



VISION FOCUS

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Alternatives: New Views of the Hedge Fund Industry

Two major trends are emerging in the hedge fund industry with far-reaching impacts: a migration among the maturing hedge fund industry to third-party administration, custody and specialized services, and the most comprehensive reconsideration of financial regulations in generations. Today's institutional investors need to understand the ramifications of these trends and participate in shaping the new structure of this critical, but evolving industry.

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The Evolution of an Industry

The global financial crisis is bringing about an evolution in hedge funds that will render significant changes to the industry. Record investment losses and investor withdrawals have cut assets under management by more than one-quarter, consolidation is under way, and both investors and regulators are calling for greater transparency.

Two major trends that will have far-reaching impacts are emerging: a migration among the maturing hedge fund industry to third-party administration, custody and specialized services, and the most comprehensive reconsideration of financial regulations in a generation. According to State Street's annual hedge fund study conducted in October 2008, 84 percent of institutional investors surveyed expect more frequent disclosure of hedge fund positions, while 49 percent anticipate more frequent reporting.

Before the dust from the crisis settles, it will be important for all of the stakeholders in this market to understand the ramifications of these trends and to participate in shaping the new structure of this changing industry. Though forever altered by current market conditions, hedge funds will retain their critical and proven role in institutional investors' financial portfolios.

A Story of Success

Hedge funds have been remarkably successful instruments for growth in modern finance. Over the past 20 years, the number of hedge funds and funds of funds around the world has exploded from 610 in 1990 to approximately 9,000 today (see Figure 1).¹ Total hedge fund assets under management have likewise skyrocketed, expanding from \$39 billion in 1990 to nearly \$2 trillion by mid-2008 (see Figure 2).² Their performance has been solid, with broadly diversified hedge fund portfolios compounding capital at some 9.5 percent annually, net of fees, between January 1990 and June 2008.³ An investment of \$100 in the S&P 500 Total Return Index in 2000 would have shrunk to \$92.10 by September 2008, whereas the same investment in the HFRI Fund Weighted Hedge Fund Index would have reached \$172, constituting a more than 80 percent performance differential.⁴

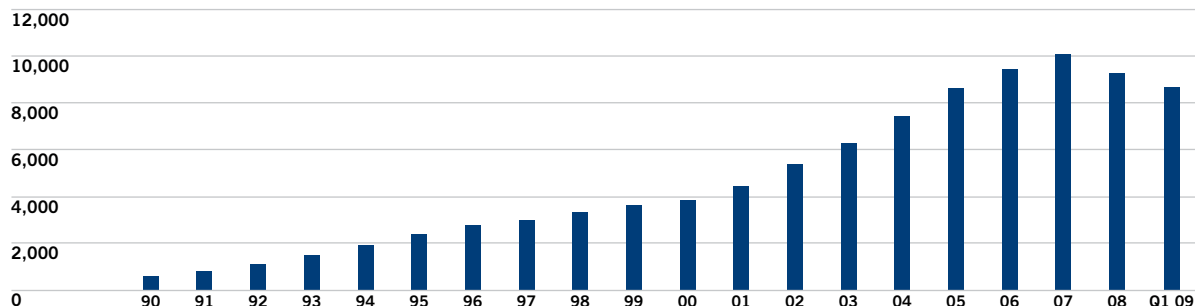
¹ Hedge Fund Research, "Global Hedge Fund Industry Report," Year-End 2008.

² Ibid.

³ Alternative Investment Management Association (AIMA), "Roadmap to Hedge Funds," November 2008.

⁴ Ibid.

Figure 1: Number of Hedge Funds



Source: HFR Industry Reports © HFR, Inc. 2009, www.hedgefundresearch.com.

Hedge funds have also played a vital role in the expansion of capital markets and economic growth. They have done so, chiefly, by investing where other asset managers and investment funds either would not or could not by virtue of their charters and style guidelines. Spanning global markets, hedge funds provide critical risk capital to emerging economies, new technologies, restructuring industries, and the burgeoning markets for securitized assets and credit derivatives. They play a critical role in the provision of liquidity and in risk management for institutional investors.

The rise of hedge funds took place during years of historically low interest rates and volatility. During this period, gains in trading efficiency, and adoption of market best practices and common standards for prudential regulation and securities information drove increasing correlation among world stock and bond markets. Hedge funds delivered absolute returns at a time when traditional asset managers were driving a kind of “global beta” built around benchmarks that were increasingly correlated.

Hedge funds’ vast appetite for eclectic investment and large-volume trading, as well as their bold use of leverage, accelerated financial activity around the

world. They can claim their share of the credit for directing investment flows to new economies, financing new industries, stimulating corporate activism and re-structuring and facilitating the privatization of state assets. Hedge funds embrace change — the entrepreneurialism and risk engagement that have helped drive economic growth, robust employment and cross-border financial flows in recent years.

Market Forces Deal a Setback

The financial crisis that began with a real estate price correction and liquidity squeeze in summer 2007 and culminated in the collapse, takeover and/or bailout of banks, insurance companies and securities houses did not spare the hedge fund industry.

