



## RBS Equity Prime Services

The Alternative Emerging Market: Equity Swaps and Synthetic Prime  
in association with TABB Group

This report has been commissioned by The Royal Bank of Scotland N.V. ("RBS"). It has been independently prepared by and is communicated by The TABB Group LLC and is distributed with the permission of The TABB Group LLC. The information contained in this report represents the opinion of The TABB Group LLC and its affiliates and does not constitute a recommendation to purchase financial products or investments, nor as an offer or solicitation of an offer. The contents of this report are solely the opinion of The TABB Group LLC and neither RBS nor any of its affiliates take any responsibility whatsoever for the contents of this report. The contents of this report are not intended to, nor do they, provide any financial, investment or professional advice and nothing in the report shall be regarded as an offer or provision of financial, investment or other professional advice in any way. In particular, you should obtain advice from a qualified expert before making any investment decision. No representation, warranty or assurance of any kind, express or implied, is made as to the accuracy or completeness of the information contained herein and RBS and each of its respective affiliates disclaim all liability for any use you or any other party may make of the contents of this document. The contents of this document are subject to change without notice and RBS does not accept any obligation to any recipient to update or correct any such information. This document is not intended for distribution to, or use by any person or entity in, any jurisdiction or country where such distribution or use would be contrary to local law or regulation.

---

# The Alternative Emerging Market: Equity Swaps and Synthetic Prime



## Vision

For hedge funds, the global financial crisis is over and life has returned to a semblance of normality; funds are re-flowing, alpha is the theme, and performance is up. Many are turning their attentions to emerging markets, whose higher GDP growth rates and inefficient market structures present some of the most attractive opportunities in terms of risk arbitrage and alpha-rich strategies.

But while the crisis may be over, it is far from forgotten. Twenty months after the collapse of Lehman Brothers, the scars are firmly etched on survivors in a tattoo spelling out three Rs: Redemptions, Regulation, and Risk. While life may appear normal, the three Rs remain very much at the forefront of hedge fund minds.

To mitigate the effect of redemptions, many are broadening their investor base beyond the concentrated realm of high net worth individuals and funds of hedge funds, and are re-inventing themselves as onshore, officially mandated investment vehicles that can appeal to a wider retail community. Hedge funds are also analysing their relationships with prime brokers, who are themselves rationalising their own business models, in ways that include multi-prime, relationships with specialist prime brokers, custody accounts and sane rehypothecation terms.

Regulation is an ongoing issue. The European Union is homing in on hedge fund regulation, further fuelling the trend among funds to set up investment vehicles that come with a seal of approval. On the execution side of things, regulators in many emerging markets have made life difficult with shorting restrictions and various disclosure requirements.

Finally, the focus by hedge funds on alpha is accompanied by a renewed and hyper-aware sense of risk and risk management. Consequently, hedge funds are looking for the tools that not only deliver returns but also manage the risks associated with geography, markets, regulation, and with counterparties.

And thus the stage is set for the world of synthetic finance.

Hedge funds of all sizes are looking to access new and exciting emerging markets and are increasingly favouring equity swaps to do so. Swaps help manage a broad array of hazards associated with cash equity trading in emerging markets, including the following:

- ▲ Exposure to turbulent, hard-to-hedge currencies
- ▲ The random introduction of discriminatory tax and capital controls
- ▲ Cumbersome and expensive registration red tape for local securities trading
- ▲ Unreliable technical and telecommunication infrastructure
- ▲ Immature clearing and settlement systems

There are indirect drivers too. The European Union's UCITS III (*Undertakings for Collective Investment in Transferable Securities III*) vehicle is becoming an increasingly popular way for hedge funds to remould themselves as regulated, onshore funds. Since UCITS III funds are restricted from going physically short, hedge funds use swaps to go synthetically short instead. And a new international tax accounting standard, FIN 48 (*FASB Interpretation 48*), is driving them to convert cash positions into swaps in the hope that it will sidestep requirements to account for uncertain tax regimes in their net asset value (NAV). Meanwhile, hedge fund relationships with prime brokers are evolving. Small- and medium-sized hedge funds are seeking out low-cost alternatives to traditional prime brokers, just as some prime brokers turn away clients not deemed profitable enough at the front door. As a result, avenues are opening up for specialist prime brokers focusing on synthetic offerings. For the larger hedge funds looking to multi-prime, synthetic specialists can help them diversify away from their exclusive arrangements with larger, one-stop-shop firms.

However, while there are plenty of reasons to trade swaps and to use a synthetic prime broker, regulatory storm clouds are on the horizon. The reconciled version of the Senate and Congressional financial regulatory reform bills in the US could still be amended to force US banks to push their derivatives activities, including swaps, into separate entities away from the larger banking umbrella. The UK is echoing the sentiment, with a new coalition government threatening to introduce its own version of the *Glass-Steagall Act* by splitting up retail and investment banking.

These initiatives will dramatically impede the ability of prime brokers to deliver a low-cost synthetic offering and hedge funds may face a dramatic rise in the cost of doing business synthetically, regardless of geography, market or investment strategy. Some prime brokers will exit the arena if the US's reform bill passes, reducing the list of potential suppliers of synthetic products.

The US Internal Revenue Service (IRS) has also put equity swaps and "dividend arbitrage" squarely in its cross hairs with the HIRE (*Hiring Incentives to Restore Employment*) Act. The act, which was signed into law in March, will focus on swaps that have been used to provide yield enhancement by converting ordinary dividend payments – which would otherwise have been subject to a 30% US withholding tax – into swap payments. The overall effect of this – apart from prosecuting and punishing the perpetrators – is that prime brokers will be less inclined to offer synthetic solutions if they suspect it is purely driven by a desire to avoid tax, be it withholding tax in the US, stamp duty in the UK, tax on foreign currency conversions for emerging equity market investments, or FIN 48, though it should be noted that this is already the case at firms with conservative mandates. As hedge funds step back out into the day after the dark night of 2008 and 2009, they must do so carefully and, of the three Rs, regulation is the one they can least control and, as such, it is also the one that presents the most significant danger.

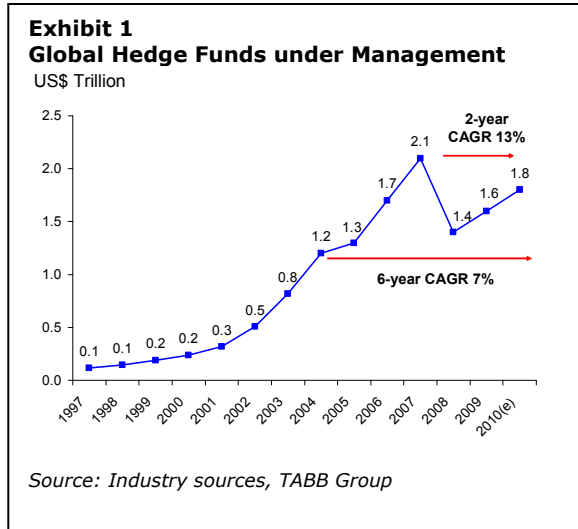
## Table of Contents

TABLE OF EXHIBITS .....	
INTRODUCTION .....	4
A COLOURFUL LANDSCAPE FOR SWAPS .....	5
THE EMERGING MARKETS – APPROACH WITH CARE .....	8
THE IMPORTANCE OF BEING ABLE TO SHORT .....	10
UNPREDICTABLE TAXES CAN BE COSTLY .....	10
THE UCITS III PHENOMENON .....	12
SWAPS – A SIMPLE SOLUTION TO MANY ISSUES .....	14
CUSTOMISED BASKETS VERSUS ETFs .....	16
THE ROLE OF THE PRIME BROKER.....	17
MULTI-PRIME MEANS SPECIALISTS CAN COMPETE .....	18
SIX CONSIDERATIONS WHEN CHOOSING A PRIME BROKER .....	19
DO YOU GIVE-UP? .....	20
CONCLUSION .....	23
TABB GROUP .....	25
THE AUTHOR .....	25

## Introduction

The downward spiral of investor redemptions, net loss of funds and negative press for hedge funds is seemingly at an end. Funds are flowing back and it is business as usual – albeit with a heightened sense of risk awareness – with business meaning two things: attract capital and generate alpha. Since alpha precipitates capital introduction, the primary focus is on performance.

