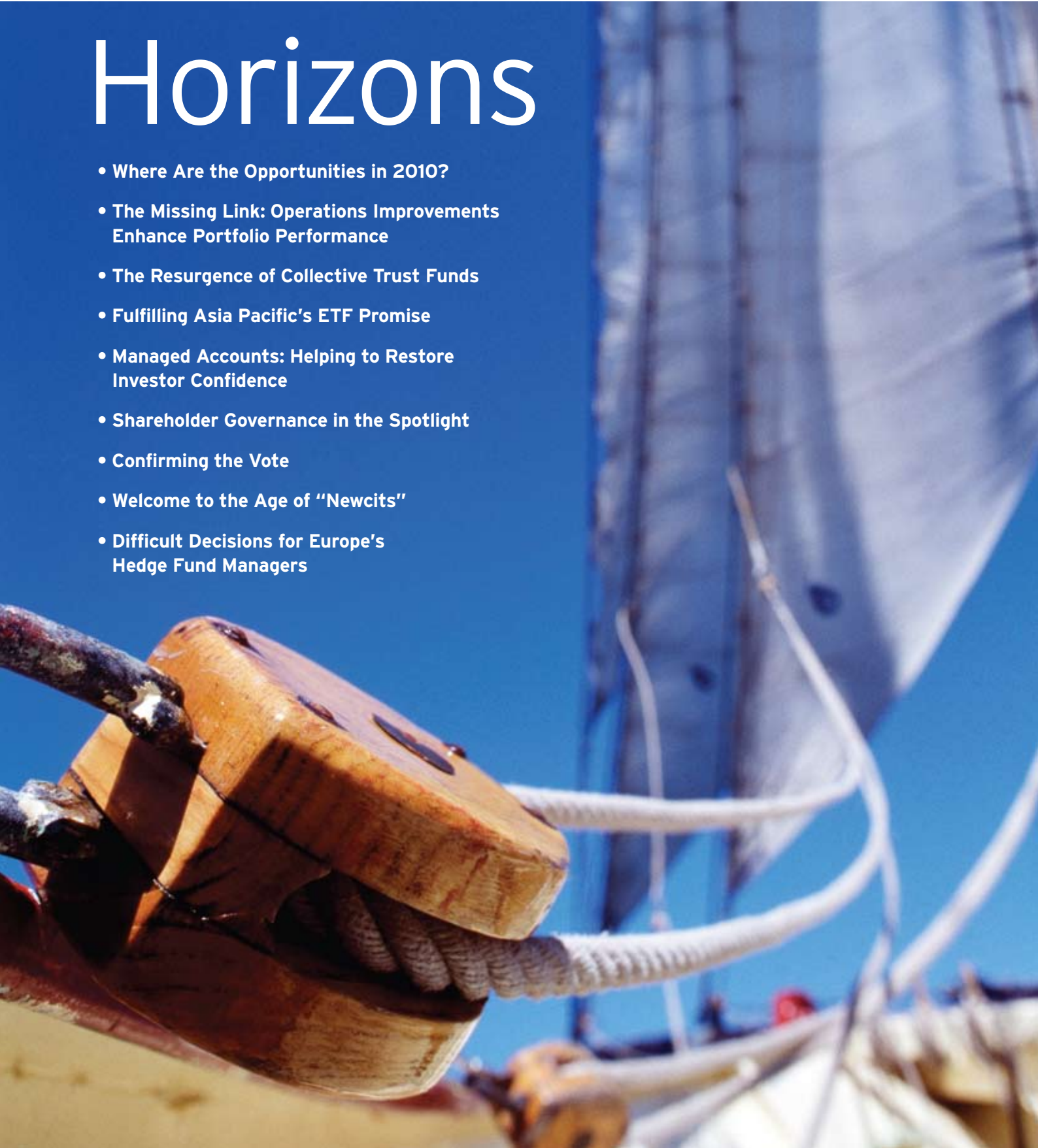


Investment Management Review

A Quarterly Update for the Investment Management Industry

Horizons

- **Where Are the Opportunities in 2010?**
- **The Missing Link: Operations Improvements Enhance Portfolio Performance**
- **The Resurgence of Collective Trust Funds**
- **Fulfilling Asia Pacific's ETF Promise**
- **Managed Accounts: Helping to Restore Investor Confidence**
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A Quarterly Update for the Investment Management Industry



IMR UP FRONT

Horizons

Welcome to the Spring 2010 edition of *Investment Management Review*. In this issue we focus on two principal issues: key trends for the year ahead and the potential impact of regulatory changes.



The alternative investment industry is in the eye of a regulatory storm at the present time. We gauge the likely impact of Europe's Alternative Investment Fund Managers Directive which is now working its way through a particularly tortuous legislative process. While its final shape remains uncertain, it will clearly present the hedge fund industry with some tough choices – not least on the best location for their business.

We also look at other pressures on the hedge fund industry as it works to restore investor confidence. Many managers are responding by moving their funds onshore. At the same time, there is new interest in the transparency that is delivered by separately managed accounts. We assess the challenges in both areas.

With every challenge comes opportunity. We look at where the opportunities lie now. Should continuing investor caution determine product strategy? Where are the growth markets and how should they be addressed? We also look at the rise in popularity of Exchange Traded Funds and the potential they offer for dramatic growth in the Asia Pacific region.

We comment on one other key trend: the resurgence of collective trust funds as an investment vehicle for U.S. defined contribution retirement plans. We look at the opportunity this presents for investment managers keen to enter the 401(k) market or become more competitive within it.

One other area comes under the spotlight: corporate governance. We look at the issues investors still face in making their vote count and in receiving confirmation that it has been lodged. We also look at the millions of dollars investors are failing to claim in securities class action settlements each year.

One thing is common to all these issues. It is Citi's ability to mobilize a range of market-leading solutions to help investment managers overcome challenges and make the most of opportunities – in whatever region of the world they arise.

I hope you enjoy this edition of *IMR*.

Neeraj Sahai
Managing Director, Global Head of Securities and Fund Services
Global Transaction Services, Citi

Where Are the Opportunities in 2010?

“... despite growing warning signals, the bursting of the bubble is probably much further away than most investors think.”

Over two parts, *Investment Management Review (IMR)* examines the prospects for the world economy in the months ahead and where the opportunities lie for asset managers. Will asset price reflation continue – and will this underpin renewed investor confidence? Can the world's leading nations be weaned off emergency support without imperiling the uptrend, or will moves by governments to reduce the burden of debt sabotage the recovery? We also look at what makes for a winning strategy for asset managers. Is Asia still the key to growth? What segments of the market should be targeted – and with what products?

1. World Economy: Staying Positive, for Now

While the longer-term outlook is uncertain, most commentators forecast steady, if unspectacular, growth in Western economies this year coupled with a strong performance from emerging markets.

In 2009 Western governments printed money and borrowed like never before. In 2010, all the talk is of “exit strategies.” Finance ministers and central bankers alike are peering warily into the future to identify the moment when they can normalize their fiscal and monetary policies. Move too early, and the house of cards will collapse. Move too late, and the danger is that inflation will get an unstoppable grip.

“Spending by governments will fall in the second half of the year,” says Leon Cornelissen, Senior Strategist at the Dutch asset manager, Robeco, “so we need the consumer to take up the slack. This is a bit of a worry, especially with U.S. consumers paying back debt – something we have never seen before. But recent developments have been positive and the good news is that while the U.S. wealth-to-income ratio has come down in the past two years, it is still in line with the historic average. I do not think we should worry too much about the U.S. consumer.”

Cornelissen is also positive about the U.S. labor market. “The message is not to worry much about the policymakers’ exit strategies – their impact will not be that serious.” Robeco expects growth in the U.S. of as much as 3% this year, with a similar outcome in Japan. Meanwhile, emerging markets are “roaring away,” he says: “China will easily achieve 10% growth in GDP. Yes, there has been some tightening there but growth remains the priority for policymakers.”

Back to Form?

He acknowledges that there may be something of a bubble brewing in emerging markets: “That may be so, but my advice is to enjoy the run. If the U.S. Federal Reserve is slow to raise interest rates, it is difficult for the Asian economies to hike theirs. But emerging market equity valuations are not worrying. We are only back to where we left off two years ago. By and large, valuations are in line with those in developed markets.”

Matt King, Credit Product Strategist at Citi in London, is also positive about the outlook but he, too, is concerned about another bubble forming. “We are not confronting the problem of excessive debt,” he says. “If the true cause of the crisis was the unsustainable buildup of private sector debt in countries like the U.S., all we have done is move from private sector borrowing to public sector borrowing.”

The probability, he suggests, is that the world will go on inflating another bubble for two or three years – with the worst of it apparent in emerging markets and government bonds. In the meantime, asset prices will continue to rise. “But despite growing warning signals, the bursting of the bubble is probably much further away than most investors think,” he says.

King’s analysis was echoed in a study from McKinsey & Company (*The Looming Deleveraging Challenge*, January 2010) that looked at the imminent deleveraging problem facing a number of economies as unsustainable levels of debt were unwound. Its analysis showed that virtually every major financial crisis since World War II had been followed by a prolonged period in which the ratio of total debt to GDP declined significantly.

This time, however, it concluded that deleveraging “may start later and take longer.” One reason was the dramatic rise in government debt in the U.S., UK and Spain, for instance. “This development could more than offset any deleveraging by the private sector. One implication is that Spain, the UK and the U.S. might postpone deleveraging until after the crisis passes and growth in government debt has been reined in.”

The Case for Equities

There is, says King, a solid case for equities in this scenario, especially emerging market equities. “The best fundamentals are in the current account surplus countries of Asia and Latin America while it may be beneficial to be short those Eastern European countries that have been borrowing like developed countries,” he says. He is also positive on the more risky end of the credit spectrum. “There has been more deleveraging in the high yield sector than in high grade. People are going for higher risk,” he says.

Cornelissen agrees. He expects economic recovery with moderate growth in the Western world and surging growth in the emerging markets. "This should be good for stocks," he says. "We have seen a 57% fall in earnings, so there is a rebound to come. Valuations are generally supportive of outperformance."

One other factor, he says, gives comfort: "In the last 40 years, we have seen a disappointing return on equities compared with bonds. The risk premium should be 4% per annum, but in the last 40 years it has been just 1.3%. You could argue that a return to mean – implying a higher risk premium – is due." Such an adjustment, if played out over a period of years, would be manna from Heaven for the funds industry.