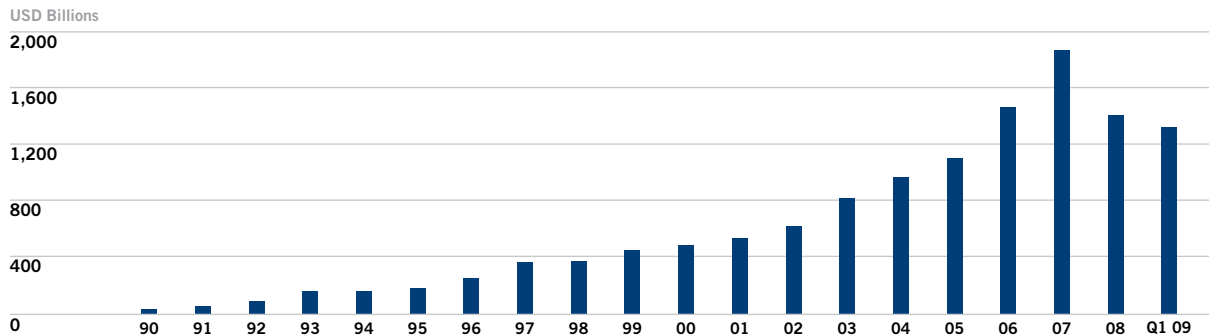
Over the course of 2008, experts believe that global hedge fund assets under management lost a quarter of their value, retreating from \$1.9 trillion to \$1.4 trillion.⁵ Fully 15 percent of funds closed their doors⁶ and total redemptions may reach 20 percent for 2009.⁷ And few are expecting a snap-back recovery for the sector. Before the crisis abates, fully half of all hedge funds may cease operations.

⁵ Hedge Fund Research, “Global Hedge Fund Industry Report,” Year-End 2008.

⁶ Ibid.

⁷ “Hedge Funds Get Earful from Clients about Fees, Withdrawals,” *Bloomberg*, April 3, 2009.

Figure 2: Hedge Fund Industry Assets



Source: HFR Industry Reports © HFR, Inc. 2009, www.hedgefundresearch.com.

As if this were not enough, markets have been rocked by allegations that financial advisor Bernard Madoff defrauded clients of some \$50 billion, perpetrating the largest securities fraud in history. These shocking revelations motivated governments and investors to call for more rigorous reporting and regulation of hedge funds. But in a sense, the impact of the Madoff scandal on hedge funds' reputations might be misplaced. Madoff's decades-old investment firm was not technically structured as a hedge fund nor considered as such by investors or regulators.

Despite these market disruptions, the strength provided by the diversity of hedge fund investment strategies was apparent. Some hedge funds continued to earn positive returns by undertaking trading strategies designed to profit from the turmoil and volatility.

Institutional investors appear to be keeping the faith. According to State Street's annual hedge fund survey undertaken in conjunction with the Global Absolute Return Congress held in Boston in October 2008, institutional investors attending the event (collectively responsible for an estimated \$1 trillion in hedge fund assets) intended to "stay the course" of their hedge fund investment. The study revealed that fully 75 percent of those polled did not plan to modify their asset allocations as a result of recent market turmoil.

The market downturn notwithstanding, 49 percent of institutional investors polled stated that they would likely increase their hedge fund allocations over the course of 2009. At the same time, they expect improved service from hedge fund managers in the areas of liquidity management, risk measurement and analysis, investment valuation, and transparency.

Regulatory Implications of the Crisis

In the wake of general capital market dislocation, hedge funds find themselves the target of both political and investor disaffection and blame. Given that some of the most prominent investment blow-ups of recent decades originated in the hedge fund sector — notably the 1998 collapse of Long-term Capital Management (LTCM) and the 2006 shuttering of Amaranth Advisors — many market observers presumed that the next big financial dislocation would originate in the hedge fund sector. This did not prove to be the case. Nevertheless, as the financial crisis of 2007–2009 unfolded, several governments that had expressed displeasure over the role international hedge funds played in the financial markets called for controls on hedge funds and private equity firms.

As the contagion of the recent financial crisis spread, the most immediate and severe financial impacts did not originate from hedge funds, which as a class outperformed major equity indices. Rather, the markets were laid low by illiquidity, unsustainable leverage and opaque financial instruments. These instruments were created, deployed and purchased by many different market participants, ranging from unregulated mortgage originators to highly regulated banks and insurance companies. While reform of national regulatory infrastructure had been previously considered to be principally an exercise in enhancing international financial services sector competitiveness, the recent financial crisis has shifted the focus to more urgent issues of financial stability, safety and soundness.

Observers have noted that in the United States, mortgage lending, investment banking, commercial banking, insurance, traditional investment management, hedge fund management and trading in stocks, bonds, commodities and derivatives takes place under a patchwork quilt of regulators, both state and federal, with varying mandates and powers of oversight. Since no single regulator or government authority has oversight over the interaction of all these activities, historic market dislocations emerged in many cases out of legally sanctioned activities that threw the system out of balance without sufficient oversight by regulatory authorities.

Of particular concern are areas of financial intermediation that slipped through the cracks under the current fragmented regulatory system in the United States, as well as in other jurisdictions. While the issue in the United States has concerned coverage and gaps, the issue in Europe has dealt with competing and inconsistent national regulatory approaches. Although European nations made progress during the 1990s and 2000s toward achieving greater harmonization of their standards, recent events such as Icelandic banks' solicitation of deposits in the United Kingdom, have revealed systemic weaknesses in the current approach.

