

# BERMUDA

**A pre-eminent global fund domicile, Bermuda's reputation for quality has facilitated continued growth, even through the recent downturn. *HFMWeek* takes a closer look at the island's progress**



**Marco Montarsolo and Sharon A. Beesley** are principal lawyers with **ISIS Law**, a Bermuda-based law firm specialising in the provision of legal services in the area of investment funds, structured finance and corporate advisory work. It is part of the ISIS group which operates in the niche areas of legal services, consultancy, corporate finance and fund administration.



**Andrew Brook** leads **PricewaterhouseCoopers' (PwC)** Investment Management Industry Group in Bermuda and is a full-time client service partner with significant financial and non-financial services experience. **Scott Watson-Brown** is a partner at PwC and a member of its Investment Management Industry Group. His range of clients includes hedge funds and private investment companies.

As one of the world's most respected fund domiciles, Bermuda's continued growth remains of great interest to the global hedge fund industry. Here, shedding some light on the island's current progress, are Scott Watson-Brown and Andrew Brook of PricewaterhouseCoopers and Sharon Beesley and Marco Montarsolo of ISIS Law. Their combined views provide a rounded industry perspective and offer insight into the durability of the island's renowned reputation.

**HFMWeek: In what areas is Bermuda's hedge fund industry currently experiencing growth? Which factors can this be attributed to?**

**ISIS Law:** One of the areas in which Bermuda has, over recent years, experienced growth has been infrastructure funds. These are funds which invest in specific large infrastructure assets, such as airports, toll roads and communications towers, on a global basis. These funds are created and managed by leading investment managers with expertise in the relevant infrastructure assets and are listed on a recognised stock exchange. The in-

vestors are typically a combination of institutional and retail and the funds provide them with a tangible uncorrelated asset class. We are also now seeing more private equity funds with a focus on asset classes in countries such as India. The managers of these large infrastructure or private equity funds have chosen Bermuda because of its reputation for quality in all areas: Its ability to handle sophisticated client needs; the depth of experience of its service providers; and, not least, the risk-based regulatory flexibility provided. In addition, over the last few years Bermuda has eliminated earlier restrictions and inefficiencies on doing business here.

Bermuda is also home to a few large insurance-linked securities hedge funds. These funds focus on event driven investments (catastrophic bonds for example) and provide investors with a proven uncorrelated asset class. In this case, the fund, the manager and the fund administrator may be based in Bermuda and are able to have direct access to the reinsurance industry based here. We would also add that Bermuda has demonstrated over the years an aptitude for innovation

in the type of offshore products offered. As market conditions change we consider that Bermuda is well positioned to respond to changing market conditions. **PwC:** Given the nature of Bermuda and the services offered to hedge funds which are principally fund administration (including NAV preparation, corporate secretarial, directorships and transfer agency functions), legal and audit services and independent directorships; hedge fund incorporations are not the sole statistic to consider when looking at growth in Bermuda.

In addition to the global consolidation among hedge fund administrators and the targeted acquisitions of certain Bermuda-based administrators, we see growth in the administration of funds, with new boutique administrators establishing themselves in Bermuda and attracting a lot of attention for offering 'traditional', personalised service. These are backed now with more effective IT solutions and an explicit awareness of controls and governance.

The implementation of the Investment Funds Act 2006 (The Act), which repealed the previous Collective Invest-



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ment Schemes Classification Regulations 1998, has been received positively by the market. The Act has introduced new classifications of funds, enhanced powers for the Bermuda Monetary Authority (BMA) and introduced a new licensing regime for Bermuda-based fund administrators.

### **HFM: What advantages does Bermuda offer to potential hedge fund clients that are otherwise unavailable in other offshore jurisdictions?**

**IBIS Law:** The most obvious advantage Bermuda has over any other offshore jurisdiction is the access to the reinsurance industry. In addition to the existence of a highly skilled professional workforce to support fund administrators, accounting firms and law firms, the presence of the reinsurance industry in Bermuda has also resulted in a great deal of quantitative expertise available in Bermuda, which is of enormous value to assisting managers and administrators with the more complex asset classes. For example, Bermuda has more actuaries per capita than anywhere else in the world, which helps with the design and structuring of

complex instruments.

Bermuda has also, for many years, been viewed as a centre of excellence in fund administration services for investment funds, regardless of where these funds are actually established. The growth of this industry has been demonstrated by the establishment over the last few years of a number of new niche administrators such as ISIS Funds (a member of the ISIS group), Equinox and Apex which have responded to the hedge fund market's need for a more tailor-made administration service. For example, the need for sophisticated corporate governance support and the ability to offer tailor-made solutions to clients. These niche administrators are in addition to the larger fund administration operations already based here, and in this area Bermuda has seen a consolidation of some of these larger Bermuda players – such as Butterfield Fund Services/Fulcrum, Citi/BISYS and Bank of New York/Mellon Bank – to enable these administrators to better service the larger institutional operations. An example of Bermuda's risk-based approach to regulation has been the licensing of Bermuda-based

fund administrators, which includes on-site visits, supervision of operations and financial reporting; the effectiveness of governance arrangements and compliance with the requirements of the Investment Fund Act 2006 and regulations. We would also note that the role of middle office activities like asset valuation and performance monitoring, risk and compliance are likely to increase and the Bermuda-based administrator industry is well placed to support this need.

Bermuda does not seek to demonstrate its success in the hedge fund industry based on a 'numbers game'; rather, it focuses on the strength of its fund administrators, accountants and lawyers and the quality of the 'Know Your Customer' regime which Bermuda has enforced since the late 1930s. Hence the US Department of State recently ranked Bermuda in the lowest risk category for money laundering and terrorism financing globally.

