New Frontiers: Law Firms in 2020

Part Three

A REPORT BY JOMATI CONSULTANTS LLP, SEPTEMBER 2011

jomati consultants LLP

About this Report

This is the third in the 'New Frontiers' series of reports focussing on key macro-economic issues that will affect clients and law firms by 2020. The next report, to be published in January 2012, will focus on the Post-Crisis landscape for law firms and consider lawyer/client relationships, the challenge of a low growth economy and new forms of production.

Contact Information

Jomati Consultants LLP
3 Amen Lodge, Warwick Lane
London EC4M 7BY
United Kingdom

Principal, Tony Williams. Contact: + 44 (0)207 248 1045, tony.williams@jomati.com

Consultant/Head of Research, Richard Tromans. Contact: + 44 (0)207 248 1045, richard.tromans@jomati.com

Disclaimer and Thanks

Data has been sourced from the publications and authorities that published the information. Jomati Consultants would very much like to thank everyone who has participated in interviews for this report.

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Introduction

"Bank – (noun), an institution offering the safekeeping of money."
Collins English Dictionary

The financial sector feels more fragile than it has for decades. The idea that banks in the West are stable, or that developed nations are better run and less likely to default than developing ones, no longer seems true. Likewise, the theory that once a recession is technically over markets and corporate activity pick up where they left off, seems to be defunct. Activity is not greatly increasing, nor does it seem likely to in the medium term – at least not in the West.

But surely the financial Crisis which started in the summer of 2007, over four years ago now, is over? Sadly, it is not. In fact, latest financial indicators are that we could be heading for a double-dip recession. Continued doubts about the ability of Europe, and now the US, to pay back its debts is only prolonging a sense of anxiety – slowing down any recovery. The downgrade of US debt to AA+ by Standard & Poor is a true sign of the times.

But, even without another technical recession, the full impact of the combined Western credit booms of the late 1990s and mid-2000s will take considerable time to fully unwind. Whatever recovery the West has will be a slow one. Ultimately we are caught between two unwelcome scenarios: one, to open up credit to stimulate growth, risking another boom-bust cycle our banks may not recover from this time; or two, to stagger on as we are, the financial sector slowly healing its wounds and hoping to avoid another crisis, but starving many corporates and funds, as well as the structurally important real estate sector, of the ability to grow – in turn stymieing the growth of law firms.

The damage that the financial sector has suffered will not heal quickly. The injuries are deep. A stress test of European banks[1] found around 10% could fail – and that is without the counter-party risks of a Greek, Spanish, Irish or Italian default in coming years. As European economists grit their teeth, US politicians have just risked a sovereign default over tax and fiscal policy – but still face the same showdown every year until the mid-2010s. This comes as China is growing stronger and its Yuan looks increasingly like an ideal reserve currency.

Much of the financial hierarchy US and UK law firms have depended upon for work still stands, albeit in a new world with new challenges. As we show, the top US investment banks are still dominant – although fewer now. The total value of private equity assets is higher than ever before, even if many funds do not know what to invest in. The best US and UK hedge funds still return huge profits – even if thousands of smaller ones do not. The New York Stock Exchange still has a market capitalisation more than triple its nearest rival – yet competition to host IPOs in Asia undermines its once pre-eminent position.

The great edifices of the Western financial world are still standing, but this does not mean it is business as usual. The inner workings of the global financial industry have changed, from the impact of Dodd-Frank to the rise of Asia, South America and Africa as counter weights to the dominance of Western financial interests. The financial markets, for so long a preserve of London and New York, are like an old empire that has stretched so far it is now in unmapped territory. The fundamental rule of investment: follow growth, will only accelerate this sense of reaching a new frontier. This is because, in many cases, growth in the financial services sector will mean investing outside of the US and UK. For example, HSBC is cutting 30,000 jobs in the US and Europe, but hiring 15,000 people in Asia and Latin America. At the same time, pre-tax profits for this global bank rose 25% in Asia, but fell 39% in Europe[2]. It seems the writing is on the wall.

[1] Reuters 18 July 2011. 'Eight European banks (out of 81 tested) would fail to survive a long recession.' Although, this is very likely an under-estimation and does not factor in sovereign defaults

[2] Financial Times, 2 August 2011.

Major law firms are therefore faced with old, predominantly Western institutions as clients, but new market conditions and geographies dictating new behaviour. The investment banks, funds and stock exchanges of Asia and South America will also keep growing fast. International firms therefore face a genuinely new frontier that will challenge their ability to generate business and maintain profits. They will have to embrace a global vision of client development, and invest abroad in talent, knowledge and a credible physical presence. Many have already embarked on this journey and for them the message is that there is no end point to this globalisation – not yet, and certainly not by 2020.

Away from the daily operational issues that absorb so much management attention, there is a deeper, macro-level change on-going that is quietly re-shaping the needs of your clients, and therefore the kind of services you need to offer to grow profits and revenue. We hope this report, the third and final part of our New Frontiers series, inspires management to contemplate these deeper factors and acts as a spur to further analysis of their strategy.

Chapter One: Banks

Retail Banks: The Debt Hangover

Despite historically low interest rates[3] in most developed economies bank lending is still weak in the West. In the UK, 27% of SME business loan applications were rejected last year compared to just 4% in 2007[4]. This is especially challenging because the majority of new job creation in Western economies will come from the SME sector – especially now that public spending has been decimated and top corporates are outsourcing jobs and using global wage arbitrage to cut labour costs. This lack of Western corporate activity will continue to impact US and UK law firms across a range of practice areas, but is unlikely to change soon.

Western banks still face the biggest debt hangover in history. It took years to build up, and it will take years to be fully removed in part because of the level of bad debts, (see table 1).

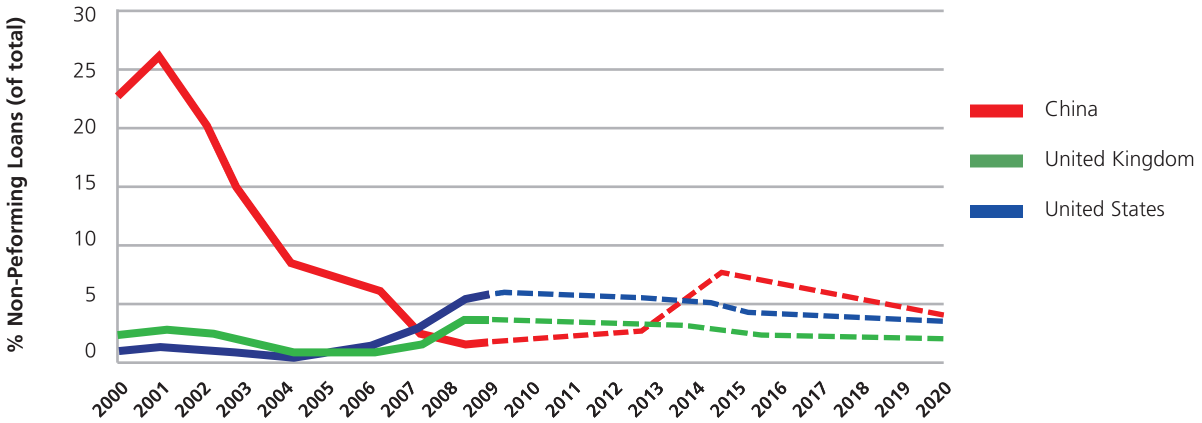


Table 1: Percentage of Non-performing loans out of total loans by banks in each major nation. Data from World Bank, 2011. Jomati estimates to 2020.

Although non-performing loans in the US are 'only' around 6% of the total capital lent to borrowers by commercial banks, in a sophisticated market such as America this is high. Normally the figure would be 1.5% of total loans, or a quarter of today's level. In the last quarter of 2010 'troubled assets' on US banks' balance sheets totalled around \$320bn[5] - equal to the GDP of Hong Kong. Moreover, in 2010 there were nearly 400 US banks – mostly smaller regional ones – with 'troubled asset ratios' of over 100[6]. Between January 2009 and March 2011 around 300 American banks closed – and that does not include the gigantic failures, near failures and tax payer rescues of investment or universal banks such as Lehman Brothers, Bear Stearns and Citigroup[7], respectively. There is also real concern that banks are under-representing loans, by renegotiating longer repayment dates with their borrowers. With historically low interest rates all but the most distressed borrowers can service their interest costs. Many however, may have no credible ability to repay all of the capital even if the loan is serviced. As one partner commented: "A rolling loan gathers no loss."

Also, once today's interest rates start to rise again – as surely they must in the medium term (see Appendix A) – this will push many borrowers into bankruptcy – adding to banks' problems. A rapid increase in interest rates, perhaps caused by a desertion of the US dollar due to continued fears over American economic instability or continued inflation,

[3] See Appendix A, UK and US interest rates, with Jomati estimates to 2020.
[4] Financial Times, 11July 2011.
[5] FDIC and Investigative Reporting Workshop, 17 March 2011.
[6] Ibid.
[7] Reuters: Feb 27, 2009, 'Citigroup…has received \$45bn of taxpayer money…and a Government backstop to cap losses on \$301bn of toxic assets.'

would further exacerbate the problem. After all, average US historical interest rates are closer to 6% - it is not inconceivable that we will return to that level in the long term.

Yet, the financial crisis did not affect all banking sectors around the world equally – far from it. For example, China, which had around 25% of its bank loans classed as non-performing 10 years ago – in part due to poor credit protocols, now performs at a level the US used to – around 2%. India has also seen its loan book improve greatly over the last decade. Brazil is more erratic, but still in healthy territory. However, Russia's retail banks look weak[8], with non-performing loans at nearly 10% of total in 2010, which is worrying for businesses and their advisers there.

Recent research by Bloomberg[9] also came to the conclusion that the world's 'strongest' banks – at least in terms of their ability to lend and overall stability - were mainly not in the US and UK, but rather in more risk-averse jurisdictions such as Canada and Singapore (see Appendix B). Singapore's banking strength is especially interesting as the city state is increasingly becoming a private equity centre for investment in the Asia region – an industry heavily dependent upon high levels of credit.

Another way of looking at the debt hangover is the growth in total domestic credit as a proportion of a country's GDP. In high growth nations one would expect a lot of credit – but that may not be cause for concern as economic expansion can balance this risk. For example, China increased total credit as proportion of GDP by 22% in nine years. That may sound quite low – however China's GDP has grown around 10% each year too – amplifying this credit level in real terms. How dangerous this credit growth is to even an economy as apparently resilient as China is up for debate. Some analysts believe China is heading for a fall of Western proportions (see below.)