While the impacts of 2008–09 have far from disappeared, there is evidence to suggest that equity hedge funds are staging a comeback. Many hedge funds did not survive 2008 and for those that did, dramatically reduced asset bases are the theme. Although hedge funds under management (FUM) are well off their peak of \$2.1 trillion in 2007, TABB Group estimates that the funds will recover to \$1.8 trillion in 2010. The compound annual growth rate (CAGR) from 2008–2010 is expected to be 13%, compared with a CAGR of 7% over the six-year period from 2004–2010 (see Exhibit 1).



Channel Capital Group, a hedge fund performance data company, reports that performance in the first quarter of 2010 has been strong, primarily driven by rising equity markets, with funds investing in Russia, the Middle East/North Africa region and India producing strong results.

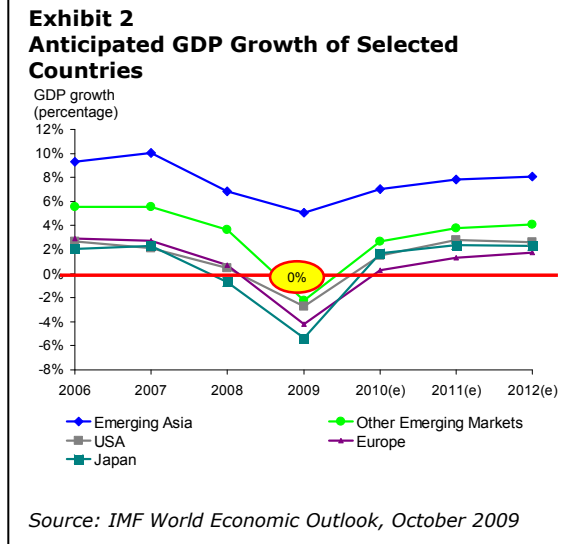
Hedge funds believe that inefficient emerging markets present some of the best opportunities in terms of spreads and easily identifiable risk arbitrage. Generally speaking, emerging market economies are characterised by political instability, strong currency turbulence, and high foreign debt. Meanwhile their stock markets generally lack information efficiency and structure. A situation in which there are multiple, volatile moving parts operating in a low-infrastructure market environment is an ideal situation for the sophisticated arbitrageur.

Moreover, emerging market economies are expected to outperform the US, Europe and Japan in the next two years. This growth will be the octane fuel to the sophisticated investment engines hedge funds have built, and thus the case for focusing hedge fund strategies on emerging markets becomes ripe.

Take Brazil as an example. In the first nine months of 2009, the BM&F-BOVESPA index shot up 70% as nearly US\$20 billion in overseas capital poured into the local equity markets and sent the real soaring nearly 50% off its lows. The Dow Jones Industrial Average rose by just over 10% in the same period.

A combination of strong banks, government incentives, the recovery of the domestic economy from recession and the introduction of algorithmic trading all helped the Brazilian index's surge but the principal dynamic remains the same: inefficient markets coupled with high GDP growth mean hedge funds can glean better returns from emerging markets than in the developed markets, even if their relative economic growth paths appear similar (see Exhibit 2).

But while emerging markets seek to attract overseas foreign investment, domestic regulators do not want "hot money" overheating their stock markets, only to see those funds flee during a collapse. Emerging market regulators are ever aware of the naïve and virgin nature of their territories and they design controls to manage the large capital inflows that result from strong GDP growth (and take advantage of these inflows). Brazil, for example, introduced a so-called IOF (Imposto sobre Operações Financeiras) tax, charging 2% on all foreign currency conversions into local equity investments following its equity market surge in October 2009.



There are also other barriers to entry for hedge funds accessing emerging markets. Central banks and local securities regulators often require exhaustive amounts of information from overseas investors on sources of capital and are increasing the documentation burden on those seeking to invest and trade their equity markets.

Finally, there is the nature of the location itself. With typically low levels of infrastructure and chaotic market architecture, execution can be a frustrating and arduous affair. The taxi ride from most emerging market airports is usually a good litmus test. If it takes three hours to get to the hotel in a country whose infrastructure is clearly buckling under the strain of overpopulation, then it is safe to assume that ultra-low latency, high-frequency execution strategies are likely to be disrupted by power cuts and telecommunication breakdowns.

Many hedge funds, especially the smaller start-ups, have neither the patience nor the resources to manage such challenges, and the lush fruit that emerging markets present can soon become little more than a tantalising conundrum, with the low-hanging alpha-rich grapes perennially beyond reach.

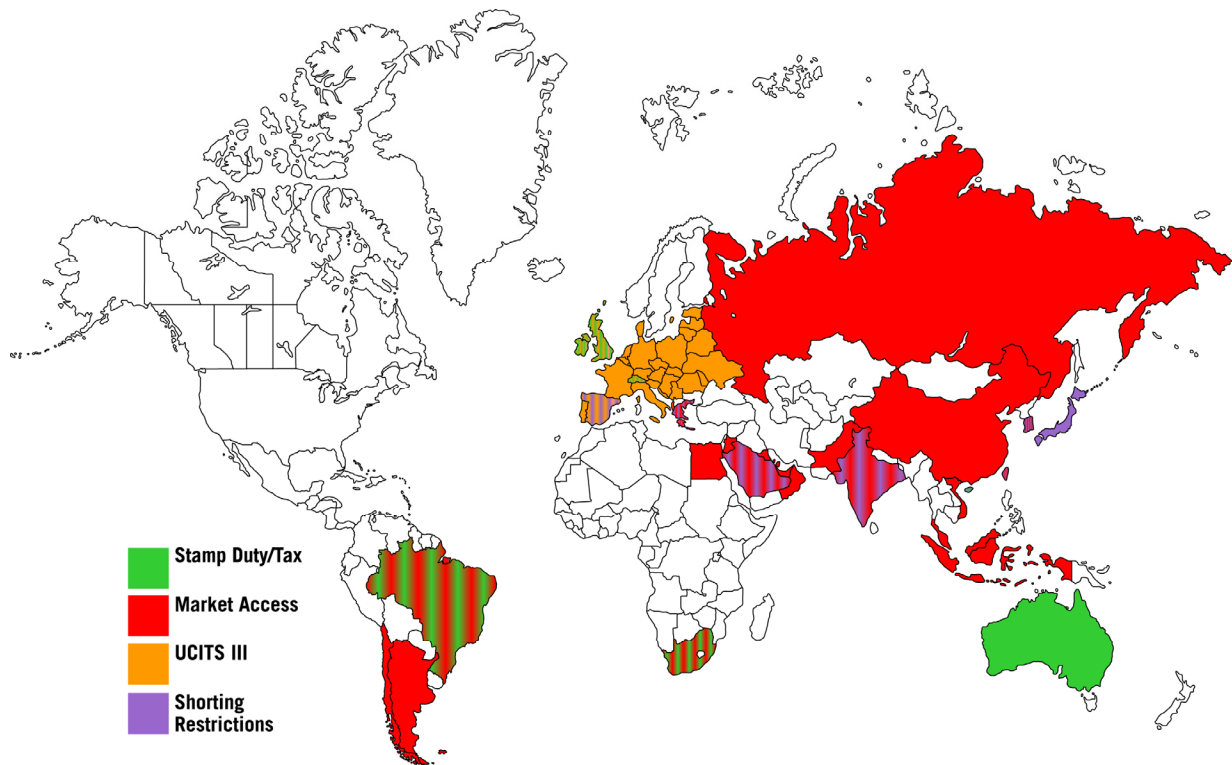
## A Colourful Landscape for Swaps

At the same time as hedge funds are seeking access to new pastures for alpha, they are also adopting new fund mandates, like those stipulated under UCITS III. Following the financial crisis, hedge funds are being increasingly funnelled

into UCITS III structures, which allow for the use of certain derivatives but do not allow for the physical shorting of shares.

