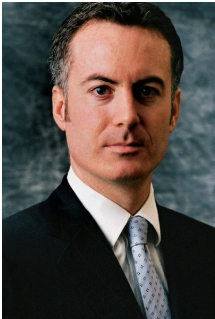


The Transformation of the Hedge Fund Space



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Dickens was half right: it was the worst of times. But now, as the hedge fund marketplace is recovering from the most brutal market conditions in decades, we believe that our industry is poised for profitable growth. At Citi, our view is that the transformation of the hedge fund space is being driven by two overriding forces: mounting pressure from investors demanding greater transparency and independent valuation; and additional regulatory and reporting requirements that will inevitably be implemented.

In a Word: Independence

The events of the past year – the global credit meltdown, the Madoff scandal, the collapse of Lehman Brothers and Bear Stearns - have brought about a seismic shift in investors' priorities. Today, as never before, investors are demanding independence and separation of functions related to valuation, pricing, compliance and custody that may be achieved through the use of a highly credible, trustworthy third-party. To an unprecedented degree, they are demanding rigorous due diligence, risk management and financial controls and are requiring proof of visibility as well as a guarantee that their money is being managed properly.

This demand for independence is being led by institutional investors and Funds of Funds. We are seeing an "institutionalizing" of the industry and acceleration in demand for industrial-strength operational processes. Likewise, investors are requiring heightened levels of transparency and third-party valuation.

In response to these market-wide demands, funds are looking to service providers for expanded valuation, custody and reporting capabilities, more middle office functionality including risk reporting and compliance services tailored for hedge funds. These key functions are under the tight scrutiny of existing and prospective investors, who are clearly concerned with the way these processes work and how they correlate with the overall risk associated with the portfolio. Increasingly, they are conducting due diligence themselves to confirm the independence of a fund administrator's analysis, pricing protocols, allocation processes and internal policies and procedures. Service providers who can demonstrate robust controls and procedures, as well as broad coverage of asset classes from both an accounting and valuation perspective, will be most successful in this regard.

Increasing Oversight and Regulatory Requirements

While hedge fund managers are adapting to the investor-led demands for increased transparency and independent valuation, they are also faced with the prospect of additional regulatory and reporting requirements by authorities in the US and around the world. The particulars of the new policies are still being deliberated, but stringent regulatory oversight and compliance requirements, which could grow rapidly in frequency and complexity, will place upward pressure on funds' operating costs. This pressure, as well as pressure on revenues, is leading to the demand for cost-effective middle office solutions in addition to more traditional administration services.

Investor-First Focus

To succeed in this transformed hedge fund space, managers must understand that our marketplace has been forever changed. Now and going forward, they will have to adopt a highly-efficient, best-practices business model that focuses on their investors to satisfy their increasing demands for improved transparency and independent valuation.

At Citi, we are optimistic about the prospects for the industry as we strive to successfully adapt to the new market conditions.

Growth - Although the market dynamics we are facing now – increased investor scrutiny and the prospects of additional regulation – will persist, we believe the industry will continue to grow at a rapid rate, likely outpacing the traditional fund sector.

Funds of Hedge Funds - Funds of hedge funds will continue to be important. From an investor's perspective, they provide an important risk management function by diversifying exposure across multiple funds, instead of individual fund managers. From the managers' perspective, FoHFs provide a valuable distribution capability, allowing them to efficiently distribute their offerings to a broader range of investors.

FoHF Custody - As a key element resulting from the market demand for independence, FoHF Custody from a third-party provider is becoming increasingly essential by delivering autonomous safekeeping, settlement, registration, income processing, corporate actions and reporting and reconciliation services.

Finally, we believe that the hedge fund space will continue to provide an attractive investment opportunity for sophisticated investors seeking portfolio diversification and above-market returns. As we can attest, investors are becoming increasingly knowledgeable about the alternatives market and about the fund administrators that actively support its success.

