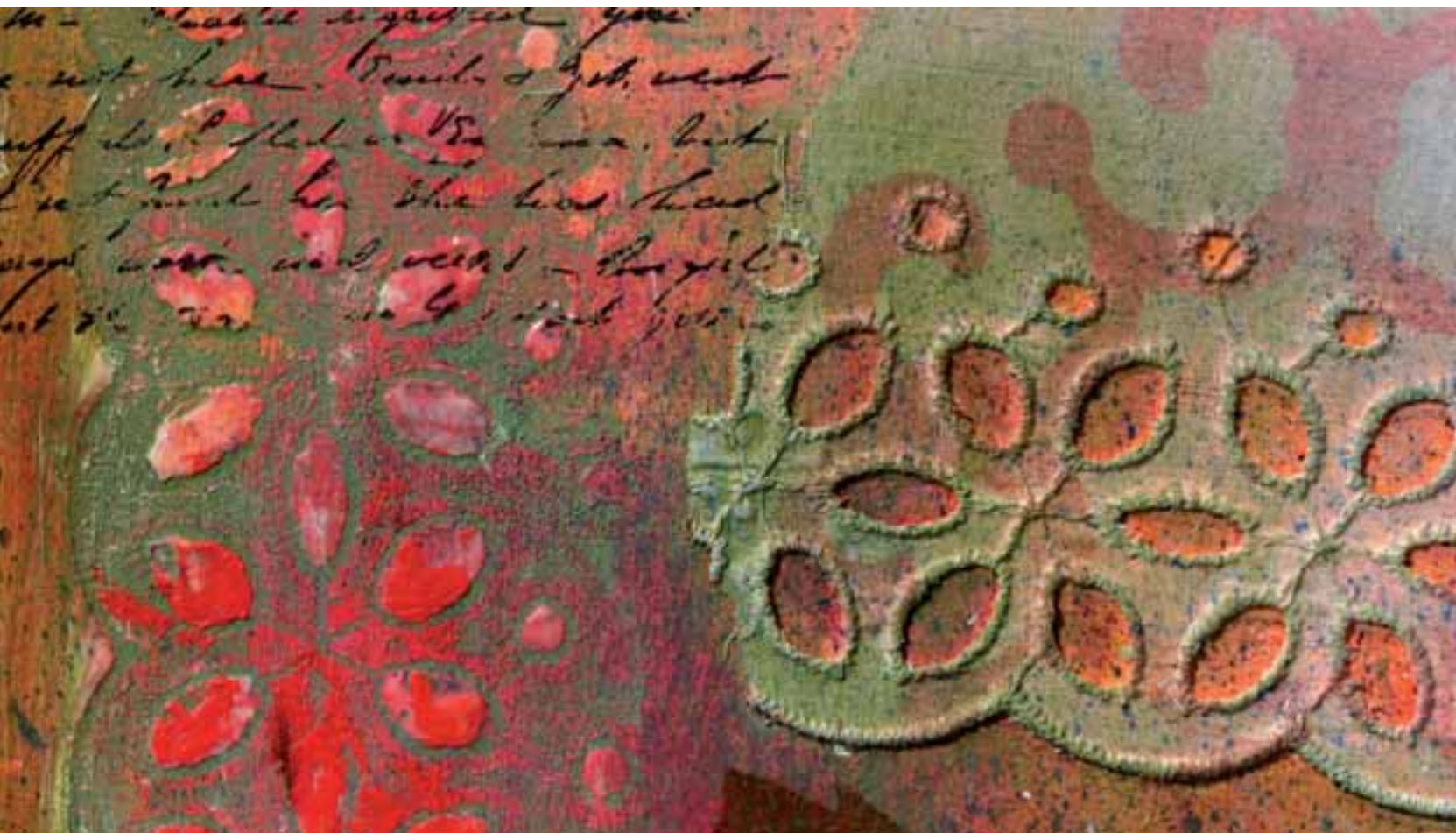


HEDGE FUNDS

THE VOICE OF THE ALTERNATIVE INVESTMENT INDUSTRY **REVIEW**



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A number of factors need to be taken into account when selecting counsel, including reputation, cost and experience



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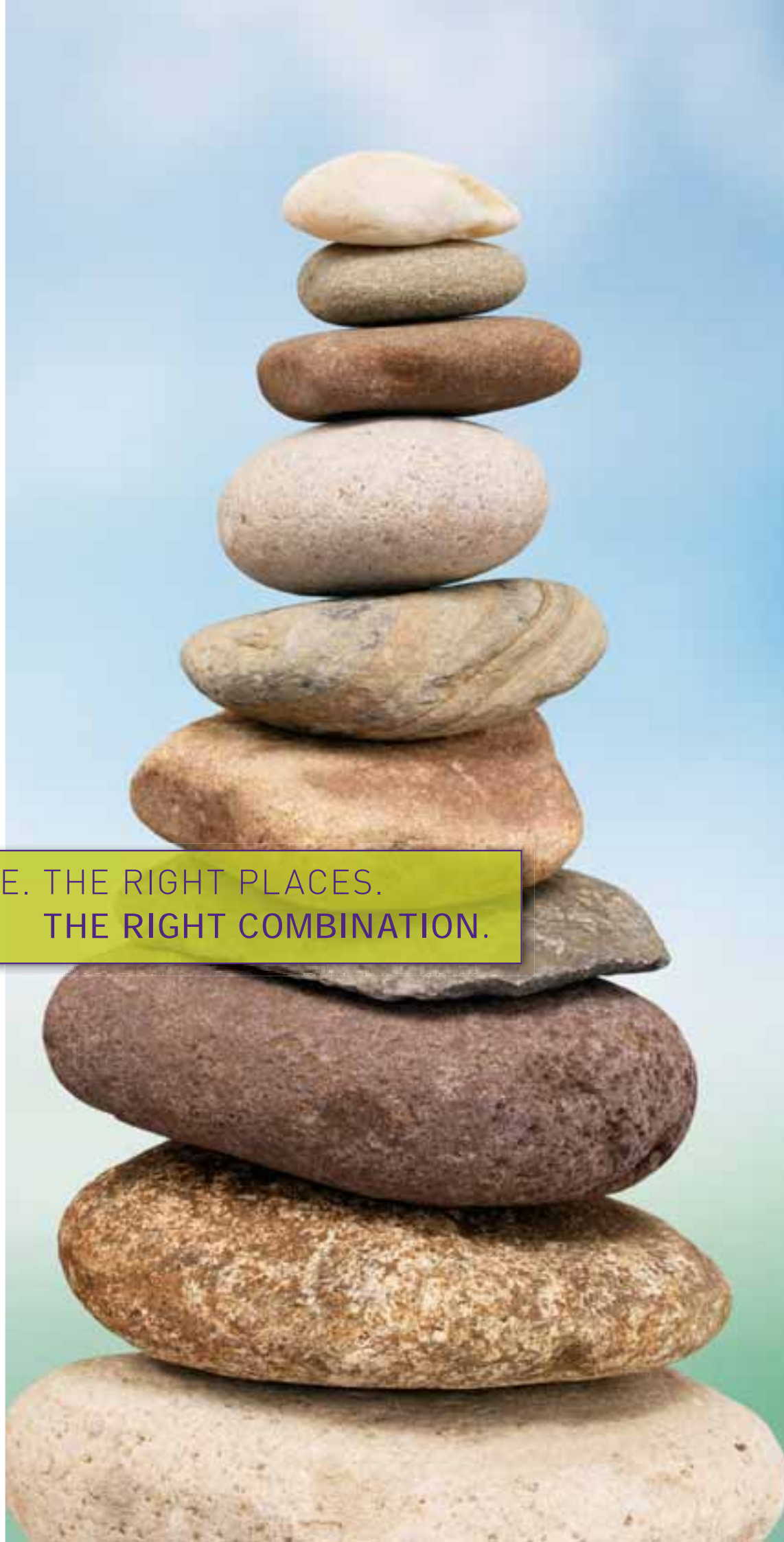
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Pricing in volatility and global reach

Are costs going to change over the medium and long term? Is cost a factor in a hedge fund's choice of legal firm? Is there any real cost difference between law firms with a global reach and those with only a few offices?

The financial crisis, frauds, increased regulation and oversight coupled with demand from investors for tighter control will all contribute to legal costs in future, believe the majority of law firms. However, those who have a global reach may be in a better position to advise and guide funds, particularly those operating in multiple jurisdictions.

Brian McDermott and Siobhán Moloney at A&L Goodbody in Dublin say the downward pressure on the fees being charged by hedge fund managers may in turn lead to a greater focus on legal fees. In their experience, cost is always a consideration in terms of choice of firm, although clients are happy to pay for a "job well done".

Dermot Deering at Hassans in Gibraltar believes law firms and jurisdictions in general need to remain competitive. "Access to human talent is an important factor in this regard. Generally, there is a perception that global law firms are more expensive but that this is justified in the circumstances of a deal," he says.

Nora Bullock and Simon Atiyah at Lovells in London agree hedge funds are likely to face "significantly increased legal and compliance costs due to increasing regulation". They point to the EU's alternative investment fund managers directive and similar US requirements. In addition they believe increased investor disputes and due diligence and disclosure requirements are also likely to increase costs.

Gray Smith at Appleby in Cayman Islands agrees that costs are likely to increase as "there will simply be more for the lawyers to do. Once a law firm is on the 'list' it then becomes somewhat price sensi-

tive, but, certainly on the hedge fund side, there are relatively few firms which are regarded as satisfactory to have in an offering document, and hence able to pitch."

At Brown Rudnick in London, Sonya Van de Graaff says hedge funds are always concerned about value for money, agreeing with Lovells that the bottom line is now a more sensitive issue. "Hedge funds are also in more pressing need of expert and prompt advice in some areas of their operations. In these areas fees are just one factor in the mix of their choice of firms," she says.

Conyers Dill & Pearman's Robert Briant in the British Virgin Islands agrees cost will always be a factor in a hedge fund's choice of law firm.

"A hedge fund which does not retain proper legal counsel will likely be less attractive to investors and more likely run afoul of regulations," he states. "While costs will always be a factor and will likely rise, it is a cost which must be incurred. If proper counsel is retained they will add value to the overall product."

Simon Firth at Kaye Scholer in London agrees with Lovells that costs for commoditised plain vanilla funds will reduce but costs for investment-related work and day-to-day issues such as regulation fees are likely to remain at current levels. "As hedge fund managers diversify and grow and especially when they bring in their own in-house lawyers, external law firms can expect greater scrutiny of their fees and possibly hourly rate discounting. It is possible that law firm panels may, as with banks, for example, be set up by hedge fund managers," he says.

"Our experience this year with

start-ups is that more than ever fees are the key to being instructed," states Firth.

Henry Smith at the Cayman Islands practice of Maples and Calder agrees with others that clients are cost-sensitive at present and lawyers need to respond to this by pricing services at a competitive level.

"One of the visible impacts of the global financial crisis is that it has separated the wheat from the chaff in terms of legal services and the ability of law firms to step up when it really matters. Clients understand the importance of quality of advice and levels of experience and responsiveness when urgent advice is required at a time of crisis in the life of a hedge fund," concludes Smith.

Mitch Nichter at the New York practice of Paul Hastings also expects legal costs to rise over the medium and long term as the regulatory, investment and operational environments in which funds and managers must compete continue to become more complex and diverse.

At Seward & Kissel in New York, Steven Nadel says costs at law firms may increase slightly just to keep up with inflation. "Generally, larger funds are less cost-sensitive than smaller launches but it can be a factor sometimes."

Ron Geffner at Sadis & Goldberg in New York believes organisational costs could be a material factor for many principals launching an initial fund with no prior operational experience and with little regard for ongoing expenses after the launch. "Managers which enjoy strong reputational background seem less concerned with cost and more concerned with the firm's reputation," he notes.

John Langan at Withers in London says cost is a major driver in choice of law firm but does concede that reputation and expertise, particularly in specialist areas of legal services, is also important. Those with experience of establishing funds do recognise that it can be worth choosing a more expensive firm if this gives them confidence that the fund will be established efficiently and will be well structured, he says.

Jonathan Tonge at Walkers in the Cayman Islands agrees. "Cost is always a factor. Increasingly, clients are looking for full service and full global support," he says.

Joey Garcia at Isolas in Gibraltar echoes other lawyers. He believes with fewer people willing to invest during a recession, the costs involved in the fund industry may have been temporarily reduced since law firms, for example, have been more willing to reduce the legal fees to funds for the sake of securing their business.

In Malta, Frank Chetcuti Dimech at CDF Advocates does not expect any significant changes in legal and regulatory costs. "Our recent experience has shown that hedge fund managers are increasingly cost-conscious and indeed there is a significant difference in costs between global and local firms," he says.

Daniel Mackelden at Cains in the Isle of Man thinks it is too early to say how pricing will go. "One might anticipate a downward pressure on fees as firms compete for new business. However, to the extent that the funds themselves may become more complex and less vanilla, then novel and innovative structures may actually command increased fees," he says.

Wilton McDonald at Higgs Johnson Truman Bodden & Co in the Cayman Islands agrees that increased regulation and scrutiny will "likely contribute towards raising costs to set up new funds. There is already a reduction in terms of new fund structures so margins on start-ups tend to be higher to enable law firms to maintain current fee levels.

"On the other hand, the need to attract new business in lean times has forced firms, especially smaller ones, to be innovative, to add value wherever they can, to market more aggressively and yes, to slash fees as well," he says.

Hannah Terhune at Capital Management Services Group in New York agrees small law firms charge less than larger ones. "There are significant cost differences between law firms and lawyers," she notes. ■

Regulation challenges

What are the key challenges facing the legal profession working with hedge funds over the next 12 months? What are the likely challenges to impact hedge funds and the legal profession for the short and medium term?