Although the term equity swap can have several meanings – encompassing total return swaps, portfolio swaps, and contracts for difference (CFDs) – their essential nature remains the same: they are designed to provide synthetic exposure to physical equities. In other words, equity swap investors can participate in the performance of a stock without actually owning it. Thus equity swaps are proving vital for those pursuing long/short strategies such as 130/30 funds, as well as managing local shorting restrictions. For this reason, the geographical reach of swaps for hedge funds encompasses both emerging markets as well as areas where they are adopting UCITS III mandates (see Exhibit 3).

**Exhibit 3**  
**Popular Markets for Synthetic Products**



Source: TABB Group

There is a variety of reasons for choosing swaps over cash securities but the market can be broadly categorised into two high-level areas. Firstly, in the liquid markets of the UK, Europe, US, Japan and Australia, swaps are frequently traded instruments with a high degree of product standardisation and execution infrastructure.

Providers of equity swaps often refer to the term synthetic finance and call themselves synthetic providers. This is, in part, historical. Synthetic prime brokerage is born out of traditional prime brokerage, which is sometimes a part of the equity finance and stock-lending desks at banks. The finance part in synthetic finance generally relates to the margin financing and stock-loan side of the business, while the synthetic aspect refers to the use of swaps and sometimes other products as well, such as futures, exchange-traded funds (ETFs), and participatory notes (P-Notes).

Secondly, in less-liquid, less-developed equity markets, swaps resemble an emerging market within themselves (thus the title for this report) – one that has been identified and is being actively targeted by prime brokers. In particular, Brazil and Argentina in South America, and Saudi Arabia and the United Arab Emirates (UAE) in the Middle East, are considered to be sweet spots in terms of returns and sustainability. These are relatively uncrowded markets that have not yet witnessed product commoditisation. In Asia, the traditional select winners have been Korea and Taiwan, with the massive markets of China and India ever looming large. Meanwhile Russia is an enormous market that hasn't yet achieved its full potential as a result of infrastructural and documentation obstacles that we detail in our April 2010 report: "*Russian Electronic Trading: Alpha in the Tundra.*" Egypt and South Africa are primary targets on the African continent.

In mature and emerging markets alike, swaps can also help hedge funds manoeuvre around many country-specific issues and, on an international scale, many funds are converting their cash-equity positions into swaps in the hope that it will solve problems associated with a new international accounting standard that risks having a detrimental effect on the way tax liabilities are reflected.

For those that offer equity swaps, there will be regulatory challenges ahead. US regulation will possibly result in the need for US banks to carve out and ring-fence their equity swaps operations, which will make some think twice about how important this business is. In addition, the use of swaps to provide yield enhancement and benefit from withholding tax payment is under further regulatory scrutiny from US tax authorities as they seek to stamp out swaps trading not motivated by genuine risk concerns.

In this Vision Note, TABB Group looks at how equity swaps are providing opportunities for hedge funds in light of new investment mandates and regulatory obligations as they look for alpha in various emerging markets. In addition to interviews conducted for this research, we incorporate information and views from our benchmark studies: "*US Hedge Fund Equity Trading 2010: Commissions, Volumes and Traders,*" published in May 2010.

Monetary figures in this Vision Note are expressed in US dollars.

## The Emerging Markets – Approach with Care

Hedge funds want easy access to new and exciting markets – from Mongolia to Nigeria, from Argentina to Azerbaijan, from Bali to Pakistan – but there is a multitude of challenges. Emerging markets, with their local languages, customs, currencies, tax laws, and ways of operating, are dangerous places to trade. Foreign hedge funds are at a significant disadvantage to their local market rivals, who are likely to have first dibs on vital information.

At best, this can mean the playing field is uneven; at worst it can mean the foreign hedge fund is routinely and outright fleeced – whether by suffering from information leakage on a block trade, or routinely being the last to know about critical corporate information during a merger.

Many hedge funds are looking for quick and easy access to liquidity, and do not necessarily want to get bogged down in the nitty-gritty of registering with local authorities in order to trade emerging-market stocks. Nor do they want to set up and staff local offices in a number of cities worldwide since these are efforts that consume resources and impose ongoing costs. Logistically speaking, hedge funds would never be able to trade many emerging-market stocks if they had to set up operations in each and every country, let alone beat their rivals to the latest opportunity as it arose.

**Exhibit 4**  
**Major Challenges to Investing in Emerging Markets**

Factor	Issue	Example
Market Access	<ul style="list-style-type: none"> <li>▲ Alpha-hungry hedge funds want easy participation in emerging equity markets on demand at lowest cost;</li> <li>▲ Time zones can also be a factor.</li> </ul>	There are at least 16 emerging markets, with more coming online from Nigeria to Mongolia and Pakistan
Infrastructure	<ul style="list-style-type: none"> <li>▲ Unreliable technology and infrastructure can mean the difference between profit and loss if orders cannot get through.</li> </ul>	Power cuts and telecom problems are common
Information	<ul style="list-style-type: none"> <li>▲ Foreign hedge funds are generally at a disadvantage to local firms;</li> <li>▲ Language can be a factor.</li> </ul>	Foreign firms, dealing only in English, may be last to know
Currency	<ul style="list-style-type: none"> <li>▲ Foreign capital inflows make emerging-market currencies volatile;</li> <li>▲ Every emerging market has its own currency; some currencies have conversion restrictions or lack a forward market for hedging.</li> </ul>	Plethora of hard to trade currencies, some with conversion issues such as the Indian rupee, Chinese yuan and New Taiwan dollar
Regulation	<ul style="list-style-type: none"> <li>▲ Without the ability to go short, hedge funds are unable to manage their risk optimally and cannot implement popular long/short investment strategies.</li> </ul>	Varying degrees of shorting restrictions in Saudi Arabia, India, Korea, Taiwan and Greece
Tax Laws	<ul style="list-style-type: none"> <li>▲ Taxes designed to manage capital inflows can happen at any time and specifically target overseas investors.</li> </ul>	Brazil's IOF tax and Colombia's capital controls

Source: TABB Group

The technical instability of an emerging market can be a culture shock. It may, for example, be possible to lay ultra-low latency dark-fibre cable across the subcontinent of India to achieve execution speeds measured in microseconds, but this counts for naught in the event of a not-infrequent statewide power outage.

There are other balls that must be kept in the air with which hedge funds do not necessarily wish to preoccupy themselves. An equity trader may not want exposure to a turbulent local currency that may have conversion restrictions or is difficult to hedge in the absence of a forward or non-deliverable forward (NDF) market. An NDF market is an important consideration for the straight emerging-market equity investor, who may want to minimise currency risk exposure; NDFs are the only way to hedge exposure to currencies that have conversion restrictions, such as the Indian rupee or the New Taiwan dollar. There are other charges to avoid, such as tax or other strange penalties specifically imposed by regulators on overseas visitors.

The cost of share ownership is all the more onerous in emerging markets, with their immature clearing and settlement environments. In Russia, for example, there is no post-trade settlement process (in order to trade, the cash or stock needs to be at the associated depository of the exchange at the time of order entry), and no obligatory delivery versus payment procedure. The complexities of emerging market post-trade processing add cost and risk to the process, and although brokers are responsible for post-trade processing, the investor will hold the hedge fund ultimately accountable.