The financial crisis has led to calls to reform the financial regulatory system, both in the United States and around the world, including additional regulations for hedge funds. Hedge funds face a high probability of encountering new regulations in several interrelated areas: new registration, reporting, disclosure and prudential requirements for either hedge funds or their managers, and oversight from a new systemic risk regulator.

A New Hedge Fund Regulatory Architecture

Amid what is perhaps the most extensive re-writing of the global financial rulebook ever undertaken, it seems that the opportunity for self-regulation in the hedge fund industry appears to have passed. Economic recovery, the rescue of the banking and insurance sectors, the restructuring of impaired assets, and the recapitalization of financial institutions are the top priorities. New rules for hedge funds, however, are probably not far behind. As the debate over regulatory reform has developed, the hedge fund industry itself seems to have shifted from resisting regulation to ensuring that regulations support hedge funds and their clients, as well as preserving the value that hedge funds provide in the marketplace.

Consider the March 5, 2009 Congressional testimony of Richard H. Baker, president and CEO of the Managed Funds Association, a principal hedge fund industry body in the United States. According to Baker, "While 'smart' regulation cannot, in and of itself, restore financial stability and properly functioning markets, it is a necessary component of any plan to achieve those ends. 'Smart' regulation would include appropriate, effective and efficient regulation and industry best practices that better monitor and reduce systemic risk and promote efficient capital markets, market integrity and investor protection."

Hedge fund regulation is a question of degree. Some market commentators, notably in continental European countries in which few hedge funds are domiciled, have called for hedge funds to be tightly regulated, along the lines of banks or retail funds. By this view, regulation should set out what hedge funds can and cannot do, as well as the nature and scale of their leverage and the obligation to render their strategies transparent to other market actors.

In the United States, initial bills emerging in Congress seek to require hedge funds, venture capital firms and private equity firms to register with the Securities and Exchange Commission (SEC) under either the Investment Company Act or the Investment Advisers Act. These proposals have been considered in the past. For example, the SEC adopted a rule in 2004 that required hedge funds to register as investment advisors, but the US Court of Appeals for the District of Columbia vacated that rule in 2006. Nevertheless, similar proposals have moved up the legislative agenda.

For hedge funds, one key element of the regulatory reform debate is the legal entity being regulated. Registration of hedge fund managers is already well established in markets such as the United Kingdom. And many US hedge funds currently register as investment advisors on a voluntary basis. While the details of the new regime remain to be seen, expanding and enhancing hedge fund manager registration requirements could likely be implemented without significant market distortion.

Regulating hedge funds at the fund level, however, could create significant concerns for the industry. Applying bank-like capital rules or mutual fund-like investment restrictions to hedge funds risks eroding or eliminating the vital role that hedge funds play in financial markets. Such regulations would also risk reducing market diversity to the detriment of both individual and institutional investors.

A measure of consensus first began to emerge around the recommendations of the Group of 30, an international public/private sector group headed by Paul Volcker, chairman of US President Barack Obama's Economic Recovery Advisory Board and a former Federal Reserve Chairman. The Group of 30 "Financial Reform" framework called for a regulator to oversee only those hedge funds deemed to be systemically significant. That new regulator would be able to require registration, periodic reports and some yet-to-be-determined level of disclosure. The framework also called for the regulator to "establish appropriate standards for capital, liquidity and risk management," though it remains to be seen whether compliance with such standards would be obligatory or voluntary.

The process in the United States was moved forward substantially in Treasury Secretary Tim Geithner's March 26, 2009 presentation of the Treasury Framework for Regulatory Reform before the House Financial Services Committee. The Geithner proposal goes beyond the Group of 30 focus on systemic risk and would require all advisors to hedge funds, private equity funds, venture capital funds and other private pools of capital, whose assets under management exceed a certain threshold, to register with the SEC.

All funds advised by an SEC-registered investment advisor would be subject to investor and counterparty disclosure requirements as well as regulatory reporting requirements. Such funds would be obliged to confidentially report whether the fund or fund family was so large or highly leveraged that it might pose a threat to financial stability. Finally, Geithner proposed that the SEC share these reports with the new systemic risk regulator, which would in turn determine whether the funds in question posed a systemic threat and therefore should be subjected to the new prudential requirements.

In the United Kingdom, the Chairman of the Financial Services Authority (FSA), Adair Turner, issued a March 2009 report that many viewed as a turning point in contemporary financial regulation. The Turner Review called for increased quality and quantity of bank capital, particularly against trading activities; a countercyclical capital adequacy regime; a maximum gross leverage ratio; enhanced regulation and supervision of liquidity; coverage of all systemically significant institutions; enhanced supervision of rating agencies; rules covering remuneration in the financial industry; and centralized clearing of credit default swaps. The report calls for regulators to extend their powers to institutions — including hedge funds — that become “bank-like,” or so important that they may threaten stability.

Meanwhile, the European Commission is finalizing a legislative proposal that would require hedge fund and other alternative investment fund managers to register and submit to regulatory supervision. Because the Commission has not clearly established a European definition of hedge funds, and because those definitions that do exist vary among the continent’s numerous financial jurisdictions, many commentators have recommended that hedge funds not be singled out. They are instead calling for regulations that monitor certain behavior, such as the use of leverage, undertaken by many financial actors, including hedge funds. Analysts have also emphasized that, given the global nature of financial flows, any European initiative should be coordinated with other regulatory and standard setting bodies in the interest of global consistency.