The main challenge, according to Omar Zerafa at Aequitas Legal in Malta, is adapting to new regulation if it is implemented. No matter what happens on the regulatory side, he believes "the task of the legal counsel will be more onerous in ensuring that a fund conforms with all the requirements, especially when compared to the current unregulated situation."

Brian McDermott and Siobhán Moloney at A&L Goodbody in Dublin say good corporate governance, appropriate risk management and proportionate regulation will all be instrumental in attracting investors and ensuring the growth of the hedge fund industry in the future.

Tania Dons and Richard Finlay in the Cayman Islands office of Conyers Dill & Pearman expect

to see a significant amount of distressed fund-related work continuing over the next months.

Legal advisors will need to provide quality advice quickly to help funds deal with issues, they say. Documents will need to be clear and flexible from inception for new launches. Legal advisors and funds have an opportunity to learn from the past and ensure provisions to address potential illiquidity issues in the future are incorporated into the documents from the start, Dons and Finlay note.

Gray Smith at Appleby in Cayman notes that his firm is seeing start-ups again. "Getting the balance right between ensuring the fund has the committed capital it needs to invest and investors being able to get at their cash is causing most headaches right now," he

reveals. "As a firm, it is making sure you are in the right places," he confides. "We have gone for the approach of being everywhere a fund may want to be and giving the investor the choice."

"Firms perceived to have been most able to meet the challenges of the last 12 months," states Nicholas Butcher at Maples and Calder in Cayman, "are likely to be rewarded with new business going forward, as well as to retain the loyalty of existing clients. Characteristics of the law firms best prepared to meet the challenges facing their hedge fund clients include a team-orientated approach, specialisation, flexibility, expertise, experience, responsiveness, ability to generate innovative solutions and understanding of the market," he concludes.

In London at Brown Rudnick, partner Sonya Van de Graaff agrees with others that helping funds with compliance issues will be a major challenge. She also thinks more legal firms may need to open in new locations in order to be close to clients.

Regulation again tops the list of challenges for Steven Nadel at Seward & Kissel. "All these new proposals will make it more difficult to start a fund and more costly to maintain, plus income earned will be taxed at higher rates," notes Nadel.

"Because capital has become harder to raise, managers will need to be sure they reach a certain critical mass from an assets under management perspective in order to maintain their needed infrastructure," he concludes. ■

ON/OFFSHORE CONVERGENCE

Do you think the regulatory requirements between jurisdictions – both on and offshore – will narrow? Will there be growing convergence between onshore and offshore documents and regulation of funds?

"There will always be differences between the approaches," prosaically comments Henry Smith in the Cayman Islands office of Maples and Calder. Offshore hedge funds and their main service providers are already well regulated in the leading jurisdictions, he points out. "The success of the Cayman model means that other offshore jurisdictions gravitate towards a similar model. This does lead to a degree of convergence of regulation among the offshore jurisdictions," he says. However, Cayman Island laws are to some extent drafted to dovetail with onshore statutes. This has led to some convergence.

Jonathan Tonge at Walkers expects regulatory requirements between

jurisdictions to narrow to the extent that there will be "growing convergence between onshore and offshore".

At Conyers Dill & Pearman in the Cayman Islands, Tania Dons and Richard Finlay agree that offshore regulators will take a lead from the final form that regulation of funds and their managers in the major onshore jurisdictions will take.

In Bermuda partner Dawn Griffiths says it is inevitable that there will be a narrowing of regulation. "The challenge will be for offshore regulators to continue to apply the pragmatic approach to fund regulation that they have evinced in the past," she notes.

Gray Smith at Appleby agrees the "gap is not that wide at the moment when analysed properly". He says the trend where jurisdictions were keen to say 'we are almost as easy to do business with as Cayman' has changed overnight to 'we are much more regulated'. "The idea that regulation is a cure-all is

misconceived. We are probably at a high watermark right now," he adds.

Ogier's Simon Schilder in the BVI is certain "we will continue to see regulatory convergence both between onshore and offshore jurisdictions and also between offshore jurisdictions." He believes the days of regulatory arbitrage are gone.

"We expect that all jurisdictions intending to participate on the top table of international finance will need to have in place laws and regulations that satisfy the new global standards demanded by regulators, financial institutions and investors," he concludes.

His colleague Frances Watson in Guernsey agrees. "Documentation is beginning to converge particularly among law firms who operate in a number of jurisdictions. Regulatory convergence may be a byproduct of the present market conditions."

At Sadis & Goldberg in New York, Ron Geffner takes a slightly different stance. "It is too early to determine

whether differences between jurisdictions will narrow," he says. "It is a function of survival of the fittest."

In London the mood is different. Nora Bullock and Simon Atiyah at Lovells think a trend of 'onshoring' may develop as investors take more comfort investing in onshore structures and enhanced regulation and associated disclosure requirements. Managers are likely to have to adapt as a result, they say.

Simon Firth at Kaye Scholer also believes offshore centres "will have to become more regulated and transparent to access onshore markets and onshore markets will permit the sale of alternative products as a quid pro quo."

"From a tax perspective, offshore jurisdictions have, of course, been popular because they offered tax-free gross roll-up of returns, although historically this has been limited by tax regimes such as the UK's offshore funds legislation," says John Langan at Withers. ■



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Making the right choice

What are the main considerations of a hedge fund when it chooses its legal counsel? Under what circumstances should a fund consider in-house legal services?

Jon Fowler in the Cayman Islands office at Maples and Calder believes a number of factors need to be taken into account when selecting counsel. He says these include depth of experience, range of expertise, reputation and cost.

"Hedge funds will be looking at the ability of firms to advise on restructurings and provide effective solutions to problems as well as the ability to establish funds. Response time and quality of advice will be as important as cost," says Fowler.

At Appleby in the Cayman Islands, partner Gray Smith believes there are a few firms in London and in the offshore world that are regarded as sufficiently expert. "They will continue to get the lion's share of the work. There has been little movement of top lawyers from these firms to firms outside the hedge fund magic circle, and until that happens, little is likely to change. Individual lawyers at firms are now becoming more important, as firms have expanded rapidly and in certain cases diluted quality," he says.

Tania Dons and Richard Finlay at Conyers Dill & Pearman in Cayman believe the larger fund operators and investment managers do not consider cost as the major consideration when selecting counsel. They want efficient, quality legal advice, say the pair. Depth and wealth of experience in the firm's funds team is also a key issue, they note.

In-house legal services will likely only be required for larger investment managers and fund groups, say Dons and Finlay, where the cost/benefit analysis warrants an internal hire. They say they find it helpful to deal with in-house legal counsel who understand the relevant legal issues and can often assist in finding the correct balance between legal and business considerations.

Jonathan Tonge at Walkers thinks the main concern when selecting legal counsel is the firm's experience and reputation in the industry for setting up and advising on the

particular fund structure and its investment strategy. "Subject to the jurisdiction in which the manager or principals are located, the fund may prefer to instruct counsel in the same or similar time zone and accordingly global reach may be a factor in the selection process," he advises.

"Certain managers will always look to counsel based in the jurisdiction of the fund's domicile, particularly where regulatory filings have to be made. The decision will depend upon the size and frequency with which new funds are established and the extent to which documents for existing funds are updated," concludes Tonge.

Partner Simon Schilder at Ogier in the British Virgin Islands looks to the past to inform choice. "Perhaps one of the main lessons learnt by investment managers from the current financial crisis is the importance of choosing legal counsel, both onshore and offshore, with the expertise and resources to effectively advise it through times of crisis," declares Schilder.

"In-house legal services become feasible if the fund requires legal support on diverse issues in a number of jurisdictions, in which case it will mostly involve a co-ordination function," says Andre Zerafa at Ganado & Associates in Malta.

He says external counsel's involvement is important because they are independent and will have had different experiences to bring to the table. "Integrity, independence, turnaround, experience and a solution-orientated mindset are all important considerations when choosing a law firm," advises Zerafa.

Brian McDermott and Siobhán Moloney at A&L Goodbody Solicitors believes funds should look for firms that are able to offer a full range of legal services areas such as tax, banking, regulatory and litigation/dispute resolutions. Boutique practices are typically unable to provide this depth of specialist service, they say. The larger, more established practices typically advise on a

wider range of structures and issues and can always draw on a large pool of experienced practitioners, note the pair.

Simon Firth at Kaye Scholer thinks in-house legal services should be considered once a fund reaches a size where it will save cost and can add value. "There is a difference between hiring a general counsel who is senior and can contribute to the operations of the manager as well as dealing with legal issues and a junior lawyer who may deal with relatively straightforward but time-consuming matters such as employment and IT," he notes.

Nora Bullock and Simon Atiyah at Lovells say typical considerations include skill and experience, reputation, existing relationships, cost, office locations, approachability, availability/workload, partner involvement and recommendations and referrals from other clients and service providers in the hedge fund community. They think in-house legal services are more important for larger hedge funds while the typical model for most London-based hedge funds would be a general counsel who outsources to external law firms when appropriate.

At Withers, partner John Langan says many fund managers want to show their investors that they have the 'right' names on the offering document. "Particularly post-Madoff the identity of different service providers to a fund has become a significant due diligence issue for investors," he notes.

"In-house expertise, however, has an important role to play, particularly in ongoing day-to-day legal work, negotiations with investors and other third parties and generally overseeing, controlling and interpreting (for management) the work of external lawyers," says Langan.

Maintaining an in-house legal service may be an expense that some smaller hedge fund operations may not be able to justify. "The size of the hedge fund operation is one of the factors which will determine

whether or not in-house legal services will be employed," notes Langan. "A further element that needs to be explored is the complexity of the operation and whether in-house legal counsel will have sufficient expertise to deal with the issues the hedge fund may face."

For larger operations he says in-house legal services may be economic if they can provide certain core legal services and can manage the outsourcing of other advice to external legal providers.

In New York attorney Hannah Terhune at Capital Management Services Group advises funds to find a lawyer that "you can communicate with easily and one that returns your phone calls and emails. You are working with a person and not an institution."

Mitch Nichter, a partner at Paul Hastings, believes the primary considerations should be the professional reputation, experience and global resources of the firm and the professional reputation and experience of the individual lawyer at the firm who will be responsible for the account. Like Terhune, he believes the fund needs to "feel personally comfortable working with this individual and his or her team" and that this is vital to an enduring and productive relationship.

"Is there genuine enthusiasm for your business or do you have the feeling that the firm is doing you a favour even considering the representation? If the firm and lead lawyer score highly on these important factors, then cost should be a secondary (but still relevant) consideration," advises Nichter.

At Katten Muchin Rosenman co-managing partner Henry Bregstein agrees with others that breadth of expertise, especially with respect to regulatory matters is essential. In-house legal services make sense when it becomes cost-effective, he says. "When I observe a client grow to a certain size, of course relative to strategy, I often recommend hiring in-house counsel," he concludes. ■



Investors show more diligence

Has the process of due diligence changed? Are investors taking this more seriously and is it having any impact on hedge funds or funds of hedge funds and their operations or structure?

Until the Madoff affair, many thought the cursory due diligence process was enough to safeguard investment. No longer. While too many are still not conducting thorough due diligence, it has become a top priority for the majority of investors. The process now encompasses not only the fund itself but also its service providers – a consequence of the demise of Lehman Brothers, which also caught out a lot of people who had not taken counterparty risk seriously.

“The Madoff affair highlights that conducting thorough due diligence prior to making an investment is a central preliminary to the investment process rather than ancillary to it,” notes John Langan at Withers.

He says clients are facing risks from many directions, including legal liability, risk of investment loss or devaluation, compliance failure and taxation. “The mitigation and balancing of risk in all its forms is of paramount importance for many clients,” Langan says. “All investors should include a thorough due diligence process in their risk management procedures.”

Not surprisingly, points out Langan, most investors now take due diligence “extremely seriously”. While in the past many investors primarily focused on analysing the performance of funds with the due diligence process taking a back seat in terms of importance, the frauds and numerous bank problems have highlighted the need for a more rigorous process.

Simon Thomas at Akin Gump says his firm has noticed investors still in the market are taking due diligence much more seriously. “Investors now have a much greater understanding of counterparty risk,” he says. “They also place greater emphasis on their likely exit from the fund, for example, seeking an understanding on the operation of the fund’s gate and any likely suspension of redemption,” concludes Thomas.

Simon Firth at Kaye Scholer

believes the process has become more standardised with Iosco principles, Hedge Fund Standard Board standards, the Alternative Investment Management Association (AIMA) recommended practices and the US President’s Working Group all vying for attention. “Following the financial crisis, investors are focusing more on fund documentation including understanding prime brokerage documentation and legal risk,” notes Firth.

Nora Bullock and Simon Atiyah at Lovells also believe due diligence and the decision-making process is becoming more rigorous and more formal. They say funds have to devote more time and costs to investors’ due diligence queries because of anti-money laundering requirements, among other demands. According to Bullock and Atiyah, due diligence is no longer just a paper form-filling exercise. All service providers are caught in the process. It is common now for the lawyers of investors to review fund documentation and produce side letters in a way that historically has been done in the private equity rather than the hedge fund world, note the pair.

Brian McDermott and Siobhán Moloney at A&L Goodbody agree that post-Madoff there is more focus on due diligence, particularly for funds of hedge funds. They say there is more intense scrutiny of funds, their service providers and counterparties, including their lawyers and auditors, as well as the jurisdiction in which they are regulated. McDermott and Moloney think this attention to detail is likely to benefit top-tier providers in each area as well as jurisdictions that are perceived to offer a more robust regulatory environment.

“The current volatility in the market, combined with recent scandals, has brought operational practices into the limelight and caused investors to begin conducting formal due diligence assessments of administration operations prior

to placing assets with funds,” says Joey Garcia at Isolais in Gibraltar.

Omar Zerafa at Aequitas Legal in Malta believes due diligence is continuously increasing. “Investors are seeking more transparency in the hedge fund investment techniques and they are demanding more open communications on hedge fund strategies and frequent reports. This has a great impact on the functioning of the fund,” he notes.