2. Picking the Right Strategy for the Times

What are the keys to success in the coming year? A range of simple, low-cost products and an effective distribution capability in Asia are two of them.

Is the glass half full or half empty? Investment managers are generally a lot happier with life than they were a year ago. According to Strategic Insight, the mutual research and consulting firm, net sales of mutual funds topped US\$13 billion over the first nine months of 2009. The European Fund and Asset Management Association (EFAMA) logged a 12.4% rise in worldwide investment fund assets over the same period.

But retail sentiment remains fragile. The U.S. market continued to experience mutual fund net outflows last year. In Britain, the Investor Confidence Index produced by the Investment Management Association in January showed UK investors were less bullish than six months earlier. Risk appetite had dropped, especially among older, wealthier investors. Two out of five investors said they

planned to be more cautious with their money. In a survey of investment managers conducted by the professional services firm BDO, 42% saw "a lack of investors" as the key risk they faced.

None of this comes as a surprise to Professor Amin Rajan, Chief Executive Officer of CREATE-Research, who argues that what the retail market wants now is "quality, simplicity and safety." He defines quality in terms of consistent, risk-adjusted returns; simplicity by liquidity and transparency around those returns; and safety in terms of capital protection. "The past decade has seen two of the four-worst bear markets on record. Client behavior has changed. Where fund managers can deliver simple, transparent, capital protection strategies with reasonable liquidity they will find a ready market."

In the high net worth and institutional market, Professor Rajan sees absolute return products as the key to success. "A lot of institutions are very disillusioned with long-only funds. They want alternative products, but ones delivering genuine alpha, not leveraged beta. We know of US\$150 billion of institutional money that has been allocated to hedge funds but not invested yet. There is a major rebalancing of portfolios in progress. There is a big opportunity here."

Retail Investor Viewpoint

At BlackRock, Richard Royds, Managing Director, Head of International Retail Clients, is markedly more upbeat about retail investors' appetite for risk. "Structured products were very successful in 2009 but the flows we're seeing now suggest rather more appetite for risk. They are not in the high beta areas but focus on core products such as U.S., European or Asian high cap." Consistent with that trend is the steady expansion of exchange traded funds (ETFs), where BlackRock is now the leader as a result of last year's takeover of Barclays Global Investors.



Where fund managers can deliver simple, transparent, capital protection strategies with reasonable liquidity they will find a ready market.

The total invested in ETFs globally recently went through the US\$1 trillion mark. Net sales of US\$93.8 billion in the first nine months of 2009 dwarfed sales of mutual funds. In Europe, the amount invested in ETFs rose by more than half over the course of 2009. There were a number of new entrants to the market – including a consortium of banks, including Citi – and most commentators expect the demand for these low-cost, passive investments to go on rising in 2010.

Cost, says Royds, is likely to become an ever more important issue in the retail market. In Britain, for instance, the Retail Distribution Review, the Financial Services Authority's initiative for a more transparent financial advisory market, will transform the way independent financial advisers (IFAs) are remunerated. "Expect an explosion of bareboat-priced mutual funds free of charges trailed to advisers," he says. ETFs are also likely to have more appeal in a marketplace where IFAs charge their customers advisory fees rather than take commissions from product providers.

Beyond the developed markets, the lure of Asia remains as strong as ever in 2010. From Hong Kong to Singapore, the UCITS "brand" commands widespread recognition. Research by EFAMA has shown that 90% of all net sales of internationally distributed UCITS funds now come from Asia. "The real success story of offshore distribution has been in Asia," says Sanjiv Sawhney, Global Head of Funds, Citi.

Looking East

The challenge for fund groups, he says, is to put the optimal distribution strategy in place. "If you take the example of a fund manager targeting an Asian country, such as Korea," he says, "there are a number of options. Is it more effective to set up a locally domiciled fund rather than distribute an offshore fund, where there could be tax implications? Or should you set up a feeder fund in-country that invests in offshore funds and save on the duplication of costs?"

"The majority of fund managers would like a one-size-fits-all strategy, but in Asia you have to approach each market on a case-by-case basis. For example, in Hong Kong, offshore funds command 90% of the funds registered for sale. The figures are pretty high for Singapore and Taiwan, too. But it is different in other markets where there are often tax implications to investing offshore," he says.

Focus on Asian Funds

Sawhney also highlights the expansion of local pension schemes in a number of markets. "This is a big target for the funds industry," he says. "Pension structures are

developing in markets such as India and Korea. This presents an opportunity to access big pots of money. This should definitely be on the 'to do' list for 2010." A strong brand identity and the ability to forge joint ventures are keys to success here, he suggests.

Signs are that the hedge fund industry is also paying more attention to Asia. Many alternative fund groups wound down their presence in Asia as the financial crisis hit. Now they are returning. More than a dozen big firms are reportedly engaged in reestablishing a presence – or setting up anew – in Hong Kong and Singapore. One reason cited is the regulatory crackdown under way in Europe and the U.S. But local growth opportunities are also seen as exceptional in markets with high savings rates.

Whatever approach fund managers adopt, Citi can mobilize powerful distribution support in local markets backed by multiple servicing hubs around the world to make that approach effective. Citi has the in-depth understanding of the regulatory, cultural and operational issues that set each region or country apart. It also has the global capability to execute processes in multiple regions and calculate NAVs overnight in order to meet the most demanding timelines.

With its worldwide fund administration, transfer agency, custody and cash management network – and its understanding of both the long-only and alternative investment marketplace – Citi delivers unparalleled service breadth on behalf of its fund management clients marketing across borders. Above all, it is always ready to tailor its skills to the demands of a particular strategy.

Conclusion

In conclusion, asset managers still need to keep a wary eye on debt levels globally and how their country-specific investment strategies fit. A successful Asia strategy is likely to be a key determinant for success while a committed approach to servicing distributors, consultants and customers is self-evident.

There are clear long-term opportunities for firms who can position themselves correctly. Whether you are a hedge fund or pension fund, efficiencies across the front, middle and back offices are vital, while finding, and maintaining, a consistent level of performance is all-important. However, the panacea that everyone seeks is a sustainable reputation – trust is paramount.

The Miss



Operations Improvements Enhance Portfolio Performance

Chandresh Iyer

Head of Global Custody and Investment
Services, Citi

Chito Jovellanos

President & CEO, *forward look, inc.*

ing Link:



The coming decade will be a difficult one for institutional asset management. A vastly more crowded market for investment and trading ideas, more constraints on leverage, demands for greater transparency, changing compliance rules and more risk-averse investors will ensure that the heady days of relatively easy alpha and benchmark-beating strategies will be much harder to sustain.

Will this be the “new normal”? The emerging consensus is best expressed by Blackstone Group cofounder Pete Peterson (in a December 2009 McKinsey interview), who sees “the center of gravity of the business shifting from financial engineering to operational improvements.”

Citi Investor Services has been at the nexus of investment operations for several decades. In our ongoing dialogues with investment managers, firms have consistently expressed the need to better understand how operational efficiency contributes directly to portfolio performance. Although they have seen how outsourcing has reduced costs and engendered workflow effectiveness at their firms, the direct link between operations quality and portfolio performance has so far been elusive.

This definitive analysis demonstrates how improved investment operations contribute anywhere from 50 to 250 basis points (bps) in realized portfolio performance. Moreover, we show the relative contributions of each of a number of components of investment operations to overall performance alpha, and discuss how investment managers can best improve their operational capabilities in support of alpha enhancement, regardless of the company’s operating model – be they traditional 40 Act complexes, retail SMA managers, institutional managers or alternative investment firms. We conclude with insights drawn from Citi’s deep experience in the delivery of Business Processing Outsourcing (BPO) services to investment managers.

A 360° View of Operational Quality

Andre Perold’s seminal work related to implementation shortfalls (“The Implementation Shortfall: Paper Versus Reality,” *Journal of Portfolio Management*, 14(1): 4-9, 1988), coupled with more recent work by Ananth Madhavan while at Barclays Global Investors (“The Value of Transaction

Cost Forecasts: Another Source of Alpha,” Working Presentation – Guttman Center for Portfolio Management, University of Vienna, 31 pages, 2006) had clarified a piece of the puzzle as relates to best execution and the impact of opportunity cost on alpha.

Investment operations, is however, a vastly broader arena. “Operations” spans the gamut from order management, settlement, reconciliation, accounts servicing, securities lending and compliance to trade execution, custodian and prime broker communications and fund accounting. These different yet complementary elements make up the complex web that defines the totality of an investment operation. Intuitively, the quality of all these facets of an operation at an investment manager’s firm must support and enable the desired outcome – namely portfolio outperformance of its benchmark.

Rigorous Research – Real-World Results

Alpha stems from a manager’s skill, which is expressed through a target portfolio representing their view of assets that will outperform a benchmark. This ideal portfolio, however, needs to be translated into reality, and reality is fraught with implementation issues, such as:

- Incorrect identifier for a security (e.g., an OSI Option symbol)
- Movement of execution price away from the model’s parameters
- Exiting from a position in time
- Failure of the Fund Accountant to provide timely instructions to custodians to move investment proceeds into a margin account to enable today’s short sales
- Step-out settlement fail causing a position break preventing trading at a critical market opportunity

- Incorrect Corporate Action captured resulting in a large trade error

In seeking to answer the question of how much operational efficiency can contribute to realized investment performance, *forward look, inc.* revisited data from its client engagements spanning Q4 1999 to Q2 2006. As with most client projects, the mandates were expressed in tactical terms (e.g., “we want to streamline our emerging markets operation”), but surprisingly yielded strategic benefit in terms of improvement to the underlying portfolio’s performance.

Projects were selected in which only one very specific process was modified (e.g., voluntary corporate actions management) or only one highly focused technology was implemented or retooled (e.g., a reconciliation system). Just as important, all other elements surrounding these investment manager operations had to have remained constant. This approach provided a form of a *posteriori* control where only the effects from one imputed variable were examined. The data screen resulted in 52 samples (from a population of 138 investment portfolios across 19 asset managers) where all known factors (e.g., style, exposure, concentration, manager[s]) were constant throughout the observation period, except the one operational change that was introduced by the project. Performance attribution data was provided by the investment manager clients (consisting of both holdings- and transactions-based techniques reported at weekly or monthly intervals).