As Europe considers new regulatory approaches, it is worth noting that the European hedge fund industry is already regulated to a great extent. While European fund vehicles are frequently established in off-shore

jurisdictions, primarily for asset gathering purposes, fund managers are for the most part located on-shore and concentrated in jurisdictions such as the United Kingdom, where they are regulated and supervised by the FSA.

In addition, hedge fund trading in Europe falls under existing EU rules such as the Market Abuse Directive, which places those activities within regulatory reach. Moreover, hedge fund trading activities are rendered transparent by the transaction reporting requirements of the Markets in Financial Instruments Directive (MiFID), which requires that detailed information be supplied to regulators on a trade-by-trade basis. The introduction of the EU-wide Transaction Reporting Exchange Mechanism (TREM) should therefore provide regulators with much of the information they require.

G20 Establishes a New Regulatory Framework

All of this regulatory discussion came to a head in the early April meeting of the G20, which adopted a broad global framework to enact for regulatory reform and shore up the global financial system. The G20 called for the creation of a Financial Stability Board (FSB) with a mandate to promote financial stability, set financial guidelines and monitor colleges of regulatory supervisors.

Calling for systemically important financial institutions, markets and instruments to be subjected to regulation and oversight, the G20 suggested that large hedge funds or their managers be registered and required to disclose information needed to assess risk to the financial system. According to the G20, hedge fund registration should be based on a minimum size, and the FSB would develop mechanisms for cooperation and information sharing among national authorities.

These new procedures should be developed in consultation with principles for hedge fund oversight established by the International Organization of Securities Commissions.⁸ As with many political documents, the G20 communiqué is less than precise in terms of which hedge funds are systemically important and whether hedge funds themselves or their managers should be subjected to regulation and oversight.

It is interesting to note that the G20, which includes many large developing countries, was the forum for this critical meeting. A generation ago, the policy solution may have fallen to the G8 industrialized countries or even an ad hoc group of principal financial players. The G20 negotiations suggest not only that financial dislocation has been widespread, but also that political leaders are looking for policy solutions based upon a broad consensus of governments worldwide.

The US, UK, EU and G20 initiatives all suggest new registration and reporting requirements for large hedge funds. But regulators appear to be keeping their options open, so that the new regulatory architecture — for hedge funds, private equity firms, banks and other financial actors — may continue to evolve.

Systemic Risk

In addition to potentially broad new registration, reporting and prudential standards, a new systemic risk regulatory regime will clearly consider hedge funds as well.

Systemic risk is a term that has been widely covered by the media throughout the course of the financial crisis, though it has no universally accepted definition. Broadly

speaking, systemic risk refers to risk generated by the action of individual financial actors — either alone, in collaboration or in tandem — that is sufficiently large to threaten orderly markets.

Anticipating precisely which financial actors have the potential to generate such risk, however, is difficult. For example, some financial institutions may be vast in size, but conservative in their activity. Alternatively, some financial actors of relatively smaller size are able to blindside markets by virtue of the concentration of their work or the leverage they deploy. Most financial regulation around the world is aimed at the activities of individual market participants and their clients, rather than at the financial system as a whole.

The role of the hedge fund industry in a new systemic risk regulatory architecture is still open for discussion. A likely starting point will be requirements for hedge funds to confidentially report, either directly or through counterparties, data relevant to systemic risk monitoring. In addition, some hedge funds, either due to their size, or their particularly important role in certain market segments, could be designated as “systemically significant.” As a result, these funds may find themselves subject to direct regulation by the systemic risk regulator. Both the standards for systemic significance and the regulatory authority and powers of the systemic risk regulator remain open questions at the time of this writing.

⁸ “Hedge Funds Oversight,” Consultation Report, Technical Committee of the International Organization of Securities Commissions, March 2009.

Hedge funds and industry associations in jurisdictions around the world have, for many years, elaborated best practice recommendations for investment funds. Academics have developed extensive analyses and prescriptions for sustainable hedge fund administration and operations. However, given the heterogeneity of the hedge fund industry, the variety of fund sizes, shapes, domiciles and philosophies, it has proven nearly impossible to generate a single cogent recipe for correct action. Nevertheless, certain common denominators have emerged that together establish a framework of best practices.⁹

Disclosure

Comprehensive disclosure provides investors with the information they need to decide whether to invest, how to monitor their investments and when to redeem them. Disclosure helps investors remain confident that they are making informed decisions regarding their investments and allows them to manage associated risks. A disclosure framework should include private placement memoranda, annual audited financial statements, periodic performance information and the disclosure of significant events. For hedge funds, this should translate into providing independently audited financial statements that are compliant with Generally Accepted Accounting Principles (GAAP), just as public companies do. Hedge fund managers should also provide periodic performance information and risk reports to investors on a quarterly basis, provided that these reports protect the confidentiality of fund positions and strategies. Consistent with pre-agreed rules for confidentiality, systemically significant hedge fund managers might regularly report on their relationships with such counterparties as broker-dealers and banks, including respective credit exposures, to the regulators charged with monitoring systemic risk.