The due diligence process, says Ingrid Pierce at Walkers in the Cayman Islands, has changed and become much more focused as a practical matter. “Funds, counsel and service providers are increasingly being asked a number of different questions and are requested to verify certain facts,” she says.

“Responding to these enquiries can be time consuming, particularly if there are multiple requests or follow-up questions. Directors are routinely being asked to provide detailed information (including supporting documents) about themselves and those who control the fund,” notes Pierce.

Tania Dons and Richard Finlay at Conyers Dill & Pearman in Cayman say investors are undertaking much more due diligence and taking a lot more care before investing in funds. They say they have seen a dramatic increase in the number of investors coming to the firm to review fund documents and provide legal advice prior to investment. According to Dons and Finlay, managers are increasingly being requested to provide detailed information, to meet with investors and to introduce them to key staff. The obvious impact on funds is an increase in costs, they conclude.

Robert Briant in the British Virgin Islands office agrees that the due diligence carried out by investors has changed significantly. “As a result of issues that were uncovered as a result of the recession, investors are being more careful in connection with their investments and in particular are giving greater scrutiny to

hedge funds,” he says. “This greater scrutiny is not having any particular negative impact on properly structured hedge funds, other than the time required to demonstrate to the investors that the hedge fund is properly structured.”

At Conyers’ Bermuda office Dawn Griffiths tells much the same story. “Investors are much more attuned to the need for a disciplined approach to their due diligence. We have already seen much more time and effort being applied to this process by prospective investors,” she says.

“Many are choosing to conduct face-to-face interviews, not only focusing on the fund manager and its operations but all the fund’s service providers including the administrators, directors and legal counsel. Funds are finding they need to deploy more resources to satisfying due diligence requests,” reveals Griffiths.

In the Mauritius office Craig Fulton notes that the approach to due diligence has been changing for quite some time. “There has been a growing trend towards greater legal due diligence over the last three to four years and with the recent financial crisis it is anticipated that this trend will only increase,” he notes.

“Too often investors invested into funds without really understanding the impact of the fund’s constitutional documentation. Going forward, investors are going to want a much clearer understanding of the documents and the impact of these documents when the fund runs into difficulties,” he concludes.

Mitch Nichter at law firm Paul Hastings in New York believes investors, and particularly institutional investors, have significantly tightened their diligence activities. “One result of this tightening is that managers will need to invest more in compliance and risk management and be able to prove to investors and regulators that these are important integral components of the investment products offered,” suggests Nichter. ■

Waiting and watching the regulators

What impact do you expect impending regulation to have on the legal profession and hedge fund clients? Will there be permanent and significant changes? What will be the main regulatory concerns hedge funds will face in the future?

“Given the current international political climate,” notes Henry Smith at Maples and Calder in the Cayman Islands, “it is likely that there will be increased regulation of hedge fund managers. But the format and scope of that regulation is not yet clear.”

He thinks it is likely there will be registration requirements for managers and increased due diligence as a starting point at the least. “We are seeing more investor-driven due diligence on fund managers and more investors demanding to see independent administrators and service providers around the fund managers and funds,” he says.

“We are closely watching the proposed EU alternative investment fund managers directive as it progresses through the EU’s legislative process,” he reveals.

Jonathan Tonge at Walkers thinks the impact of legislation will depend “entirely on the extent of any new regulation, including whether it affects the fund or just the investment manager. If certain registration requirements are imposed, this will obviously place an administrative and potentially costly burden on the affected parties. However, as long as the regulation is appropriate and not excessive, we believe it can bring long-term benefits to the industry and its reputation.”

In the British Virgin Islands office of Conyers Dill & Pearman, Robert Briant thinks a more significant change than regulation is the increased scrutiny that investors are giving to hedge funds. “This will require hedge funds to adopt a more transparent structure and ensure that the ‘t’s are crossed and the ‘i’s are dotted. With respect to regulation, any proposed regulation will increase the regulatory burden on funds while at the same time, arguably, give greater safety to investors,” he states.

“I would not anticipate that this would have a negative impact on the growth of the hedge fund industry,” says Briant, “although it will increase the cost of launching and maintaining a hedge fund and may eliminate some of the more mar-

ginal funds. Like taxes, regulations are rarely decreased.”

Gray Smith at Appleby believes regulation is inevitable in the US and EU but adds “we are all unsure as to what form that will take”.

“We are seeing regulation moved to the morning of the first day at conferences which shows that managers are more and more interested in an area they previously had as little to do with as possible,” says Smith.

He says a law firm is going to have to be able to advise authoritatively on a range of jurisdictions “if it is to be able to demonstrate that it can identify the best structure and domicile for a fund. The changes will be long term. The main concern will be restrictions on what a manager can do, costs of compliance and restrictions on marketing,” concludes Smith.

Ogier’s Simon Schilder agrees that it is too early to say how some of the regulatory initiatives currently being debated will ultimately play out and impact on hedge funds. “In our view hedge funds will continue to adapt and evolve with the evolving regulatory landscape, both in terms of how regulatory considerations impact upon how they actually invest and so generate their investment returns and also in what regulatory considerations impact upon the parameters in which they operate,” says Schilder.

Daniel Mackelden at Cains in the Isle of Man expects both on and offshore firms will “need to be adaptive to any new regulatory regimes although it is somewhat difficult at the moment to define where the goalposts will be short to medium term.”

Dermot Deering at Hassans in Gibraltar expects greater use of Uciits III structures will be the main impact of impending regulation. “Migration of funds from outside the EU to Dublin, Luxembourg and Gibraltar will also be a factor,” he predicts.

Brian McDermott and Siobhán Moloney at A&L Goodbody say they have seen a distinct move away from less regulated jurisdictions such as Cayman and the British Virgin

Islands to onshore jurisdictions such as Ireland. This shift has been caused by the demands of institutional investors for a more robust regulatory environment.

Investors already spooked by the Madoff fraud, the Stanford Bank disaster and the ongoing financial crisis are increasingly viewing regulated funds as the better option for hedge fund investment, they believe.

In London, John Langan at Withers agrees the impact of the Madoff affair is likely to be increased regulation in many jurisdictions. “Hopefully the upshot will be sensible supervision rather than overly prescriptive and meddling changes,” he says.

“Regulation of hedge funds will of course have a material impact on their operations,” points out Sonya Van de Graaff at Brown Rudnick. “Many hedge funds have minimal back office personnel and so this will be an added expense,” she says.

“The problem with any regulation is that unless it applies equally worldwide, there will necessarily be a migration of funds to jurisdictions with less regulation. This will not be in the interests of Europe,” says Van de Graaff.

Angela Hayes at Mayer Brown in London says the biggest imminent regulatory issue for the European hedge fund industry is the EU alternative investment fund management directive. “It is hard to believe that current restrictions on marketing third country funds in the EU could be allowed to stand because that would fundamentally change the existing tax-efficient market structures. Assuming that this fundamental point will be changed, then despite tinkering with regulation,

the overall feel of the industry will probably continue largely as before. In that case the most significant industry issue will be the recovery of investor confidence,” she concludes.

“Hedge fund management is undergoing a fundamental transformation,” declares Mitch Nichter at New York law firm Paul Hastings. “Increased political and media scrutiny combined with a major shift in investor expectations, the ongoing credit and liquidity crisis, higher regulatory compliance costs and lower returns, seem to make significant changes in the industry unavoidable,” he says.

“Managers will need to invest more in compliance and risk management and be able to prove to investors and regulators that these are important integral components of the investment products offered,” he suggests. Less manager discretion in fund operations will become more common. “Managers will need to develop investment strategies that can operate effectively and efficiently in an environment where leverage and the use of derivatives and shorting are more costly, less readily available and more regulated, and in a world where strategy and holdings information will be more readily available to regulators and competitors,” he concludes.

Steven Nadel at Seward & Kissel believes that if the SEC registration rule passes “it will create a barrier to entry, due to the added compliance costs to register and to maintain same.” He says managers will need to, among other things, designate a chief compliance officer and adopt and implement robust compliance policies. ■



Be prepared for anything

What can law firms do to help a hedge fund avoid or survive a crisis?

John Langan at Withers thinks no matter the cause and nature of the crisis, prevention is often better than cure. He suggests some areas to look into to avoid future problems include initial structuring and ensuring the fund as well as the management/advisory entity has the appropriate structure in the first place.

“Generally, if measures to protect investors are in place and it is clear that investors’ rights will be dealt with consistently and fairly, a fund is more likely to survive a crisis,” he says.

Angela Hayes at Mayer Brown in London says it is a “sad fact that it is often simple and obvious gaps in risk management procedures that are at the heart of crises, such as failures in due diligence and failures in basic risk control like data security.” She believes a law firm experienced in this area can do a lot to help hedge funds avoid a crisis by reviewing and advising on upgrades in internal procedures and training staff.

“When it comes to surviving a crisis, speed is of the essence and steps taken in the first few hours are often critical to the outcome. This can be managed with good, experienced legal advice and also by having a crisis management plan in place and at the ready,” she notes.

Solicitor Nora Bullock and consultant Simon Atiyah at Lovells believe an important aspect of a law firm’s role is to ensure the fund structure and documentation is robust and flexible. They say it is now necessary to foresee and deal with a range of potential issues, including counterparty risk. Also law firms will negotiate key documentation such as prime broker agreements and ensure these are as fair and balanced as possible.

According to Bullock and Atiyah, law firms should aim to cap levels of rights of use or rehypothecation in documentation.

It is likely that in the future as a result of a UK Treasury consultation document on developing effective resolution arrangements for

investment banks, there will be a shift in bargaining power so that prime broker agreements will no longer be broadly non-negotiable.

Partner Simon Firth at Kaye Scholer advises that well-drafted documents should furnish the fund’s board with the maximum array of options in the event a crisis develops. “With hindsight it is clear that many funds who encountered a crisis situation in the last year or so were inadequately served by their constitutional and contractual documents, for example being unable to set up side pockets without investor consent,” says Firth.

As boards become increasingly professional and independent, he expects they will involve lawyers early on when problems develop to seek strategic as well as strictly legal counsel.

At Brown Rudnick in London, Sonya Van de Graaff believes law firms can help hedge funds at the formation stage by drafting flexibility into constitutional and investor documents (for example, by including gates and an ability to suspend redemptions) and ensuring the documentation with the funding providers and prime brokers are reasonable by drafting clearly defined financial covenants and not allowing an unlimited discretion to the financier or prime broker to determine net asset value (NAV) and other critical provisions regarding ability to draw on credit or post collateral.

“At the pre-investment stage, legal firms should ensure the hedge fund understands the risks and pressure points of the proposed investment,” she says.

In New York, Ron Geffner at Sadis & Goldberg says the first step in protecting a hedge fund is making certain the business has been formed “most optimally to the circumstances. The terms of the fund should take into consideration the investment strategy including but not limited to inflow and outflow of assets, potential risks associated with the strategy and management of the fund.”

After launch the manager must “contemplate the ramification of entering into side letters,” cautions Geffner.

If a manager has entered into an agreement obliging the fund to only return cash, it presents a dilemma, he notes.

“Advise them not just legally but also based on past experience and provide colour as to what others are doing,” advises Steven Nadel at Seward & Kissel in New York. “Lawyers should do the following: put together a strong compliance manual; review client business to identify major risks and address same and draft offering documents with sufficient flexibility to deal with major crises,” he says.

Henry Bregstein at Katten Muchin Rosenman in New York believes discipline is at the heart of avoiding a crisis. “Assuming a law firm has the requisite expertise to undertake legal risk and how this relates to business risk, the law firm must be able to convince the fund manager that the cost of establishing meaningful, reality-based compliance and due diligence procedures and rigorously maintaining those procedures is not a waste of time and money, but rather a prudent investment,” advises Bregstein.

“Numerous managers have lost significant market cap or have simply disappeared because they didn’t understand that economic proposition. There is a reason people buy insurance,” he adds.

Ingrid Pierce at Walkers in the Cayman Islands believes law firms need to be attuned to the latest market developments and “be able to promote creative solutions and adapt their work product to meet changing demands.”

She says law firms need to work closely with their clients “as they can play a significant role in helping a fund to avoid or survive a crisis provided they are involved at a very early stage in the process. We have seen many cases where a fund fails to instruct counsel until after key decisions have been made.”

Michael Richardson in the Cayman Islands office of Maples and Calder thinks it is important at the structuring stage and during the life of the fund to understand the market in which the fund oper-

ates and the potential catalysts of a crisis.

“The law firm’s approach needs to incorporate flexibility, expertise, availability, experience innovation and communication. From a practical point of view, experienced lawyers can help fund manager clients get to grips with the complex relations between the fund, its service providers and shareholders,” advises Richardson.

Partner Gray Smith at Appleby’s Cayman office believes the key is in drafting the documents correctly in the first place. “We have a large fund disputes practice and have been able to see a lot of other firms’ work. The quality has been a little mixed with too great a reliance on precedent. More thought and planning needs to go into offering documents and constitutional documents,” notes Smith.

“Once in a crisis, handling the more aggressive investor responses can help to give managers time to formulate structures which will work for all going forward,” he advises.

In Gibraltar, associate at Isolais Joey Garcia says lawyers and managers should benefit from hindsight in relation to the credit crisis. He thinks they will be much more inclined to place greater emphasis on the planning and risk management aspects of the fund.

“A general rule in most areas of business is to be proactive rather than reactive since a little planning and foresight can go a long way to prevent major problems and disruptions at the later stages,” he says.

In the Isle of Man office of Cains, Daniel Mackelden agrees a properly structured fund is a must. Documents need to contain “the necessary protections and flexibility to match with the fund’s investment aims and investor expectations. There is also an ongoing need to keep the fund up to speed on the latest developments in structuring and make consequential changes.”