The firms in the study ranged from \$5 billion - \$100+ billion in AUM, with individual portfolios typically running between \$250 million to \$1.1 billion of managed money. Asset classes included equities [~65%], fixed income [~15%] and listed derivatives. Geographies covered were global (developed [~80%], emerging), and all sectors were represented, including alternatives. Strategies spanned long-only,

long/short and equitization. The minimum sampling period was three contiguous calendar months, with the bulk of the data collection spanning a six- to nine-month window.

Empirical Evidence: 50- to 250-BP Improvement

The investment managers experienced a 50- to 250-basis-point improvement in risk-adjusted performance (annualized, gross of fees) for the underlying portfolios that were affected by the investment manager’s operations initiatives. Effects were visible generally within six to nine months of project initiation.

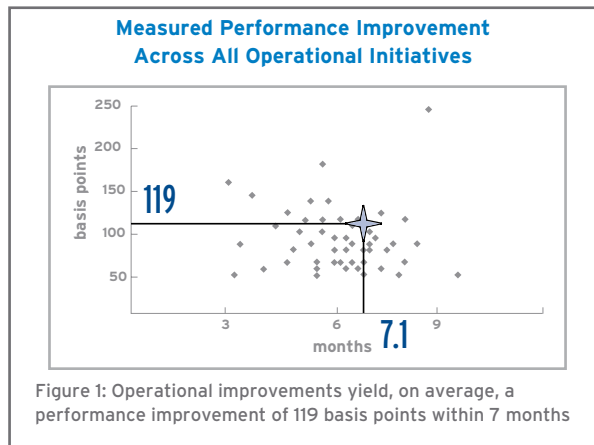
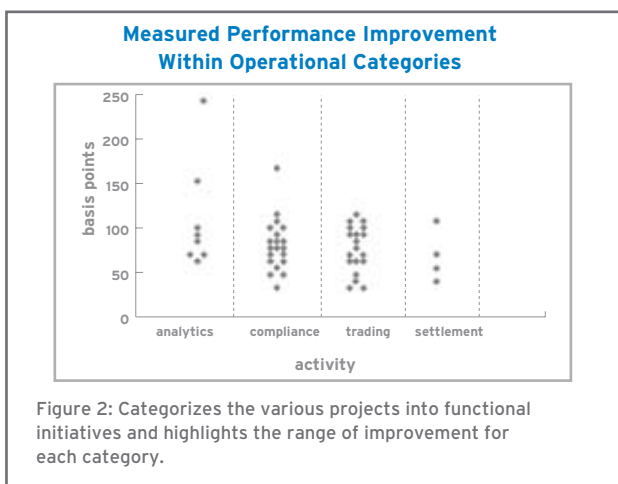


Figure 1: Operational improvements yield, on average, a performance improvement of 119 basis points within 7 months

Figure 1 provides an overview of the 52 sample portfolios and the measurable improvements in performance after the implementation of a given operational initiative. The cluster center indicates an “average” 119- basis-point improvement within seven months of a project’s initiation. Note that these returns were tracked across extremes of market cycles – both bear (2000 - 2002) and bull (1999 - 2000; 2003 - 2006), and performance improvements were measured relative to the portfolio’s benchmark (not absolute return).

What was the cause of these observed improvements in performance? *forward look's* hypothesis was that weak information flows (within a firm and with its counterparties) arise from a firm's operational inefficiencies, and are the precursors to a broad class of implementation shortfalls. Subsequent factor analysis indicated that these shortfalls in the portfolio implementation framework stem from "Information Latency," i.e., the inability of people and systems to deliver and act on data in a timely manner.

When portfolio managers review their investment operations, they routinely discover inefficiencies that create operational friction, which in turn reduces portfolio returns. Size per se is not necessarily the primary drag on performance. Other contributors include inefficient or ill-defined processes, disparities in data and generally poor data quality, mispricing, latency, reconciliation lags, the wide diversity of asset classes managed, disconnected geographies – in a word: complexity.



“Book-of-Record” Framework

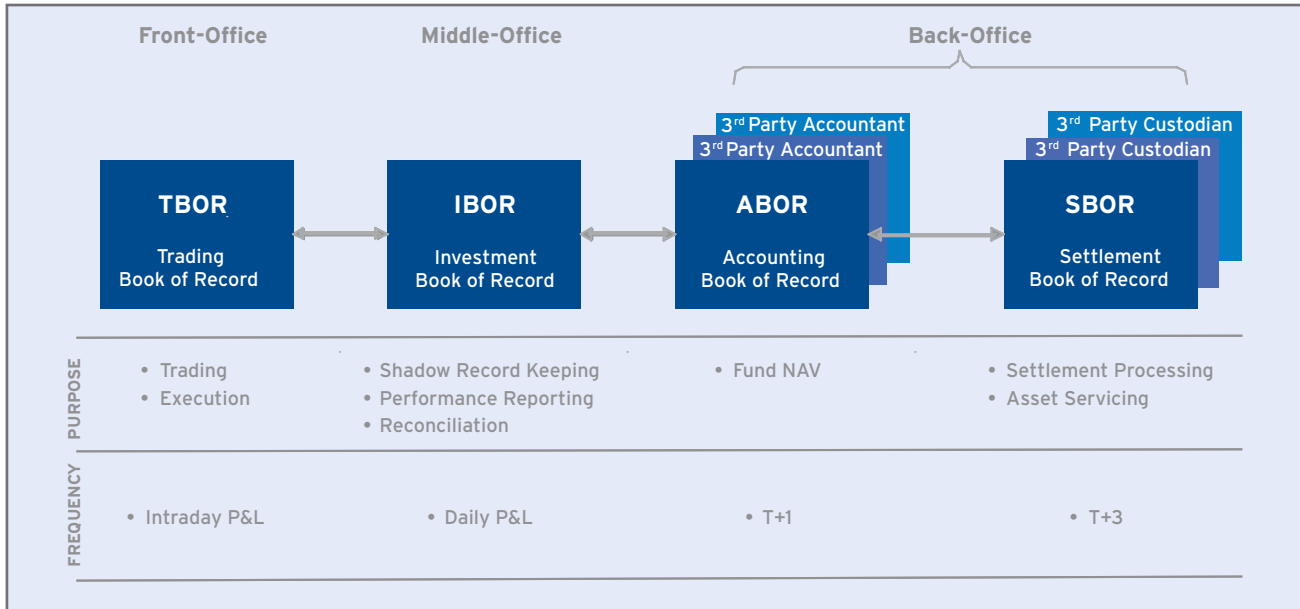
Working with the leading asset managers globally, Citi Investor Services has developed a proprietary method that delivers investment operations performance improvements to buy-side firms. This method is based on precise information delivery to the right book of record and the respective interconnected activities throughout the entire trade life cycle.

Citi’s ongoing success is built on being a leading service provider with best-in-class platforms and “best practices.”

A more detailed breakout of the observed performance upside within the categories in Figure 2 follows:

FACTOR CATEGORIES	OUTCOMES
Analytics	
market data quality	51 - 242
economic macro data quality	64 - 88
reference data quality: securities counterparties printing	55 - 122
risk modeling framework	55 - 94
portfolio trade list optimization	62 - 153
Compliance	
client guideline quality	92 - 119
pretrade restriction checks	83 - 211
post-trade restriction checks	100 - 202

FACTOR CATEGORIES	OUTCOMES
Trading	
securities located; for shorting	76 - 189
trade execution	85 - 173
Settlement	
automated reconciliation	52 - 106
automated FX	50 - 58



Blending our experience with *forward look's* research highlights a number of operational areas that could readily deliver increased performance opportunities:

Reconciliation and Portfolio Accounting

Portfolio managers who don't keep their own portfolio accounting records (or shadow record keeping) are missing opportunities to reduce operational friction. Using custodial, plan sponsor or fund accounting data is often highly labor intensive and fraught with opportunities for error. Without their own record keeping, managers lose visibility into the daily activity of their investor clients. Portfolio accounting enables managers to anticipate their clients' and custodians' actions, thereby taking alpha-enhancing opportunities as they arise.

At Citi, our view is that the tightly integrated trade capture, portfolio accounting and reconciliation processes support performance by ensuring all cash flows, trades and corporate actions are properly reported and investable cash balances are available to the investment management process.

Portfolio accounting enables managers to track their own activities in real time and manage their intraday investment activities based on accurate data, which reflects all the current trading activities, deposits and withdrawals. The shadow accounting is key to operationally derived returns because managers then get their own view of cash, and positions are not beholden to the limited capabilities of sponsors regarding corporate actions, for instance.

Restriction Management and Portfolio Compliance

Effective restriction management requires the automated application of complex rules from multiple sources, among them investors, custodians, brokers and managers. In addition, restrictions management requires the consolidation of disparate supporting data and industry conventions relating to assets, counterparties, industries and geographies. Overlaying investment manager concerns are compliance provisos around risk budgets and regulatory requirements.

Currently, most managers have a hodge-podge of manual oversight coupled with some unintegrated pretrade and some post-trade engines.

At Citi, effective compliance monitoring and restrictions management centers on total automated best-in-class, pre- and post-trade restriction applications integrated into accurate books and records controlled by the manager. This is coupled with integrated, leading market data sources for securities classification. This automated capability helps portfolio managers avoid inappropriate trades for an account which then need to be unwound. Our capabilities help avoid the costs of having held the wrong position or, perhaps worse, not being in the right position to optimize exposure to favorable market factors.

Collateral Management

Collateral management has become an indispensable part of the financial world's answer to the practical mitigation of credit risk. It has increasingly replaced the monolithic default risk of the counterparty with the more complex, yet more diversified and more readily managed combination of counterparty default risk, collateral issuer default risk and legal and operational risks. At the same time, collateral management programs are increasingly affecting more trading products (e.g., OTC derivatives) and workflows (e.g., securities lending).

Collateralization creates its own set of legal, market and operational risks that must be managed in order for it to successfully mitigate counterparty credit risk. These include the structure of collateral agreements made between counterparties, exposure monitoring control, the changing market value of collateral, the settlement of collateral transactions, and concentration and correlation risks within a collateral portfolio.