Finally, there is the sheer unpredictability of emerging markets. One day, overseas equity investors will receive the red carpet welcome, the next they will be targeted as protagonists of domestic market problems and penalised for it. In 2007, in an effort to curb appreciation in the peso, for example, Colombia introduced capital controls that forced overseas equity market investors to deposit 40% of the value of their purchases in cash with the central bank for a period of six months. There are frequent, unpredictable swings on the wind vane of this nature all the time in emerging markets. The general message: tread carefully and approach with care when it comes to new adventures.

Hedge funds may be looking for exposure but that does not mean they court unnecessary, undesirable risk. If anything, the opposite is true, and if the steep learning curve that it takes to be a savvy market participant in each and every emerging market can be avoided, it should. That way, hedge funds can concentrate on what they do best – focus on the statistics and managing the risks they do want.

Synthetic products are thus an attractive solution for the hedge fund looking to access emerging markets both in terms of avoiding the above-mentioned risks and also because the vast majority of hedge funds have little or no need to own the physical. This is equally true of high-frequency statistical arbitrage funds, emerging market funds and risk arbitrage funds. A notable exception would be

activist funds, which seek to influence the outcome of corporate actions based on their percentage shareholdings in a company.

## **The Importance of Being Able to Short**

Since the financial crisis, emerging market regulators have focused on shorting, imposing varying degrees of restriction and disclosure requirements, primarily because of the broader systemic risks they may pose to the marketplace. These risks include a disorderly market due to short squeezes, the use of short selling in conjunction with market abuse, settlement disruptions at the time the asset is re-called, as well as issues surrounding Sharia-compliance in the Middle East, which views shorting as part and parcel of the prohibited practice of gambling.

In the main, the political debate centres on the belief that shorting was instrumental in the rapid fall of share prices during the financial crisis. Only some emerging markets have shorting restrictions and disclosure requirements, and the reasons for this go beyond the scope of this note. But suffice to say, anyone trading in these markets must ask their prime brokers to acquaint them with the rules, which frequently change and are often randomly introduced without notice, or they may be caught out. Notable current examples of markets with some level of restriction or disclosure requirement include Saudi Arabia, India, Korea, Taiwan and Greece.

Some authorities apply uptick rules that limit short selling in shares that have fallen beyond a certain limit in one trading day. Most countries maintain reporting requirements for short interests above 0.2% of a stock's issued share capital. Naked short selling – or the practice of short-selling a financial instrument without first borrowing the security – is limited in many jurisdictions, including Hong Kong and Singapore.

The irony is that short selling is more commonly pursued as a hedging instrument. If an investor owns an asset whose market price he expects to fall, he can hedge that risk through shorting. Such investors can include strategic equity investors who wish to maintain an equity position even though the price will fall. While hedge funds are pinpointing alpha, the financial crisis has left them with a renewed focus on more efficient risk management. In addition, many employ long/short strategies, so the ability to go short is a critical component of their investment strategy.

Swaps are used extensively in markets where local restrictions prevent shorting, so synthetically shorting becomes the only effective way to minimise downward exposure.

## **Unpredictable Taxes Can Be Costly**

No one likes taxes but for hedge funds seeking alpha in emerging markets it can be the difference between profit and loss. The indiscriminate way in which

national governments introduce taxes against foreign equity investors can destroy alpha plays.

Away from the national perspective, a new accounting standard with international application is also now being introduced. FIN 48 was initiated by the Financial Accounting Standards Board (FASB) in the US in June 2006 and was later adopted under US Generally Accepted Accounting Principles (GAAP). It will be implemented by most countries throughout the world as part of compliance with the IASB's International Financial Reporting Standards (IFRS). FIN 48 is scheduled for implementation in the UK in December 2010 and will cover trading by all pass-through entities, including offshore funds trading in cash equity securities.

For hedge funds, FIN 48 has become a tax nightmare because it means they have to reflect grey-area tax issues in their net asset values (NAVs). The possibilities range from withholding tax on share dividends to capital gains tax in a broad variety of jurisdictions, from Argentina to Zimbabwe.

Even though there are few precedents for many of these national taxes to be applied to offshore investors, they could yet, in theory, be implemented. Since FIN 48 focuses on significant exposures where there is uncertainty as to the outcome and where tax is "more likely than not" to be imposed, it means that hedge funds may have to start accounting for the various possibilities. Chile and Greece, for example, could in theory impose a 35% withholding tax on offshore investors, while capital gains in India could be 10%, Zimbabwe 10%, Chile 15%, Korea 27.5% and Slovakia 29%, depending on interpretation by local tax authorities.

The new standard states that the tax liabilities will extend back to the inception of the fund, or to the introduction of the new standard (whichever comes first), as well as interest on, and penalties for, underpayment. Hedge funds are only just starting to get to grips with the potential magnitude of the problem and are searching for ways to minimise the damage.

Moreover, fund managers fear FIN 48 could become a self-fulfilling prophecy. While FIN 48 requires funds to reflect uncertain tax positions in their NAV, the mere process of identifying offshore trading activity to local regulators in order to comply with FIN 48 could make them the target of actual local tax authority scrutiny. In other words, FIN 48 has the potential to turn uncertain tax positions into certain ones. Some hedge funds are liaising with local tax authorities in an effort to get clarity on potential FIN 48-related issues but they will only be successful in some instances; and where they fail could determine whether or not they continue trading in those markets.

Swaps offer a potential solution to the very significant ill of FIN 48 since a hedge fund does not take delivery of the underlying cash security. There is therefore the possibility that offshore hedge funds could continue to claim exemption from a rich tapestry of potential tax liabilities.

## The UCITS III Phenomenon

Capital introduction is an ongoing challenge for hedge funds and they are always looking for ways to increase their investor base. A trend that started in Europe, called UCITS III, is catching fire around the world as regulators in Asia and Latin America allow for local registration of such funds so they can be directly distributed and marketed to the local population. Many prime brokers are now actively offering UCITS III services to hedge funds as an alternative to traditional capital introduction methods.

In essence, UCITS III-compliant funds act as onshore wrappers that come with a seal of regulatory approval and that allow hedge funds to repackage and sell their investment techniques to retail investors. While the hedge fund won't have changed in nature, the wrapper makes it appear as if it has. Instead of being offshore vehicles that engage in high-risk trading strategies, UCITS III makes a hedge fund appear to be a neatly packaged onshore, regulated, and reliable fund for investment. This opens the door to an enormous retail investment community, distributed via an extensive distribution network of traditional asset managers, in much the same way as the mutual fund industry operates. Without the UCITS III wrapper, hedge funds are limited to selling to their traditional investor base of high net worth individuals, institutional investors, and funds of hedge funds.

There is a strong correlation between those who have or plan to have UCITS III funds, and those who intend to start trading equity swaps. This is primarily because swaps are the only way for such funds, which are restricted in their mandate, to go short. To this end, swaps activity will also be fuelled by new UCITS III fund launches and the attendant fund management mandate that promotes the use of swaps where physical shorting of shares is not allowed, regardless of investment strategy.

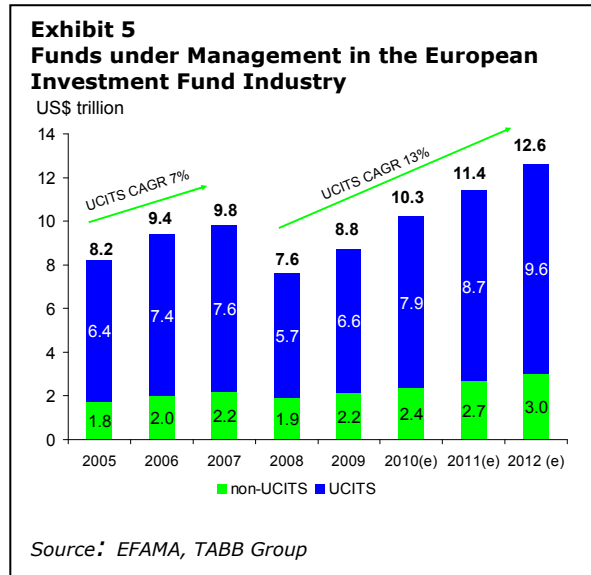
In 1985, the European Union introduced the UCITS directive, which allowed for the creation of funds that could be marketed and distributed freely across Europe. The idea was to create a single market for financial services and to promote pan-European competition in the investment management community.