Frank Chetcuti Dimech at CDF Advocates in Malta says most of the safeguards need to be built into the offering documents. “Typically these would include designated share classes for illiquid securities, lock-out periods, limitations on redemptions and suspension of dealing,” he says. ■

On or offshore? Pros and cons

What are the pros and cons of on/offshore hedge funds from a legal perspective? How do the options vary among on/offshore jurisdictions?

On or off? This is a moot question given the recent attacks on, misunderstanding of and bad press for offshore locations. All of this has combined to make many hedge funds nervous of being associated with any offshore location. At the same time the majority of funds continue to use the traditional model of Cayman Islands domicile, Irish fund administration and London or US-based managers. How long this will continue and what, if any, impact regulation will have on this pattern is an open question. The EU's Ucits brand continues to gain in popularity. This, coupled with changes to UK laws that could encourage onshore funds, expands the choices for hedge funds for onshore products.

Gray Smith at Appleby in the Cayman Islands believes there is room for both. "We are seeing managers setting up parallel or master/feeder structures in both. Offshore tends to be quicker and cheaper, and is well established with the industry. EU and US protectionism may try to persuade funds onshore, but the market is still keen on the offshore product," he concludes.

At Conyers Dill & Pearman, Tania Dons and Richard Finlay say offshore jurisdictions tend to be similar from a legal services and legislation point of view, although there is still a perception that some jurisdictions are more efficient. They believe flexibility of legislation and fund structures, tax neutrality, the lack of restrictions on investment policy and the quality and expertise of local service providers, regulators, infrastructure and legal systems are all positives for establishing funds in offshore jurisdictions. The perception of a lack of transparency and under-regulation offshore

– a view they say is unjustified – is a factor that may make investment managers look onshore.

Maples and Calder partner Nicholas Butcher is enthusiastic about Cayman. "The beauty of Cayman as a jurisdiction is that it has a legal and regulatory structure capable of accommodating the full range of investment fund models required by onshore investors," he says. Cayman fund structures are widely acknowledged by institutional fund managers, investors, lenders and swap counterparties as the product of a tried and tested legal system, he adds.

"While traditionally we talk about onshore and offshore, we are also seeing the emergence of a hybrid jurisdiction – an on-offshore jurisdiction if you like in Ireland and to a lesser degree, Luxembourg. In many ways the Irish fund industry is a good compromise," notes Butcher. "We believe that while the offshore jurisdictions will continue to be attractive and remain highly competitive, there is a growing class of investor that wants the efficient regulatory environment of an offshore jurisdiction in a jurisdiction that is not generally recognised as offshore," he concludes.

Ogier's Simon Schilder in the British Virgin Islands says the differences between offshore jurisdictions are subtle and not substantive. "The overall regulatory convergence between offshore jurisdictions as it relates to the regulation of hedge funds will continue," he declares. "In many respects the events of the last 18 months have perhaps enabled everyone to focus their minds and recognise the existence of a convergence which has been ongoing for some time now," says Schilder.

Craig Fulton in the Mauritius office of Conyers Dill & Pearman believes whether a fund is set up offshore or onshore is largely determined by the nature of the investment manager, particularly its regulatory regime, by the nature of the proposed investors and by the nature of the investments that the fund intends to make. "Once it has been determined that an offshore structure is appropriate, then the next question is to determine which offshore jurisdiction best serves the needs of the investment manager and the investors," he says. For example, if a fund intends to make significant investments into jurisdictions such as Africa, China and India, then forming a fund in Mauritius will make a great deal of sense, he says.

"The pros and cons are all relative and must be considered in light of the relevant business objectives," states Mitch Nichter at law firm Paul Hastings in New York. "The basis calculus should be: in which jurisdiction should I locate 'X' – with 'X' being any crucial product, investment, management, marketing or operational component of the business – to maximise the chance of achieving the business objectives at an acceptable cost?," he says.

At Sadis & Goldberg, partner Ron Geffner believes the domicile of the offshore fund will have a material impact from an investor's perspective. "For example," he says, "both investors and managers alike should determine the integrity of the judicial system in the country in which the fund is domiciled, as well as the service providers in that country."

Robert Duggan at Walkers in London says "taxation is one of the more complicated items in any jurisdiction shopping list and it is not particularly surprising to see entities domiciled in several jurisdictions – both onshore and offshore – within a fund structure." He concedes that tax rates are not the sole determinant of jurisdiction choice. "Offshore jurisdictions such as the Cayman Islands, while embracing tax transparency, are often compelling prospects in any tax analysis for its zero tax rate," he notes.

"Undeniable is the importance of striking a balance between effective regulation of funds and managers, with regard to their activities, and the need to protect investors and the integrity of the financial system," says Duggan.

"Onshore and offshore jurisdictions offer graded levels of regula-

tion and extensive choice exists, both as to the extent of regulation and to the philosophy of regulatory approach. The constructive approach adopted by regulators in leading centres such as the Cayman Islands, the British Virgin Islands and Jersey has resulted in different levels of regulation by reference to sophistication of underlying investors and therefore the need for regulatory protection," he says.

The flight towards regulation, however, appears to have been driven by political expedience rather than a need for overhaul where fine-tuning would suffice, notes Duggan.

"Offshore jurisdictions are generally more cost-effective than their onshore counterparts and the costs can vary significantly. However, depending on the size of the proposed fund the costs of establishment and maintenance of the fund are likely to be relatively insignificant, although cost is always of concern," he concludes.

John Langan at Withers says the main reason hedge funds were incorporated offshore in the past was to take advantage of the low tax rates in those jurisdictions and their greater legal and regulatory flexibility. "The recent focus on regulatory supervision and tax avoidance suggests, however, those onshore jurisdictions with significant financial services industries such as the UK may be able to win some of this business back if they can develop the right legal and tax structures for hedge funds," he says.

Omar Zerafa at Aequitas Legal in Malta points out that the choice between offshore and onshore jurisdictions has to take into consideration the quality of the service providers, legislative remedies in default and adequate judicial systems that can assist the fund in times of crisis.

Frank Chetcuti Dimech at CDF Advocates in Malta says offshore jurisdictions typically offer fast licensing, maximum flexibility and minimal regulatory oversight, while regulation and flexibility of varying degrees and various licensing speeds would be encountered in onshore jurisdictions. "The battleground between onshore regulators is how to strike the right balance in terms of regulation, flexibility and speed of response. With tax disclosure being gradually imposed on all offshore jurisdictions, fund managers will seek tax-friendly structures onshore to provide greater peace of mind to their investors," he concludes. ■



Staying afloat

What can funds do to protect themselves from liquidation?

While it may seem simple to say “pick the right investments”, it is not that straightforward. Determining if the fund is a viable concern can be a tricky process, particularly when taking into account the rights of shareholders (who may also be creditors). What most believe is key to any situation, including potential liquidation, is frequent and clear communication with investors.

Henry Bregstein at Katten Muchin Rosenman in New York believes a key concern is redemption terms. “Make sure that redemption terms match portfolio liquidity and provide transparent gate and suspension of redemption provisions that benefit investors as opposed to merely trapping assets,” he advises.

“I have to believe that material mismatches in portfolio liquidity and redemption terms and the misuse of gates and suspension provisions will be a focus of investor litigation,” cautions Bregstein.

According to Steven Nadel at Seward & Kissel, funds should monitor their book and counterparty exposure carefully and be careful with leverage.

Mitch Nichter, partner at Paul Hastings, says funds can protect themselves by clearly communicating to investors, both initially and throughout the investment term, the primary attributes of the product they are purchasing such as liquidity, volatility and other risk/return characteristics.

He also thinks they should structure the fund and the management company to manage these attributes. “In our experience many crisis situations, including those that resulted in fund liquidations, could have been minimised or avoided by ongoing effective communication with investors.

“Avoiding the perception of unfair surprise avoids crisis,” notes Nichter.

Using accurate and descriptive

private placement memoranda and gate provisions limiting withdrawals by percentages is the advice from Hannah Terhune at Capital Management Services Group. “Avoid fraudulent practices. Communicate proactively with your existing investors,” she says.

Sonya Van de Graaff at Brown Rudnick in London thinks funds should protect liquidity by including gates, side pockets, lock-ups and suspensions of redemptions in the investors’ agreements.

She also advises clearly defining the boundaries to financial covenants and margin calls in prime brokerage and other funding documentation and limiting the scope of discretions of the financier to refuse drawdowns and make margin calls.

“Don’t be afraid of negotiating prime brokerage documentation,” she declares.

The main challenge is to continue good investment performance, say Brian McDermott and Siobhán Moloney at A&L Goodbody. The use of investment strategies, effective selection of service provider counterparties, maintaining good investor relations, working within a jurisdiction which offers an effective regulatory regime that protects and is attractive to investors can all assist in protecting funds from liquidation, they advise.

Omar Zerafa at Aequitas Legal in Malta believes law firms have their limitations in helping a fund avoid or survive a crisis “since most of the time a crisis is the result of a conglomerate of external forces which are very often unpredictable.”

He does concede that law firms can help strengthen the fund and prepare it for times of crisis. “Careful drafting of fund documents and foresight of possible risks can mitigate the effect of turbulence on the fund,” he says.

Daniel Mackelden at Isle of Man law firm Cains thinks properly structuring the fund on set-up is the

first step. It is important, he says, to ensure it contains the necessary protections and flexibility to match the fund’s investment aims and investor expectations.

“There is also an ongoing need to keep the fund up to speed on the latest developments in structuring and make consequential changes,” he says.

“Have cash!” is the snappy answer from Gray Smith at Appleby in Cayman Islands.

“Liquidation happens when you can’t pay your debts when they fall due, so make sure wherever possible that you have the liquidity needed (easier said than done) and have documents which allow you to postpone payments (rather easier),” he advises.

Tania Dons and Richard Finlay in the Cayman office of Conyers Dill & Pearman have a different answer.

They agree with others that it is key to ensure the fund’s documents are sufficiently flexible and clear to enable it to manage its way through a crisis. Fund managers are now more aware of the pitfalls and want to include tools in the documentation to provide for possible future contingencies, they note.

Robert Briant in the British Virgin Islands office thinks the question really should be: how can funds protect themselves from being in crisis?

“The short answer to the question is a fund can avoid insolvent liquidation by ensuring it remains solvent. Otherwise liquidation is a necessary part of a fund’s life and takes place when that life comes to an end,” he says.

“Otherwise a fund will avoid liquidation if it has sufficient assets and remains solvent. A fund will have sufficient assets if it has good returns and the support of investors.

“Having said this, even a strong fund may be under pressure in a crisis when investors are looking to redeem investments, irrespective of the return. It is here where gates and the temporary suspension of redemptions may be appropriate,” Briant concludes.

In the Bermuda office Dawn Griffiths says clients need to ensure careful management of investor expectations and “seek restructuring solutions that are in the best interests of the funds. Close consultation with legal counsel on the drafting of the fund’s constitutional documents is essential.”

Because some issues have been tested in the courts of certain offshore jurisdictions, funds should

ensure they review their own documentation to leverage off the lessons learnt over the past year, she advises.

Ingrid Pierce at Walkers thinks in certain cases it is “simply impossible to avoid liquidation”. She notes that the directors may be under a fiduciary duty to consider liquidating the fund.

“However, the emphasis must be on pre-emptive action, keeping investors informed, seeking their views and if necessary, their consent to a proposed course of action. Otherwise, the fund is at risk of winding up proceedings from investors as well as outside creditors,” she concludes.

Michael Richardson in the Cayman office of Maples and Calder says funds fail and are no longer a viable entity for a number of reasons, including sudden large unexpected market pricing dislocation and illiquidity in asset classes, leverage and funding mismatches, loss of investor confidence, fraud, inability to meet margin calls and an investor liquidity crunch.

“Early identification of problems and development of solutions is vital. Funds need to involve legal counsel as soon as possible where there are concerns that any cause for the fund failing may arise.

“Good and open dialogue with the fund’s investors, lenders and other counterparties as to the reasons for the fund’s problems and the development of a credible business plan to deal with the fund’s predicament might enable the fund to weather the storm,” advises Richardson.

Together with legal counsel the fund needs to analyse its documents or counterparty documents as applicable and assess the flexibility available in order to develop a strategy of defence, he notes.

“Gating or suspending redemptions of shares may be required to take the pressure off the fund and reduce the need for the fund to make fire sales of assets in illiquid markets.

“Negotiations with lenders or leverage providers to deal with margin calls or other potential loan default situations may also be necessary,” concludes Richardson.

The importance of clear and open investor communication is also highlighted by Simon Schilder at Ogier in the British Virgin Islands.

“If a hedge fund in a crisis can manage to retain the confidence of its investors, then it will already be beginning to win the battle to avoid liquidation,” he says. ■



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Disputes spotlight ways to deal with illiquid assets

What are the main issues affecting practices such as side pockets, synthetic side pockets, gates and suspension of redemptions?

According to Nora Bullock and Simon Atiyah at Lovells, side pockets and the imposition of gates have led to many legal disputes over the last two years. They expect more to follow once these positions are unwound and money is returned to investors. Many see these mechanisms as a way for a manager to hold onto assets (and therefore fees) when investors want to get out, they say.

Investors that require valuations or liquidity can be more disadvantaged than investors who do not, note the pair. They point out that assets can often be disposed of but the manager and maybe some investors believe the timing is not right, while other investors just want the cash no matter what the potential value of the assets might be if they waited.

"Make sure that the fund's constitutional documents contain the necessary powers to permit the creation of side pockets without the need for a shareholder vote," advises Simon Firth at Kaye Scholer. For gates and suspension of redemptions his advice is to be precise about the terms of the gate and particularly about who comes where in the order or exit.

At Withers, partner John Langan looks at the issue from a different perspective.