Although trading strategies have become more sophisticated, the infrastructure to manage operational risk in the back office has not kept pace. Many of the operations linked to collateral management are still conducted on a manual basis and, therefore, result in increased risks.

At Citi, we have developed Open CollateralSM, a value-added service that delivers both operational solutions to help mitigate risk and improve return on assets.

Reference Data Management

The optimum reference data management system aggregates, reconciles and monitors the agreed aspects of a portfolio manager's reference data at an individual data field level. The overriding objective is to ensure that the systems are producing the right data so that the manager is working with good information when making investment decisions. At the same time, a complementary goal is to make certain that, further downstream, trading and settlement counterparties have the proper details to effect timely clearance and settlement.

Unfortunately, most reference data systems are incomplete and rely on a single source of data from one vendor or one custodian. Incomplete data often results in numerous problems such as:

- processing holds for missing or stale pricing files
- unresolved reconciliation breaks from conflicting prices or security identifiers
- trading errors from incorrect or delayed application of corporate actions

At Citi, the Global Securities Master scrubs and ranks multiple sources of security issuer and industry data to create complete information prioritized for a manager's needs. This virtually eliminates delays and errors in procuring accurate security pricing and identification information. This, coupled with Citi's golden source of Corporate Action information and automated processes around the maintenance of this capability, helps portfolio managers minimize reference data-driven errors and delays to timely trading of portfolios.

Trade Order Management, Execution and Settlement

There is general agreement that electronic trading improves execution timeliness and provides data to support Best Execution analysis. What is less well-understood are the processes deployed across a manager's entire book of business to deliver fully electronic execution and the utilization of execution tools such as algorithmic strategies, automated market making, direct market access engines, dark pools, etc. Operational inefficiencies exist in coordinating and optimizing block trades across retail, institutional, fund and alternatives products that may be trading the same securities on behalf of different investors through different venues.

At Citi, the CitiConnect® trade hub offers a unified trade routing tool with robust rule sets, which allows a manager the flexibility to define Best Execution. CitiConnect allows a manager to combine and deliver trades electronically to any destination in any manner necessary to tap the above-mentioned execution tools and capture the results for Best Execution measurement and other compliance needs. The system automates settlement processing required with Step-Outs and Trade-Aways, assuring minimal trade breaks and limiting the negative impact of opportunities costs and market slippage on portfolio performance.

What's Next: Asset Managers and the "New Normal"

What are new things asset managers have to think about in terms of investment operations: better risk management, greater transparency from regulatory or client perspectives, cost of servicing? What does new normal mean in terms of investment operations: more flexibility, automation, risk management, transparency?

Positive Prospects: Top- and Bottom-Line Benefits

The insights correlating improved operations quality with improved portfolio performance clearly resonate with a number of constituencies. For investment managers, they naturally see it as a prescriptive tool to:

- improve strategy and product performance; and
- better capture and retain clients.

More interestingly, institutional investors also envision these techniques as a predictive tool to:

- improve fiduciary oversight (by benchmarking the quality of the manager's operations);
- identify, engage and retain the better managers (based on both skill plus operational competency); and
- maintain ongoing due diligence (utilizing an unbiased and repeatable technique for evaluating their manager's operational soundness).

So what options does a manager have to beat their benchmarks? Perhaps looking inward at the quality of their investment operations is a long-overdue alternative. It can potentially yield anywhere from 50 - 250 basis points in risk-adjusted performance. Moreover, looking deeper into operational quality at a firm can help clarify the ROI for remediation choices, and point to the optimal initiatives that will address the broader spectrum of implementation shortfalls.

Through its Securities and Fund Services business, Citi's industry-focused experts provide investors worldwide with tailored solutions delivered through proven global platforms that feature modular, open architecture. With over \$12 trillion of assets under custody and the industry's largest proprietary network, clients can leverage Citi's local market expertise and global reach to extract value across the entire investment value chain.

forward look, inc. enables investment managers to grow their revenue streams by improving portfolio performance and minimizing implementation shortfalls associated with complex product initiatives. For more information, visit our websites at www.forwardlook.com and www.riskforecast.com.



Collective trust funds (CTFs) are on a roll.

Although they've been largely eclipsed by 40 Act mutual funds in institutional retirement plans over the past several years, CTFs are regaining popularity among sponsors as a lower-cost, less-regulated, still-diversified component of retirement portfolios.

Bob Wallace

Head of Securities and Fund Services
North America, Citi

The Resurgence of Collective Trust Funds in the U.S. Market

Collective trust funds are not a new investment structure in the U.S. market. In fact, they have been available for decades, to both defined benefit (DB) and defined-contribution (DC) plans. In the past, however, CTFs had been perceived as a bank product, and mutual fund companies were, for several decades, the growth leaders in the retirement plan arena. As 401(k) plans began to grow quickly in the 1980s, they found mutual funds a convenient and easy-to-use product, further slowing the development of CTFs.

However, the CTF market has recently begun to reattract a considerable amount of attention from asset managers. Collective trust funds are gaining steam and coming to the fore of defined contribution retirement plan investing. Some even think that they are now the biggest competitive threat to mutual funds in the DC market – even beating out exchange-traded funds, which face certain operational and record-keeping challenges that CTFs don't.

Because of their cost advantages over 40 Act funds (generally lower startup and operating costs), collective trust funds are especially attractive in target date portfolios, a growing category of retirement investment vehicles.

Recent regulatory scrutiny of plan fees and expenses, coupled with investors' and plan sponsors' greater awareness of the product, is creating an opportunity for providers of CTFs to scoop up assets. We can, therefore, anticipate continued growth of these products, particularly in the defined contribution space.

"There has definitely been an increase in client interest in collective trust funds. We expect to book more new CTF business in the next few months than in the last two years combined," said Robert Thomann, President of Invesco National Trust Company. Invesco National Trust Company is an affiliate of asset manager Invesco Ltd. and is one of the largest providers of collective trust funds in the United States with over \$40 billion of CTF assets under management.

"We view ourselves as an asset management firm offering investment solutions to clients. As a firm we are neutral on the delivery vehicle. We let the client choose the type of investment delivery vehicle such as a mutual fund, separate account or a commingled fund, whatever meets the client need," continued Thomann.

The provider should leverage the best practices of its mutual fund servicing arm while allowing its clients to take advantage of the cost-effectiveness of CTFs.

CTFs vs. 40 Act Funds

Although they can share marked similarities in terms of portfolio holdings and investment strategies, CTFs differ distinctly from their mutual fund cousins. First of all, unlike mutual funds, CTFs are exempt from SEC registration as an investment company under Section 3(c) (11) of the Investment Company Act of 1940. Sponsors or trustees of CTFs are banks or nondepository trust companies. In addition, CTFs are institutional-only investment vehicles aimed at the retirement plan market, including defined benefit and defined contribution plans. Examples include 401(k) plans, Taft-Hartley plans, profit sharing and cash balance plans, and governmental 457 plans.

Contributing to the popularity of CTFs have been a number of operational enhancements and increased investor-related convenience. One of the most significant improvements was the development of funds that are valued daily, so they can meet the reporting needs of 401(k) plans. Technological advances also have made portfolio information more accessible to investors, greatly boosting the ease with which plan sponsors can use CTFs.

As a result, investment managers are realizing that CTFs can provide them with access to new markets, lessen their burdens related to increasingly complex regulations and oversight requirements, give them a faster time to market and lower costs to investors.

	Collective Trust Fund	Mutual Fund
Target Client	ERISA and certain governmental plans (includes 401(k) or other participant-directed plans)	Almost all U.S. institutional and individual investors
Investment Discretion	Sponsored and managed by bank or trust company Investment manager may be retained as nondiscretionary subadvisor	Investment manager of registered investment company in accordance with guidelines established by fund's prospectus
Regulatory Considerations	Exempt from SEC registrations Governed by bank regulations (e.g., Office of Comptroller of Currency) Unlimited number of participants	Subject to SEC regulations under the Investment Company Act of 1940 Subchapter M for tax purposes Unlimited number of participants
Governing Body	Board of Trustees	Board of Directors
Costs	Lower overall fees because of no SEC regulatory reporting and processing requirements	Higher fees because of SEC reporting and processing requirements; other marketing expenses
Information Access	Daily unit values obtainable from third-party administrator or plan record-keeper	Daily unit values available in newspapers

Although a fund's investment objective is a major factor in determining fees, CTFs can also be far less expensive for large plans, because they are free of certain compliance reporting requirements as well as marketing costs. According to industry research firm Cerulli Associates, at year-end 2008 the asset-weighted average fee for a \$100 million CTF mandate was 40.8 basis points versus 50.7 basis points for an actively managed mutual fund.

Being exempt from SEC oversight, CTFs are not required to adhere to the compliance and reporting regulations of the 40 Act. These rules stipulate, among other things, that mutual funds provide prospectuses to potential investors and provide regular written reports on the status of the fund. Because they are not sold directly to retail investors, CTFs are able to issue a much shorter and simpler disclosure statement in lieu of a prospectus. Similarly, CTFs do not need to support toll-free telephone service centers and deal with retail investor inquiries. Nor do they issue proxies, helping to further reduce their cost.

At Citi, we believe that – although CTFs are not subject to 40 Act regulations and reporting requirements – a service provider should deliver to sponsors of these investment offerings the same disciplined support and control structure as with mutual funds, from product creation through full continual servicing of assets. The provider should be able to leverage the best-practices of its mutual fund servicing arm while allowing clients to take advantage of the cost-effectiveness of CTFs. In this way, managers can take advantage of the CTF structure to enter the 401(k) market or become more competitive within that space. Given the strength and movement of the CTF trend, this represents a major business opportunity that allows asset managers to quickly and cost-effectively bring new products to U.S. markets, lower overall operating costs and even reduce the cost of managing separate accounts.

Matt Brown

Managing Director
Regional Head of Fund Services
Asia Pacific, Citi

Fulfilling Asia Pacific's

When institutional and retail investors in Asia Pacific discuss exchange traded funds (ETFs) and listed funds, much of the talk is centered on the potential of these investment vehicles in this region.

This will change, however. Recent events in regional and global financial markets may prove to be the catalyst required by ETFs and listed funds to gain greater acceptance in Asia Pacific. As many retail and institutional investors have become disenchanted with traditional mutual funds during the market turmoil, the signs are positive for the future of these funds in the region.