Since then, the directive has been progressively updated to the current version, UCITS III, and will soon be modified again to become UCITS IV. In essence, the current relevance of the evolving forms of UCITS to the hedge fund community is the role they can serve as onshore, regulated, and trusted investment vehicles that have the mandate to use certain derivatives and employ common hedge fund trading strategies. Hedge funds, which had the negative experience of investor redemptions during the financial crisis, today face a number of pressure points when it comes to capital introduction, including the following:

- ▲ New mandates barring funds of hedge funds from investing in hedge funds registered in offshore locations such as the Cayman Islands and the British Virgin Islands

- ▲ Increasing demand from institutional investors to not directly invest but for a managed account that they can control themselves
- ▲ Aversion among the investment community towards the perceived reputation of hedge funds as high-risk, unregulated entities

The success of UCITS III means it is becoming an internationally recognised brand with regulators in other jurisdictions allowing the funds to be sold and directly distributed in their markets. TABB Group estimates that UCITS III funds in Europe will total \$7.9 trillion by 2010, and there will be a CAGR of 13% for UCITS III funds from 2008–2012, compared to a CAGR of 7% from 2005–2007 (see Exhibit 5). Rapid adoption of UCITS III by hedge funds is helping fuel this growth.



The vast majority of funds being launched in Asia, for example, are UCITS III-compliant. Although the funds are raised outside the European Union, the fund itself is domiciled in one of the two most tax-friendly EU nations, Ireland or Luxembourg. The combination of the EU domicile and UCITS III mark of quality mean the fund is recognised worldwide by regulators, institutional and retail investors alike as being officially mandated.

And the trend looks set to accelerate. The European Union’s proposed Alternative Investment Fund Managers (AIFM) directive will require hedge funds to register and disclose closely guarded trading information such as the way they conduct business and their risk management protocols, as well as the arrangements they make for the valuation and safekeeping of assets. In addition, the AIFM directive will require registration, an annual report with an asset and liability statement, capital adequacy provisions and disclosure obligations to potential investors. Finally, the directive seeks to impose limits on leverage.

But this myriad of headaches can be effectively bypassed by setting up a UCITS III fund. The trend is most recently manifesting itself among US funds, in part because of the proposed AIFM directive that will make it harder for US funds to find investors in Europe without a UCITS “passport” into the continent. Thus hedge funds worldwide are being funnelled – both by their own needs to broaden their investor base and also by regulation – to move away from traditional prime-broker capital introduction services towards UCITS III-compliant funds targeting the retail investment community.

## Swaps – a Simple Solution to Many Issues

For hedge funds looking for access to the emerging markets, swaps have the greatest potential. As products they offer

- ▲ the same price, risk and liquidity profile as the underlying cash equity;
- ▲ optimal capital usage in terms of margin and leverage; and
- ▲ the ability to avoid foreign-exchange risk.

In terms of the benefits they offer when it comes to emerging markets

- ▲ swaps provide a medium to invest when legal issues prevent an investor from entering a specific market;
- ▲ there is no requirement for foreign regulatory licensing;
- ▲ reduced costs and operational simplicity associated with clearing, administrative, custodial and regulatory reporting; and
- ▲ they can assist in managing local shorting restrictions and tax regimes.

But on the negative side swaps

- ▲ lack of ownership means no voting rights. Swaps are therefore inappropriate for activist hedge funds;
- ▲ there are no dividend payments;
- ▲ they entail exposure to credit risk associated with a single counterparty;
- ▲ trading technology infrastructure tends to be poor; and
- ▲ the level of product standardisation varies widely according to market.

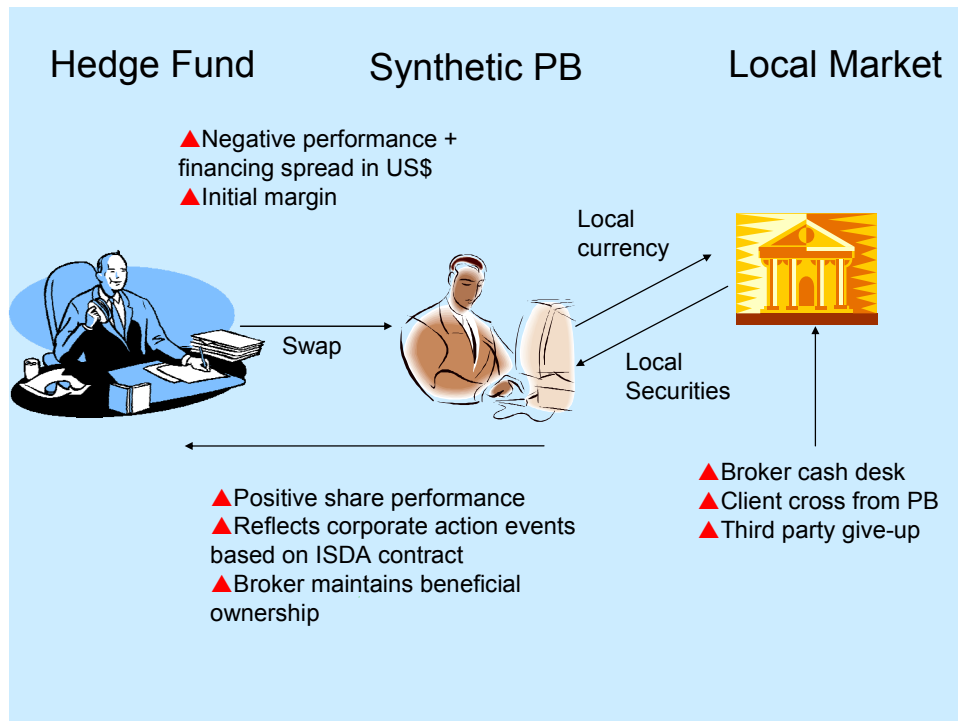
Using swaps, funds have the opportunity to access liquidity more immediately than the cash equity markets. In the case of the physical, large block orders can take time, patience, investment sophistication and a broad range of methods to execute without adverse selection or other market risks such as front running. This is true of developed markets and even more so in emerging markets, which are often characterised by low levels of liquidity and information leakage. The foreign investor attempting to buy a large amount of stock in an illiquid name in a country where local investors understand the terrain far better stands at a significant disadvantage. Futures are an alternative in some cases but they are only available in a smattering of emerging markets. Where they are absent, swaps can help the hedge fund bypass such problems.

Swaps help hedge funds satisfy a desire to access new regions without building out the necessary infrastructure to trade the underlying. For those seeking independent market access, local registration as a foreign institutional investor can be first required. In India, for example, the process takes a minimum of six months with an initial and annually recurring compliance cost of \$10,000, as well as significant operational back-office costs. In general, hedge funds struggle with the access issues that range from geography, to currency, language, tax laws and sporadic shorting restrictions. Equity swaps offer relief from such vagaries.

In return for initial margin, hedge funds receive a US dollar-denominated (or alternative major currency of their choice) payment that reflects the

performance of a local stock (adjusted to reflect relevant corporate action events) without their actually owning it. They pay a financing spread to the broker, who maintains beneficial ownership of the shares that have been secured in the local equity market, via his own cash equity desk, or through a third-party give-up process, which we discuss in more detail later. In the event of the share price going down, the hedge fund pays the negative difference to the prime broker (see Exhibit 6).

