second half of 2008, claiming as casualties the storied firms Bear Stearns and Lehman Brothers and pushing a few others to the brink. By September, a number of firms were on the Federal Reserve's dole, a move that crimped

their risk-taking ability. These developments rocked the financial world around the globe, including that of hedge funds and their service providers.

The aftershocks have been pronounced, especially during the October to December stretch when the massive alleged Ponzi scheme perpetrated by the once high-flying Bernard Madoff came to light. It's no surprise that 2008 has earned the blemish of being the worst year on record for hedge funds, both in performance and asset outflows. Some experts expect the industry's assets to halve from a peak of nearly USD2trn.

In response, some of the largest players in the prime brokerage arena, notably Goldman Sachs, Morgan Stanley and Merrill Lynch, now part of Bank of America, are altering their business units servicing these funds.



"We've lofty plans to continue to grow the business smartly, in a controlled manner."

**Jeremy Todd,
Pershing**

Some are even stripping them down to the bones, at least for the time being. To be fair, this also plays into the banks' attempts to de-leverage their balance sheets.

Additionally, they are also scaling back capital introduction events. Among the larger players, Goldman Sachs and Merrill Lynch have pulled out of their large-scale annual hedge fund conferences in Florida and will now reconvene them on a smaller level in New York. This is partly because the banks can't be seen hosting extravagant events while accepting handouts from the government. JP Morgan, meanwhile, is maintaining its schedule of educational client seminars in small, intimate settings, in keeping with the style of Bear Stearns, which it acquired last year.

"There are momentous shifts occurring in the marketplace," says Jeremy Frommer, the New York-based head of RBC Global Prime Services, a Royal Bank of Canada unit that sells prime brokerage, trading technology, securities lending and capital introduction services to hedge funds.

Some firms admit that they have altered the terms at which they sell leverage, with little or no advance notice to managers. Mostly, they have substantially reduced the amount of available financing while upping margin and collateral requirements. Some funds, especially those pursuing risky bets outside the U.S., have seen their margin and collateral terms go through the roof. In public, prime brokerages insist they're doing

their best to maintain client relationships. Most argue hedge funds have become a higher risk business, given that investors are redeeming en-masse at a time when their asset valuations are ebbing.

"The overall prime brokerage business is less profitable now," says Jeremy Todd, the business development director at Pershing Prime Services, the Bank of New York Mellon's prime brokerage business. "In absolute revenue terms, there's less money to be made because the market place is smaller and business risks have widened."

Yet, opportunities abound for some mid-tier firms.

"We're capturing market share due to a combination of two things: Lesser competition and our methodical, conservative approach to risk," says RBC's Frommer. Its parent's tight risk control is among the reasons why it has weathered the ongoing financial storm unscathed. So far Canadian banks have performed well during the bust due to their limited risk taking. "As an institution, we continue to be focused on controlling risk." Even as Frommer's business has benefited from this firm-wide tight risk management, its services such as a dark pool access product called 'RBC Dark' and the algorithms suite 'RBC Quants' are helping it gain market share.

Despite an unfavourable fund-raising environment, Frommer expects increased fund-launches from "top of the heap-type" portfolio manager spin-offs and proprietary traders who were made redundant by shrinking banks. It is positioning itself to meet the increased operational and risk control needs arising from both the Madoff scandal and proposed regulatory changes. Adds Frommer: "While the high-octane leverage of recent years is certainly something the hedge fund industry in general will reconsider, it's premature to say it will go completely out of style."

Pershing's Todd, meanwhile, says his Jersey City, N.J., firm has tripled its business in the last three months, albeit from a smaller base, and is one of the few prime brokers that's adding to headcount. He adds: "We've lofty plans to continue to grow the business smartly, in a controlled manner, and in the new direction we see the prime brokerage business evolving into."

▶ 13



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Looking at LIFE in a new light™

The life settlement asset class

By Mark Todd

Life insurance policies have emerged as credible investments that have drawn the interest of institutional investors across the globe. Today, some of the world's most sophisticated investors are including life insurance assets in their investment portfolios, either via direct purchase or through innovative synthetic products designed and sold by financial institutions around the globe.

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Mark Todd is Vice President of Capital Markets for Maple Life Financial, a mortality-based products provider and servicer based in Bethesda, MD. You may reach Mark at 240-477-1417 or mtodd@maplelf.com; www.maplelifefinancial.com.

and who are turning to the market for solutions to meet their changing financial needs.

- **Increasing Liquidity and Sophistication of the Market:** Increasing liquidity in the market is evidenced by the emergence of electronic trading platforms for both initial settlements and tertiary trades. Securitisation of assets has occurred and when the markets resume an acceptable level of turnover, portfolios will be structured to capture any liquidity for alternative assets. Most transactions are 'private label' and not rated but they have provided smaller institutions with the ability to gain exposure to the sector. The rise of synthetic life settlement products, including both virtual portfolios and mortality indices, highlights both the growing acceptance of the asset class and the continued need for physical asset trading.

The need for assets like life settlements and the attractiveness of the stability they may provide is highlighted by the current turbulence in the global capital markets. While virtually all kinds of securities are being negatively impacted, the performance of life settlements has been largely unaffected by the global credit crisis.

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10 ► Pershing is seeing interest rise in its separately managed accounts offering. In managed accounts, investors' assets are held separate from those in the co-mingled fund, resulting in greater transparency and control for limited partners. Previously, managers were less amenable to such structures. But in the current unfavourable fund-raising environment, the balance of power has shifted back to investors, says Todd.