Although knowledge among investors on ETFs and listed funds remains modest, acceptance is growing for several reasons. Market education has clearly pushed the line that ETFs are cheaper than traditional mutual funds and hedge funds, provide access to offshore markets and generate much-needed liquidity in what many investors could only describe as a dry environment.

Additionally, the fact that the number of country-specific indexes in Asia Pacific has grown by 8% to over 200 in the last two years is not lost on investors. Add in supportive regulation changes from local securities commissions and exchanges, and the time is ripe for ETFs and listed funds in Asia Pacific to establish themselves as legitimate investment vehicles rather than products with regional potential.

The Current Situation

Globally, ETFs hold over \$1 trillion in assets under management. The vast amount of assets is held in North America and Europe. The penetration and commoditization of the product in Europe is so large that it is estimated that between 15% - 25% of daily trading volume on European stock exchanges derives directly from ETF or ETF-related products.

Excluding ETFs, the listed fund penetration in these markets is sizable. According to Citi research, listed funds represent approximately 2.2% and 3.5% of total U.S. and UK stock market capitalization, respectively. Going by the numbers, it is difficult to argue that ETFs and listed funds are not entrenched products in these sophisticated markets.

Asia Pacific, by comparison, is a far less underdeveloped geography for ETFs and listed funds. In Asia Pacific, there are approximately 180 ETFs out of a global total of 2,500 – just over 7%. ETFs in this region account for roughly \$70 billion of assets under management, which again stands at approximately 7% of the total value of the funds globally.

ETF Promise

Although these products do exist in Asia Pacific, ETFs and listed funds have yet to make any significant penetration into the investor market.

The listed fund market in Asia Pacific is also significantly smaller in comparison. Listed funds, excluding ETFs, represent only 0.17% of the market capitalization of major Asia Pacific stock markets. However, these products have only been launched in Australia, China, Hong Kong, India and South Korea. By far and away, China stands as the largest market through its listed open-ended fund (LOF) scheme – restricted to joint ventures or the Qualified Domestic Institutional Investor (QDII) scheme – with over \$40 billion in assets under management.

The Changing State of Play

In terms of the global ETF universe, Asia Pacific's place is decidedly small. However, in our experience, we believe that there are several compelling reasons to believe that acceptance and investment into ETFs by institutional and retail investors is about to change. Coupled with the growing understanding that ETFs are investment vehicles that provide investors with lower one-off fees, quicker access to offshore markets and enhanced portfolio liquidity, several market developments are likely to drive demand going forward.

Firstly, the underdevelopment of ETF markets in Asia will likely serve as a catalyst for greater fund creation. As it currently stands, there are large investment markets in Asia such as Australia, Japan, Korea, Singapore and Taiwan with a limited, albeit growing, number of listed ETFs. Recent moves in Hong Kong and India to encourage ETF listings will likely spur other markets to execute similar directives in order to remain competitive. Similarly, it is also expected that China will build on its LOF market to include more cross-border-focused ETFs as QDII funds have not performed to expectation.

Secondly, barriers that previously gave banks difficulties in distributing complex products are being relaxed. In several major Asia Pacific markets, well-publicized cases of distribution of nonperforming assets and asset classes have forced a reexamination of wealth management practices. In several cases, regulators have been offering stock exchanges a unique opportunity to introduce alternative distribution channels through the listing of funds as wealth management vehicles.

Thirdly, in Asia Pacific there is significant pressure to reduce the distribution costs of funds, which are high compared to mature markets. Typically, bank distribution of mutual funds in Asia Pacific comprises a 2% - 3% front-end load fee and 0.3% - 0.5% share of management fee on an annual basis. In comparison, ETFs provide more attractive fee structures to potential distributors. On average, ETFs in Asia Pacific have a lower underwriting fee of 1% - 2% and an annual listing fee of 0.02%. When these numbers are benchmarked against each other, estimates of distribution cost savings are in the 40% to 60% range.

Finally, the transparency aspect of ETFs is likely to only increase their popularity in Asia Pacific in the coming years. As is consistent in North America and Europe, ETFs are more likely to be regulated stringently by in-country securities commissions with disclosure requirements. Backed by a high level of transparency-supporting regulation, markets will justifiably provide enhanced liquidity to a product like ETFs.

Selecting the Right Provider

As ETFs have and will continue to gain further traction in Asia Pacific, providers of securities and fund services have been adapting their solutions. In our experience, providers that service ETFs in Asia Pacific must have defined capabilities that go beyond traditional accounting, reporting and compliance solutions.

In Asia Pacific's more developing markets, providers must have the capability of assisting the firm on the listing process. This will involve in-depth knowledge of local listing regulations and disclosure requirements. Additionally, as listing fees vary among exchanges, knowledge of individual pricing tiers for ETFs across the region is a key advantage when selecting a securities and fund services provider.

The ability to act as a local trustee is another key consideration for any ETF manager when selecting a provider. By regulation, clients launching ETFs in Asia Pacific, in selected markets, require local trustee services not only for reporting purposes but also to authorize the creation and cancellation of units.

From a fund administration standpoint, daily NAV calculations of the listed fund are clearly required. For the underlying asset, as in more mature ETF markets in North America and Europe, a global custodian is required, particularly for cross-border investments and for safekeeping and settlement. This same provider should assist an ETF appointing a share registrar, which aside from maintaining a register of the ETF, will also provide daily reconciliations from the listing exchange.

While all these ETF capabilities are becoming commoditized, providers such as Citi have a distinct advantage as more complex funds emerge in Asia Pacific and cost pressures from distribution agreements become a challenge for fund manufacturers.

In the case of Citi, we stand as one of the few providers in Asia Pacific with the ability to combine global custody and fund administration with local trustee services to support global funds listed on regional exchanges. We also have the advantage of not only providing wide-ranging solutions, but also through our ability to integrate solutions, including securities lending, to enhance the investment yield of the ETF.

As this market further matures and demand for more complex ETFs in Asia Pacific evolves, Citi is ideally placed to create end-to-end service offerings, combining the strength of our Securities and Fund Services franchise with transaction banking, consumer banking and wealth management services. We are also ideally placed to leverage the strength of our Citi Global Markets franchise to help ETFs structure and execute.

And mature this market will. Demand for ETFs from institutional and retail investors will only grow as greater numbers will realize the cost, market access and liquidity advantages of this investment vehicle in Asia Pacific. A demand spike is also expected as more indexes and supporting regulations become available.

In our view, greater proliferation of indexes in this region across all asset classes and geographies will not abate as fund managers will continue the trend of diversifying into ETFs. Although the Asia Pacific ETF market has taken a hit as a result of the global financial crisis, outflows appear to be steadying and confidence is returning to the regional ETF model. Demand will only grow, as will the options available to a more conscious investor class in Asia Pacific. Clearly, the potential will finally be realized for ETFs.

An aerial photograph of a formal garden. The garden features a series of manicured, rounded hedges that form a winding path. The hedges are a vibrant green color, and small red flowers are scattered throughout the foliage. The path is a dark, narrow strip that winds through the hedges. The overall scene is well-maintained and symmetrical.

MANAGED ACCOUNTS:
Helping to
Restore Investor
Confidence

Mike Sleightholme

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Although the managed account structure gives investors more control and visibility to the underlying investments, managers running managed accounts face significant challenges. In fact, they report that operational complexity is the number one reason they are reluctant to take money in from managed accounts.



Investor confidence in hedge funds appears to be making a comeback. Just over \$1 billion of net investments moved to hedge funds in the third quarter of 2009, the first quarter of inflows since mid-2008, according to Hedge Fund Research.

Despite the rebound, the events of 2008 and 2009 – market turmoil, fraud and the widespread use of gates or suspension of redemptions – left a lasting mark on the industry structure. Investors and prospective investors, such as pension funds, sovereign wealth funds and other large institutions, are demanding higher levels of transparency and control, greater liquidity and more flexible fee schedules. They are requiring rigorous due diligence, risk management and financial controls, and are demanding independence and separation of functions related to valuation, pricing, compliance and custody.

This marked shift in investor dynamics has resulted in the accelerating demand for managed accounts.

- The number of investors that use managed accounts rose from 20% in 2004 to more than 50% in 2009.
- Upwards of 85% of hedge fund managers have seen an increase in requests for MA structures.
- Approximately 50% of hedge funds manage at least one managed account.

Managed accounts are now increasingly an option for investors who are under pressure from their own stakeholders to demonstrate they are doing all they can to minimize the risks of fraud, illiquidity and style drift. Hedge fund managers serve as subadvisors to the accounts, with responsibilities limited to making investment decisions. Several MA structures have emerged that involve managed accounts, each with different service requirements: single-manager hedge funds accepting managed accounts and fund of hedge funds placing managed accounts. In addition, fund of funds are increasingly launching managed account platforms to offer investors easier access to funds and the advantages of the managed account structure.

Investor Benefits

Transparency and Control. Managed accounts provide investors deeper disclosure of the manager's investment activities – including investment transactions, holdings, leverage levels and asset values. They can also provide increased control over the assets because investors can use the prime broker or administrator of their choosing, rather than the providers designated by the fund.

Liquidity. As the recent financial crisis demonstrated, liquidity during times of market stress can be a major problem for institutions investing directly in hedge funds. A managed account can insulate investors from this risk by offering capability to redeem more frequently or on short notice.

Fee Customization. Hedge fund managers offering managed accounts can customize the fees and fee structure because of the individualized nature of the accounts. Some managed account investors have negotiated fee discounts relative to the fees paid by investors in funds run by the same manager.

Managers' Primary Concern: Operational Complexity

Although the managed account structure gives investors more control and visibility to the underlying investments, managers running managed accounts face significant challenges. In fact, they report that operational complexity is the number one reason they are reluctant to take money in from managed accounts.

Managed accounts bring with them more operational overhead than pooled vehicles. The accounts need most of the same daily and monthly accounting and trade processing services of a fund. In addition, the inherent individualization of managed accounts multiplies the trading and support functions facing the manager. The manager has to separate the transactions for each account, separate reconciliations with potentially a different set of prime brokers, personalize reporting on each account's activities and track for performance differences with the main fund due to scale. Yet the relatively small asset size of the average managed account can make the operating costs as a percentage of assets look relatively high. Offering managed account investors enhanced liquidity can constrain the trading strategy and require managers to put in operational mechanisms for short-notice redemptions.