Valuation

Hedge funds should ensure clear valuation by sticking to written policies regarding segregation of duties between portfolio managers and those responsible for valuations. This is particularly important as hedge funds often invest in assets that are difficult to price and in which manager compensation is directly impacted by those valuations. Performance fees for hedge funds ensure that the interests of managers and investors are well aligned. Nevertheless, funds should establish new governance mechanisms, such as valuation committees, to govern the segregation of functions and minimize potential for conflicts.

Third-party providers can also help to eliminate potential valuation conflicts. Independent administrators, together with managers, can create a checks-and-balances system in support of accurate valuation. To guide this process, funds should consider using the hierarchy of asset pricing proposed by the Financial Accounting Standard 157 (FAS 157). This rule segregates investments into three categories: those with observable prices (for example stocks traded on open markets); those with regular pricing other than quoted market prices (such as broker quotes for OTC derivatives); and assets that have no observable market price information (such as private equity investments). By examining returns through this lens, investors can accurately determine the types of assets that contribute to their returns, and in what proportion. Hedge funds should establish comprehensive frameworks that provide for clear, consistent valuations of all fund investment positions while minimizing potential conflicts that may arise in the valuation process.

⁹ President's Working Group on Financial Markets, "Best Practices for the Hedge Fund Industry — Report of the Asset Managers' Committee," January 15, 2009.

Risk Management

The goal of risk management is not to eliminate risk, but to render it transparent and to handle it prudently. Hedge fund managers should identify risks inherent in their chosen strategies and should measure, monitor and manage all types of risk — liquidity, leverage, market, operational and counterparty credit risk — to ensure that they are consistent with the manager's intended risk profile for a given fund. At the same time, managers should engage investors in qualitative discussions, bearing in mind that each fund has a unique risk target profile, while maintaining appropriate confidentiality standards. Hedge fund managers should take special care to assess the creditworthiness and complex legal relationships that they have with their counterparties, including prime brokers, derivative dealers and counterparties for lending, trading and cash management.

Trading and Business Operations

For trading and business operations, hedge funds should segregate functions, document relationships with counterparties and continually assess operational and internal controls. To do this effectively, they should ensure the competence and qualification of custodians, prime brokers and third-party administrators. Senior managers of the fund company should oversee operations and be responsible for the segregation of duties as well as reconciliation and operational checks and balances. Hedge fund managers should maintain and monitor signed agreements with counterparties involved in prime brokerage, stock lending and other trade operations with a particular view to monitoring risks that may affect the counterparty's obligation to extend credit or that may increase collateral requirements.

Compliance, Conflicts and Business Practices

To maintain the highest standards of integrity and professionalism, hedge funds should establish codes of ethics, publish written compliance manuals, create processes for managing conflicts of interest and retain a senior-level compliance officer dedicated to overseeing the effort and reporting annually. Managing conflicts of interest is critical in this regard. Investors must have confidence in their managers and in financial markets as a whole, if they are to provide critical liquidity. Hedge funds should consider establishing internal committees to assess potential conflicts arising from proprietary trading, valuation, allocation of costs and expenses, brokerage arrangements and cross-trades, and third-party service providers.

Preserving the Role of Hedge Funds

If governments undertook a precipitous round of regulation, many believe the future of the hedge fund industry would be at risk. Simply put, hedge funds that were forced to behave like mutual funds or banks might cease to be hedge funds. Financial markets would no longer fully benefit from the role that the hedge fund industry plays in liquidity provision, price discovery and the narrowing of spreads, contrarian investment, and sophisticated risk management for pension funds.

One area of hedge fund activity that has been particularly singled out is the practice of short-selling. Short-selling can be used for different purposes, but commonly involves a bet on the decline in the value of a security via its sale, with the intention of purchasing the instrument at a later date and at a lower price. During the difficult trading weeks of September 2008, the SEC and numerous other global regulators instituted bans on the short-selling of a selected list of financial stocks. In certain markets such as Australia, the ban was extended to prohibit the short-selling of all listed securities.

While the SEC enacted its ban with the intention of allowing a “time out” to forestall the collapsing stock prices of certain financial firms, US regulators rescinded the measure less than a month after implementation. Moreover, former SEC Chairman Christopher Cox later told interviewers that the ban may not have been as successful as intended.¹⁰ Others have noted that short-selling may simply have mirrored, rather than precipitated, price declines. The need to cover short positions, they argue, actually served as a cushion for collapsing stock prices.

Although the short-selling ban was rescinded in the United States in October 2008, regulatory attention to short-selling continues. The SEC has adopted a number of measures, including a new T+3 hard close-out settlement requirement, designed to discourage naked short-selling. On April 8, 2009, the SEC also issued for comment a proposal to reinstate a modified uptick rule, possibly in tandem with a “circuit breaker” mechanism.

Short-selling can temporarily distort price signals, particularly in fragile and illiquid markets, thereby degrading overall market efficiency. But short sellers are an integral component of financial markets, playing a key role in both price formation and the provision of liquidity. Long-term regulatory initiatives aimed at short-selling should therefore be carefully structured so as to mitigate identifiable risks, without undermining its benefits. This includes the regulatory reporting of short positions, preferably to the market regulator rather than to the market as a whole.