Country	Growth in domestic credit as a proportion of GDP (2000 to 2009)	Credit as Proportion of GDP in 2009
Brazil	35.6%	98%
China	22.0%	145%
Greece	25.2%	113%
India	30.9%	69%
United Kingdom	76.1%	229%
United States	16.4%	230%

Table 2: Growth of Domestic Credit[10] as a Proportion of GDP, from 2000 to 2009, plus actual credit as % of GDP in 2009. IMF data.

In nations where growth is far lower – as in the case of most of the West – credit far outstrips economic growth. In 2000 the US already consumed 198% of GDP in credit, by 2009 it was 230%. While, in the UK credit rose from 130% to 229% of GDP to match the US in just nine years – and was the driver behind the nation's biggest ever property boom. And yet, during a period that some might have thought was a success i.e. the mid-2000s, the UK never saw more than 3% annual economic growth. That is to say, despite the credit, the 'real' economy was achieving only moderate growth, add in inflation and one could argue there was little or no growth at all. In America's case, the credit

[8] Guardian, 18 July 2011, 'Barclays sale of (Russian Expobank bank) to make a tenth of 2008 purchase price.'
[9] Bloomberg, May 2011, of the top 10 strongest banks, three were in Singapore, two in Canada and only one in the US – Fifth Third Bancorp. A key factor was the level of retained capital. See Appendix B.
[10] IMF Data July 2011. Domestic credit provided by the banking sector includes all credit to various sectors on a gross basis, with the exception of credit to the central government, which is net. The banking sector includes monetary authorities and deposit money banks, as well as other banking institutions. Examples of other banking institutions are savings and mortgage loan institutions and building and loan associations.

crunch was the end of a credit boom that had lasted far longer and built more slowly – but the end result has been more painful. The US also never saw annual GDP growth higher than 3.6% in that period[11]. UK and US law firms also now have to share in this historical problem: having grown in size and profit because of a credit fuelled market – anything other than an exceptional financial year now feels like a poor performance. As a comparator, Greece – whose economy is close to collapse – has a credit to GDP rate of 'only' 113% - or half that of the UK and US.

Finally, increasing demands for higher capital buffers[12] following the proposals of Basel III are not making the ability of banks to lend further any easier, which in turn would feed more corporate activity and boost law firm activity. The new Basel rates will see minimum capital buffers of 7%, going up to around 9.5% for the 30 largest most 'inter-connected'[13] banks. The July 2011 stress tests by the European Banking Authority have not helped either, and only underlined that many banks are under-capitalised, even if perhaps to a lesser degree than initially feared. Overall, Basel may be great news for banking regulatory lawyers in the short term, but safer, or 'boring', banks will mean less work for the rest of the firm.

The Next Credit Crisis: The Chinese Wall of Debt

Analysts are increasingly worried about a huge loan market in China that outsiders know very little about. This 'dark' market is driven by borrowing by Chinese local government from national PRC banks. In some cases the New York Times[14] found "clever accounting that masks the true size of the debt". Meanwhile this July, Moody's Investors Service issued a report saying China's national auditor might have "understated" its banks' "actual risks" from loans to local government. Corruption among the nation's thousands of public bureaucrats muddies the paper trail even further. If there was a crisis it may not be immediately possible to understand what toxic debt is owned by which Chinese banks. Moreover, the market may not know how far certain US or EU banks that have dealings with Chinese banks are exposed. As detailed below, at least one Chinese investment bank is part owned by US investors. Already Chinese authorities have ordered banks to increase reserve requirements eight times since October 2010[15]. Meanwhile some larger Chinese banks are already cutting off funds to smaller businesses due to fears of over-lending and the expectations of economic contraction in the medium term.

At the same time, more Chinese private companies are turning to market funds and unregulated 'shadow banks' for credit – building up another dangerous barrier to transparency and market information. This development will also exacerbate the panic that might ensue from any future Chinese crash. It was partly the lack of knowledge about the underlying value of credit derivatives in the US that fed the panic on Wall Street in 2008. A Chinese crash is not certain – but can't be ruled out. For law firms – Chinese or foreign – the impact would clearly kill off deal flow – but it may also produce some very interesting restructuring work.

And then there is the issue of a US or European Sovereign default and the billions lent by Europe's banks to Greece, Italy, Spain, Ireland and Portugal. In Chapter Five, these macroeconomic issues will be looked at in more detail – however, as this report went to press, the European debt problems were still so great talk of another systemic collapse in confidence in the West did not seem exaggerated. Likewise, US politicians' brinksmanship through July this year, did

[11] 2001 to 2009. This is also despite the US population increasing now at the rate of 10% per decade.
[12] Despite what economists claimed back in the early 2000s, sharing risk didn't work – as if spreading a disease made it less dangerous. Sub-prime derivatives prevented risk from being valued, strangulating inter-bank lending and killing Lehman Brothers. Sharing risk that couldn't be valued could have destroyed the Western financial system. More cash reserves and less total risk per bank seem an unavoidable industry response.
[13] Financial Times, 26 June 2011.
[14] NY Times, 7 July 2011, 'Building Boom in China Stirs Fears of Debt Overload'.
[15] Financial Times, 31 May, 2011.

nothing to reassure investors from Asia that Western Governments are the responsible and prudent economic actors they profess to be.

Regulatory Benefits?

America's Dodd-Frank Act[16] is the biggest overhaul of financial regulation since the Great Depression with many implications for banks ranging from the sale of consumer finance products to capital and liquidity levels. For the banks the key piece of legislation is the 'Volcker Rule' – still unimplemented and under heavy lobbying efforts to be watered down – yet if enacted in its most stringent form would force investment and universal banks to cease proprietary trading. It has been estimated this will cost some banks, especially the most entrepreneurial investment banks such as Goldman Sachs, around $3.7bn in annual revenue[17]. But it is a mixed picture. Some banks such as Bank of America have said that although they have a large volume of trading for clients, trading 'on their own account' is a tiny piece of their revenues. Experts also point out that defining what is proprietary trading, and judging its benefits to the financial system are very hard. First, some ask: who would want to stop banks buying US Treasuries on their own account? Second, others point out, that underwriting activities may result in a bank effectively trading with its own capital – and that is something that cannot be banned. Proponents of the Rule suggest that it was banks buying up mortgage derivatives to hold for themselves, or sell on to their own clients, that helped create the recent Crisis. Yet, many believe stopping licensed banks trading with their own money risks killing off Wall Street's greatest institutions. As examined below, it does not seem likely Goldman Sachs and its rivals are about to die off. But, there are reports of traders already deserting US investment banks to join investor funds such as Glencore instead[18]. For lawyers the key regulatory demand will be the classification of trading activities – and protecting them from investigation.

The Vickers Report[19] in the UK also adds to the regulatory challenges for banks. The Vickers report summed up its task: "The challenge is to make the UK banking system more stable, and markets for banking services more competitive." This may be difficult. For example, it found that 30% of all current accounts in the UK were held by one banking group: Lloyds. Meanwhile the five largest banks in the US now hold over 34% of all deposits – up from a far safer 8% in the mid-1990s. This could raise the question of anti-trust and the failure of a free market[20] to use competition to benefit consumers and reduce systemic risk to the State.

Such concentrations of capital allows banks' trading arms to expand into large scale underwriting of both debt and equity offering, and to permit proprietary trading. Although, as noted above, the Volcker Rule, could curtail this 'prop' trading in the US. But, it also means these banks absolutely cannot fail now – even more so than before. It is hard to imagine what would happen if the US, UK or other Western nations, were forced to seek another publicly-funded bail-out of its top banks within the next 10 years.

[16] The Dodd-Frank Act contains over 315 rulemaking requirements and145 study and reporting provisions, many of which are still a long way off full implementation. Understandably, this report cannot discuss these in detail, nor is the purpose of this report to focus on regulatory issues. Although important, these changes are only one factor in a wider macro-economic picture affecting the world's financial services sector to 2020.

[17] Business Insider, 29 July 2011. 'Is The Era Of Goldman Sachs Over?'

[18] Ibid

[19] The UK's Independent Commission on Banking's 'Interim Report on Reform Options' also knows as the Vickers Report, sets out to ensure the UK never witnesses the 2007-9 Crisis, which saw a similar US-style collapse of confidence in major UK banks, rescue mergers and huge public bail outs that have led to public funding cuts and the loss of thousands of public sector jobs as a result.

[20] One might add that the entire regulatory debate rests upon a far greater debate: whether an unfettered 'free market' can really perform in the interests of the majority, or whether without restraint it will always revert to controlling interests that are rarely benign. Pragmatically, lawyers would likely prefer a more regulated world, and perhaps one with a greater number of major banking clients too.

Threats of a second Crisis aside, this is clearly a 'boom time' for financial regulatory lawyers, especially those that advise international banks that straddle the US, UK and wider European regulatory jurisdictions. Although, that said, Republicans and many financial industry lobbies are expected to try and roll back many of the provisions in Dodd-Frank[21]. Equally, a Republican victory in the 2012 Presidential elections could further reduce the impact of Dodd-Frank. As former President Bill Clinton once said, to explain the public's number one priority: "It's the economy, stupid." For President Obama, this factor may well play against him, thereby opening the door for a return back to a lighter regulatory environment.

Among the many proposals on both sides of the Atlantic, one of the more potentially structurally important ideas – and most interesting from a legal point of view - is made by the UK's Vickers report. The proposal is that universal banks should ring-fence their retail bank operations – but won't have to spin them off entirely. The logic is that if ring-fenced, a bank's failed trading activities won't hurt its High Street-facing business.

But, ring-fencing is no cure-all. Ring-fencing in one country will not solve all problems as the largest banks are increasingly international. If the trading arm did collapse it cannot be certain that assets of the retail bank would not be demanded. The outcome will very much be in the hands of the lawyers that draw up any such agreements. Also, ring-fencing may not change bank behaviour. It could be argued that by protecting retail you give a green light for traders to be reckless again – and trading arms have a bad reputation for recklessness. After all, the most dangerous assets banks held in the 2000s boom years were the derivatives of never-to-be-paid NINJA[22] mortgages that their wholesale trading and bond arms had bought, not the retail loans themselves. That is to say, the retail arms were reckless in lending – but it was the trading arms that made this into something so dangerous it could have 'crashed the system'.