**Exhibit 6**  
**The Flow of a Long Equity Swap Trade**

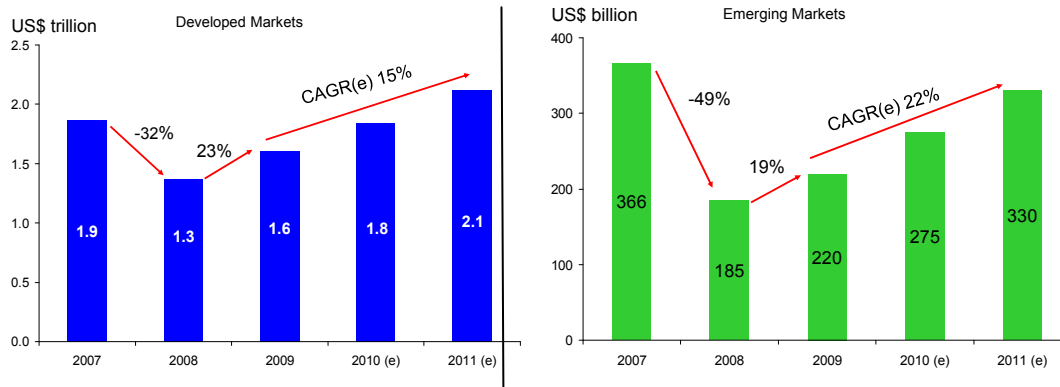


Source: TABB Group

Using the outstanding notional in global equity swaps as a benchmark measure, TABB Group expects growth in the use of swaps to be strong, particularly in emerging markets. Outstanding notional amounts in swaps in developed markets fell 32% during the financial crisis before recovering a large portion of their losses the following year, and TABB Group expects that the outstanding notional will continue to grow at a CAGR 15% up to 2011 (see Exhibit 7).

While the emerging markets are dwarfed by the developed markets and should be measured in US\$ billion rather than trillion, these markets are in a hurry to catch up. The outstanding notional for equity swaps in emerging markets plummeted 49% in 2008 and only bounced back by 19% in 2009. Even though developed markets rebounded better in the last drop, expectations going forward are for emerging market swaps to grow at a CAGR of 22%, outpacing the recovery rate of the developed markets (see Exhibit 8).

### Exhibits 7 and 8 Outstanding Notional in Equity Swaps (Developed Markets Versus Emerging Markets)



Source: TABB Group

### Customised Baskets versus ETFs

Hedge funds also use other products to access emerging markets and, when it comes to country and index exposure, ETFs are a popular alternative to swaps. They are liquid, have a low tracking error, and low management fees. However, they have drawbacks:

- ▲ Despite being listed, ETFs entail counterparty credit risk.
- ▲ They are blunt, off-the-shelf products.
- ▲ The short ETF market outside the US is nascent, and illiquid.
- ▲ Pricing is not as transparent as it may seem.

Emerging market ETFs tend to be synthetically replicated since it can be hard to access the local market for full replication. Therefore, ETFs bear exactly the same counterparty credit risk profile as a swap with the cost of financing and stock borrow opaquely bundled into a single, final price.

Meanwhile swap-based customised index and sector baskets have a significant advantage over ETFs in that they can be specifically tailored to suit the precise needs of the investor. For the alpha-seeker looking to be differentiated from users of ETFs, which tend to be heavily weighted in the most obvious stocks, swap-based baskets may suit the investor who wants to eliminate basis risk or fine-tune his exposure to certain stocks or factors.

## The Role of the Prime Broker

Prime brokers hold the key to a hedge fund's ability to use swaps to access emerging markets and, broadly speaking, they can be divided into two groups: large and small. While large prime brokers tend to be one-stop-shops, offering a range of products, including cash equities as well as synthetics, smaller brokers often specialise in core strengths. This could be a pure cash execution offering in a particular market, or it could be a pure synthetic offering, that has little or no cash execution service. Sometimes the decision to specialise is not born out of choice. The pure synthetic prime broker, for example, may not have a cash execution business to offer. Alternatively, the prime broker specialising in cash execution for a particular market may not have a derivatives capability.

Specialisation in service offering means that small prime brokers are able to compete for hedge fund business and, on the other end of the stick, hedge funds face a greater variety of choice when it comes to selecting a prime broker. This offering manifests itself in two ways:

- ▲ High-touch, service-oriented offerings focusing on small- and medium-sized hedge funds
- ▲ Low-cost offerings for large hedge funds looking to multi-prime

Generally speaking, large hedge funds do not have a problem finding a prime broker to service them. They trade frequently and in size and usually require a full range of prime brokerage services. Large funds have the resources at their disposal to be relatively self-sufficient, both in terms of research capabilities and building out their own models to drive investment strategies. Moreover, they want to control as much of their business as possible.

It is a different story for medium or smaller hedge funds. Rationalisation of clients and services by some larger prime brokers has left some hedge funds out in the cold. Smaller funds are less concerned with minimising execution costs and taking control of the execution process and are more interested in hearing trade ideas and on focusing resources on the investment decision process. They are unlikely to get the attention they need at a large prime broker. Despite their willingness to pay a premium for ideas and execution, their business may simply not be voluminous enough for a close relationship. This leaves the door open to hungrier, service-oriented, prime brokers specialising in synthetic products, which target smaller start-up funds and medium-sized funds that lack internal resources but need investment ideas and frequent feedback.

Prime brokerage is traditionally a "high-touch" business, with start up assistance, capital introduction, customised reporting and a sense of being part of a family, all hallmarks of the "old school" way of doing things. Prime brokers who specialise in synthetics deliver the service levels smaller hedge funds

require – from trade idea through to trade execution – in the area in which they are strong. To this extent, they are more closely aligned to the traditional “high touch” way of doing things.

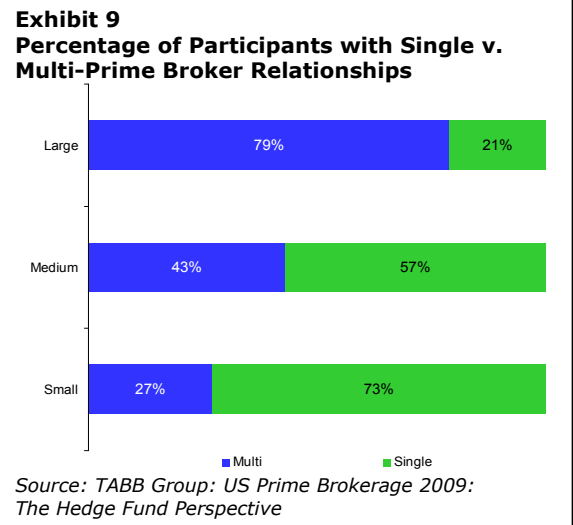
Ironically, larger prime brokers are fostering smaller prime brokers that specialise, which some term as so-called mini-primes. Rather than lose all associated revenues with the smaller hedge fund clients that they can’t service, they look to build relationships with prime brokers who want the business and who can deliver at least a portion of the associated revenues back to the large prime broker. Meanwhile, prime broker specialists rely on large prime brokers for infrastructure to support more complex instruments.

Rather than offering a diverse set of services under a “cost of funding” umbrella, there is a general trend with prime broking to unbundle services and specialise in strengths. Trying to please everyone eventually satisfies noone, so one answer is to aggregate (rather than consolidate) services. In a marketplace of best-of-breed solutions, prime brokerage is becoming a land of alliances, between large prime brokers and smaller prime broker specialists. This allows prime brokers to continue refining their offerings and create seamless linkages between distinct business models providing niche services.

### Multi-Prime Means Specialists Can Compete

Through alliances, small prime broker specialists are able to tailor their service to offer a low-cost alternative to the traditional prime brokerage model. In particular, as niche players they can refine their offering to better serve hedge funds focused on emerging markets.