Healthy markets, like natural ecosystems, benefit from diversity. Hedge funds, throughout their history, have profited from seeking out market inefficiencies, mispricing, capital misallocation and sub-par corporate productivity. They routinely invest in complex, illiquid, opaque and difficult-to-price investments that are passed over by traditional asset managers who tend to limit their activities to long-only allocations. Hedge funds are a natural corrective to the herding instincts of relative value investors and therefore lend balance to asset markets.

¹⁰ *Washington Post*, December 24, 2008.

Focus on Counterparties

In any case, it remains to be seen whether hedge funds even *could* be subjected to aggressive controls over investment activities they undertake on their own behalf and on behalf of their clients. With thousands of hedge funds pursuing diverse strategies in hundreds of different asset markets and domiciled in dozens of international jurisdictions, it is not entirely clear what sort of agency might plausibly undertake such regulation. Nor is it obvious why regulatory agencies would want to go through the complex and expensive process of telling investors what they can do with their own money. Micro-management of hedge funds seems to be as practically unfeasible as it is unwise in terms of financial market practice.

Increased scrutiny of hedge funds may not achieve all the regulators' desired outcomes, because the activities of hedge funds alone do not generate systemic risk. Rather, the risk is a product of excess leverage and relative opacity in the market as a whole. Seen in this light, a more efficient way for regulators to address the potential for systemic risk may be to more closely regulate the activities of prime brokers, bank counterparties and securities firms that deal with hedge funds on a daily basis.

Where hedge funds number in the thousands, these counterparties consist of several dozen critical firms. Looking at the flow of cash and securities through the hedge fund ecosystem, several critical monitoring points

may be identified that could fulfill the need for systemic risk mitigation while at the same time honoring investors' fundamental freedom to invest, whether in hedge funds or some other vehicle.

The challenge in this new era of regulation will be to regulate well, creating new mandates that emphasize registration and reporting rather than arbitrary limits on hedge fund activities. This "confidential disclosure" might include assets under management, portfolio holdings and generic information on market, credit, liquidity and operational risk. It is imperative that this data be analyzed in aggregate rather than on an isolated basis. The data itself should be strictly limited for regulators' use alone and should not be released to the general public, except in its aggregated form.

A particular area in which a regulatory initiative could support industry initiatives is in the area of rehypothecation of hedge funds assets at the prime broker level, the source of so many difficulties after the collapse of important prime brokers in autumn 2008.¹¹ Regulators might consider the following: limiting the extent to which funds may rehypothecate assets, as such a restriction would likely reduce access to leverage; introducing reporting and transparency requirements for rehypothecated assets so that the extent of these activities is clear; and introducing more prescriptive requirements about assets that are not rehypothecated (excess assets), including requirements that govern how and where they are held. Regulators should also discuss proposals to require the segregation of assets and the placement of the assets with non-affiliated third-party entities.

¹¹ Rehypothecation is the pledging of securities in customer margin accounts as collateral for a brokerage's bank loan.

Hedge Fund Operations and Administration

As financial markets regain their equilibrium, investment flows will return and institutional investors will again seek out risk. Hedge funds are taking measures to restructure, retrofit their processes and optimize their administration to be ready for market recovery and a landscape composed of fewer, larger hedge funds and new regulatory requirements. Further over the horizon, new hedge funds will arise with their own investment ideas for the post-crisis period. These new funds will likewise seek to achieve maximum efficiency in the management and administration of their businesses, while they concentrate on uncovering investment opportunities for their clients.

The financial crisis has driven hedge funds to renew efforts aimed at both cost efficiencies and improved risk management. Market dislocation has prompted hedge fund managers to re-examine their various risk monitoring techniques and to stress-test their portfolio models through worst-case scenarios. The untimely collapse of critical financial institutions in autumn 2008 led hedge funds to increasingly contract with multiple prime brokers as a means of diversifying risk. Funds have also started using traditional custody banks and have increased their use of third-party custody arrangements that allow collateral to be held away from counterparties. And hedge funds are increasingly engaging third-party administrators and independent portfolio valuation services to address the concerns of regulators, central banks, finance ministries and their clients.

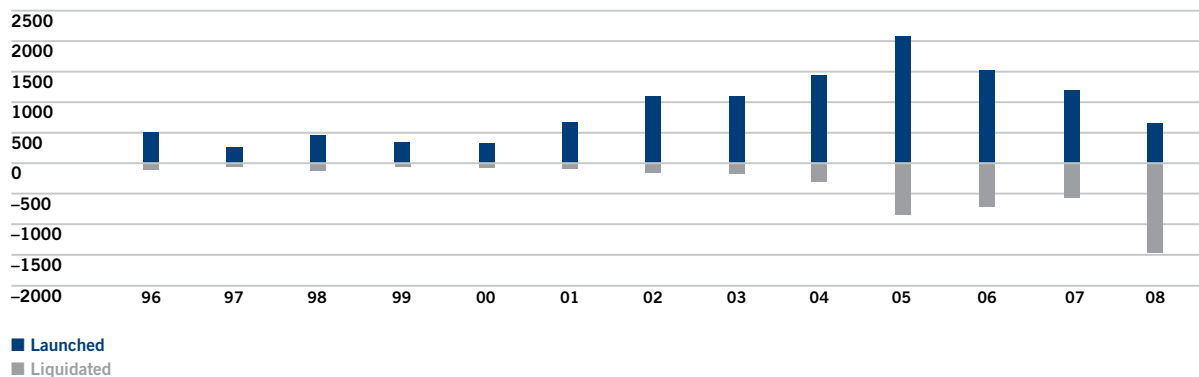
Whatever new architecture emerges from the community of global regulators, market forces are already well under way that will lend greater transparency and surety to hedge fund administration and operations. A stable, sustainable hedge fund industry would benefit

from administrative innovation, including independent pricing and avoidance of counterparty pricing whenever possible; the standardized reporting of price/performance measures; segregation of safekeeping functions; independent fund administration; and the exclusive use of regulated entities to provide such key services as administration, safekeeping and prime brokerage.