In the US, in order to prevent systemic risk to the banking system, Dodd-Frank is creating the Financial Stability Oversight Council (FSOC). The FSOC is charged with identifying and monitoring systemic risk to US financial markets. Primarily this gives the US Government the power to demand that banks increase capital buffers. To ensure such an agency can function, it also comes with powers to demand information, so as to judge whether banks or other non-bank institutions pose a risk to the nation. To some extent it is adding a Federal layer of enforcement on top of the already proposed Basel III global initiative to boost capital and liquidity levels in banks. And as mentioned, higher capital buffers means a higher cost of doing business and less capital available for lending and trading activities.

One other major Dodd-Frank banking development that should prevent such practices as the incredibly toxic NINJA loans happening again is the creation of the Consumer Financial Protection Bureau (CFPB). The CFPB will be a Federal agency with extensive powers to investigate and pursue sellers of consumer financial products. It will also be allowed to define what is 'unfair' or 'deceptive' practice. From a legal point of view this makes the CFPB incredibly powerful and relevant to a huge range of clients.

Another area of regulatory work will be connected to selling off the 80% of RBS and more than 40% of Lloyds that are in the UK Government's ownership. We may also see the creation of new banks in the UK as larger banks, such as Lloyds, sell off branches – or are forced to by UK or European regulators. In the US the bail-out will also continue to generate regulatory work, with plenty of work related to many smaller banks as well as the few large universal banks. Through the Troubled Asset Relief Programme (TARP), the Government bought around $250bn in preferred stock in 16 of America's largest banks and institutions, as well as far smaller amounts in literally hundreds of smaller banks and

[21] Some of the more vociferous lobbying has been around the increased oversight of investment managers, who had until recently been operating in a far freer environment than the banks.

[22] NINJA - No Job, No Income, No Assets – mortgages sold to Americans who would begin to default almost as soon as the loans were made. However, the ability to sell on the debt made the products profitable.

finance companies. However, in many cases these larger stakes in the major banks have already been paid back. In total 928 entities received TARP funds. Yet, of the $573bn given to the private sector by the citizens of America – via the Treasury Department - only $340bn has been returned[23], ($273bn in refunds, plus $63 billion in fees, dividends and interest). Literally hundreds of smaller banks are still holding onto this remainder of $237bn in TARP support or 41% of the total – in part because to return it now could risk destabilising them when so many of their loans are still un-performing. TARP has also contributed to the US's public deficit problems. For example, in 2010 the federal budget totalled $3.5 trillion. The unpaid TARP funds would therefore be the equivalent of 7% of annual Federal spending. This is ironic, as by using public money to help privately owned banks, the Government has added to its over-borrowing problems[24].

The Property Solution: A Way Out?

Many US and EU banks' problems are tied directly to property values. While desirable and luxury properties in key business centres such as Manhattan or central London continue a slow rise in value, many regions continue to see declines. PricewaterhouseCoopers (PwC) recently stated that taking into account inflation in the UK – the most important real estate market in Europe – that national average house prices may only increase 1% by 2020[25]. In the US the National Association of Realtors found that the median average price of a home had fallen by 5% in Q1 2011 compared to Q1 2010. That is bad, but even worse when one considers the median US house price was 58% higher in November 2007 than it was at the end of Q1 2011.

The weakness in house prices also has a knock on effect on the confidence of investors in commercial real estate. For example, property investment transactions in the UK in 2011 Q2 were down 30% on 2010 Q2 in value[26]. The only way to regain the 2000s' momentum in national house prices is to open up easy credit again – something that simply cannot be done for many years to come. Real estate lawyers are therefore waiting for the banks to come up with a quick answer for which there is none, other than to rebuild their balance sheets.

High unemployment compounds the matter further. US unemployment is fluctuating around the 9% mark in 2011, before the crisis in 2007 the figure was on average 4.5%. US unemployment has not been this high since the second and third years of President Reagan's first term, 1982 and 1983, when it was routinely above 10%. Unemployment in the UK in Q1 2011 was around 7.7%. The average EU unemployment rate in April 2011 was 9.4% - in March 2008 it had been as low as 6.7%, a record low for Europe, which has long had stubborn areas of high unemployment, such as eastern Germany.

And finally, there is some positive news and it may form part of the solution to banks' debt problems: inflation. Although seen as a negative factor by many investors – for those who are in debt, inflation steadily reduces the relative value of that debt. If growth does not permit banks to rapidly stabilise their balance sheets, rising inflation may complete the task for them. Inflation also assists indebted Governments by reducing the real value of their debt. This, of course, is subject to interest rates remaining negative in real terms as an early return to real interest rates may kill off the recovery.

[23] ProPublica, July 2011. www.propublica.org/ion/bailout: "$237 billion is the net still outstanding as of Jul. 25, 2011". The Government also 'loaned' via stock purchases $13bn to General Motors and $4bn to Chrysler. $424bn was also set aside by Government to guarantee assets of Citigroup and Bank of America.

[24] It is also ironic, but perhaps not surprising given politics' short-term focus and opportunism, that President Obama is now receiving criticism for leading the US economy to this point when he only assumed office in January 2009, many months after the Crisis began and TARP was initiated. Also, because of the economic crisis tax receipts in 2009 and 2010 were far lower than previously, increasing the deficit further.

[25] PwC, 12 July, 2011, Daily Telegraph.

[26] Propertydata.com, 18 July 2011.

Investment Banks: American Rules

Many investment banks have felt a strong reputational and economic impact since the financial crisis – yet anyone believing America's top investment banks are about to see a rapid decline would be wrong. Of the top ten investment banks six are American (see table 3). That they will have to keep adapting to a financial world that is no longer so dominated by the US and UK is true. But, these institutions will keep pace with globalisation, using their strong structural foundations in the US to fund further international expansion. One might say the US is still the fountain head of their capital, but the global pool they operate in is now many times wider than when they first rose to prominence in the 20th century.

Rank by Deal Volume	M&A Adviser Bank (to Target or Buyer)	Country	Total Deal Value (US$m)	No. of Deals	Market Share by Volume
1	JPMorgan	US	$5,458,638	2,940	4.9%
2	Bank of America Merrill Lynch	US	$5,166,762	2,714	4.5%
3	Goldman Sachs	US	$6,343,271	2,670	4.5%
4	Citigroup	US	$4,681,183	2,437	4.1%
5	UBS Investment Bank	Switzerland*	$3,501,080	2,407	4.0%
6	Morgan Stanley	US	$5,244,934	2,340	3.9%
7	Credit Suisse	Switzerland*	$3,627,135	2,297	3.8%
8	Rothschild	UK*	$2,120,250	2,181	3.6%
9	Lazard	US	$2,360,382	1,911	3.2%
10	Deutsche Bank	Germany*	$3,056,371	1,788	3.0%
Total:			$41.5 trillion (or 66% of total value)	23,685	39.5%

Table 3: The top 10 Banks[27] by global M&A deal advisory volume Jan 2001-June 2011. (Merger Market data.) (*Despite bases outside the US – a significant part of each banks' operations are located in the US.)

Together these ten banks advised on deals over the last decade worth $41.5 trillion, or 66% of all major corporate deals in the world from 2001 to June 2011[28] by value, and 39.5% by deal volume. Not as consolidated a position perhaps as the Big Four accountants, but an impressive concentration of financial power none the less.

In comparison, the top 10 corporate law firms in the world – by deal value over the last decade – have also seen a powerful concentration in the US and UK – with a similar split – six American and four European (see table 4). All the European-based advisers are UK global law firms, namely the Magic Circle. Among the US firms, some are global too, such as Skadden Arps. However, some have a smaller global footprint in terms of total offices abroad, such as New York's Sullivan & Cromwell, which leads the rankings by a significant margin. It will be very interesting to see in another ten years which firms form the top ten M&A advisers around world: the global firms with many foreign offices, or the firms that maintain a smaller international footprint.

Another important factor will be which firms build a strong Asia-Pacific presence. That is to say, not just small offices to help manage inbound deals in the region, but large bases focussed on taking significant market share in Asia. Much of the top tier M&A activity in the early part of the 2000s was in relation to the US and Europe – where the ranked 10 firms were strong. If quality M&A activity continues to build in Asia to 2020, the list in table 4 may change significantly. Those firms that seek to remain mainly Western in outlook and investment could well slip down the rankings.

[27] A complete list of the top 10 major M&A advisers by volume would also include two of the Big Four global accountants – KPMG and PwC - however, as they are not banks, they have been omitted from this list. It is also worth noting that the value of their deals are far less than the major banks. For example, a decade's worth of M&A deal advisory roles for PwC totalled $500bn, compared to Goldman Sachs' $6,343bn for the same period – or around 8% of what Wall Street's top bank handled.

[28] Data provided by Merger Market.

Rank by Value	Law Firm	Global Value US$m (2001 - Jun 2011)	Share of M&A Value, Globally %	Deals (2001 - Jun 2011)
1	Sullivan & Cromwell (US)	$4,472,591	4.12%	1,336
2	Skadden Arps Slate Meagher & Flom (US)	$4,021,162	3.71%	2,016
3	Linklaters (UK)	$3,706,823	3.42%	2,897
4	Freshfields (UK)	$3,390,057	3.13%	2,624
5	Clifford Chance (UK)	$3,081,212	2.84%	2,838
6	Simpson Thacher & Bartlett (US)	$2,928,862	2.70%	1,057
7	Cleary Gottlieb Steen & Hamilton (US)	$2,828,251	2.61%	1,386
8	Allen & Overy (UK)	$2,471,703	2.28%	2,409
9	Shearman & Sterling (US)	$2,401,687	2.21%	1,333
10	Latham & Watkins (US)	$2,374,061	2.19%	2,393

Table 4: Top 10 Global M&A Legal Advisers[29], Jan 2001 to June 2011. Merger Market.

Meanwhile, Chinese and Latin American investment banks such as China International Capital Corporation (CICC)[30] or Banco Itau, (see table 5) will also grow rapidly over the next ten years. The growth of non-US and non-European banks will be important for law firms, especially when advising on South to South, or Asia to South deals that do not need to involve either European or US financial institutions. Law firms will have to learn to work with a wider set of investment banks as a result.

The dominant US investment banks are not about to go into rapid decline, but, as noted, they are increasingly part of a far wider financial market that no longer sees New York as the de facto centre – even if for the last 60 years this has been the case.