The prime brokerage industry is becoming more competitive as more firms are willing to multi-prime, either to spread their risk or to better leverage the services available or to see more prices for comparison. Essentially this means it is open season in the prime broking landscape (see Exhibit 9). A large fund turning attention to emerging markets will find that multi-prime provides access to a better inventory of stocks available for loan, with more prices to compare against. In addition, they are able to more easily disguise the overall portfolio from the prime broker and minimise information leakage – an especially important concern for a large fund. It should be noted, however, that multi-prime is expensive and operationally difficult. As such, small- and medium-sized hedge funds are less inclined to adopt the model.



The multi-prime model means small prime brokers with a low-cost offering have the chance to get their foot in the door with large hedge funds that have pre-existing prime broker relationships. This is less of a tall order than trying to win a large hedge fund away from a large, well-established prime broker and it means that smaller prime broker specialists are more able to compete for large hedge fund business.

## Six Considerations When Choosing a Prime Broker

When it comes to trading emerging markets, hedge funds, regardless of size, are looking for diversification, good credit ratings, strong balance sheets and good risk management. But aside from these broader considerations, emerging market hedge funds must also consider the following:

- ▲ **Need for Risk Capital** – Access to risk capital is not always a must. Risk capital is a service that has to be paid for, and it is a service that will only get more expensive as new regulations requiring banks to hold high risk-based levels of capital under Basel III are introduced.
- ▲ **Price** – While there has been intense focus on counterparty credit risk in the past two years, price is re-emerging at the forefront of concerns for alpha-conscious hedge funds.
- ▲ **Rehypothecation** – Synthetic prime brokers will use hedge funds' assets to trade futures, asset swaps and basis swaps on their own book, and some of the profits will then be passed back to the hedge fund in terms of lower servicing costs. The key for hedge funds is to be on top of rehypothecation terms.
- ▲ **Separate Custodial Account** – For those nervous of having their assets used as collateral, or for those with investment vehicles that demand a high degree of transparency such as UCITS III funds, third-party custodians can be used, though these can be operationally difficult to manage and expensive. A low-cost alternative is to custody assets within the prime broker, or to set up long-only trust accounts for unencumbered assets.
- ▲ **Control** – Many prime brokers are now offering hedge fund clients managed account solutions, in much the same way that hedge funds offer managed accounts to their investors. The account belongs to the prime broker, but the hedge fund has complete trading discretion.
- ▲ **Operational Concerns** – Smaller emerging market hedge funds seek concise, simplified reporting so they can concentrate on making efficient tactical and strategic trading decisions. Middle-office services are an important way for prime brokers to differentiate their offerings.

## Do You Give-Up?

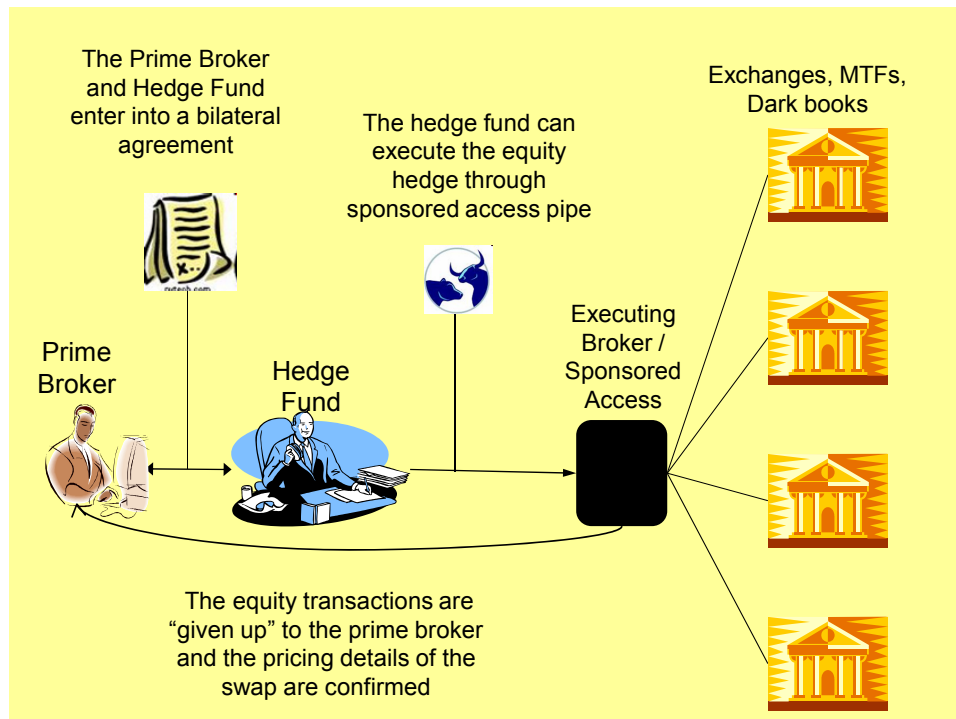
Key to hedge funds and prime brokers alike is the “give-up process” that acts as an infrastructural framework to make hedge funds less dependent on the prime broker as a middleman. The “give-up process” focuses on the hedge with which the prime broker must execute if he is to sell a swap to a client.

### Execution

Emerging markets may have many potential executing brokers and means of execution but only a few synthetic providers. Since there is a strong correlation between the price at which the stock hedge gets executed and the swap that the prime broker sells to the hedge fund, it is then in the fund’s interest to see the hedge executed at a competitive price. And they may know an alternative source to their prime broker. In this instance, the fund may find their own means of execution and have the hedge “given up” to their prime broker.

This is all the more significant when it comes to pure synthetic prime brokers that lack cash execution capabilities. In essence, the hedge fund has the flexibility to go out and execute a stock purchase with any number of executing brokers, venues or means, and then see that the hedge is delivered to its swap provider at the most competitive price. The synthetic prime provider can, in turn, price the swap accordingly at a more competitive rate (see Exhibit 10).

**Exhibit 10**  
**Long Equity Swap with Execution “Give-Up”**



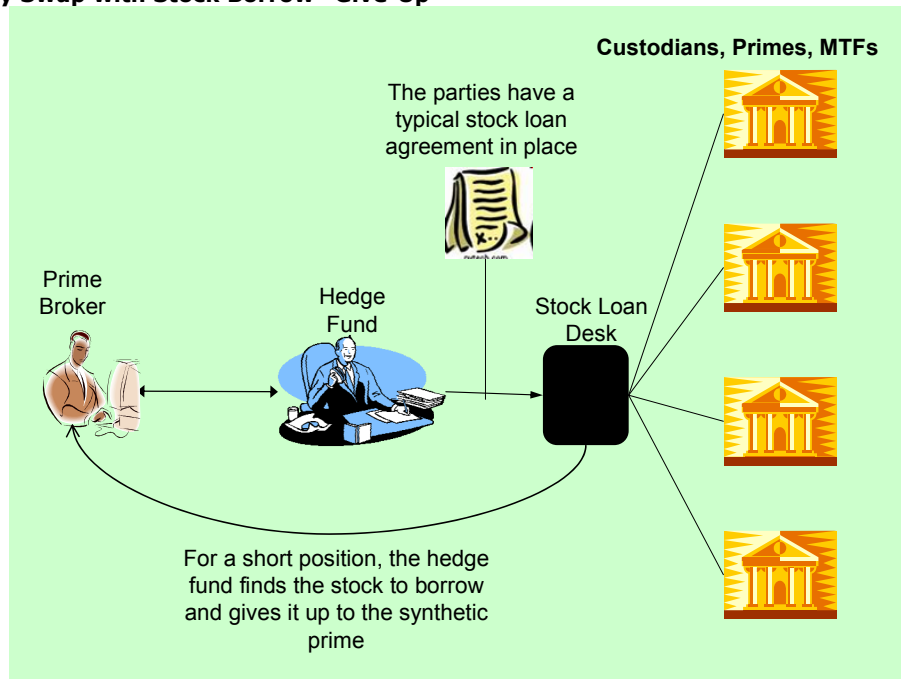
Source: TABB Group

On the long side of things, hedge funds frequently favour the give-up process so that they might take as much control of the execution process, though it should be noted that the practice is frowned upon by US authorities and it is thus not widely practiced there. The long execution version of the give-up is in essence the same as the stock borrow give-up but focuses more on the relationship a hedge fund might have with executing brokers than on its relationships with lenders of stock inventory.