Many large hedge funds are still self-administered and are understandably reluctant to walk away from the substantial investment they have made in internal administration, including technology platforms. But the segregation of assets and the introduction of a custodian/depository function would enhance both transparency and investor protection. Hedge funds want to concentrate on investing. But they know that client demand for information, support and clarity is at a premium after all that has taken place in global markets. To allow for this, and to gain cost efficiencies, they are asking administrators with experience in all asset types and investment strategies to provide a complex and ever-expanding list of services, including daily information delivery, maintenance of books and records, the reconciliation of cash positions and cash balances, and the provision of customer reporting; real-time portfolio trade capture and P&L calculation; cross-asset and multi-currency reporting; and fund of fund analytics.

In the middle office, administrators provide trade processing, collateral management, confirmation and settlement; securities pricing; derivatives processing and valuation; prime broker and custodian interface; foreign exchange; and cash management. And at the back end of the process, third-party administrators take care of fund accounting, tax reporting, trade settlement, asset safekeeping, securities finance, credit service and liquidity lending.

Figure 3: Estimated Number of Funds Launched/Liquidated



Source: HFR Industry Reports © HFR, Inc. 2009, www.hedgefundresearch.com.

Institutional investors were once primarily concerned about hedge fund pricing and valuation. Today, they demand much more rigorous transparency and control, including better technology and compliance processes, trading tools, risk analytics, and accounting and reporting systems. Third-party administration can effectively provide a governance mechanism to monitor adherence to agreed-upon best practices. It can eliminate many potential valuation conflicts, taking on some of the responsibility related to portfolio pricing and providing checks and balances in support of managers' policies.

Hedge Funds in a Healthy Capital Market System

The turmoil of 2007–2009 effectively redesigned the global financial landscape. Independent investment banking as we knew it no longer exists. Some of the best known banks, insurance companies, securities and investment firms have vanished or have been absorbed. Scandal raised doubts about investment management and funds of funds business models.

Investors who expected absolute returns to survive unscathed were disappointed. For hedge funds, 2008 was the worst year on record; the HFRI Hedge Fund Weighted Composite fell by 18.3 percent, only the

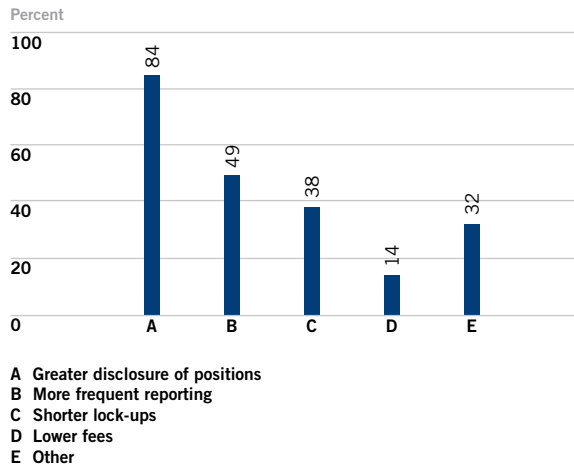
second calendar-year decline since 1990.¹² However, hedge funds still outperformed the 38 percent decline in the S&P 500 and the 45 percent slide in the Dow Jones World Index.

Investors facing margin calls and other liquidity constraints fled to cash. Taken as a whole, 2008 was the first year since 1994 in which outflows outranked inflows. Hedge funds struggling with evaporating credit and illiquid markets made few friends when they decided to freeze redemptions, impose gates and distribute illiquid assets in lieu of cash.

In the post-crisis period, hedge fund managers face the daunting prospect of earning no performance fees until they can recoup market losses and return to “high-water marks” that, in many cases, are double-digit percentage points above current portfolio valuations. Contraction is under way — 2008 was a record year for fund liquidations (see Figure 3). While hedge funds withstood the storm bravely, there were winners and losers. According to some estimates, more than 80 percent of hedge funds were underwater at the end of 2008. And fund liquidations are expected to continue as long as markets await recovery.

¹² Hedge Fund Research, “Global Hedge Fund Industry Report,” Year-End 2008.

Figure 4: Market Turmoil's Impact on Hedge Funds



Source: 2009 State Street Hedge Fund Research Study.

But hedge funds are here to stay. The Darwinian forces of the market correction will narrow the field; hedge funds that perform well across the recovery will emerge stronger and much sought-after by investors whose liabilities are more under-funded than ever. Investors will find that post-crisis hedge funds are more transparent, provide superior documentation and governance, offer more varied investment choices, and are open to more extensive due diligence. State Street's annual hedge fund survey, undertaken in conjunction with the Global Absolute Return Congress, further solidifies these assertions by illustrating which changes institutional investors expect to see in the industry (see Figure 4).