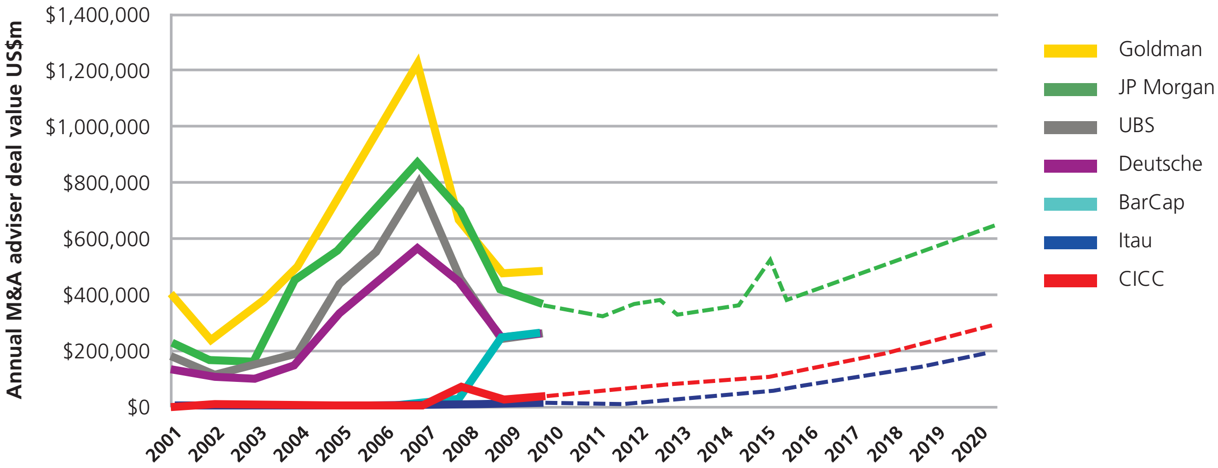


Table 5: M&A Deal Value by Bank to 2010, Jomati estimates for JP Morgan, Itau and CICC to 2020 (dotted lines). Merger Market Data.

29 In many cases multiple law firms will have advised on the same deals. This underlines just how unconsolidated the legal market is still. While expecting firms to have far more than 5% market share may be unrealistic for now, given that a number of top 10 M&A firms only have around 2% to 3% share, there is clearly room for growth globally, perhaps by merging with smaller firms, or consolidation among the top firms.

30 CICC – one of China's top investment banks - may seem wholly Chinese, however, America's Morgan Stanley is a founding shareholder along with the Government of Singapore Investment Corporation (GIC). Morgan Stanley sold its stake in 2010 to investors including Kohlberg Kravis & Roberts.

If other nations' banks wish to beat the top US investment banks – an event that in turn would reshape the map of legal advisory services – they will need to confront the following factors:

- The US is the world's largest economy – for now - and its companies are among the most active and expansive in the world – again, for now. Although China is catching up rapidly.
- The US Government and corporate sectors are the largest issuers of debt in the world and need their investment banks to advise, underwrite and book run. The global value of bonds outstanding at the end of 2010 totalled $95 trillion. Currently the US, whether Government or corporates, issued around 25% of world debt by value[31] and US investment banks see a large slice of this work. Again, this may not last forever given the nation's troubled fiscal situation.
- The market cap of the US stock markets dwarfs anything else in the world – within which its top banks are constantly trading and advising clients. Although the movement of many companies to list in Hong Kong and the continued impact of Sarbanes-Oxley have dampened US-based equity listing activity[32].
- The US has more Global 500 companies than any other country: 133. Again, for now. These are among the largest companies in size, most international and have the most complex corporate and finance needs – playing directly to the strengths of the nation's top investment banks. In comparison, the UK has 30, but China already has 61 and the number is steadily building.
- The law in many US States, as well as the business culture generally, facilitates takeovers and mergers. With the strong pressure from short-term shareholder interests to continually increase value, America sees a high volume of quality corporate activity – again demanding the advice, and supporting deal finance, of the top investment banks.
- These banks are very large and in more normal market conditions have sufficient capital to underwrite far larger debt or equity issues than many other banks around the world could. Even increased capital buffers won't alter this dramatically.
- The current – but now threatened - ability to funnel high levels of cash into proprietary arms, in some cases funded by huge US retail banking arms that tap the higher levels of GDP per capita wealth in the US than in most other countries, also gives them an edge. In some cases these trading activities take the form of 'own brand' private equity and hedge funds. Trading generates huge profits, which in turn further strengthens the banks' position. However, the Volcker Rule (see above), could end this strategic benefit.

Although the US economy is currently over-burdened with debt, as too is its Government, the fundamental benefits of being an American investment bank on the world stage have been apparent for decades. China's position will very likely improve with time and one day challenge that of America – but we are not there yet. Economic might is not everything in determining banking success: business insight; quality research and analysis; and innovation are critical too. US banks lead in the creation of new financial products, and others follow in their wake. Some of these innovations, such as the securitisation of credit card payments or the development of credit default swaps have been successful, others, such as securitizing NINJA loans have been terrible failures. Nonetheless, they have led the way.

The question now, as America's financial might as a nation begins to look relatively less mighty compared to the combined power of the BRICs, is will the US investment banks be able to keep innovating and keep leading? It seems likely, at least for the medium term. But can banks in Shanghai, Hong Kong and elsewhere catch up? Surely they can. And if and when they do, major corporates may go to them for advice and underwriting instead. Finally, if that did happen, major law firms would have to reassess which banks they most needed to develop as clients. We are not saying this will happen overnight, especially after noting the points above – but given how the world is evolving, it would be naïve to assume US banking hegemony will last forever.

[31] TheCityUK, July 2011. Although the UK remains by far the largest centre for secondary bond trading, handling around 70% of the annual market by value.

[32] See Chapter Three for more analysis of the rapid evolution of the world's largest exchanges.

Impact on Law Firms

- **Corporate and Commercial Work Faces Continued Drag in West** – Limitations on lending and lack of enthusiasm for investment in lower growth markets by banks will continue to slow all elements of corporate work. As recent data shows, M&A volumes in the UK and US in H1 2011 are now the same as in the depths of 2009. This will improve over the medium term – but only slowly[33].
- **Regulatory and Tax Arbitrage** – as banks consider the implications of different tax and regulatory regimes law firms may see demand for advice on how best to structure and locate international operations.
- **Possible need to Reposition Lawyers** – as noted above, the continued flatness of commercial activity in the US and EU, may mean greater numbers of lawyers could be re-located to Asia, where there is still significant growth. Although, such commitment to Asia will not be risk-free in the medium to long term.
- **Continued Weakness in Property in the West** – Law firms have already slashed their staffing commitment to this practice area – however, firms specialising in serving property sector clients may have to accept they now need to diversify and invest heavily in new practice areas/markets, rather than just cut costs and wait for a new property boom that may simply not come – at least not in the West.
- **Short term Boost for Regulatory Work** – With so many regulatory changes planned or proposed it is natural that firms with top-tier banking regulatory practices will prosper – however, no major law firm would choose more regulatory advice over a greater deal flow. While regulatory work relies on the time of a few partners, deals absorb leverage. It is clear which is more profitable. Also, this regulatory glut will not last long. In two to three years the key elements will be in place. Banking clients will then see compliance as a hygiene issue, not a matter of bespoke advisory work.
- **Wider Range of Investment Banks** – The dominance of the leading US investment banks is not in doubt over the medium term. However, in markets where investment banking fee expectations are lower, and local cultural links are vital, such as in South America, Hong Kong or China, law firms will have to expend greater efforts to build links with indigenous banks. For some law firms this will be wholly unknown territory and a serious challenge to business development. Yet, as globalisation continues and developing markets mature, the need to focus here will grow.
- **Future Consolidation of Global Banking** – It is possible that if and when sufficient global competition emerges over the next ten years to take market share away from the top US and European banks, those banks will launch take-overs – subject to regulatory approval – of the challenger banks, generating enormous banking mergers and increased global opportunities for advisory work to the combined entity.
- **Consolidation of Global Legal Market to Follow Future Bank Consolidation** – Another long term outcome of international banking mergers may be that if such powerful global clients extend their influence globally, the rationale for major UK-US mergers of top law firms will increase, uniting UK firms' traditionally far larger global spread of offices, with the US firms' home jurisdiction advantages.
- **Litigation Against Investment Banks** – Although the market has been waiting since the start of the Crisis for an uptick in litigation against investment banks over the sale of derivatives of sub-prime mortgages, it is only now starting in earnest. One landmark case – and one which will determine enthusiasm for future cases – is that of AIG's $10.5bn claim[34] against Bank of America (BoA) over the sale of mortgage backed securities to the insurer. AIG has stated: "Investors, no matter how sophisticated, were entitled to rely on its [BoA] numerous written representations about the securities it sold... Bank of America must be held to account." This is high stakes work that will keep some of the best litigation lawyers fully occupied on what will be reputation shaping cases for the firms involved. If the case is successful there are potentially dozens of extremely large claims that could be levelled at a number of US investment banks that packaged and sold sub-prime derivatives[35].

[33] Legal Week, 7 July 2011.

[34] Financial Times, 8 August 2011.

[35] Although, as yet, these potential claims have focussed on civil claims, and we have not yet seen a series of criminal cases brought against the management of US investment banks as some observers had initially expected there would be over the sub-prime debacle. Despite this, some bankers have been consulting white collar defence lawyers.

Chapter Two: Funds

Private Equity: Frustrated Potential

The inevitable impact of banks withdrawing buy-out funding, the uncertainty over valuations of both targets and companies currently under management, as well as the failure of some fund-operated businesses, has led to a mix of challenges for private equity. An increasing regulatory burden will not help either – such as the EU's Alternative Investment Fund Manager Directive (AIFMD)[36] and the creation of the European Securities and Markets Authority. High profile legal battles[37] such as that between Terra Firma and Citigroup over the purchase of struggling media company EMI, have also not helped confidence and are perhaps indicative of where the industry stands after the Crisis: surprised at its own failings. Increased pressure on what are now considered 'excessive' management fees, adds another headache. And perhaps most challenging for fund managers, investors now want even better performance from their commitments than even during the 2007 peak. Today 63% of investors want returns of 4% or more above public markets[38], whereas in 2007 less than 20% of people had that expectation level. It seems inevitable the many smaller funds will disappear in the coming years, with the better managers jumping ship and the more sophisticated investors shifting their allegiances too, leading to consolidation.

Evidence of the problems the industry faces can be seen with the huge amounts of capital potentially available[39], but with so few opportunities the number of funds forming is currently declining (see table 6).