The Madoff debacle has greatly heightened interest in managed accounts, experts say. Madoff's broker-dealer had custody of clients' assets while a no-name firm acted as the fund-administrator.

Pershing's clients want to diversify counterparty risk; they don't want a repeat of the Lehman bankruptcy scenario where receivership proceedings have yet to untangle assets of prime brokerage clients. This month, the Bank of New York Mellon also launched MarginDirect, a liquidity tool that helps hedge funds manage margin positions and reduce counterparty risk.

Fund administrators are adapting to the new reality and market opportunities. Stuart Feffer, co-chief executive of New York-based LaCrosse Global Fund Services, says declining asset levels are hurting overall administration business and will result in consolidation of players. At the same time, business prospects are healthy as more managers are now looking to outsource their internal middle office and operational support functions in a bid to lower their fixed costs.

Additionally, investor sentiment toward the industry will turn in 2009, he says. There's a large amount of capital sitting on the sidelines that will return to good quality managers who can present a compelling investment thesis and a solid operational infrastructure. But fee schedules will be different from before, though. Says Feffer: "Investors aren't going to stuff their money under mattresses forever. Capital will eventually look for alternatives to the current low-interest options."

Strategy rotation, which occurs every five-seven years, is currently underway, he says. And LaCrosse, which has 300 staff, aims to take leadership in strategies that are garnering investor-interest. For instance, it



Business prospects are healthy as more managers are now looking to outsource their internal middle office and operational support functions.

Stuart Feffer, LaCrosse

expects to launch a new administration and middle office operational service targeting mortgages and whole loans. This sector has already begun drawing in managers and investors.

Robert Caporale, who heads the hedge fund services business of JP Morgan Chase, says he too is fielding more inquiries from self-administered funds looking to engage third-party firms. Furthermore, its customers are asking for its help to meet their investors' heightened due diligence needs. "We're hosting a number of requests from managers whose existing and prospective investors now want to personally meet with their service providers to ask us questions about asset-pricing, valuation processes and systems."

Says Caporale: "Following the short-term fallout of last year's "unprecedented developments," hedge fund outflows and performance somewhat stabilised during January and February, aiding the view that long-term industry growth prospects remain positive." For the time being, JP

Fielding more inquiries from self-administered funds looking to engage third-party firms.

**Robert Caporale,
JP Morgan**



Morgan Hedge Fund Services is focused on strategies conducive to current market trends. For example, it has expanded its distressed debt offering, particularly on the loan portfolio side, including processing, accounting, capturing trades and reconciliation of swaps. Still, the unit services a diverse portfolio of funds and can handle all hedge fund strategies, says Caporale. The business employs 500 people in Stamford, Connecticut, Dublin and Hong Kong.

Another administrator, Meridian Fund Services, says demand for its services is rising amid heightened regulatory oversight. "Increased scrutiny and regulation means that more and more hedge funds will be looking to third party administrators to add a layer of independence to their operations, especially in providing services such as independent pricing verification," says Meridian's general counsel Natasha Concepcion. "In addition, hedge funds will need to work closely with their administrators to impose robust due diligence, compliance and corporate governance schemes going forward," she adds.

Law firms, meanwhile, are inundated with work stemming from the Madoff scandal. Widespread redemption freezes and gates are another area that lawyers are digging into on behalf of their investor clients. Attorneys are also preparing their clients for imminent changes in taxation of carried interest. "We've seen a significant up tick in the amount of work over the last few months," says Jedd Weider of Morgan Lewis in New York.

Due to a variety of complex factors, Donald Chase, a partner of New York-based Morrison Cohen expects the Madoff suits to be drawn out for a number of years. "Madoff's a full litigator employment act," says Chase. At his firm, 10 or so lawyers from the financial services practice are busy scoping various angles of this alleged fraud.

Under the threat of higher litigation and other recent developments, hedge fund insurance costs are rising. "Two years ago was definitely a better time to buy coverage," says Tom Clark, who recently joined insurance broker Theodore Liftman in Boston, Massachusetts. Managers buy policies to cover themselves against potential



"Hedge funds will need to work closely with their administrators to impose robust due diligence, compliance and corporate governance schemes."

Natasha Concepcion, Meridian

damages from investor suits and regulatory reviews. Investors mainly insure themselves against manager fraud or negligence and huge losses. "Clients now require hand-holding. The biggest fallout from the Bernie Madoff issue is the panic it's spread among investors. Unfortunately, he's given a bad rap to the whole industry." As a result, underwriters now provide less coverage for more money.

Trading technology needs enhancement. Managers want to be ready with the ability to invest in all asset classes, says Peter Sibirzeff, chief executive of trading technology firm Alphacet of Stamford, Connecticut. Nobody wants to be left out from a huge market shift because of inefficient legacy systems.

From a compliance perspective, "transparency is the key word in the industry," says Martjin Groot, director of product marketing at Asset Control, a data management company. "Requirements for transparency have changed meaningfully following 2008, the industry's most severe stress test so far." More managers are looking to sign up the firm's key aggregation service that presents key data including asset prices and terms of securities in a format that managers can navigate easily and precisely, says Groot.

Judith Gross, principal of JG Advisory Services, expects that under proposed legislation, unregistered investment advisers will have to put in place a written compliance manual and code of ethics. They will also have to follow applicable document retention and proxy voting requirements, among other obligations, and have in place a designated compliance chief. Additionally, she indicated funds would be required to establish the anti-money laundering program and report suspicious transactions. ■