Without question, managed accounts are more expensive to support and operationally complex to run, and can affect a hedge fund manager's scalability. Outsourcing the operational infrastructure to a third-party service provider can relieve the manager of these responsibilities. Fund managers should look for a service provider with reporting capabilities flexible enough to meet the demands of the different account holders. Also key are the scale and automation of the provider, given the need to support account-level operations and reporting.

Managed account structures have become an important tool for hedge fund managers to attract new assets. With the right operational model and reporting capabilities in place, managers can overcome the operational challenges and thrive by providing individualized service and more frequent customized reports to this growing client segment.

A photograph of a rowing boat on a body of blue water. In the foreground, a wooden oar with red and white triangular markings is positioned horizontally. The background shows the dark hull of the boat and another oar with yellow and green accents. The water is slightly rippled, and the overall scene is brightly lit.

Shareholder Governance in the Spotlight

Jane Kenyon

Director, Global Custody Product Management
Citi



Political demands for more shareholder engagement, new legislation and the worldwide spread of securities class-action suits – all combine to make shareholder governance a pressing issue right now, reports Jane Kenyon, Director, Global Custody Product Management, Citi.

In an age of increasing shareholder governance scrutiny, institutional investors are expected to play their part by engaging with the companies in which they invest. At the very least, that means formulating an engagement policy and voting at shareholder meetings.

The twin poles of this engagement – proxy voting and securities class actions – are both areas of keen interest right now. In the first of these, continuing obstacles to voting in many international markets may be removed in the next year or so. In the second, the proliferation of class actions beyond American shores is materially complicating the process of tracking settlements and making claims.

Getting the Vote Out

The pressure on institutional shareholders to make their voice heard is today reflected in high levels of voting at shareholder meetings in the U.S. and UK. In the U.S., the 2009 proxy season saw an average vote of 85.7% – even though the new “Notice and Access” rules facilitating e-proxies reduced the level of retail voting. Electronic voting is now the norm.

In the UK, all institutional investors are required to set out their policies on engagement, monitor the performance of portfolio companies, intervene where necessary and report back to their clients or shareholders. The last report from the Investment Management Association noted that “all firms have a policy to vote all their UK shares.”

Elsewhere, the position is less clear-cut. Certainly, custodians and proxy services providers are witnessing rising numbers of clients voting in international markets. In 2009, Broadridge Financial Solutions, the investor communications and proxy processing business, sent out 2.6 million ballots to clients invested in 87 world (ex-U.S.) markets. Around 57% were returned for voting. The comparable percentage a few years back would have been in the high 30s or low 40s, says Elizabeth Maiellano, Senior Director, Broadridge.

But many firms are still failing to vote their shares in continental European and some Asian markets. One reason for this is cost. In countries such as Japan and Sweden there are charges for voting. But the bigger issue is share blocking – the practice of preventing trading in shares that are to be voted in the run-up to the shareholder meeting.

Dealing with Share Blocking

Share blocking is particularly prevalent in Europe. This is despite the Shareholder Rights Directive, adopted in 2007, that was designed to do away with share blocking and related practices and introduce a record date system. The Directive should have been implemented by every EU country by August 3, 2009. But, at the last count, 13 countries had still to complete the process. Among them was Sweden, where physical attendance at a meeting is still required if a shareholder wants to vote. Italy is currently discussing the legislation with Denmark expected to go ahead in March 2010 and Hungary in May 2010.

Even implementation is no guarantee that share blocking will end. Germany has transposed the Directive into its legislation, yet the practice of share blocking goes on. “There are markets, like Germany, where the legislation has eliminated share blocking but local market practices continue unchanged,” says Maiellano. “The sub-custodians and issuers are working together to determine the process. In Germany, blocking no longer exists; however, the shares are ‘flagged’ or ‘earmarked’ for operational

processing which is essentially blocking, but not called that. This occurs when the sub-custodian receives the vote instruction through meeting date +1. Also, in Austria if the sub-custodian receives a vote in Austria prior to record date, the shares are blocked until record date. Since Broadridge does not issue voting until the voting deadline (after the record date) the shares are not blocked,” says Maiellano.

How do investors deal with this issue? In January 2010, Citi invited a number of institutional clients in London and Edinburgh to roundtable discussions on this and other shareholder governance issues. Some said they chose not to vote rather than lose their ability to trade – unless the stake was strategic. Some voted a portion of their holding, giving them the flexibility to “trade the rump.” Much depended on the size and importance of the holding.

The hope is that this will happen over the course of 2010. When it does, it should pave the way for the more efficient management of proxy voting for firms with geographically diversified portfolios.

That will leave one more loose end to deal with. Vote confirmation remains a haphazard process in many markets. The problem is the number of intermediaries in the voting chain. Custodian, proxy service provider, vote agent, sub-custodian, registrar and transfer agent may all play a part in the process. All must agree on the voting entitlement and process the vote instruction as directed to allow the vote to be accepted and then passed through to the next link in the chain. Vote confirmation requires the information to pass in the opposite direction – but it relies on issuers and registrars to set the process in motion.

SWIFT’s new 20022 standard incorporates a message for vote confirmation. “With no free-form text it facilitates straight-through processing,” says Maiellano. “The problem is that it needs the participation of all entities in the communication chain and these same parties have to take some ownership of the process.” The majority of financial

institutions have yet to embrace SWIFT 20022 but the hope is that the new standard will mark a step forward.

Tracking Class Action Settlements

One of the biggest shareholder governance challenges is in tracking securities class action settlements and pursuing claims. Thousands of notices relating to class actions appear each year – most of them in the U.S. They can issue from courts, law firms or claims administrators, or appear in a variety of publications. They are easily missed.

Once a relevant settlement has been identified, the investor must pull together a complete transaction history in the security or securities concerned and make an error-free filing. This can be a daunting task. Many institutions, it seems, are not up to it. According to recent studies, more than half those eligible to participate in settlements fail to file claims. “As class action lawsuits grow increasingly larger, investors are leaving hundreds of millions of dollars on the table,” says Jane Kenyon, Global Custody Asset Servicing Product Manager for Citi’s Global Transaction Services. At the last count, some US\$9 billion in class action settlements and civil penalties awarded by the U.S. courts were still unclaimed. Failure to claim a payout can invite litigation. In 2005, a group of 40 U.S. mutual fund managers was sued for more than US\$2 billion in unclaimed class action settlements.

The challenge is getting bigger as the class action bug spreads around the world. The legal systems of Australia and Canada have long permitted class actions, and group litigation has been possible in the UK since 2000. More recently, new laws in Germany and the Netherlands have similarly led to collective action on the part of investors or their representatives. Activity has also been tracked in Taiwan.

Institutional investors are at risk if they fail to focus on this issue. But with the right partner to manage the process for them, they can turn that risk into an opportunity. They can of course outsource the process to a specialist

vendor – provided they are willing to open up the firm’s trading records to third-party scrutiny. For many firms, it makes more sense to turn to their custody provider.

As holder of the firm’s securities, the custodian already has all the relevant data on purchases and sales. It should be well placed to monitor settlement notices, interrogate client trading data, file claims on the client’s behalf and collect and disburse cash distributions.

At Citi, we are currently extending our U.S. class action service to cover other world markets, starting with Canada and the Netherlands. Other countries will follow as local market activity demands. By using Citi’s class action service, clients avoid the need to buy vendor information and can offload the entire claims process, leaving them free to focus on strategic activities. They can track and monitor each case online. The service includes the processing of distributed payments to client-designated cash accounts.

Citi is also working on behalf of investors to improve and standardize settlement claims processes for securities class actions through the industry body, the Bank Depository User Group (BDUG), a forum for the bank depository member community. As a member of BDUG Citi currently co-chairs the BDUG’s Class Action Focus Group, which has been established with a mission to develop standard practices for the processing of notices, claims and payments for institutional clients.

But as class actions increasingly appear in new markets, the landscape will likely get more complex, and more difficult to monitor, in the years ahead. The cross-border challenges will persist – just as the issues around proxy voting continue to rumble on. Both areas demonstrate the critical need for a service provider such as Citi with genuine worldwide reach, a global systems capability and a professional understanding of local markets and practices. With Citi as their partner, clients can turn shareholder governance risk into an opportunity.



Confirming the Vote

In the past year, the most buzzed-about topic in the proxy voting world was vote confirmation – how is the investor assured that their vote instruction has been lodged at the meeting?

Elizabeth Maiellano

Senior Director
Broadridge Financial Solutions

This issue looms larger than ever with over 100,000 meetings in nearly 90 markets processed worldwide. The mechanics to support the volumes of votes generated by both the institutional and retail investors has many challenges. Foremost is the transparency available to the investor once they have submitted their vote instruction. While the shareholders are generally assured of receiving the materials and accessing a means to register their vote (paper, Internet, telephone), they are also generally left in the dark as to what happens after that.

What Is Vote Confirmation?

The term “vote confirmation” seems to define itself: A vote instruction is attested to by the receiver. However, in the world of proxy the act of authorizing someone to vote on matters of corporate governance on behalf of someone else can be complex and fragmented – making confirmation of that action even more challenging.

In its basic form, vote confirmation is the acceptance of a vote instruction and the acknowledgement that the shares corresponding to the instruction have been counted and will be represented at the shareholder meeting. Initially investors did not require vote confirmation because they physically attended shareholder meetings for companies in which they held shares. Vote lodgment took place by a show of hands. If the shareholder was present and raised their hand, their vote instruction was counted and they knew it.

Why Is Vote Confirmation Important?

With the introduction of the institutional investor, whose portfolios contain thousands of individual stocks in many countries, attending all shareholder meetings is not only impractical but also impossible. When voting via proxy there can be several intermediaries in the voting chain – custodian, proxy service provider, vote agent, sub-custodian, registrar and transfer agents may play a role in the process. Intermediaries must agree on the voting entitlement, receive and process the vote instruction as directed (with all instructions achieving a “good order” standard) to allow the vote to be accepted and then passed through to the next intermediary. While there are more intermediaries in a cross-border voting scenario than a local market one, the same opportunities for a vote to not be cast exist in both circumstances.