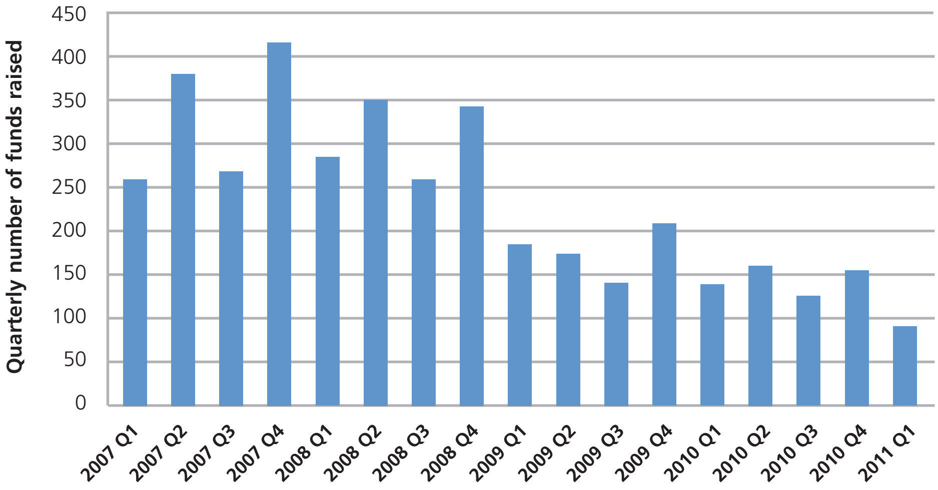


Table 6: The Peak and then Decline in Fund Formation, Q1 2007 to Q1 2011. Preqin Data.

Another problem for private equity is its previous stellar success during the 2000s boom. In a rapidly growing economy, with huge quantities of credit that multiplied the gearing effect of buy-outs and rising stock markets that allowed companies to be over-valued on exit, the industry did extremely well. In many cases, US- and UK-based fund managers found numerous, quality opportunities at home. They, and importantly their lawyers, did not often have to consider the issues surrounding new and unknown emerging markets to find targets with growth potential. Neither did these

[36] To be transposed into law in 2013, it will regulate funds and managers operating in UK and Europe. It will cover conduct of business, conflicts of interest, risk management, liquidity, valuation and transparency requirements, as well as remuneration of managers. The directive will also apply to hedge funds, see below.

[37] Legal battle commenced late 2010, amid allegations Terra Firma was misled. The fund lost its case.

[38] Preqin and Life Insurance International, 13 January 2011.

[39] The huge volumes of capital generated by the pensions industry and insurance sector, as well as banks, sovereign States, Trusts and High Net Worth Individuals (HNWIs) must have an investment outlet. Rapidly increasing inflation puts ever greater pressure on these holders of un-invested capital to gain higher than the generally lower public market returns, and private equity funds remain a trusted route – even if right now it cannot deliver on expectations, sending investment in other directions.

funds have to focus on less traditional areas such as infrastructure – an increasingly active area for funds as more mainstream corporate buy-outs cease to be attractive under current conditions. For example, in early 2011 there were at least 500 funds investing into infrastructure projects[40].

At present the US, UK and wider European markets remain fundamental to private equity for the simple reason that is where many of the world's best companies are based and the population of companies is broad and varied. However, Asia can only become more important for private equity. There are three key reasons for this:

- Increasing maturity of companies offers less risky investment opportunities.
- Macro-economic and equity investment growth in the region provides a solid basis for exit with substantial profit, and increasing numbers of local or foreign buyers in a trade sale.
- Hong Kong and mainland PRC exchanges provide a buoyant equity market for public exit strategies.

For example, at the end of 2010, Kohlberg Kravis & Roberts announced half of its new investments in 2011 would be in Asia[41]. According to Dealogic, last year around 40 bought-out Chinese companies were listed by funds on either Hong Kong or a mainland exchange. This is especially noteworthy as a number of planned private equity public exits were pulled from the NYSE in 2010 and 2011 after fears of a poor take-up.

Although key equity indexes such as the Dow Jones Industrial Average recovered well at first from the extreme decline of 2008, they have now entered a period of extreme turbulence again. The Dow Jones had fallen from around 12,600 points on 5 July to around 11,400 by the 5 August, 2011. That is a fall of 9.5% over one month, at a time many were expecting to see equity markets climbing again. At time of going to press [24 August] the Dow Jones was at 11,176. The index reached its all time high on 9 October 2007, just as the credit crunch began, with 14,164 points.

Meanwhile, the FTSE 100[42] had risen to over 6000 points in early July 2011 – 50% up on the dark days of the Crisis in 2008/2009 – and seemed to be healthy again. But, by August 5th, had fallen back to around 5,250 points – a 12.5% fall over one month and raising fears of a new financial crisis. At time of going to press [24 August] the FTSE 100 was 5,128. The FTSE reached its all time high almost 12 years ago on New Year's Eve 1999, with 6,930 points. These market movements over the summer of 2011 underline the inherent fragility of the Western financial sector – with investor fear due to bank exposure to Sovereign debt and low growth forecasts for corporates.

Understandably, the West is still not seeing the appetite for public sell-offs it once had. The exceptions to this trend have been big brand internet companies such as LinkedIn and soon to be listed, Groupon. In the short term there may be the promised IPO of Facebook too, which back in April 2006, was helped on its way by just $25m[43] of funding from venture capital investors such as Greylock Partners, Meritech and Accel Partners. Yet, these cases do seem like exceptions to the rule.

It therefore seems that law firms developing a private equity capability may need to look seriously at Asia. However, the results are not all one way there either. One expert explained that although developing market fund managers are keen to talk-up the potential of investing in markets such as China, local conditions have to be taken into account. Investors outside of the industry can often forget private equity is not just investing in companies, but working together with distinctively different management teams, grounded in sometimes quite alien cultural and regulatory backgrounds.

40 Preqin, July 2011.
41 FT 16 December 2010.
42 FTSE data.
43 SiliconBear.com, 18 April 2006. 'Facebook raises $25 million; says never intended to sell.' This is in contrast to the $450m investment, five years later, by Goldman Sachs in Facebook in January 2011, amid plans for a private placement share sale to the investment bank's favoured customers.

As the expert says: "There is potential in emerging and developing markets. But, when you dig deeper you see a mixed picture. You can't always just fly people into these companies. Local regulation in Asia, especially China, is also a problem." He concludes: "Investing in growth markets is a lot harder than many in the private equity industry assumed."

But, what of the future? As noted, the short to medium term picture for funds in the West is not likely to improve dramatically. Asia and other growth markets have significant opportunities. In Asia we will also see generational change in companies offering buy-out opportunities. Many of the developing world's up-and-coming companies are still first generation. These may well seek external investment to take them to the next stage and may also want new management.

Private equity to 2020 is therefore a mixed picture. But, this does not mean it is in decline, just that total growth rates will be slower than in the last decade. As seen in table 7, the total value of managed investments will continue to mount. But we are unlikely to see the doubling of dry powder and invested capital levels the market witnessed from 2000 to 2007, which saw assets under management trebling to $2.5 trillion – significantly more than the GDP of the United Kingdom.

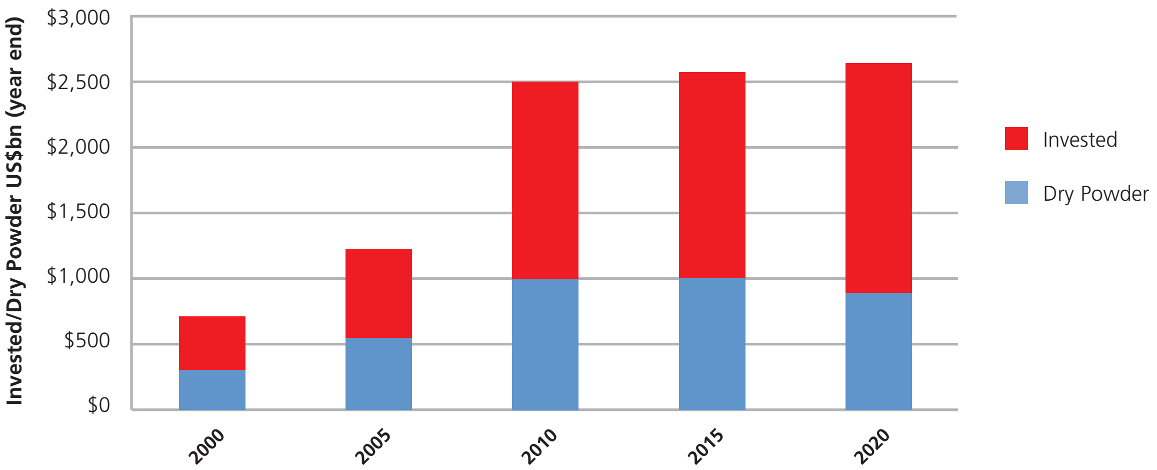


Table 7: Private Equity assets under management, invested and dry powder. Dow Jones data to 2010, plus 2015 and 2020 Jomati projections.

What we may see – as shown in our projections – is a slowing in the growth of funds to 2015, with a small but healthier rise to 2020, in part due to the increasing capital reserves that will have built up around the global economy by then, and will need to be invested.

There may be fewer mega-deals in the short to medium term as banks continue to stand back from offering huge leverage. Instead we may see smaller, less risky deals. Today only around 6% of buy-out deals are over $1bn. The remaining 94% of deals are far smaller. In 2011 the aggregate total Quarterly value of deals has been around $45bn, whereas in 2006 the average total Quarterly value was closer to $200bn – or four times higher. In the peak of 2007, the Quarterly value was around $250bn. We can therefore expect: less fund creation, smaller deals, plus the need to look further afield into less well understood new markets, and beyond the core pattern of corporate buy-outs. Law firms may feel despondent about this, however, this also means larger funds need more high level help than ever before. Those law firms able to provide this – especially internationally – will be a great asset to private equity houses.

Sovereign Wealth Funds: Giant Clients

Sovereign Wealth Funds (SWFs) are set to become more important to law firms. Today there are over 20 SWFs with assets between $30bn and $600bn, with dozens of smaller funds spread around the world. Currently, it is estimated the total assets of the top 50 SWFs are approximately just over $4 trillion – significantly more than the total invested in private equity funds today. They have been in existence for over half a century. Among the first were the Kuwait Investment Authority, set up in 1953 to pool and invest State oil revenues; along with the less expected, Kiribati Revenue Equalisation Fund; created in 1956 by British colonial advisers to manage the Micronesian state's phosphate revenues.

As the demand for fuel, minerals and other raw materials increases – along with global trade – the revenues of some SWFs will greatly increase over the next 10 years.