What's more, hedge funds, together with private equity groups, may play a crucial role in financial recovery by participating in the US government's recovery plan through the acquisition and restructuring of impaired assets. The recently announced TALF (Term Asset-Backed Securities Loan Facility) and PPIP (Private-Public Investment Program), sponsored by the Federal Reserve and Treasury, may draw interest from hedge funds that in turn may provide badly needed additional liquidity to the markets.

The hedge fund industry that emerges from this period of unprecedented market turmoil will likely depend far less on leverage. For as long as de-levering exists, strategies that rely on leverage will have a difficult time. Such strategies include those that use substantial leverage to turn very small arbitrage opportunities into high-return investments, as well as many long-short strategies that depend on leverage to outperform passive returns. In a sense, a de-leveraged hedge fund industry may be more meritocratic, with returns driven more by superior investment skill than the simple application of leverage. Truly non-correlated returns will be of paramount importance. In a bull market, some successful hedge funds with a long-bias can be considered as disguised long-only funds, with returns simply amplified by leverage. These strategies will not likely find favor in newly volatile markets.

Many observers believe that hedge funds may move back toward their original mission of managing risk, rather than ratcheting it up unsustainably. In this new environment, investors looking for more transparent and liquid strategies may seek macro hedge funds that invest in stocks, bonds, currencies, futures and options.

As markets recuperate, investors will struggle with lingering market volatility, burdened by the unhappy memory of seized markets and gated investments. But they also face the prospect of great potential for returns created by the combination of recovering markets and dramatically reduced numbers of hedge funds, brokerage firms and proprietary trading desks. They may demand that their managers offer variable pricing with fees scaled in accordance with fund performance and more flexible terms for lockups and gates.

To hold on to customers and win over new prospects, hedge fund managers will offer more varied investment strategies and more complex pricing. The standard 2 and 20 fee structure has been opened for review. Some hedge fund managers will charge a fraction of this fee, while a smaller pool of higher quality managers will be able to demonstrate why they deserve to charge more. But investors will expect these funds to concretely demonstrate their ability to deliver absolute returns to justify their extra compensation relative to long-only investment vehicles.

Investors may demand fee clawbacks in down years, fund pricing predicated on the liquidity characteristics of investment strategies or even private equity-style fees charged only at withdrawal for distressed and severely illiquid investments. Some observers have even proposed that hedge funds disaggregate their fees, charging performance fees only for the alpha portion of returns.

In what many consider a bellwether event, the \$174 billion California Public Employees Retirement System (CalPERS), the largest public pension fund in the United States, asked 26 hedge funds to create separate managed accounts, reporting on the holding of individual securities, the payment of fees spread out over several years and the ability to claw back fees in case of manager losses.¹³ Other large pension funds are expected to follow suit. For example, the Utah Retirement Systems released new guidelines requesting that hedge funds cut management fees as their holdings grow and provide increased transparency, including weekly return estimates and a scorecard of winning and losing investments.

Creating managed accounts allows investors to police their managers and manage risk with much greater precision. Such tactics also protect the separate accounts from the negative impact of redemptions undertaken by other investors. But providing these accounts is technically challenging for hedge fund managers who typically gain trading efficiencies by commingling client assets.

¹³ "Hedge Funds Get an Earful from Clients about Fees, Withdrawals," *Bloomberg*, April 3, 2009.

The Next Phase for Hedge Funds

Investors are expected to continue undertaking redemptions from hedge funds in 2009. But anecdotal evidence suggests that, even as investors make greater demands of hedge funds, they are starting to regain confidence. After a year of record losses and withdrawals, select hedge funds enjoyed positive returns and saw new investment flows in the first quarter of 2009. Some investors have canceled withdrawal requests, partly in response to more flexible fee structures. Government incentives have stimulated interest in distressed investing. Investors have agreed to allocate new cash to hedge funds embedded within private equity-style structures that lock up capital for longer periods in exchange for more favorable fees.

In reaction to the disorderly withdrawal of investor funds over the course of the credit crisis, the secondary market for hedge funds is expected to grow much larger. Investors restricted from redeeming their investment from hedge funds have demonstrated a willingness to sell their stakes to others at a discount. Funds with ready cash to invest will find these opportunities attractive, because by acquiring these positions, they also acquire whatever fee discounts the original investors had negotiated, together with the selling investors' "high-water mark" threshold.

In the next phase of the hedge fund industry, investors are almost certain to demand independent custody of their investments. They will require complete clarity regarding accounting of their funds and the transfer/withdrawal of assets. They will likely demand independent asset valuations and portfolio pricing, particularly for less liquid assets, along with third-party risk analysis and stress-testing.

And they will demand a heretofore unprecedented level of information access, including digital "dashboard" views of investment positions at the individual securities level, near real-time reporting of valuations for illiquid investments and single-view analysis of geographical allocation and currency exposure for all investments — public, private and real estate.

The hedge fund industry will emerge from the financial crisis — smaller, in terms of the number of funds, but eventually larger in terms of assets under management.

But the new industry will be vastly more complex — for investors as well as for managers. It will entail greater requirements for regulatory reporting and systemic risk analysis as well as highly variable structures for fees and lockups. In a sense, the crisis has forced the maturation of the hedge fund industry. Certainly, it constitutes a second chapter in what has, on balance, been a story of steady success.

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