He thinks managers, faced with a difficult time in raising new funds, may need to bow to investor pressure and modify certain terms of their proposed funds. "Regulators may focus on certain practices or contractual features of funds that might previously have been accepted as standard," he notes.

In New York, Steven Nadel at Seward & Kissel says managers must balance investment liquidity against investor concerns for ease of liquidity. "On the investment side,

if assets are hard to trade or value, the safest and fairest approach would be to side-pocket them," he advises. "From the investor perspective, given what happened at the end of 2008, they prefer not to have the uncertainty associated with part of their money held in a side pocket with a term that cannot be defined clearly," he says.

The basic issue, according to Mitch Nichter at legal firm Paul Hastings, is that a fund needs to be structured to accommodate both the liquidity needs of the chosen investment strategy and the liquidity requirements and expectations of fund investors. "All of these practices and others are simply liquidity/redemption regulation mechanisms that can be useful if clearly understood by investors and used fairly and consistently by managers," he says.

In the last year the Irish Financial Regulator gave guidance to the industry as to its thinking on measures being used to alleviate liquidity difficulties for Irish funds in current market conditions, explain Brian McDermott and Siobhán Moloney at A&L Goodbody.

The regulator took the practical approach that each fund affected by liquidity issues must consider the position in its own context, taking into account the fair treatment of incoming, existing and outgoing investors. To the extent that fund documentation needs to be amended, the flexible regulatory position permits this being done quickly without additional delays waiting for individual shareholder consent, note McDermott and Moloney.

At the Cayman Islands office of Walkers, partner Ingrid Pierce believes it is "pivotal to find the appropriate mechanism with which to manage liquidity and to ensure

that such methods are permitted by the constitutive documents of the fund."

She gives the example that if the fund is proposing to impose a gate or to suspend redemptions, it is critical to manage the timing to avoid redemptions crystallising. "The fund must also ensure that it acts in the best interests of investors as a whole. The valuation of underlying assets held by the fund is also a hugely important issue, whether or not the assets are formally designated as side-pocket investments," she says.

For Gray Smith at Appleby in Cayman these mechanisms are part of the tension between investors and managers. He thinks managers to varying degrees will use these tools. "The communication between managers and investors must improve," he advises. "Investors also need to be more sophisticated and probably increase the use of advisors and lawyers when making investments."

However, he cautions that some strategies will inevitably see a greater use of these and resulting lower liquidity. Investors must work out exactly what they are looking for before choosing.

Recent case law needs to be taken into account when considering any options that may impact on the ability of an investor to redeem its interests in a fund, says Nicholas Butcher in the Cayman practice of Maples and Calder. "One effect of the liquidity problems faced by many funds has been a significant refining of techniques to combat crisis. At the same time defensive strategies have been under the microscope as investors have a much greater awareness of how they can be affected," says Butcher.

As investors become more alive to liquidity tools, he says there will be a need for more dialogue between investors and managers. "Investors want to know what is available in the fund's arsenal of defences and in what circumstances the defences will be used," notes Butcher.

Tight, accurate and consistent drafting of constitutional and offering documentation is essential, advises Butcher. This, he says, can

help avoid "expectation mismatches in a crisis scenario".

The use of side pockets has not yet been rigorously tested in the offshore courts, note Tania Dons and Richard Finlay at Conyers Dill & Pearman in Cayman. They expect to see the use of gates and the suspension of redemptions as well as others continue to be challenged by disgruntled investors in offshore jurisdictions.

Some guidance on the suspension of redemptions and the status of investors following the redemption date has been given in recent decisions of courts in the Cayman Islands, the British Virgin Islands (BVI) and Bermuda. These matters, note Dons and Finlay, are likely to continue to be the subject of other court cases in offshore jurisdictions and will be further debated and refined over the coming months.

Simon Schilder at Ogier in the BVI agrees. He expects stress-testing of many of the traditional liquidity control mechanics used by hedge funds over the last 18 months will demonstrate the importance of properly providing for some or all of these types of mechanics in fund documents.

"The lessons learnt from the experiences of the financial crisis have necessitated drafting changes to fund documents so as to enhance the workings of these mechanics in practice," he says. He points to the fact that provisions in fund documents have been tested in court and the legal interpretations will mean change to fund documents in future. Hedge fund practices have also necessitated particular refinements to the drafting of some of the mechanisms in fund documents.

"An interesting question for hedge funds in the future will be how investor tolerance for some of the liquidity control mechanics which hedge funds are now seeking to employ will then play out going forward, particularly whether current themes and practices for liquidity control mechanics continue or evolve yet further as financial markets stabilise and investment performance returns," says Schilder. ■

Pricing problems

What are the legal concerns resulting from valuing instruments? What are the main legal pitfalls and challenges concerning illiquid instruments?

The problems around valuations are legion. There are concerns about the closer involvement of administrators in valuating investments as well as the inherent conflict of interest when the investment manager values generally illiquid assets. More subjectivity in pricing is needed as well as consistent methodologies. How this particular problem will be resolved is not clear as the legal profession also battles with the issues.

Henry Bregstein at Katten Muchin Rosenman in New York expresses concerns over the general trend over the past few years towards administrators 'calculating' net asset value (NAV) as opposed to 'valuing' investments. Although the trend is beginning to reverse, he is cautious about the implications.

"Even where an administrator is valuing investments – for example, obtaining independent third-party values and applying a consistent methodology – an issue arises with so called Level 3 assets under FAS 157 which can be thought of as assets that are neither traded on a market nor are analogous to market-traded assets," explains Bregstein.

These assets, which are generally illiquid, are often only effectively valued by the investment manager. "This implicates a significant conflict of interest and, as has often been the case, the value of illiquid assets has not reflected the liquidation value. This has resulted in investors facing significant losses and managers facing potential legal liability," he notes.

John Langan at Withers believes there is a fundamental conflict of interest between the compensation a fund manager receives, which is based on a fund's performance, and the manager's involvement in determining the value of complex or illiquid securities in the fund's portfolio.

"Ultimately, investors in a fund want to ensure that the NAVs used as the basis for all subscriptions, redemptions and performance calculations have been calculated fairly," explains Langan.

He recommends independent

valuation, where possible by an independent third party, such as an administrator, over more subjective methods of valuation such as those based on a model.

Nora Bullock and Simon Atiyah at Lovells see the fundamental problem as hedge funds marketing themselves as relatively liquid investments. They say open-ended products such as hedge fund structures historically were not thought to be compatible with the acquisition of illiquid assets. So real estate funds and private equity funds are not considered 'liquid' and are not open ended.

Hedge funds, however, are open ended. While the market for a particular hedge fund is in equilibrium – when redemptions do not markedly exceed new subscriptions – problems do not occur. But, cautions Bullock and Atiyah, when redemptions are significant, questions can be raised over the appropriateness of values ascribed to illiquid assets.

Simon Firth at Kaye Scholer believes the lack of an independent valuation can be a problem for US funds. US-based managers are not required to appoint an independent valuer or administrator and there have been cases of fraud arising from false valuations, he points out.

"Illiquid investments can be hard to value and may require specialist valuation beyond what the administrator can provide," says Firth.

"If illiquid assets are overvalued and they have formed a component of a NAV calculation on the back of which an investor has exited the fund, then continuing investors may have a claim against the fund," he says.

According to Jonathan Tonge at Walkers, the valuation methodology may be prescribed by the fund's documents or by the accounting standards the fund follows. "However, in a distressed situation," he warns, "valuation is likely to become more subjective and therefore more difficult to test. Hard-to-value securities are self-evidently more open to challenge and it is possible to ascribe two different values which are equally justifiable."

At Brown Rudnick, Sonya Van de

Graaff thinks the problems around pricing are different depending on whether the investment is involved in an insolvency or not. "There are two relevant questions: what is the claim under the instrument and what is the recovery rate under the instrument?" she says.

Lehman is an example where it is possible to have a view as to the recovery rate that requires a legal analysis of the instrument including set-off rights and where there is an understanding of what the claim is under the instrument.

"Take the situation of notes issued by Lehman BV. While the issuer is a Dutch entity, the notes may be governed by English law and guaranteed by a Delaware company under a New York law guarantee," explains Van de Graaff.

"In an insolvency situation you may have to determine under English law what your claim is and submit it in the Dutch bankruptcy process and also in the New York bankruptcy. So, multiple sets of law may need to be analysed," she says.

Robert Briant at the British Virgin Islands office of Conyers Dill & Pearman believes if there is a miscalculation in the value of an asset, then certain shareholders will benefit while other shareholders will be harmed. "It is the duty of the directors of the hedge fund, as delegated to the administrator or manager, to ensure that an accurate valuation as possible is ascribed to each asset," says Briant.

For him the main legal concern for failure to properly value an asset is "a breach of fiduciary duty as well as a likely breach of the subscription agreement and memorandum and articles of association, potentially exposing the directors and as a result the manager and administrator to legal action."

At Conyers Dill & Pearman in the Cayman Islands, Tania Dons and Richard Finlay say the main legal pitfalls and challenges surrounding illiquid assets are how to deal with them without impacting the liquidity of other investments and to enhance recovery from those assets as far as possible. They say

the key mechanisms currently used by funds include lock-ups, gates, suspensions and side pockets.

Eliot Simpson at Appleby in the Cayman Islands says the main problems his law firm has seen with valuation are either where the values are difficult to assess or where the reported values come from a manager or advisor but turn out to be dishonest. "In either case the administrator can end up reporting false values. Given that investments and redemptions are determined by NAV, these problems can cause all sorts of headaches," says Simpson.

"Investors who bought in at an overstated NAV might try to rescind their investment and extract 100% of what they put in, notwithstanding an overall drop in the real value of the fund," he suggests. Investors redeeming at overstated NAVs might expect to be the subject of 'claw-back' claims.

"Pending resolution of these issues redemptions or distributions are likely to remain suspended and investors are unlikely to be able even to extract what limited value is left in their investments. These issues may take many years to resolve," he says.

At Maples and Calder, Jon Fowler says the main issues include determining who is valuing the assets: the manager, the administrator, both or a third-party valuation agent?

"If a fund wants to have the ability to designate side pockets it needs to have the flexibility in its documents. It is important that the structure is capable of preserving existing rights without encumbering new investors," advises Fowler.

"The usual model is a separate class of shares either issued to investors following compulsory redemption of their general class shares or by a re-designation of general class shares. The ability to do this needs to be built into the fund documents up front," he explains.

He concludes valuation policies need to ensure that the competing interests of redeemed and remaining investors are taken into account and are disclosed in the offering documents. ■



Flexibility and tax dominate structure

What are the main legal considerations in choosing a structure for a hedge fund?

Brian McDermott and Siobhán Moloney at A&L Goodbody say agility in terms of industry, investor and regulatory demand should be considered when selecting a fund structure. They note the Irish qualified investors fund (QIF) allows the use of the most complex of investment strategies. The Irish Regulator's usual requirements regarding leverage and diversification do not apply; few investment restrictions are imposed on QIFs. There are also a number of structures that can be used to mitigate difficulties in obtaining tax treaty relief.

They have also seen an increasing trend in hedge fund managers launching Ucits funds. The convergence of these two spheres is linked to the extended scope of eligible investments under Ucits III, in particular relating to the use of derivatives as well as the ability to use an advanced or sophisticated risk measurement methodology such as value at risk (VaR).

Nora Bullock and Simon Atiyah at Lovells believe funds should take into account several issues: where the investments are based/will be traded; where the targeted investors are based (for example if there will be both US and non-US investors); whether these investors would be interested in an offshore or onshore hedge fund product; and what legal structure (such as company or partnership, single portfolio or umbrella fund or protected cell company, open ended or closed ended) would be most attractive; and what kind of distribution channels to use.

In terms of choice of fund vehicle, they think it needs to achieve limited liability to investors and not increase the amount of tax investors pay on the underlying investment. The overall aim is not to place the investor in a different position than if it were to invest in the underlying investment directly. Fund vehicles/structures all have advantages and disadvantages, comment Bullock and Atiyah.

In Malta, Omar Zerafa at Aequitas Legal thinks most funds look for a flexible and strong mechanism. He, too, believes tax is an important factor. "Bearing in

mind the international nature of the fund, double-taxation treaties are crucial in determining how a particular income from the fund is to be treated in another jurisdiction," says Zerafa, agreeing with his colleagues at Lovells. "The chosen structure of the fund ultimately depends on the investors and the type of investment. It is important for the hedge fund to make this decision correctly from the moment of incorporation, as this could have serious repercussions afterwards," he concludes.

John Langan at Withers believe there can sometimes be a crucial marketing advantage in being able to offer investors better tax treatment than similar fund vehicles. "In most well-established types of fund, such as hedge and private equity, there is an accepted 'standard' structure and the client's main concern will be the lawyer's degree of knowledge of such structures and familiarity with the standard documentation," notes Langan.

Joey Garcia at Isolais in Gibraltar says a hedge fund's structure should be primarily based on the needs of the target investors. An influencing factor would be any potential restrictions associated with the fund and its investors, such as being able to promote the fund to a specific group of persons or restrictions on eligible assets. "If any potential obstacles are not identified at the outset, no matter how good the investment strategy, the fund could run the risk of not receiving enough subscriptions to allow it to commence trading," says Garcia.

Frances Watson at Ogier's Guernsey office agrees with others that the principal considerations are flexibility of fund structure and the ease with which it can be distributed. "Where the hedge fund runs a multi-strategy approach, the availability of protected cell companies or similar could be relevant," she says, picking up Garcia's point.

"Regulatory considerations are equally important and in particular seeking a balance between regulation of an internationally acceptable standard and flexibility. It is a given that the structure must be tax-efficient," she concedes.

In the British Virgin Islands office Simon Schilder also believes the starting point for any structuring is the hedge fund's potential investor base. "This will inextricably influence both how a hedge fund is practically structured (master/feeder, side by side, offshore/onshore), the types of entities used in the structure and the jurisdictions which will be utilised for these purposes," he says.