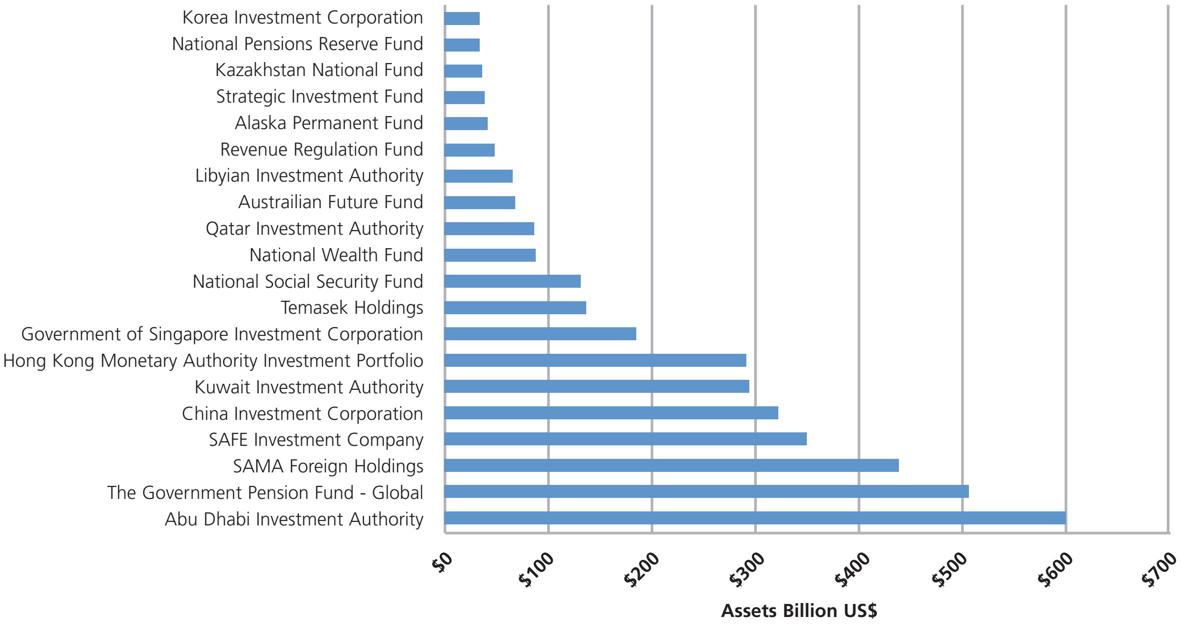


Table 8: Top 20 SWFs as of 2010[44]. (SWFs tend not to be transparent, therefore data is estimated in some cases.)

On face value this seems a very exciting area for law firms to 2020. However, SWFs' appetite for risk is low – although this is changing. For many, activity has been conservative, buying bonds, or going long on marquee name equities. Some have strayed into property purchases, but again, these seem to be long-term investments, with no growth strategy behind them other than to hold a 'safe asset'. More positively, funds are increasingly well run, such as Norway's Government Pension Fund, which draws on revenues of now dwindling North Sea Oil. The China Investment Corporation (CIC) could almost be classed as an investment bank, considering its level of sophistication. It showed this by its $3bn investment into Blackstone private equity house and $5bn stake in Morgan Stanley in 2007.

[44] Data: www.sovereignwealthfundsnews.com/ranking.php. See Appendix C.

In 2010 the top 10 SWF corporate investments totalled $30.3bn[45]. Some might say this is hardly market-shaping, especially for funds with so much capital. Yet, deals such as Qatar Investment Authority's $6bn investment in the Agricultural Bank of China in July last year shows the future direction. The CIC $1.6bn investment in US-based energy company, AES Corporation[46], last year may also be a shrewd move. As can be seen the largest deals are multi-jurisdictional, linking the Middle East to Asia and Asia to America. Such work clearly plays into the hands of those law firms with a global capability. Overall, SWFs are learning and becoming more ambitious and this can only be positive news for legal advisers.

One major challenge is how can law firms get to know these clients? They are State-owned companies, but often in States that are not transparent. Some funds are directed by members of a country's Executive, or others a member of a Royal Family – rather than a truly independent body. Yet, some US and UK law firms have managed to build strong links with these funds, boosting deal flow at a difficult time for all advisers.

Another pertinent factor will be where the leading SWFs of the future will come from. As table 9 shows, one possibility is that as demographic and economic growth of the world's developing nations continues, demand for energy resources and minerals, will push up prices further, making many Middle Eastern and African SWFs extremely cash-rich. Although Asian funds will keep on growing over the next 10 years, they may find themselves outpaced by what are likely to be extremely elevated profits from hydro-carbons and Africa's huge mineral wealth.

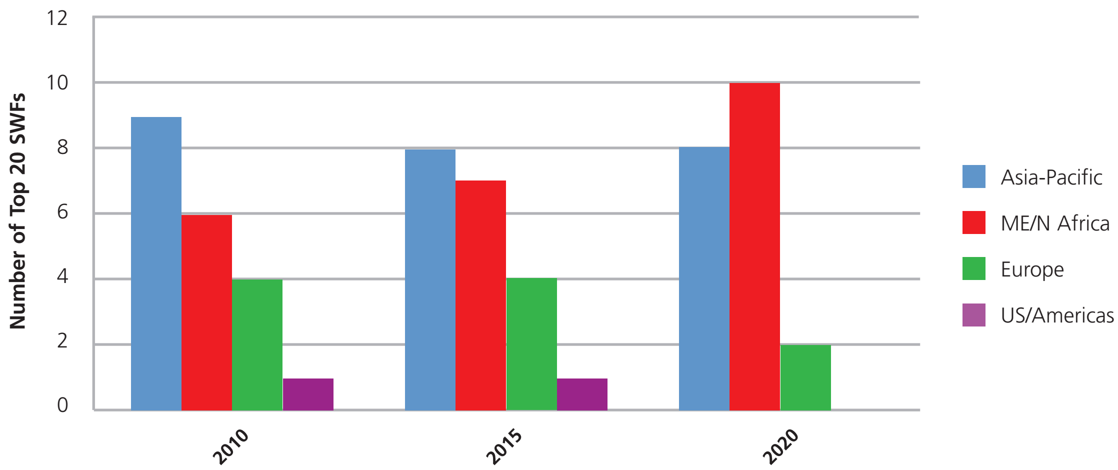


Table 9: Number of SWFs by region, plus 2015 and 2020 Jomati estimates.

This possible rise in the number of SWFs in Africa may raise challenges for some law firms. While a number of law firms have built up offices in Saudi Arabia, Abu Dhabi and Dubai, and most recently in Morocco[47] in order to cover North Africa, the coverage of Africa as a whole often relies on alliances and associations with local firms. Although, Norton Rose has recently merged with South Africa's Deneys Reitz.

[45] www.swfinstitute.org/statistics-research/top10swftd/
[46] Forbes, 23 May 2011, AES Corporation is the largest power company in America with revenues of $17.1bn and has a Fortune 500 Rank of 150.
[47] Three UK law firms are opening in Casablanca in 2011: Allen & Overy, Clifford Chance and Norton Rose.

Hedge Funds: Unusual Business

Although the bête noire of post-Crisis regulators, whether European[48] or American[49], in particular in relation to the need for oversight of fund managers and increased transparency – the fundamental demand for nimble funds headed by experts, operating outside the huge investment banks[50] remains strong. As long as there is sufficient talent willing to operate in small, higher risk units and sufficient investors who trust them, hedge funds, despite current challenges, will continue to develop to 2020.

The threatened 'exodus' of hedge funds from London over higher rates of tax, or from the US over regulation, does not seem to have materialised. The largest are certainly staying in the traditional homes of 'hedgies': New York, Boston and London. As table 10 shows, of the world's top 20 hedge funds, 16 are in the US and 4 in the UK.

Name of Hedge Fund	Base	AUM US$ Bn
Bridgewater Associates	US	60
JPMorgan Asset Management	US	41.1
Man Group	UK	39.5
Brevan Howard Asset Management	UK	32
Paulson & Co.	US	32
Highbridge Capital Management	US	27
Soros Fund Management	US	27
Och-Ziff Capital Management	US	26.3
BlueCrest Capital Management	UK	24.6
Cerberus Capital Management	US	24
Angelo Gordon & Co.	US	23
Baupost Group	US	23
BlackRock Advisors	US	22.8
Farallon Capital Management	US	20
King Street Capital Management	US	20
Goldman Sachs Asset Management	US	19.1
Canyon Partners	US	19
Elliott Management	US	16.8
Lansdowne Partners	UK	16
Moore Capital Management	US	15
Total:		**$528.2bn**

Table 10: Top 20 Hedge Funds by Assets Under Management (AUM), and location. Bloomberg February 2011. Total AUM for top 20 funds is $528 billion.

One reason why hedge funds developed in these centres and so many of the more established ones will stay there is the talent that leads these funds came from the great 'schools' of the US investment banks in these centres. But, it is not a Western monopoly. More hedge funds will develop in Asia and other regions. Although, US investment banks are also growing and producing talent in Asia too.

48 The EU's Alternative Investment Fund Managers Directive has greatly exercised hedge funds. The directive seeks to reduce leverage while enforcing transparency and registration requirements.

49 Hedge Funds Review, 23 June 2011, SEC will require US hedge fund managers with over $150 million in assets to register with the regulator by March 2012.

50 Although, two of the top 20 hedge funds are divisions of US investment banks.

Hedge funds' greatest future threat to 2020 is not greater regulation demanding more transparency, nor even the Galleon fund scandal[51] that has dented confidence in the industry in the US, but a proliferation of smaller, less experienced funds around the world diverting and diluting the capital available from the larger funds. Too many smaller funds are making too weak a return or even losses (see table 11), while a flood of new, inexperienced funds increases the possibilities of more scandals and bad management coming to light in the future. While some of the top US funds have assets in the tens of billions, among the now 1,300 'Asian-focussed' hedge funds[52] – 40% manage less than $20 million dollars each. Such small funds are very unlikely to seek the relatively costly advice of major global law firms.

Funds with positive ROR	30.16%
Average positive ROR	1.49%
Funds with negative ROR	69.84%
Average negative ROR	-2.09%
Average ROR	-1.01%

Table 11: Rate of Return reported in June 2011, from a sample of hedge funds, Barclays data.