When shareholders vote by proxy they give their voting authority to a person or persons who will attend the meeting and represent the shares on their behalf. Typically, the proxy will either be a representative of the company or a representative or agent of one of the organizations involved in the voting process. The proxy has the right to act for the shares of the underlying shareholders for matters raised at the shareholder meeting. When voting by proxy a vote confirmation is the communication back to the investor that their vote was cast and accepted at the meeting of shareholders.

Defining vote entitlement is the first step in the proxy voting process. An investor’s entitlement to vote at a shareholder meeting is dependent on the class of shares held and then a determination based on the records of the company shareholder register or records of the custodian.

Voting entitlement calculations are made based on settled shares held in an account that are not pledged, on loan or otherwise hypothecated. Markets may establish a record date or entitlement could be determined based on the shareholder’s position as of the meeting date. In some markets, the UK for example, the voting entitlement date is set after the registrar’s voting cutoff date. This practice adds to the confusion – causing voting instructions to be submitted against current entitlements rather than the final entitlement date.

What Is Being Done?

Institutional investors, with the greatest access to the many research and voting tools, still continue to have a growing concern: Are all of their eligible shares, or those shares earmarked for voting, and the associated vote instruction actually represented at shareholder meetings? In 2004, Paul Myners outlined a comprehensive action program to remove obstacles to casting votes by institutional

investors at UK company meetings. One step included urging institutional investors to review annually a sampling of shareholder meetings in order to provide a level of confidence in the process. Rather than rely on individual record keeping and reporting, it is now time for the industry to deliver on vote confirmation. It is a matter of confidence and integrity. To implement vote confirmation requires the active involvement of every organization involved in the process.

Today Broadridge is able to confirm voting in the U.S. where Broadridge acts as tabulator. In 2007 Broadridge implemented a vote confirmation process through its ProxyEdge® system for those U.S. corporate issuers for which Broadridge provides direct tabulation services. Users of the platform are able to receive confirmation that their vote instructions were lodged at these shareholder meetings. In this case transparency is possible because the entity that has the information provides it directly to the voting party. In most markets, Broadridge and other proxy processors are dependent on the various entities in the chain to provide their processing status of the instruction.

Broadridge recognizes that all parties in the industry must be involved in the confirmation process in order for it to be effective. Partnering with the Yale's Millstein Center for Corporate Governance and Performance, Broadridge will co-host an industry conference to examine the way forward to achieve complete vote confirmation. Additionally, Broadridge has hosted educational sessions in the U.S. regarding end-to-end confirmation for both the Society for Corporate Secretaries & Governance Professionals and the Council of Institutional Investors. Today, community commitment to the process varies. There are cost, transparency of data and automation as obstacles to overcome. Issuers, investors, custodians and intermediaries must work together to ensure vote confirmation is the accepted standard.

Lack of consistency by servicers opens all instruction statuses to question: What does it mean when it is provided? What does it mean if not provided? When should the status be expected? When does an investor need to begin communications to make certain their vote instruction is accepted? With whom should an investor begin communications?

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Welcome

Hedge funds have staged a comeback after the disasters of 2008. But is performance enough to win back investors' trust? And what of the rush to launch onshore vehicles?

There is an old saying in the investment world: "Let your performance do your talking for you." On that basis, many in the hedge fund industry should now be sighing with relief and saying little. Most funds posted double-digit returns last year and some – in convertible arbitrage or emerging markets – made gains of 40% to 60%.

But, for many, the job of repairing the damage done in the crisis is a work in progress. Investor trust was shaken not just by the collapse in asset values but by the disappearance of liquidity, the introduction of gating, the loss of assets suffered in the Lehman crash and, worst of

all, the Madoff scandal. Priorities have shifted. Many big investors now want regulated funds offering transparency, liquidity and strong risk management.

As a result, hedge fund managers have had to learn new tricks. Many are now turning their backs on the offshore domiciles that have served them for a decade or more. Where European or Asian investors are the target, an increasing proportion of new hedge fund launches involve either Dublin- or Luxembourg-domiciled vehicles. Some managers are even looking to redomicile existing funds onshore.

to the Age of "Newcits"

Opening the Distribution Doorway

Many of the leading names have launched new funds as UCITS – Undertakings for Collective Investment in Transferable Securities – putting them on a par with other European-regulated investment funds. Dubbed "newcits," these products must conform to all the UCITS restrictions on leverage and shorting and offer fortnightly liquidity – which puts a number of strategies off limits. Others have used non-UCITS structures that give them more investment latitude. These structures still require an independent administrator and custodian and are subject to onshore oversight.

"The process is almost entirely investor-driven," says Catherine Brady, EMEA Head of Fund Services for Citi's Global Transaction Services. "The likes of GLG Partners, Brevan Howard and Marshall Wace have all taken this route," she says. A recent survey by KdK Asset Management of 30 leading funds of hedge funds managers

with a primary focus on European distribution found that most intended to launch Undertaking in Collective Investment (UCI) products in the course of 2010.

One benefit of the "newcits" route is that it opens up access to the retail market Europe-wide. UCITS III, the most recent iteration of the UCITS legislation, allows funds to be "passport" across Europe. For fund groups such as Gartmore with a long-established retail business, says Brady, newcits products slot straight into an established retail distribution network.

The KdK Asset Management survey of funds of funds asked respondents where they saw the demand for their proposed UCITS funds. Three quarters cited retail networks and fund platforms/fund distributors. A majority also mentioned high net worth individuals and family offices. "In terms of distribution, access to retail is seen as the major advantage a UCITS offers," the report said.

More Opportunity, More Responsibility

As the new UCITS bandwagon gathers momentum, the regulators are already keen to remind new entrants that there is no free lunch here. Dan Waters, asset management sector leader at the UK's Financial Services Authority, fired a warning shot across the industry's bows at the McKinsey Asset Management Conference in London on January 25, 2010. "We would remind new UCITS managers that compliance with the UCITS framework will take considerable investment in systems and controls, and while asset managers may delegate various functions they retain ultimate responsibility for compliance with the detailed requirements of UCITS III ...," he remarked.

Certainly, this is no free lunch. "The initial cost of getting into this space is relatively expensive," says Lou McCrimlisk, EMEA Head of Relationships, Prime Finance, Citi: "For a UCITS fund to be successful it needs to raise a lot of money. I think we will see 'tiering' – with the UCITS route being taken only by the leading managers in Europe."

To a degree, cost depends on the choice of structure, says Nina Kleinbongartz, Luxembourg Head of Alternative Investment Products, Global Transaction Services, Citi. The promoter of the UCI funds needs to be approved by the CSSF including minimum capital requirements to be met, she says: "All funds must appoint a depository bank and there must also be sufficient controls in place for the regulatory oversight including the monitoring of UCITS investment restrictions."

However, like Ireland, Luxembourg also offers a set of more lightly regulated fund structures. "Most retail funds of hedge funds are set up under the UCI Part II regime, which is very cost-effective," says Kleinbongartz. UCI Part II funds do not qualify for a European passport in the same way

as UCITS funds; therefore, application to market has to be made on a country-by-country basis.

Kleinbongartz says two of Citi Luxembourg's asset management clients are currently taking the UCI Part II route in the knowledge that institutional and retail investors who have been wary of investing offshore will be quick to write checks once the onshore vehicles are up and running.

More Than UCITS in the Armoury

Luxembourg's big winner, however, is the Specialized Investment Fund (SIF) structure. "This has proved highly successful in attracting hedge funds, private equity and property funds," says Kleinbongartz. At the last count, there were 971 funds with net assets of over US\$150 billion in SIFs, with the total rising day-on-day. The SIF Law of February 13, 2007 was the primary cause for the rise in new funds set up in Luxembourg between December 2008 and December 2009. There are reduced reporting requirements for SIFs – the NAV frequency is minimum once a year, no long form reporting required, and the financial statement reporting is reduced. The more lightly regulated SIF structure is exempt from the promoter approval unlike the UCI structure as explained above.

The appeal of the SIF is that it offers near-total investment flexibility, allowing hedge fund managers to replicate strategies they pursue in their Cayman, Bermudian or British Virgin Islands vehicles – but within a regulated environment. However, it can only be sold to the professional marketplace. Claude Niedner, of the Luxembourg law firm Arendt & Medernach, says a lot of asset managers are looking at launching SIFs: "They know that having only a Cayman vehicle is not going to be sufficient. They will create a feeder structure or redomicile to meet the buy-side demand."

Ireland's equivalent of the SIF is the QIF – or Qualifying Investor Fund. Here, too, there is a renewed surge of interest. "We have clients setting up both UCITS and QIF funds at the same time to cover different areas of the market," says Carol Widger of A & L Goodbody, the Dublin law firm. QIFs can be set up on a filing-only basis with authorization the following day. Like SIFs, they allow pretty close replication of most offshore strategies, though Widger points out that there is a requirement to spread investment risk for QIFs that are established as investment companies.

"There is an awful lot of interest in redomiciling following the introduction of new legislation in Ireland which permits non-Irish investment companies to migrate to Ireland by way of reregistration as an Irish company," says Widger. "How much of it will actually happen, I'm not sure. Such a migration is of course subject to the approval of the Irish Financial Regulator and there are differences in a regulated environment. For instance, except for the use of certain derivatives at the share class level, you cannot have a separate pool of assets for different share classes within a fund in Ireland and, until late 2008, the Irish regulator did not permit side pockets. Also, there are fewer rules around gating in less-regulated jurisdictions," she says.

Taking the Lead

Some firms have already taken the plunge. Marshall Wace is a case in point, says Citi's Brady. "They have taken a business decision to convert their entire Cayman range into Irish-domiciled QIFs," she says. She believes this is just the start, for reregistering a company in Ireland has just become much easier. Until this year, the reregistration process involved the creation of a new entity, a scheme of amalgamation and the danger of tax leakage as assets

were transferred from the old domicile to the new. Now the process has been streamlined and, importantly for managers, the fund can keep its track record intact.

With a one-stop-shop approach, Citi can deliver all of these components in-house as part of an end-to-end offering that spans fiduciary services, hedge fund and long-only fund administration and accounting, prime finance and global custody. And with a global fund servicing network, it can deliver distribution support in almost any territory – an important capability as UCITS increasingly becomes a global, not just European, standard.


The new legislation brings Ireland in line with Luxembourg, and could serve to increase competition between the two domiciles.