The right legal advice for the relevant jurisdiction is crucial, declares Jon Fowler at Maples and Calder. "Issues affecting structure include tax and regulatory restrictions, location of the fund manager or the main part of the fund's investments, geographic spread of investor base and simple preference or familiarity of managers and investors. The predominance of certain types of structure in different jurisdictions can be a more influential factor," he says.

Fowler has spotted trends for jurisdictional bias, such as partnerships for the US market, companies for the UK and unit trusts for Japan.

Cayman, he says, has become the domicile of choice for international hedge funds and private equity funds because it is a tax-neutral jurisdiction serving as a platform for funds targeted at institutional investors with a wide geographic spread where otherwise it would be impossible or unduly burdensome to reconcile different tax codes. "Cayman fund structures are widely acknowledged by institutional fund managers, investors, lenders and swap counterparties as the product of a tried-and-tested legal system. Cayman also benefits from stable government and a deep bench of professional and legal expertise," he concludes.

Tania Dons and Richard Finlay at Conyers Dill & Pearman both agree with the view that structure is generally driven by the type of investors the fund is targeting and/or its proposed investment strategy. So funds that want to market into Japan will often be established as unit trusts for tax reasons. The majority of offshore hedge funds are still set up as exempted companies, they note. Whether or not a master-feeder structure is needed depends on the particular client. They are aware of

an increase in the use of managed accounts and single investor funds for large institutional investors who can dictate terms and not have to compete for liquidity.

Gray Smith at Appleby in Cayman says power has "shifted hugely to the investor and funds will have to ensure that any structure works for the investor in terms of tax, liquidity and transparency."

Catherine Gardner and Fred Levy in the Washington office of Brown Rudnick believe tax and regulatory issues should determine the choice of jurisdiction for a hedge fund. They say the main consideration for most hedge funds in choosing a jurisdiction in which to domicile are the location of investors and fund managers. The jurisdiction should provide the most advantageous tax scheme for the investors as well as a well-developed regulatory and legal scheme for hedge funds, they say.

Ron Geffner at Sadis & Goldberg says there are three primary considerations that determine the structure of any hedge fund: the investment strategy to be used; the type of investment (taxable or tax-exempt) and domicile of investors (US and non-US); and tax and regulatory matters.

A set of questions is the starting point for Steven Nadel at Seward & Kissel: who are the investors? What is the strategy? What is the liquidity make-up of the portfolio? Any unique tax or other operational issues? What will the fund and manager domicile be? "Once all these items are discussed, the law firm should walk the manager through all the possibilities and suggest a best course of action," he says.

"The structure should facilitate the efficient and effective delivery of the chosen investment strategy to the targeted investors," explains Mitch Nichter, a partner at Paul Hastings. "The primary attributes of the strategy, such as use of leverage, location of primary investment markets and investor requirements and expectations, for example, domicile, tax status and liquidity expectations of the investors, should drive the structure of the product," he concludes. ■

Making a good match

What are the main things a hedge fund should consider when choosing a jurisdiction? What are some of the main legal decisions hedge funds need to make before they set up a fund?

The choice of jurisdiction for a hedge fund, according to Catherine Gardner and Fred Levy at Brown Rudnick in Washington, should be determined on the basis of taxation and regulatory issues. They say the main consideration for most hedge funds in choosing a jurisdiction in which to domicile is the location of its target investors and fund managers.

The jurisdiction should provide the most advantageous taxation scheme for the investors as well as a well-developed regulatory and legal scheme for hedge funds, say Gardner and Levy.

According to Mitch Nichter at legal firm Paul Hastings, the primary factors in choosing a fund domicile include location and type of targeted investors, for example investor domicile and tax status, investment strategy of the fund and location of fund personnel.

Robert Duggan at Walkers in London thinks the decision on jurisdiction cannot be simplified to just a question of on or offshore. "Some of the main considerations underpinning choice of jurisdiction generally, and not solely the question of onshore versus offshore, are tax, regulation, cost and ease of use," he says.

"Ease of use, for example, will always be relative," notes Duggan. "Language and cultural barriers are often cited as concerns, and validly so, but the more fundamental concern should be the ease of use of available structures."

Speed of set-up, language, light regulation (although the availability of light regulation will be more restricted following the implementation of the draft EU directive on alternative investment fund managers), flexibility, tax treaties of relevance to the strategy, and availability of experienced/competent support services (lawyers/administrators/accountants) are all highlighted by Simon Firth at Kaye Scholer as important.

Brian McDermott and Siobhán Moloney at A&L Goodbody say regulation and the tax environment are the two most important factors

to consider. Expertise and international recognition are also important.

They say there is a tendency for institutional investors to prefer funds domiciled in onshore jurisdictions with efficient regulatory environments and that this has prompted funds to establish in jurisdictions like Ireland this year.

The quality of service providers is of key importance to investors, say McDermott and Moloney. They point to Ireland's position as the largest hedge fund administration centre in the world and its recognition as a centre for excellence for hedge fund administration.

"Increasingly, choice of jurisdiction governed by issues of service quality and jurisdictional legal, regulatory and financial credibility are key to choosing a jurisdiction," concludes Daniel Mackelden at Cains on the Isle of Man.

Dermot Deering at Hassans in Gibraltar says considerations include the "general soundness of the jurisdiction and its regulatory and business environment, tax, competent and competitive professional advice and services and, of course, the weather," he cheekily adds.

Joey Garcia at Isolas concedes that the choice of jurisdiction is likely to be the most complex and significant legal decision a fund manager takes. "Once a domicile has been chosen, the hedge fund structure and legal form may be determined," he says.

Before making that decision the manager needs to determine the type of investors the fund has secured or is attempting to attract.

"There is no point in establishing a fund which caters for sophisticated investors in a jurisdiction which provides little or no products of this type when another location that enjoys more flexibility may offer a greater variety or better class of product. Some lesser known and emerging locations may have exactly the niche product which a fund manager is searching for with legislation in place which caters for the clients' specific needs," he notes.

He also believes clarity and secu-

rity are of particular resonance in today's environment. "Both managers and investors must be able to rest assured that their choice of jurisdiction operates within a legal framework that affords them all of the necessary legal protections and mechanisms. This, along with political and financial stability of a jurisdiction, is likely to become a more and more important factor when deciding on a jurisdiction to domicile your fund," concludes Garcia.

Cost, too, is also a consideration. Corporate tax rates and financial stability remain key, he says. "The importance of structuring a fund in a tax-efficient way will also always be paramount as in some cases the accumulation of taxes, charges and levies may determine whether a fund remains profitable to its investors," he notes.

The amount of time a fund takes from conception to launch is also significant, says Garcia.

The stability of the jurisdiction and its reputation is of paramount importance, declares Omar Zerafa at Aequitas Legal in Malta. He says funds are "looking for a sturdy yet dynamic legal framework which offers flexibility to the fund in its operations as well as adequate protection to the investors. Undoubtedly, a lenient tax regime is also an important consideration in choosing a jurisdiction for a hedge fund."

Time to market, regulatory framework, the country's and regulator's reputation, the tax regime, investor protection, the sophistication of the legal services offered and more should be taken into account, advises Andre Zerafa at Ganado & Associates in Malta. "The main decisions tend to revolve around legal nature, residence of directors, control over the structure, rights and collateral given to the prime broker over the fund's assets, NAV calculation mechanisms, acceptance or otherwise of *in specie* subscriptions and the possibility to benefit from the particular domicile's double-taxation treaty network," he says.

Well-regarded, tried and tested legal structures, stability of govern-

ment and constitution, absence of relevant taxation, quality of service providers, flexibility of statutory and regulatory regimes and size of fund industry are all important considerations, according to Jon Fowler at Maples and Calder in Cayman.

Key considerations, say Tania Dons and Richard Finlay at Conyers Dill & Pearman, include the quality and sophistication of the legal system and key legislation, particularly in the event of liquidation and insolvency, the political stability of the jurisdiction, time to market, tax-efficiency and the quality of local service providers.

In the British Virgin Islands (BVI) office, Robert Briant says the key decision in choosing a jurisdiction is to ensure the domicile has robust laws and a sound regulatory framework.

"With the OECD finally making a distinction between offshore financial centres (being jurisdictions such as the BVI, the Cayman Islands, and Bermuda) and bank secrecy jurisdictions (such as Switzerland and Lichtenstein), greater comfort will be offered to managers and investors using offshore financial centres," concludes Briant.

In the Mauritius office, Craig Fulton says the starting point is to decide if the fund is being set up as an offshore structure. "Once this is settled then it is a case of determining which offshore jurisdiction best suits your needs," he says.

He believes hedge funds want a jurisdiction with a respected legal system where there is a strong local judiciary and law firms that offer a high standard of service operating in that jurisdiction.

"They also want a jurisdiction that is well regulated with effective legislation and a respected regulator," states Fulton.

Gray Smith at Appleby in the Cayman Islands believes the reputation of the country is crucial and is what investors will look at. "Why give yourself the headache of explaining why you chose somewhere off the beaten track if you don't need to? Capital raising is hard enough as it is," he concludes. ■



Offshore future

Is there a future for offshore legal practices specialising in hedge funds?

John Langan at Withers in London is confident of the continued necessity of offshore legal practices for “as long as offshore jurisdictions remain major players in the funds industry”.

“However, for as long as there are significant concentrations of managers and investors in particular onshore jurisdictions, for example the US and UK, it seems likely that offshore and onshore firms will continue to work actively and extensively together, particularly where onshore tax and regulatory expertise is crucial.”

At Seward & Kissel in New York, Steven Nadel is adamant that there will be a continued need for offshore legal services “although the EU’s alternative investment fund managers directive and other possible regulatory proposals could greatly impact them. Some jurisdictions, such as the Caribbean, may not be as appropriate to certain investors in the future.”

At present offshore legal services are needed, say Nora Bullock and Simon Atiyah at Lovells in London.

They believe as onshore government and tax authorities continue to push hedge funds offshore, there will be a demand for offshore legal services.

Simon Firth at Kaye Scholer in London thinks many offshore legal firms now have an EU presence, principally Dublin, and will be able to cash in on the move to onshore EU jurisdictions inspired by expected legislation. “We can expect to see offshore firms invest in ‘offshore’ Europe in places like Malta and Cyprus. As for pure offshore, such as Cayman, it is possible that fund formation work will dry up on the back of the alternative investment fund managers directive and a clampdown on offshore centres by the US authorities. But for the Middle East and Asia there may continue to be a future in offshore funds work,” believes Firth.

Michael Richardson at Maples and Calder in Cayman is convinced “the offshore hedge fund model may go through some structuring changes but it will remain attrac-

tive as a model that aims to enable a broad spectrum of investors to beat the markets and outperform traditional investments.”

Also in Cayman, Gray Smith at Appleby says he is seeing more managers wanting to move operations to well-run offshore jurisdictions such as Cayman, Jersey, the British Virgin Islands (BVI) or the Isle of Man. “The whole focus on offshore centres of the last few months has shown them to be well-regulated and co-operative with regard to tax. The OECD blacklist showed more countries on mainland Europe than offshore,” he notes.

“The spotlight has been on places such as Cayman for many years and they have responded positively as the reports have shown,” he concludes.

Tania Dons and Richard Finlay at Conyers Dill & Pearman in Cayman also believe there is “a sound future for offshore fund specialists”. However, what form the regulation of funds and investment managers will take onshore and what impact that may have on the offshore industry

is less clear. Nevertheless, they both think there will always be a need for the options, structures, services and expertise that offshore jurisdictions provide. So far they have not seen any significant move away from the establishment of funds offshore.

In the firm’s Mauritius office Craig Fulton agrees. “Offshore jurisdictions have certain tax and regulatory advantages that will always make them attractive to the investment fund industry. As a result, specialist law firms in offshore jurisdictions are always going to be needed.”

In the BVI office of Ogier, Simon Schilder believes that despite the effect of any regulatory changes in the US or in Europe on the hedge fund industry that may or may not impact upon offshore domiciled hedge funds “with sources of capital for investment managers increasingly being located in regions such as South America, the Middle East and Asia, the need for offshore funds is likely to remain strong in the foreseeable future.”

In the Guernsey office Frances Watson also says there will be onshore opportunities for the establishment of hedge funds. “However, as the industry regains ground the geographical spread will continue to widen, as will the investor base. Inevitably the use of well-regulated and tax-neutral, but fundamentally tax co-operative, jurisdictions, and therefore law firms based in those jurisdictions, will increase,” she concludes. ■

INVESTORS DRIVE STRUCTURE

How do the legal needs or requirements of investors influence the setting up of hedge funds? What, if any, are the differences between different types of investors, say family offices and institutional investors?

Ingrid Pierce at Walkers in the Cayman Islands says issues related to transparency may differ. “Certain institutional investors that allocate a substantial amount of their investable assets to a particular manager or fund may require special terms, such as their own class of shares, portfolio or fund,” says Pierce. At Appleby in Cayman, Gray Smith believes the needs of most investors are largely the same: good returns, transparency, liquidity and a good dispute resolution forum. “Logic would, therefore, send you to the major centres with a solid court

system and a number of good law firms who can advise the various sides in any conflict,” he concludes. Nicholas Butcher in the Cayman Islands practice of Maples and Calder points out that the landscape following the restructurings of hedge funds has changed in relation to exit terms. “Investors are looking for a matching of asset type to liquidity and are bearing down on suspension criteria. Investors want access to capital and are having a greater influence over the structuring of funds,” he says. The tax profile of different investors can be radically different, notes John Langan at Withers in London. “Institutional investors may often operate on an essentially tax-neutral basis whereas for family office investors tax treatment is a key driver in decision-making,” says Langan. “It is key for hedge fund start-ups

to identify their likely investors and develop their fund structure to suit them. It can, of course, be possible through feeder structures to try to accommodate investors with very different tax profiles,” he says. An important current issue for funds with UK investors, points out Langan, is the reporting fund status that comes into effect later this year. “Some hedge funds may qualify for reporting fund status which will give UK-resident investors capital gains tax (18%) treatment rather than income tax treatment at rates of up to 50% from April 6, 2009. If funds can obtain reporting fund status, they will give themselves a competitive marketing advantage in the UK marketplace,” he concludes. Nora Bullock and Simon Atiyah at Lovells in London think hedge fund managers targeting certain investor groups or specific investors will

structure and locate their funds to accommodate particular investor groups. As laws and investment mandates become tighter, say the pair, other structural considerations may become more important, such as investor requirements for independent boards or greater investor reporting. For onshore EU funds this may result in hedge funds adopting different models. Omar Zerafa at Aequitas Legal in Malta agrees the legal needs and requirements vary according to the type of investor. “Individual investors may be more interested in getting tax exemptions and personal investment advice. Larger institutions and family offices would normally have greater lobbying power and would normally seek to have a say in the administration of the fund,” notes Zerafa.