The variance in performance among the 5,000 hedge funds operating[53] around the world is huge. According to Bloomberg's 'The World's Richest Hedge Funds' only 50 funds gave returns higher than 10% in 2010. Of these only the top 10 see the legendary returns of 30% to 40%. Such numbers are stunning – yet, the other 99% of hedge funds reporting their performance[54] in June 2011 do not do so well. Clearly not all hedge funds are equal in quality. During the boom of the mid 2000s huge returns were perhaps not always the result of major business insights, but rather investing heavily in obvious growth using very high levels of cheap and available debt leverage. The next decade will see far more complex and challenging conditions, in which far fewer hedge funds will be able to make massive returns.

For law firms the hedge fund industry is therefore a complex and diverse client base. A fund that does well one year, may fail badly the next. Smaller, up-and-coming funds of which there are now literally thousands, may have little desire to use major commercial firms whether for fund formation, tax, regulatory or general advisory needs. Secondly, will many of these potential clients even be around in a couple of years' time given how small and erratic many are? Although, one source of work this disorganised expansion of the hedge fund industry in Asia might produce is litigation, when promises of huge returns to inexperienced investors end as large losses, especially if we see an Asian crash in the next few years.

Retail Funds

Although not as exciting an area for major commercial law firms as private equity, the retail funds market is huge and massively important to all major financial markets. Given the generally rising levels of wealth and economic development around the world, the reduction in public sector jobs and public pensions in the West the need for privately funded retail funds is growing.

51 BBC 12 May 2011, 'US hedge fund billionaire Raj Rajaratnam has been found guilty (in New York) of making tens of millions of dollars from insider trading. The unanimous verdict, which he plans to appeal, ends the largest hedge fund insider trading case in history.... For day after day the court listened in on Rajaratnam, (via wiretap evidence) getting illicit tips and boasting of having 'his' people on the board of companies.'
52 The Hedge Fund Journal, April 2011.
53 Barclays Hedge Fund Database, July 2011.
54 Ibid.

Tens of millions of Chinese, and millions more in other developing nations, are now reaching an income level where they will want to invest in private pension plans and other investment funds in order to gain a better return from any remaining income. From Argentina to Nigeria to India a new global middle class is emerging[55] – which in total numbers will eventually dwarf the middle class of the West. We are therefore likely to see many more pensions and mutual funds evolving around the developing world. Some no doubt will be backed by Western institutions, but many will be entirely home-grown, and create a whole new strata of funds clients for law firms, stretching from South America to South East Asia.

Meanwhile, in more mature markets we may not see many more new institutions created to manage retail funds, but rather a greater overall level of capital invested. In the UK, for example, the retail fund market is extremely mature, yet it will grow in terms of total capital invested to 2020, but not as fast as it did from 2001 to 2010, (see table 12).

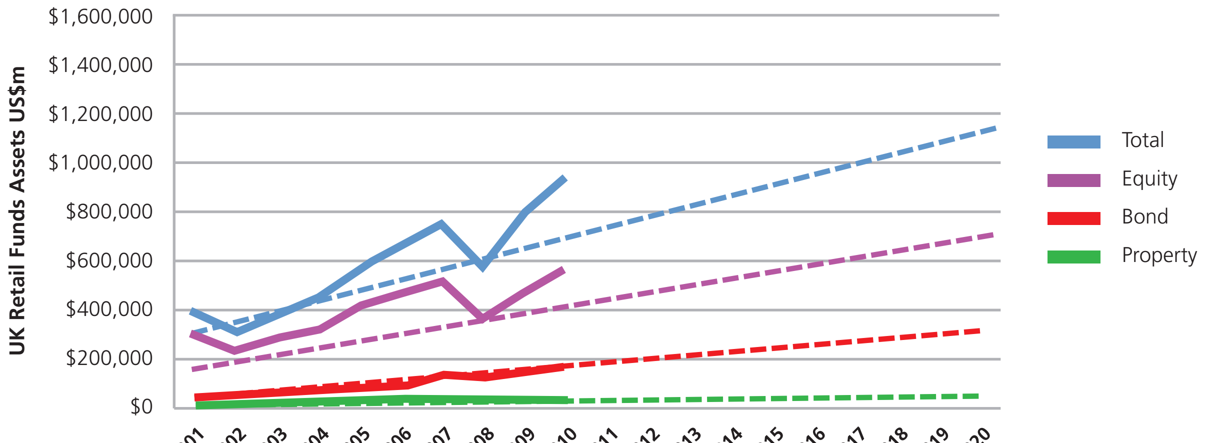


Table 12: Growth of UK retail funds. Data: Investment Management Association. 2011 to 2020, Jomati estimates.

The 2000s boom in the UK, and wider Western economy, saw retail fund totals more than double from 2001 to 2010, to $925 billion, but we estimate that this growth will slow considerably over the next ten years. One key reason is the Baby Boomer generation are now retiring, and will do so over the next decade. Baby Boomers are far larger as a population cohort than the one in its 30s and 40s that are still paying – or should be paying - into pension funds. This large number of retiring people will now be withdrawing money from pension funds. Meanwhile those in younger generations face the challenge of diverting money into pension or other funds in a time of high inflation, especially for food and energy, frozen salaries, higher unemployment, as well as the need to save a far larger proportion of one's salary to build a deposit to buy a house and the need to pay off what will be increasingly larger student loans, at least for people in the UK. There will therefore be far less disposable income directed into retail funds. In some cases, a relatively poorer younger generation may mean Baby Boomers seeking to withdraw higher levels of capital out of funds in order to support their children.

[55] For more information on the 'global middle class' please see Part 1 of the 'New Frontiers' Jomati reports.

Funds will also be under increasing pressure to reduce their fees and be more transparent on fees. This may result in mergers and general consolidation in this sector in order to reduce the impact of lower fees by increasing total volume. Increased volume rather than creating more new funds also seems to be a pattern we may see in the US. The strategy of America's BlackRock is perhaps indicative of the future direction of retail funds in the West. This large institution announced in April 2011 that it would be heavily expanding its mutual funds offering, with a plan to double its $300bn American retail-side funds business by 2014. However, BlackRock is understood to not want to create new funds, but rather place its increased investment into marketing the funds it already has in order to attract a greater volume of business. Given that much of the most interesting work for retail funds lawyers is around fund creation, such as in relation to tax, this trend in the West may not be especially good news.

One other interesting development we may see is large funds, such as pension funds, in developed but relatively smaller economies such as Canada, investing more money abroad. This is not always because other economies are growing faster, but rather these funds have invested as much as they wish to in their own market and are now broadening the geography of their portfolio. Canadian pension funds for example have been investing in infrastructure projects and property abroad, including the UK.

Law Firm Impact

- **Funds Invest Where There is Growth** – Economic growth cannot be ignored, even if trusting in developing markets may be more risky and not always suited to all funds, such as retail funds. This indicates that UK and US law firms will increasingly feel pressure to offer funds advice, whether formation, tax or regulatory in developing markets, from Africa to Asia, as Western fund managers drive East and South in search of returns.
- **More Indigenous Funds** – At the same time more 'indigenous' funds will be set up in centres such as Singapore and Hong Kong, and also in developing, smaller regional financial centres such as Lagos or Casablanca. Funds in smaller centres may feel too obscure for major law firms to consider – but, in time they will grow – perhaps being taken over by US or UK funds. First mover advantage is always important, especially when it comes to building relationships with local regulators and major local investors and a number of global firms are embracing this tactic.
- **Need to Expand Beyond Domestic Investments** – This is already being seen with Canadian pension funds. This is because they have 'out-grown' the investment opportunities of their own domestic market. Law firms may need to increase their business development efforts in similar markets, such as Australia, to tap this work flow.
- **Making Regulatory Work a Business Developer** – There will be plenty of funds regulatory work for law firms with Dodd-Frank and EU regulation such as the Alternative Investment Fund Manager Directive (AIFMD). However, funds will be well aware of these changes, therefore deluging clients with the same fact-sheets on Government proposals everyone else is sending may not be sufficient to develop business. The challenges will be to differentiate your firm's offering at a time of universal need.
- **The Value in Frontier Experience** – While literally dozens of law firms in the US and UK will be attempting to advise on the issues funds face domestically, far fewer will be able to help with any credibility in the many new markets where the larger funds are investing. This appears to be another driver in favour of building teams in developing markets. For example, the opening of offices in Casablanca by Allen & Overy, Clifford Chance and Norton Rose this year, is a case in point.
- **Hedge Funds Attract More Litigation** – The Galleon scandal (see above) is unlikely to be a one off event. As regulation increases and funds grow ever more international, statutes such as the US Foreign Corrupt Practices Act and the UK's new Bribery Act may become ever more important too. The large number of smaller funds starting up in Asia may well trigger more litigation as inexperienced managers and investors, investing in a less than transparent market, e.g. China, create dispute resolution work.

Chapter Three: Securities

While hundreds of billions of dollars are traded every day in securities[56], whether equities, debt or derivatives, and those totals will increase with global development, this will not by itself produce a major increase in work for law firms. The Dodd-Frank Act and other regulatory developments may also provide work for securities lawyers working on compliance matters, but again this is not going to profoundly boost firm profits to 2020. In the US, securities litigation will also continue to be a steady source of work too, however, aside from some major derivatives-related cases against investment banks (see Chapter One) it will likely remain at current levels given many companies' increasing desire to settle.

Yet, the securities sector may well provide increasing levels of significant work for some international firms. This will be due to: a long term increase of IPOs around the world, but perhaps not in the US and UK, and the growing pressure for exchanges to merge.

New Areas of Growth: Asia's Hunger for Capital

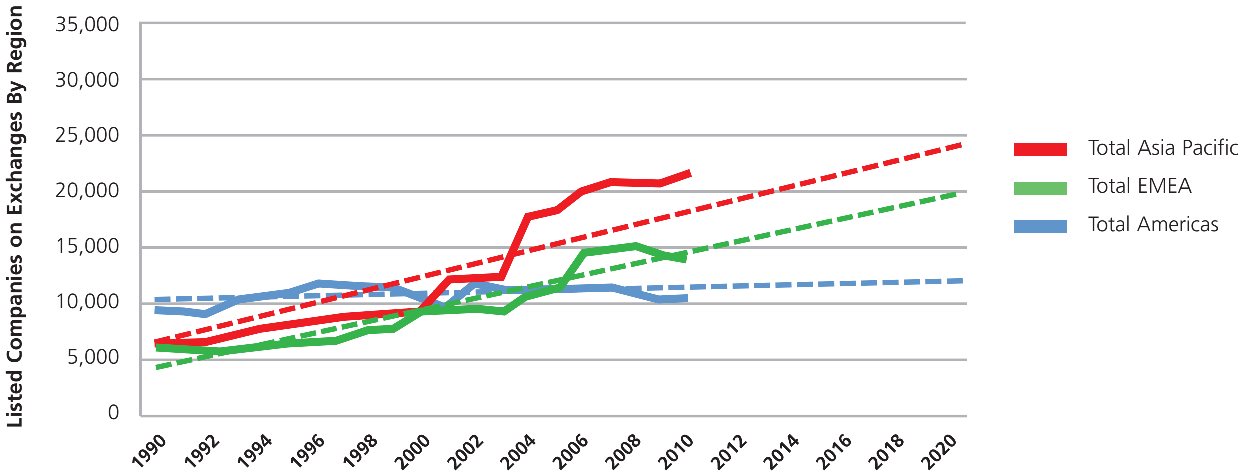


Table 13: Number of listed companies by three main regions. Dotted lines represent long term trends to 2020 based on 20 years of listing data from 1990 to 2010. World Federation of Exchanges (WFE) data.