### Stock Borrow

One of the most critical features of the prime brokerage service industry is access to stock inventory. Without access to stock, prime brokers are unable to offer shorting as a service to hedge funds – a key theme to a large number of hedge fund investment strategies. The prime broker always has to be able to access the stock if he is to sell a short swap; otherwise he is simply taking the other side of the market position -- something he does not want to do. When it comes to the stock borrow “give-up,” the hedge fund is essentially sourcing stock inventories that serve as the hedge on behalf of the prime broker.

**Exhibit 11**  
**Short Equity Swap with Stock Borrow “Give-Up”**



Source: TABB Group

Consider this example: A prime broker is unable to deliver a borrow rate on stock at an attractive level because it lacks inventory, but the hedge fund has the ability to borrow away and see the position “given up” to the prime broker. If a hedge fund wishes to borrow XYZ stock but the prime broker has only managed to source inventory at 7%, the fund may try to find an alternative lender at a cheaper rate. An alternative lender could be another prime broker

(under the multi-prime model) or it could be a pension fund looking to leverage its stock inventory through a lending programme. The prime broker then has the option to match the terms or ask for the stock loan to be “given up” to it. The fund pays a nominal fee for this service (see Exhibit 11).

In essence, the “give-up” process means that hedge funds are able to directly access alternative sources of inventory rather than rely solely on a two-dimensional relationship with a broker. Through the give-up, hedge funds have access to a broader array of stock inventories – a critical issue in some of the less liquid and difficult to access emerging markets.

It can be easy to borrow highly liquid stocks but when things become hard to borrow, as is often the case in emerging markets, the ability to access inventory becomes critical. In Russia, for example, brokers are required to place collateral at the exchange depository chamber (DCC) to cover all trading positions, and the broker needs to have access to an extensive inventory of long positions to offer any kind of shorting capability.

Traditionally, many prime brokers have tried to build up inventories by a variety of means including bidding for exclusive access to portfolios and index arbitrage; single-stock forward trades; and portfolio trading. But this expensive and time consuming business, which has often translated into higher service costs to the hedge fund client, is being made more efficient through the infrastructure of the give-up.

By being able to directly access their own means of execution for long stock acquisitions, or their own sources of inventory for short stock positions, hedge funds are less reliant on the traditional, one-stop-shop, prime broker model. In turn, prime brokers are also freed up and they now have the ability to specialise in particular areas without having to be all-things-to-all-men in order to be a contender for hedge fund business. In essence, prime broker offerings continue to be refined to more closely reflect the specific needs of hedge fund clients in all their various manifestations and investment goals.

## Conclusion

Alpha-hungry, cash-rich hedge funds are charting their course for new and exciting markets and are looking for the tools to help them navigate their way. Hedge funds face a myriad of challenges when it comes to investing in emerging market equities. While inefficient market structures present some of the most attractive opportunities in terms of risk arbitrage, they also come with attendant hazards.

For a start, emerging markets are notoriously difficult to access and there are barriers to entry in terms of local customs, language and overall street-wisdom. Hedge funds can stand at a significant disadvantage to the local trading community when it comes to information leakage or accessing critical corporate information. Exposure to local equities bring with them exposure to volatile and difficult-to-hedge currencies, as well as a range of local regulatory and tax hazards.

Equity swaps are the potential panacea to these ills, helping hedge funds access new regions without building out the necessary infrastructure such as foreign regulatory licensing for trading stocks. Since there is no direct exposure to the underlying, swaps help hedge funds avoid unforeseen regulatory swings, such as capital controls designed to manage foreign capital inflows into the local equity markets. They also help manage national shorting restrictions and dramatically reduce the costs and operational burden associated with trading the physical, such as clearing, custodial and regulatory reporting.

At the same time as seeking access to new pastures for alpha, hedge funds are also adopting new fund mandates, like those stipulated under UCITS III. Driven by potential new European hedge fund regulations, as well as by a desire to broaden their investor base, hedge funds are being increasingly funnelled into retail-friendly and regulatory-compliant UCITS III structures. Such funds allow for the use of certain derivatives but do not allow for the physical shorting of shares. Just in the case of national shorting restrictions, the ability to go synthetically short using equity swaps is a critical tool for hedge funds looking to effectively and efficiently manage downside risk or execute common long/short investment strategies.

Swaps offer a potential solution to FIN 48, the new international accounting standard that could force hedge funds to reflect uncertain tax liabilities in their NAV. Since a hedge fund does not take delivery of the underlying cash security, there is the possibility that offshore hedge funds could continue to claim exemption from a broad array of potential tax liabilities. But there's no certainty it will work and the jury is still out on whether this strategy will be successful.

Hedge funds rely on prime brokers when it comes to using swaps, but it's not just the usual suspects. The shake-up in prime broker landscape means there's

now far greater choice and competition in the industry. Away from the large one-stop-shop firms, specialist small prime brokers are today offering high-touch, low cost, service-oriented solutions focusing on small- and medium-sized hedge funds, which typically lack internal resources but need investment ideas and frequent feedback on trading strategy.

The advent of multi-prime is also giving specialist smaller prime brokers the chance to compete for large hedge fund business. They can now offer their services in addition to pre-existing relationships between large prime brokers and large hedge funds. This is less of a tall order than trying to win a large hedge fund away from a well-established prime broker, and it means there is an opening through which to get their foot in the door.

But while equity swaps are helping hedge funds access restrictive emerging markets, the irony is that it could be regulation in the developed markets that ends up most significantly hampering their ability to use the instruments. The proposed financial reform bill in the US is potentially threatening the way banks deliver derivatives services and this could dramatically raise the cost of services. It will either no longer be economically viable for certain prime brokers to participate in the derivatives market, or there will be a severe increase in the cost of service for hedge funds should the bill pass.

In addition, the HIRE Act will see both hedge funds and prime brokers reduce their US swaps business if there is a perception that authorities no longer find the practice of so-called "dividend arbitrage" acceptable from a tax perspective.

Hedge funds are driven by a desire to understand risk in order to maximise return. While equity swaps are proving to be a flavour of choice in this regard, they will need to tread carefully when it comes to managing the most unquantifiable and difficult to evaluate risk of all: that of regulation.



## About

### TABB Group

TABB Group is a financial markets research and strategic advisory firm focused exclusively on capital markets. Founded in 2003 and based on the methodology of *first-person knowledge*, TABB Group analyses and quantifies the investing value chain from the fiduciary, investment manager, broker, exchange and custodian. Our goal is to help senior business leaders gain a truer understanding of financial markets issues and trends so they can grow their business. TABB Group members are regularly cited in the press and speak at industry conferences. For more information about TABB Group, go to [www.tabbgroup.com](http://www.tabbgroup.com).

### The Author

#### Will Rhode

Will Rhode joined TABB Group in March 2010 as an analyst based in London. He brings 14 years' experience as a financial journalist specialising in the risk management and derivatives industry, principally for *Risk* magazine and its associated publications. Previously, he was Editor Americas for *Risk* in New York and Editor of *AsiaRisk* magazine in Hong Kong. In addition to journalism, Will has also worked as a novelist and has had three thrillers published and translated into five languages by major international publishing houses. He holds a Bachelor of Arts degree in Political Science from the University of Newcastle-upon-Tyne, England.





[www.tabbgroup.com](http://www.tabbgroup.com)

Westborough, MA  
+ 1.508.836.2031

New York  
+ 1.646.722.7800

London  
+ 44 (0) 203 207 9397