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Devil is in the detail

What are the most important legal lessons learnt from the financial crisis for hedge funds?

A variety of lessons have come out of the financial crisis. Not only will documentation for hedge funds substantially change in future, transparency will be a key issue for investors. The dangers of counterparty risk, of not performing proper due diligence and much closer attention to detail are all issues that investors will be concerned with in future.

According to Sonya Van de Graaff at Brown Rudnick in London, hedge funds have learnt to engage in active negotiation over funding documentation and prime brokerage documents. "The old bargaining powers have altered. Hedge funds have learnt to focus on counterparty risk, including that of their prime broker and custodian," she admits.

At Withers, partner John Langan says transparency is the key to hedge funds regaining the trust and improving their relationship with investors and regulators. "Custody agreements and counterparty risk should be assessed on a regular basis," says Langan.

"A good risk management process is the best way to minimise loss when problems arise, or at least anticipate and avoid potential problems before they arise," he advises.

When establishing a hedge fund the choice of structure should be one that is robust and can adapt to future changes where necessary, Langan says.

At Lovells, Nora Bullock and Simon Atiyah believe the collapse of Lehman's was a "wake-up call" exposing the dangers of prime broker relationships and the inadequacy of protections to counterparties. They say many investors were unaware of the nature of the risk.

They also think it is clear that the term 'hedge fund' covered a wide range of products, many of which carried little or no hedge to the market turmoil.

The crisis has reinforced the need for more investor due diligence, they believe. Both say investors are no longer content to rely on the blue chip reputations of institutions or individuals.

Finally, the inadequacy of many

hedge fund prospectuses and disclosure documents was exposed, they say. Risk disclosures were inadequate, the ability to impose gates and suspend redemptions was inadequately explained and sometimes the criteria were non-existent with inadequate independent oversight, they conclude.

Simon Firth at Kaye Scholer advises investors and funds to read and understand what the legal documents say and assess and monitor legal risk. "Investors are business partners, not friends," he cautions, adding that they want protection against enforced redemptions.

"After a tumultuous year for the industry that brought transparency and liquidity issues to the forefront of investor concerns, there has been a move by many managers towards managed accounts which offer full ownership and transparency for investors," notes Joey Garcia at Isolais in Gibraltar. "The challenge for hedge funds is to reduce their total expense ratios in order to be competitive and to return to levels of performance that make them attractive," he says.

The importance of instructing knowledgeable counsel and taking advice from legal firms with the expertise to deal with specific structures has also been highlighted by the crisis. "Well-drafted legal constituting documents and material agreements can make a considerable difference at times of crisis," adds Garcia.

"The expertise that fund lawyers can provide to their clients may ultimately prove the difference that ensures the survival of the fund should it run into a situation where investors are panicking and creditors are calling in debts. Whether it is through the inclusion of suspension of redemption provisions, lock-up periods, gates, or side pockets, such measures may prove vital for a fund to remain liquid during difficult times in which it may find itself inundated with redemption requests from anxious investors," he concludes.

In Malta, Omar Zerafa at Aequitas Legal says the crisis was

a test for "subsistence for hedge funds. It clearly demonstrated that those funds in a strong regulatory environment were the most capable of surviving duress. As a result, funds are now seeking jurisdictions with adequate regulation and legislation."

He believes having an authority supervising the regulatory and disclosure requirements, rather than having such requirements imposed in the fund documents, would help to create a common system for all funds. "Apart from adding to the overall stability of the system, it helps to create legal certainty which would be greatly appreciated by the investors," he adds.

In New York, Steven Nadel at Seward & Kissel simply advises funds to diversify counterparty exposure and "be careful re liquidity and valuation of investments".

Another New Yorker, Mitch Nichter at Paul Hastings, suggests funds should "be upfront with investors about potential liquidity constraints and redemption mechanisms and craft more precise and thoughtful fund documents to disclose and implement these constraints and mechanisms and the policies the manager will look to in times of turmoil to meet its obligations to investors."

At Walkers, Jonathan Tonge's advice centres on greater scrutiny of all agreements and constitutive documents before the fund launch. "This is principally to ensure that all parties clearly understand the remit of the directors' authority and the ability of the directors and the manager to manage liquidity. This is true even for funds that are considered to be highly liquid with no need for such measures," he says.

He adds there has been a much greater understanding of the relevant custody issues, in particular to identify the circumstances in which the fund's assets may be charged or rehypothecated.

Managing liquidity, even if it affects performance, is the issue highlighted by Gray Smith at Appleby in the Cayman Islands. "Legal documents can put you in a

robust position when dealing with investors but only keeping them happy is going to make you successful in the long run," he adds.

At Maples and Calder, Michael Richardson says it is important to consider the level of flexibility required at the structuring stage.

He believes it is crucial to have access to top-tier legal counsel with the ability to gear up during a crisis, survey the available options and implement effective, robust solutions.

"It is important to avoid drift between underlying documents and marketing documents or even oral representations. The fund should be aware of side letters with particular investors and factor in contractual obligations when considering restructuring options, communication and early identification of problems," advises Richardson.

Tania Dons and Richard Finlay in the Cayman office of Conyers Dill & Pearman say the key lesson for funds and managers is "to get their ducks in a row from day one" by ensuring fund documentation is sufficiently flexible, clearly drafted and provides the tools and mechanisms necessary to deal with potential future problems. Preparation is the key to success, they say.

In the British Virgin Islands office, Robert Briant suggests the most important lesson is the need to structure funds properly. "In good times many persons are not particularly concerned with the detailed language of contracts or the memorandum and articles of association. However, when a crisis occurs, that is when it is necessary to ensure the memorandum and articles of association and contracts are robustly drafted to ensure there is sufficient power to side-pocket assets, impose gates, or suspend redemptions, subject to the requirements of investors to ensure that these powers are not to be exercised too quickly or inappropriately by the hedge fund," cautions Briant.

In good times no one is particularly concerned about these issues, he says, "but in a crisis these are the issues that come to the forefront". ■

Liquidity concerns drive demands

The redemption and liquidity requirements demanded by investors affect the type and liquidity of investments a hedge fund can make, explain Catherine Gardner and Fred Levy at Brown Rudnick in Washington. They say many investors are requiring managers to eliminate or reduce the use of side pockets and want to eliminate the ability of managers to restrict redemptions.

Henry Bregstein at Katten Muchin Rosenman in New York agrees there is increased scrutiny of whether the liquidity of the underlying portfolio matches the redemption terms. "There were any number of instances where underlying hedge fund liquidity for a fund of

fund averaged far in excess of fund of fund redemption terms or where illiquid strategies carried quarterly redemption terms," he notes.

In the Cayman Islands, Jonathan Tonge at Walkers says there "is a tension between funds seeking to have flexible powers to manage the fund in what they determine to be the best interests and investors with bespoke requirements seeking to have these provisions hard-wired into the documents." He says investors are also "increasingly less willing to rely on side letters. With regard to fund documents, we expect to see greater risk disclosure, including in connection with redemptions in kind."

These sentiments are echoed

by Gray Smith at Appleby in the Cayman Islands. "At the moment new funds are desperate for cash and putting in highly liquid terms, while at the same time maintaining gate and suspension language. However, investors are looking more to protect themselves and side letters, concentrating on liquidity rather than fees, are making a comeback. But that is a risky route for the manager," cautions Smith.

Simon Firth at Kaye Scholer in London says one consequence of the financial crisis for the fund industry is that the price demanded by investors who agree to be locked in is lower fees, so, for example, a 15% performance fee rather than the standard 20%.

Are the redemption and liquidity requirements demanded by investors affecting hedge fund and fund of hedge fund structures and documentation?

"Others demand more liquidity and enhanced transparency and funds have now been established with daily liquidity and a facility for providing real-time portfolio information," he points out.

"Investors appear to be demanding greater investor liquidity which is not surprising following recent events in the hedge fund industry," say Tania Dons and Richard Finlay in the Cayman Islands practice of Conyers Dill & Pearman. This will be reflected in fund documentation. They say they are also aware of an increase in the use of managed accounts and single investor funds for large institutional investors who can dictate terms and not have to compete for liquidity. ■

EMERGING MARKETS OFFER PROMISE

Where are the new or expanding markets for hedge fund legal services? Will law firms need a global presence or will they be able to offer only local or regional services to hedge fund clients in future?

"EU onshore centres will grow in importance as a result of the alternative investment fund managers directive," says Simon Firth at Kaye Scholer. He also believes Asia and South America will increasingly provide new managers.

At Aequitas Legal in Malta, Omar Zerafa thinks if regulators can come up with a "robust yet flexible regime regulating funds, there will be an expanding market in the EU".

At A&L Goodbody in Dublin, Brian McDermott and Siobhán Moloney believe the market for Ucits funds, especially those offered by traditional hedge fund managers, is expanding significantly. They say hedge fund managers will continue to rely on local law firms with expertise in individual jurisdictions and will rely on 'best of breed' advice in each jurisdiction where they operate.

In the Cayman Islands at Higgs Johnson Truman Bodden & Co, Wilton McDonald is backing Brazil, Russia, Indian and China (the BRIC countries) as well as some Middle East countries, like Bahrain and Qatar. He also sees potential in some African countries.

"Firms do not need to have a global presence to be successful in attracting business or being profitable," he says. "They just need to have a global marketing outlook and flexible approach and the ability to service key markets around globe. It is not realistic, practical or cost-effective to have offices in each country. Better to have offices in key regions," concludes McDonald.

In New York, Steven Nadel at Seward & Kissel agrees that Asia and the Middle East are attractive possibilities. He also agrees that firms can stay local but will need affiliations with "proper local law firms".

Asia may be the largest expanding market for hedge funds, believe Nora Bullock and Simon Atiyah at Lovells in London. Compared to the US and the UK, this region is under-represented currently.

"Investors in Asia, the Middle East and South America are seeing the benefit to alternative investment products and will spur demand for hedge funds," says Henry Smith at Maples and Calder in the Cayman Islands.

At Withers in London, John Langan believes giving cross-border expertise is useful if "synergies can be found such that a law firm can provide the full creation service with advice on structuring, implementation of structuring and provision of tax advice."

In London at Brown Rudnick, Sonya Van de Graaff says the new and expanding markets for hedge funds depend on growth and opportunities. She tips India as an area of interest in the coming years. "But of course the level of interest depends on political and legal risk and these need to be assessed jurisdiction by jurisdiction," she adds.

Back in Cayman, Gray Smith at Appleby says his firm's view is that different markets in terms of where the investors are coming from and where the fund is investing require different structures and jurisdictions.

"You cannot simply say we can offer you A or B, and we can shoehorn you into one of them. Which do you want? As this side of things comes more into focus, you have to be able to say 'the very best place for you is C and we can help you out there'," says Smith.

Firms need to focus on providing local legal advice from a global platform, agrees Robert Briant at the British Virgin Islands office of Conyers Dill & Pearman. "Specifically, hedge fund managers, as well as their investors, expect legal counsel to be available locally and in the same time zone but to also have expertise in the jurisdiction of incorporation."

So he thinks law firms will need to have offices in multiple jurisdictions to cater to the needs of their clients. "It is not desirable for law firms to expand beyond their core practice of providing legal advice to hedge funds and their managers. To the extent that law firms begin to offer additional services, such as hedge fund administration, they quickly run into conflicts of interest which make it very difficult for them to act in the best interests of the hedge fund," concludes Briant.



See you in court?

Will there be increased litigation in the coming months/year related to the events of 2008? In general do you expect to see more litigation relating to hedge funds over the medium to longer term? What do you think will be the main issues/areas of litigation?

Robert Briant in the British Virgin Islands office of Conyers Dill & Pearman believes most of the funds in crisis have already been identified and any litigation has either commenced or is imminent. "The litigation surrounding the Madoff feeder funds, as well as the other fraudulent schemes uncovered as a result of the financial crisis, will continue for years to come," he cautions.

Both Tania Dons and Richard Finlay in the Cayman Islands office of the firm do not expect any dramatic increase in the level of fund-related litigation in that jurisdiction over the coming year or longer term. While there has not been as much litigation in Cayman as people may have expected, their view is that this is in large part due to the quality of legal services funds have traditionally received in Cayman when establishing their funds. They also think funds, managers and their counsel have managed to manoeuvre their way through liquidity issues and restructure without alienating investors and without the need to resort to litigation.

Brian McDermott and Siobhán Moloney in the Dublin office of A&L Goodbody paint a different picture for funds in Ireland. They believe as the fund industry in Ireland continues to grow, there will be a growing need to resolve commercial disputes. Funds domiciled in Ireland, their investment managers and service providers have consulted A&L Goodbody recently, reveal the pair, on a range of disputes, including breach of contract and/or negligence claims, allegations of mispricing, breaches of investment restrictions, the interpretation of fund documentation including the adequacy of disclosure on strategy, regulatory investigations, claims against fund directors and the extent of due diligence on, and supervision of, any investment manager.