**PwC:** Key advantages include:

- **Reputation:** Bermuda is a quality offshore jurisdiction.
- **Regulation:** Regular dialogue between Bermuda's international business and government encourage regulations that are innovative while preserving the highest standards of conduct. The current regulatory framework is purposeful but not obstructive.
- **Experience and expertise:** Bermuda's strong administrator services date back to the early 1980s and they, together with a critical mass of financial services expertise (including a pool of highly-qualified accountants, directors and lawyers) specialise in fund servicing, structuring and setting-up. This concentration of intellectual capital arguably exceeds competing jurisdictions.
- **Accessibility:** Bermuda's situation geographically (with easy access to and from New York and London) serves as a hub for the hedge fund industry.
- **Economic stability:** Over the past decade, Bermuda's economic growth has surpassed that of the US and UK.
- **Potential tax benefits:** Bermuda companies are not subject to corporate, income, capital or dividend tax and individuals are not subject to personal taxation.

### **HFM: How is the convergence of hedge funds and private equity impacting valuations, and what effect is this having on the due diligence process?**

**PwC:** Convergence places stress on all participants in a fund structure – advisers, administrators, auditors, prime brokers and counterparties. All parties need to ensure they understand the risks involved and the demands they will be faced with as illiquid investments are combined in structures that traditionally have provided greater liquidity and shorter investment realisation timeframes than that of private equity structures. There is an increased need to understand more about the overall strategy of the fund in order to understand not just the fair value of an investment but also how it fits into the picture of the fund from a risk/return and liquidity standpoint.

More specifically, with an increase in illiquid investments coming into portfolios of hedge funds, challenges include: Managing the liquidity requirements of investors; ensuring the skill set to perform rigorous valuations is available; managing expectations as to the level of segregation or independence in the valuation process; developing fee structures that reflect the nature of the portfolio investments and the inherent uncertainty in the valuations and liquidity of these positions. Furthermore, given the current environment and the valuations of illiquid investments, there are further considerations for the monthly/quarterly liquidity needs of hedge fund investors. Accordingly, we have seen a significant increase in the use of side-pockets, boards enacting gates or even temporary suspension of redemptions as a means to protect investors and be seen to treat them equally and fairly. Not surprisingly, there are also growing calls to step up the levels of transparency, disclosure and risk management.

**HFM: What stage has the IFRS/US GAAP convergence reached and what new considerations is it raising for Bermuda's service providers?**

**ISIS Law:** Bermuda law allows the adoption of any internationally recognised accounting standards and we are seeing more investment funds adopting IFRS. The evolution of Bermuda's statutory and regulatory regime in accordance with international best practice allows us the flexibility as a jurisdiction to adapt to international developments and provide suitable structures for our clients. Generally the BMA is observing trends and is working to allow flexibility in reporting. Though the convergence of accounting standards will be welcome, it is still

some way off.

**PwC:** The SEC and the FASB have taken the first steps towards a transition from US GAAP to IFRS. In fact, within the next few years, the SEC is likely to designate a date for mandatory adoption of IFRS by all US public companies, including US investment companies.

An IFRS conversion will present some upheaval and uncertainty as investment managers, fund administrators and the users of their financial statements grapple with the new standard of accounting. In particular, US GAAP has maintained industry specific guidance; the IFRS approach is that of one reporting framework that all entities and industries follow. IFRS convergence is not only an

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accounting and reporting matter but it will also affect operations including fund structure, marketing and investor relations. Conversions typically take more than one year to complete, and involve not only internal accounting functions but also shareholder servicing, management and vendor contracts, information systems, debtor/lender agreements and tax reporting and compliance. Accordingly, Bermuda service providers, including fund administrators and legal counsel, will be integral in this conversion process.

We have already seen specific areas where the standard setters are bringing the two accounting standards together, in particular in the areas of consolidation standards and valuation frameworks. There are also industry groups working to provide guidance on how to apply, in a practical sense, the valuation standards prescribed by US GAAP and IFRS.

**HFM: What challenges are the current market conditions presenting to your company and/or your clients?**

**PwC:** As the capital markets continue to experience a liquidity crunch and the

impact ripples across industry and geography lines, those of our clients in legal and compliance, risk and finance roles face huge challenges. All businesses, not just those in the capital markets, will need to:

- **Manage liquidity:** Understand corporate and legal documents to ensure they provide a framework (gates, rolling redemptions, creation of side-pockets) for dealing with liquidity constraints.
- **Concentrations:** Monitor your exposure to single corporations, sectors and geographic areas. Diversification is more important now.
- **Prime broker and counterparty exposures:** Understand the terms of accounts and agreements and consider carefully which entity you have an agreement with and understand the risk that you may face delays in access to cash or securities or even loss of those investments.
- Monitor events and keep board members informed to allow you to move or act quickly
- **Transparency:** maintain a level of transparency with investors on how you manage these risks and events.

**ISIS Law:** In the wake of the current credit crisis, the global economy is going to be more risk adverse and it will, therefore, become harder for hedge funds to deliver the alpha sought by their investors via traditional investment mandates (such as long/short funds and fund of funds). However, hedge funds are innovative; alternative strategies and structures will develop. The investment focus now seems to be on the development of less correlated returns and we anticipate that there will be opportunities for customised structured finance products with capital protection and transparency. Convergence and restriction of investment opportunities will lead to more focus on differentiation by administration costs and quality of services.

In this market environment both Bermuda and ISIS Law are well positioned to take advantage of the flight to quality and transparency. There will be opportunities in distressed debt, and longer term, hedge funds may become more active in their investments as timing opportunities and other strategies wane. As a result of the legal and regulatory regime in Bermuda there is considerable flexibility both in the structuring of the investment fund vehicle and the extent of regulatory oversight. ■