With most hedge fund managers expected to retain a range of onshore and offshore funds, it is important that they have an administrator with the experience of servicing both areas. The range of skills required is a wide one. At one extreme, it takes in trade compliance and risk monitoring, backed by an ability to deal with the pricing issues presented by complex derivatives. At the other, it takes in international distribution support, including the ability to track flows and calculate trailer fees.

More changes are coming to the UCITS regime that will make it more flexible still. The arrival of UCITS IV, due to become effective within the next two years, will facilitate master-feeder structures and speed up the process of initiating cross-border marketing. That, in turn, will make UCITS funds still more attractive. Recent interest in newcits and other onshore structures on the part of hedge fund managers looks part of a gathering trend. However, the decision is not one to be taken lightly.

DIFFICULT DECISIONS FOR EUROPE'S HEDGE FUND MANAGERS

The proposed European directive on alternative investment fund managers continues to present the hedge fund industry with some tough choices – not least over the best location for their business. Service providers also have issues to confront.



The Alternative Investment Fund Managers Directive (AIFMD), the European Commission's (EC) proposals for tightening up the regulation and sale of hedge funds, is having a difficult birth. Different versions – from the Council of Ministers, the former EU Swedish presidency, the current EU Spanish presidency and French Member of the European Parliament (MEP) Jean-Pierre Gauzès who as the Parliament's rapporteur has the task of managing the directive's development – contain conflicting clauses. But one thing is certain. Whatever the finished product, it is likely to have a dramatic impact on the business model of EU hedge fund managers.

The European Parliament is due to vote on the proposed directive in the ECON committee meeting in April 2010, and in plenary in

July 2010. Claude Niedner, a Partner at the Luxembourg law firm Arendt & Medernach, and a member of the Luxembourg investment funds association working committee looking at the AIFMD, stresses that the short timeline poses its own danger: "We might end up with a political compromise that will not serve the interests of the hedge fund industry."

There are certainly plenty of outstanding issues that worry industry insiders. The directive is likely to impose remuneration restrictions on managers. It may require disclosure of the amounts of leverage being used and allow for limits to be imposed in exceptional circumstances. It gives national regulators emergency powers to restrict hedge fund portfolio activities. And it will certainly increase compliance costs.

Threats and Implications

But the biggest threat to many firms' existing business model is contained in the so-called "third-country regime." This focuses on two areas. The first is whether EU-domiciled funds can delegate asset management or any other function to a service provider domiciled outside the EU. The Swedish presidency's proposals permitted this. The Gauzès version does not.

This has big implications for U.S.-based managers, many of whom manage Dublin-domiciled funds. While the UCITS III/IV legislation would permit them to continue to manage the portfolios of UCITS funds from outside the EU, the AIFMD, if enacted in line with the Gauzès draft, could bar them from doing the same for European hedge funds. Carol Widger, a Partner with the Dublin law firm A & L Goodbody, says the proposals could have a big impact on Ireland: "U.S. firms could reconsider bringing their funds to Ireland." There are also big implications for those managers now moving to Switzerland and whose funds remain EU-domiciled.

The other element of the third-country regime is the way in which non-EU-based hedge fund products – whether managed by a European or non-European manager – can be sold in the EU. Here there are a variety of different proposals. The Commission's draft came up with the concept of "reverse solicitation," which would have prevented European investors (including institutions) from investing in funds from any third country if the relevant country had not signed an effective exchange of information agreement with the member state the investors originate from. That would have ruled out Cayman funds.

The concept was dropped in the Swedish presidency version and reintroduced in the Gauzès draft with an approach that relies on the effective exchange of information between European and third-country regulators – but still requires third-country legislative equivalence. Clearance would be down to individual European member states, which introduces a further element of confusion.

Keeping Parity

"It is important that Europe does not turn into a fortress and push managers outside. There needs to be a level playing field between European and non-European managers," says Niedner. "The Gauzès approach imposes less rigorous requirements than the Commission, while the Swedish presidency compromise could actually favor some non-EU managers over EU-domiciled managers," he says.

Certainly, Switzerland's credentials as a fund center are looking better all the time. The country's legislative and supervisory framework appears close to "equivalent." That would leave cooperation agreements to be signed between the Swiss regulator and EU member states. "The Swiss Fund Association has already said that it would be more sensible to negotiate an agreement at an EU, rather than member state, level," says Niedner.

Taken together with the proposed restrictions on remuneration, the possible imposition of leverage limits for hedge funds and increased emergency powers for regulators across the EU, the appeal of Switzerland as a domicile is not hard to see – provided, that is, the directive continues to allow the private placement in Europe of non-EU funds from approved jurisdictions. "If all that fits into place," says Niedner, "the managers will all go there."

This explains why an EU committee in the British House of Lords recommended in February 2010 that Britain should withhold its consent to the proposed directive unless the legislation is changed substantially. Both the EU and UK economies would be seriously damaged by the directive as it stands, said the committee. London, the location of so many hedge fund managers, has much to lose.

This still leaves the question of where Cayman funds will sit in the new regime. In principle, they could be banned from sale in the EU from 2011. "A better approach," says Niedner, "would be to create a three-year 'grandfathering' period, giving Cayman or other jurisdictions until 2014 to meet the required standards, either through new legislation or through contract." Although the Gauzès report is silent on this point, we understand that MEPs recent amendments may push for such a compromise solution.

Depositories' Roles Redefined?

One other vexed issue involves the role of depositories. It is an irony of the directive that while it requires every hedge fund to appoint a custodian, it could reduce the number of providers and increase costs throughout the industry. This is because the current drafts impose much stricter liabilities on trustees or custodians than they bear under the UCITS rules. Widger says there is concern over the impact this would have on the Irish trustee community. The danger is that some players will leave the industry, reducing competition. "It could result in increased costs for investors," she says, "and depositories may withdraw services in areas where they are most at risk."

At Citi, Marion Mulvey, EMEA Head of Alternative Investments Product for Global Transaction Services, says "We are trying to assess the impact on every portfolio. We are working with clients to determine where they see the risks." With a proprietary network of 57 branches, Citi's exposure is limited by comparison to those custodians who do rely on a network of third-party sub-custodians. Nevertheless, says Mulvey, if the final version of the directive imposes open-ended liability on custodians, many will be asking themselves whether the balance of risk and reward is in their favor. "I do not think clients will pay up to cover this exposure and it is not insurable," she says.

The directive would also extend the responsibilities of a depository. A custodian would be responsible not just for safekeeping but for oversight of the investment manager, the transfer agent and the administrator and ensuring proper valuations. Some prime brokers are said to be considering entering this field but, says Ms. Mulvey, there is some doubt over whether they are set up to perform all these additional functions.

As drafted, the directive will also impact fund structures, says Shane Baily, EMEA Fund Services Product Management, Global Transaction Services, Citi. "Both the Swedish presidency and the Gauzès versions are silent on the role of the board of the fund, essentially making the asset manager, not the fund, ultimately responsible for appointment and oversight of service providers. But, at present, if a fund is a corporate entity, this responsibility rests with its board of directors, not its asset manager. If it is a fund established by contractual arrangement between a trustee and a management company, the management

company is responsible for making and overseeing the appointments. There will potentially be significant legal and other costs putting new structures in place unless changes are made to the draft directive," he says.

Finding the Right Path

Although many in the industry, their advisers and service providers have had input into the more recent drafts of the directive, it is hard to avoid the conclusion that it is still off-target. "Because of political pressures," says Niedner, "the initial proposals from the European Commission were not well thought through. The text was not balanced and, surprisingly, not aligned to the fund regulation contained in UCITS. The Commission went into uncharted waters by suggesting regulation of managers, rather than just funds. Europe is missing the opportunity to set a new quality standard for alternative investments as it has for mutual funds with UCITS."

Not surprisingly, the funds industry has been extremely vocal about the effect of the directive and its impact on the wider EU economy. Along with asset management associations, global custodian associations have made their voice heard to make sure that any new regulation takes into account the reality of the global securities services infrastructure.

Citi continues to meet with key EU bodies, such as the Association for Financial Markets in Europe and Eurofi, to better understand the proposed rules and implications of the Directive and promote the interests of our clients. Moreover, our dedicated European-based Fiduciary Services team provides the trustee services to investment managers in Ireland, Jersey, Luxembourg, including the all-important regulatory fulfillment and oversight functions.

For managers, the question is whether they can live with the final version. Until we see the text that will go before the Parliament in April/June, that will remain an open question. What is certain is that many pairs of eyes will be perusing the third-country rules to see whether a Zurich or Geneva bolt-hole is a viable option.

Citi has also published its "AIFMD/UCITS IV – Where Are We Now?" Spotlight newsletter (March 11, 2010) and webinar (March 25, 2010). Please contact your Citi representative for a copy or replay details.

Calendar of Events

APRIL:

- 1 Asia Pacific Investors Roundtable
Hong Kong, China
- 14 - 15 Citi Chief Compliance Officer (CCO) Forum
New York, USA
- 19 - 22 ICBI Fund Forum Asia
Hong Kong, China
- 20 Quebec IFIC (Investment Funds Institute of Canada)
Conference
Montreal, Canada
- 28 Hedge Funds Care
San Francisco, CA
- 28 - 29 The EuroHedge Summit 2010
Paris, France

MAY:

- 2 - 4 *Institutional Investor's*
16th Annual Global Hedge Fund Summit
Bermuda
- 5 - 7 Investment Company Institute (ICI)
General Membership Meeting
Washington, DC, USA
- 11 - 12 International Finance Corp (IFC)
Annual Global Private Equity Conference
Washington, DC, USA
- 19 - 20 Money Management Institute (MMI) Annual Convention
New York, USA
- 20 Hedge Funds Care
Chicago, IL
- 26 - 28 Carbon Expo 2010
Cologne, Germany

JUNE:

- 1 IMN NY Beneficial Owners Securities Lending
Conference
New York, USA
- 2 - 7 ICBI SuperReturns Americas
Boston, USA
- 21 - 23 Canadian Pension & Benefits Institute Conference
Halifax, Canada
- 21 - 23 Citi Information Technology Outsourcing (ITO)
Client Conference
Collingwood, Canada
- 22 - 24 International Securities Lending Conference
Berlin, Germany
- 23 - 25 ICBI Fund Forum International 2010
Monte-Carlo, Monaco

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