In London the mood is similar. Sonya Van de Graaff at Brown Rudnick also expects to see much more litigation. "Hedge funds will need to be prepared actively to protect their investments," she says.

Hedge funds have and will continue to face threats from other investors, such as in structured finance transactions. Investors in other tranches will often want a different outcome to a situation than investors in another tranche. Also the government, through the privatisation of investments, can throw a spanner in the works on any investment, she cautions.

Ingrid Pierce at Walkers in the Cayman Islands is also braced for increased litigation over the coming months. "Funds are contemplating restructuring plans and in some cases are still dealing with liquidity problems. The main areas are principally related to the treatment of investors, valuation issues and whether funds are operating within the fund documents," she says.

Gray Smith at Appleby in Cayman agrees. "We have seen a huge amount of litigation, actual and threatened, and the drafting of documents has not always helped. It is probably peaking now, which means another two years of activity for most litigation departments due to the length of the process. Most of it boils down to investors not getting their cash and that will always be the key issue," he concludes.

Also in Cayman, Matthew Crawford at Maples and Calder is expecting litigation activity relating to hedge funds to increase over the next two years. "Based on our experience of activity in 2009, the main issues are likely to be how funds respond to continued liquidity problems, how they deal with counterparty risk and the performance of their service providers in times of crisis," he says.

Ogier's Simon Schilder in the British Virgin Islands believes litigation is likely to come in two stages. The first stage will be actions bought by disgruntled investors challenging the imposition of suspensions and gates and/or the refusal of funds to provide information.

"We are seeing this litigation coming through the courts at the moment and this is posing interesting and important questions as

to the construction and meaning of certain provisions of fund documents, which were previously market standard," notes Schilder.

The second stage is likely to be actions brought by funds, possibly through the liquidator of the fund, against various service providers for things like breach of mandate claims and other issues, says Schilder.

"There will almost certainly be increased litigation in the coming months in relation to the events of 2008," predicts John Langan at Withers in London. He thinks the most common areas of litigation are likely to be claims from investors who think they have been misled about the value of assets; inaccurate industry-specific data which influenced their decision to invest and skewed the rates of return; and allegations that a fund manager misled them about exposure to the mortgage-backed securities market or to another type of investment which has failed or underperformed.

"In addition, material mis-statements in the offering documents may give rise to claims against the fund manager," forecasts Langan.

"It may also be possible to hold investment banks that securitised the mortgages or other receivables at least partly responsible, in the case of a major collapse of the market, for failure to disclose material facts about the credit quality of the mortgages or assets receivable," he notes.

Other possible actions by the liquidator on behalf of the stakeholders against directors may include breach of fiduciary duties, fraudulent preference, trading while insolvent, misfeasance, fraud and theft. "Often the actions of the directors, managers and functionaries will give rise to tracing claims against third parties for recovery of money belonging to the fund which has been wrongfully paid away," explains Langan.

In the much more litigious US courts, Mitch Nichter at legal firm Paul Hastings in New York is convinced there will be more court action. "Litigation and regulatory

enforcement actions in this area have increased and we likely will see more of the same in the immediate and longer term. Once markets settle down and resume their advancement, we expect to see fewer disputes and less litigation," he expects.

Nora Bullock and Simon Atiyah at Lovells believe there will be an ongoing trend towards more disputes and more litigation in the hedge fund area. These cases will be driven by greater regulation providing investors with more avenues of legal recourse. Because of higher levels of due diligence and more rigorous disclosure requirements, managers will have less "wriggle room" when things go wrong, they say.

At Kaye Scholer, partner Simon Firth thinks most future lawsuits will be fought over breaches of investment policy and alleged favoured treatment of some investors over others. "For the future as due diligence becomes more precise and more representations are required of managers, their operating and compliance procedures will need to be enhanced and tightened. Failure to follow those procedures, or misrepresentation given to investors, will be more likely to be punished by seeking legal remedy," he forecasts.

In Guernsey at Ogier, Frances Watson also expects an increase in litigation. "Themes include termination of investment management agreements, loss of key persons, shareholder activism at general meetings and queries as to the robustness/disclosure level of fund documentation by investors," says Watson.

"The precision with which certain clauses within documentation was drafted has been under considerable scrutiny, which impacts upon future documentation," points out Watson.

"Considerable thought is currently being given as to how to balance requirements for liquidity with protection of value for ongoing investors, in a way which would be attractive to all investors. This also is starting to impact upon documentation," she adds. ■

Limited opportunities for expansion

“Law firms themselves are unlikely to diversify from the provision of legal advice and matters ancillary to that,” says Nicholas Butcher in the Cayman Islands office of Maples and Calder. “However, we expect there will be additional services resulting from technological advances such as increased client access to information via the online availability of registers and other corporate documentation.”

Diversification, he says, has been happening for a number of years through affiliated service providers. “Any further diversification is likely to be conducted by affiliated entities rather than directly by law firms. A service provider affiliated to a law firm can benefit from synergies, leveraging off the knowledge and expertise of the law firm while maintaining independence,” he notes.

“We certainly expect to see some expansion into hedge fund-related activities as the legal profession continues to adapt and respond to market conditions,” admits Ingrid Pierce at Walkers in Cayman.

Tania Dons and Richard Finlay at Conyers Dill & Pearman in Cayman confess they have seen a dramatic increase in investors approaching the firm to perform due diligence services and/or comment on fund-related documents for Cayman-domiciled funds they are considering investing in. As the fund industry becomes increasingly regulated they expect to see an increase in advising on the implication of the new rules.

Depending on the regulation they suspect legal advisors will need to be innovative and creative in helping funds pursue their investment activities in compliance with the rules in a way that is workable and profitable.

In the British Virgin Islands office Robert Briant expects to see changes in the hedge fund industry as investors and regulators scrutinise more closely the funds and their structures. “Legal counsel is able to provide support to a hedge fund to ensure that the hedge fund’s structure is capable of such scrutiny by investors and regulators and is compliant with any changes in regulation,” he says.

As for the diversification of law firms into other hedge fund-related activities, such as fund administra-

tion, Briant expresses some concerns. “The hedge fund is the law firm’s client and the hedge fund’s interest is the law firm’s primary duty. When a law firm starts diversifying its practice into support functions, such as administration, it begins to run into conflicts of interest that make it difficult for the law firm to provide independent advice. These points of tension reach a critical stage in a crisis, such as during a recession,” points out Briant.

His colleague Dawn Griffiths in Bermuda agrees. “Law firms must focus on providing the best legal services, first and foremost. It can be beneficial to clients to have a one-stop source for all fund-related activities but discerning clients still look for the best in any field,” she says.

It will be a “distinct challenge, probably impossible, for any provider to be best of field in each of these areas and clients may not be as willing to compromise on quality just for easy one-stop access to such varied services,” she says.

In Gibraltar associate at Isolas Joey Garcia believes the legal profession will need to continue to adapt to provide value-added services, potentially creating synergies between existing client bases and associated businesses and in promotional activity relating to investor security.

He expects to see legal firms adapting themselves to the current economic and regulatory environment. “We envisage that there will be an increased demand for legal firms to take a more proactive role in advising a fund on any potential flaws which could materialise in the operational structure of a fund, in particular, due to the various parties’ involvement in the operation of the fund and the possibly conflicting roles each plays,” he states.

Daniel Mackelden at Cains in the Isle of Man thinks diversification will become key for some of the larger hedge fund-orientated offshore firms. “Some already are providing these value-added, integrated services and we can see these becoming more important as business models change. UK firms will be facing similar issues with liberalisation here – the days of the pure law firm may

What new services will the legal profession offer over the next 12–18 months? Will legal firms continue to diversify into other hedge fund-related activities (such as fund administration, marketing support, provision of directors) or should they focus purely on legal services?

well be numbered,” he says.

In Malta at Aequitas Legal, associate Omar Zerafa believes that if hedge funds are regulated in the EU, the legal profession will have to adapt itself and mirror the needs of the market. “These new services may include closer scrutiny of taxation laws, specialist advice on moving funds across the EU, together with advisory services to the administrator, the manager and the custodian of the fund,” he states.

Brian McDermott and Siobhán Moloney at A&L Goodbody in Dublin would rather offer impartial recommendations to clients on the fund administration service providers that are best suited to their individual client needs without being fettered by an obligation to promote any in-house capabilities. They expect firms to focus more on legal services due to the increasing concerns around potential conflicts of interest arising from the provision of other services.

They also think additional services that compliment the pure legal services will be attractive. These include providing company secretarial services and acting as listing broker for funds listing on the Irish Stock Exchange. There is also an increasing trend, they point out, of resorting to law firm experts in dispute resolution as the amount of fund-related litigation increases.

John Langan at Withers says there are significant regulatory constraints on the services the legal profession can offer. “On balance, law firms should probably focus on ensuring that they offer funds the full range of services they need following creation: tax advice, litiga-

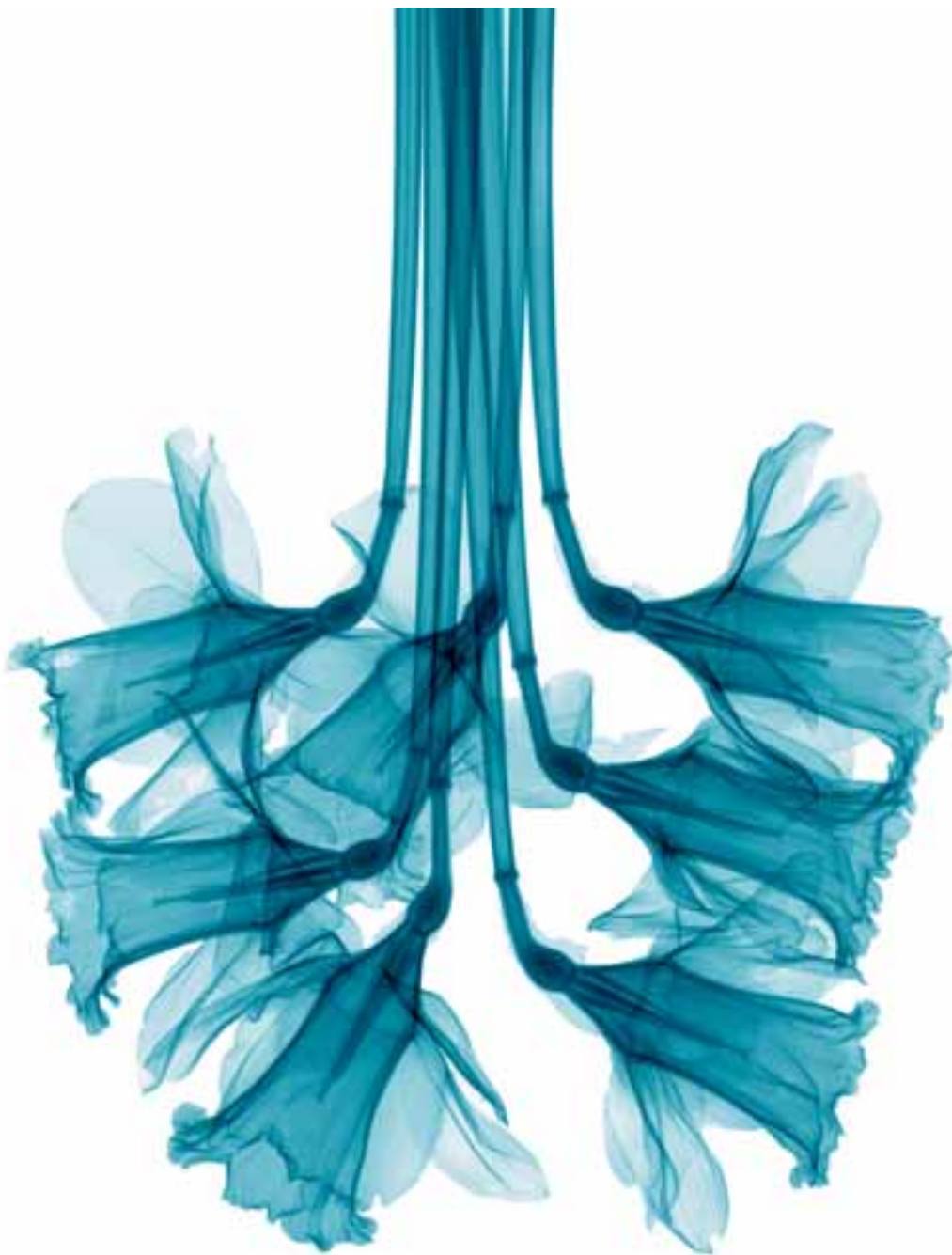
tion advice, advice on investment structuring and regulatory and securities law advice,” he says.

Nora Bullock and Simon Atiyah at Lovells agree. They think it is unlikely that global full-service law firms will branch out and take on directorships and fund administration and similar roles. However, for niche offshore law firms, the position is different and they say they have already seen a number of these offshore firms providing other fund services.

At Kaye Scholer, partner Simon Firth expects new services to include operational due diligence working alongside accountants and pension consultants as well as transfer pricing advice. He says some law firms have already started to move into this area. “The areas you specifically mention relate to offshore firms and not onshore firms. The only likely service to apply to an onshore firm would be acting as director but I can’t see many firms taking that route because of liability issues,” he says.

In the US, law firms are limited with respect to their ability under the legal ethics rules to perform non-legal work, points out Steven Nadel at Seward & Kissel. “However, on the legal side managers will continue to seek law firms who can do more legally than just form the funds. They want law firms that can act as their *de facto* general counsel,” he says.

Mitch Nichter at law firm Paul Hastings agrees. “From a US law firm perspective, I do not anticipate diversification into activities that do not involve the provision of legal services,” he concludes. ■



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where minds comprehend*

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