As can be seen in table 13, the number of listed companies has grown rapidly in Asia – despite starting with around the same level as the EMEA region. For example, Hong Kong has seen the number of companies listed rise from 300 in 1990, to 1400 in 2010 – an increase of nearly five times. With that has come an increase in securities related work – even if fees for landmark IPOs in Asia are generally lower than in the US. In the EMEA region, listings have risen healthily too, in part due to former-Communist countries in Eastern Europe privatising and fast developing countries in the region producing dozens of new companies. Another important EMEA nation, Turkey, has seen its Istanbul exchange grow from 110 listed companies in 1990 to 340 in 2010.

56 The total Over the Counter (OTC) value of derivatives in the global market at the end of December 2010 was $601 trillion. The global bond market's global value was around $80 trillion at the time of the Crisis – but is rising rapidly due to Sovereign issues, and the global equity market was around $40 trillion. By way of comparison the global economy's annual GDP totalled around $62 trillion in US dollars in 2010, i.e. derivatives total ten times the world's economic output. Also, if one were to add foreign exchange trades to daily market activity, you would need to add around $3 trillion a day to any total for trading values. (Bank of International Settlements.) Yet, as discussed above, relatively little of this gargantuan flow of capital creates interesting legal work. This is no doubt welcomed by the world's brokers who are ever aware of their margins.

In the Americas there has been far less growth, with an only slightly better than flat forward trajectory for total listings in North and South America over the next ten years. But, it should be noted that, 'Americas' includes many less stable exchanges such as Argentina's Buenos Aires exchange, which has actually seen a decline in the number of listed companies – down to around 110, from a peak of 180 back in 1990.

Yet, even the great North American exchanges, the NASDAQ and NYSE, have not fared as well as some might expect given their huge market capitalization (or cap). For example, the NYSE has a market cap of around $13.5 trillion – more than three times the next largest foreign bourse, that of Tokyo at $3.8 trillion. Yet, at the same time, the NYSE and NASDAQ have not seen a great number of companies flocking to list. See table 14, showing listings growth since 1990.

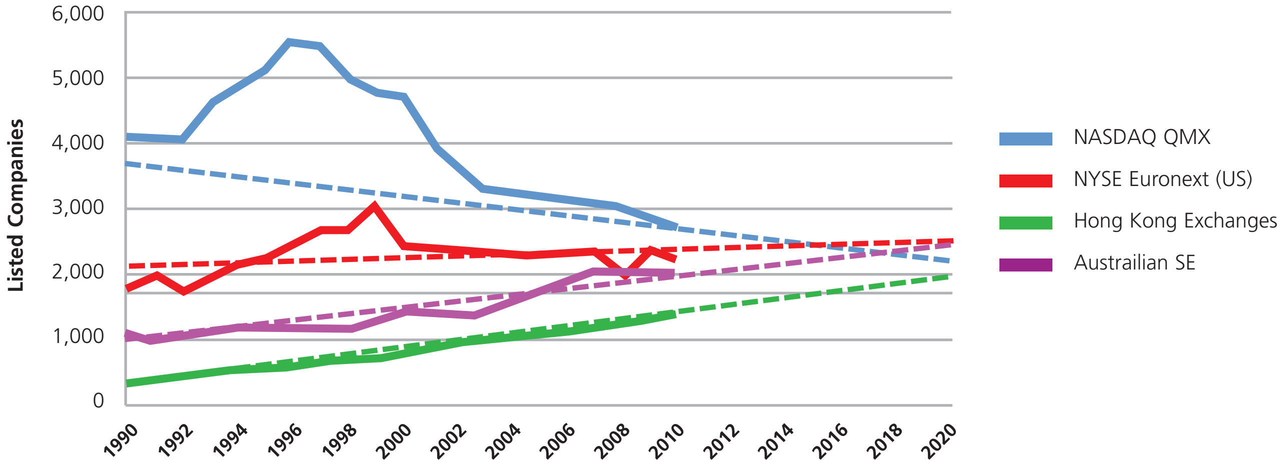


Table 14: Number of Listed Companies Showing Relative Position of US listings vs Asia-Pacific region. (WFE data). Jomati estimates to 2020.

While there has been a spurt of internet-related IPOs in the US in 2011, such as LinkedIn, the perhaps more important longer-term picture shows the direction of travel for IPOs around the globe. In Asia some of this will be because of non-Asian companies, such as Prada[57], listing in Hong Kong, in order to tap the desire of Chinese investors to buy into big name or luxury Western brands. However, it is the overall maturing of the Asian economies that could prove the more important macro-economic factor. As companies in China and South East Asia grow larger they will seek equity capital to expand still further. In some countries such as India, where there are over 5,000 listed companies on the Bombay Exchange, this has become an essential development for any large business. Although, some may argue this number is excessive, and perhaps needs to be pared down.

This shift toward Asia is of understandable concern to both US and UK law firms. Every month is now met with new announcements of Western law firms opening in Asia, or of firms strengthening their teams there by hiring in lateral talent. But, what is more complex is why the greatest securities exchange in the world ceased to be so attractive for new companies? Sarbanes-Oxley has been blamed for raising the costs and level of transparency demanded by listing companies. The threat of costly securities litigation has not helped either. Meanwhile, as can be seen (in table 14) the NASDAQ never really recovered from the dot.com collapse, perhaps sending out a message to global investors that just because a new American company is seeking equity capital it doesn't necessarily mean it will be a long term success

[57] Prada's Hong Kong listing did not meet expectations, $2.1bn, around 20% less than hoped. BBC 24 June 2011. It is understood that confusion over whether there may be tax liabilities in Italy for holding Prada shares deterred some local investors. This may seem like a set-back, however, by 2020 Western companies having a listing in Hong Kong, or other Asian exchange, may have become de rigueur, because this is where sustained appetite for new Western listings will remain.

or give a good return. Taking that argument further, one could postulate that market conditions in the US are so competitive that many institutional investors would rather trust their capital to established brands such as Nike or Microsoft, than something new. That then becomes a Catch-22 scenario for new US companies wanting to list in the US. Other reasons may be macro-economic, such as lower growth in the US undermining the desire to invest in US stocks over Asian-listed ones.

The London Stock Exchange, dominated by its main market and AIM, has fared slightly better than the US in terms of total listed companies, with around 3,000 companies listed at the end of 2010. However, this is still 100 less companies than were listed back in 2005. Although, securities regulation in the UK is lighter than in the US, and securities litigation far less aggressive, the costs of listing in London are still higher than in Asia. And, for some companies the level of transparency in the UK is still too high. The rest of Europe's markets are not seeing growing investor confidence either. As the Financial Times[58] powerfully pointed out: "Almost $10bn of IPOs were pulled in Europe in the first half of the year – the worst six-month period for scrapped IPOs since at least 2005." The financial paper adds that of those few IPOs that did go ahead half saw their share price go down rather than up.

This is more than just temporary headwinds. The Western exchanges, tied to low growth economics are at a different evolutionary point to the energetic markets of Asia and the BRICs. Traders and law firms alike cannot change this, and can only move with the times – and that means moving into the new geographies the smart money favours.

Mergers of Exchanges: Consolidation Now?

The World Federation of Exchanges has 68 member bourses, and there are many more that are not members. Some would argue that in an interconnected world with a truly global market, this number of exchanges is inefficient, costly to investors and badly serves public companies which might otherwise gain global access to liquidity.

The natural progression of the argument asks whether it would not be better for all shareholders, investors and exchange owners, if the world's largest exchanges combined, and that smaller, but strategically important exchanges like the TMX in Canada with a high number of energy and mineral companies, were also integrated into one of the larger 'international' exchanges? The logic behind such mergers is:

- Merging exchanges cuts costs as economies of scale help pay for the huge, and continual, IT investment needed to manage security, trading and settlement.
- Listed companies benefit from gaining access to investors in other countries, which boosts liquidity, increases the spread of prices for stocks, and is believed to produce a more efficient market.
- The merged exchanges benefit as they can offer institutional clients a wider range of products, such as derivatives based on securities listed across the merged exchanges.
- Merger permits elimination of shared costs, such as backroom staff, while extending the overall revenues of the exchange. Greater revenues also make the balance sheet cost of regulatory compliance relatively smaller.
- The cost of settling trades can be significantly reduced if all the trades are conducted on the same platform.

Indeed, in a world when the investor base in all securities has never been more diverse and international, parochial exchanges do seem a thing of the past, just as a large corporate that refused to consider foreign mergers from reputable, value-adding suitors would be seen as dangerously inward looking.

[58] FT 18 July 2011.

After many years of abortive talks between exchanges, it does now feel that momentum is gathering for a period of sustained consolidation over this decade. Among the few successful mergers of the last ten years was that of the NYSE's 2006 merger with Euronext and the NASDAQ with the Nordic OMX group, finalised in 2008. However, the next merger that may be far more important is that of Deutsche Bourse's bid for NYSE Euronext, which would create the largest combined exchange in the world.

However, exchange mergers have been dogged by challenges. The recent attempt by the London Stock Exchange (LSE) to bid for Canada's TMX exchange was ultimately abandoned due to protectionist objections by Canadian business leaders who put together a counter bid to out-price the LSE's efforts. Meanwhile, the Australian Government has recently vetoed[59] the merger with Singapore's SGX. Its argument is that 'Australia needs time to recover from the financial Crisis' was clearly a thin veil to hide a strong protectionist response.

The question whether commercial logic can outweigh local interests is finely balanced. However, if one looks at the way the share of listings will move in the next 10 years it seems unavoidable that Western exchanges will either merge to counter-balance the growth in Asia, or seek to tap Asian growth by merging with exchanges there.

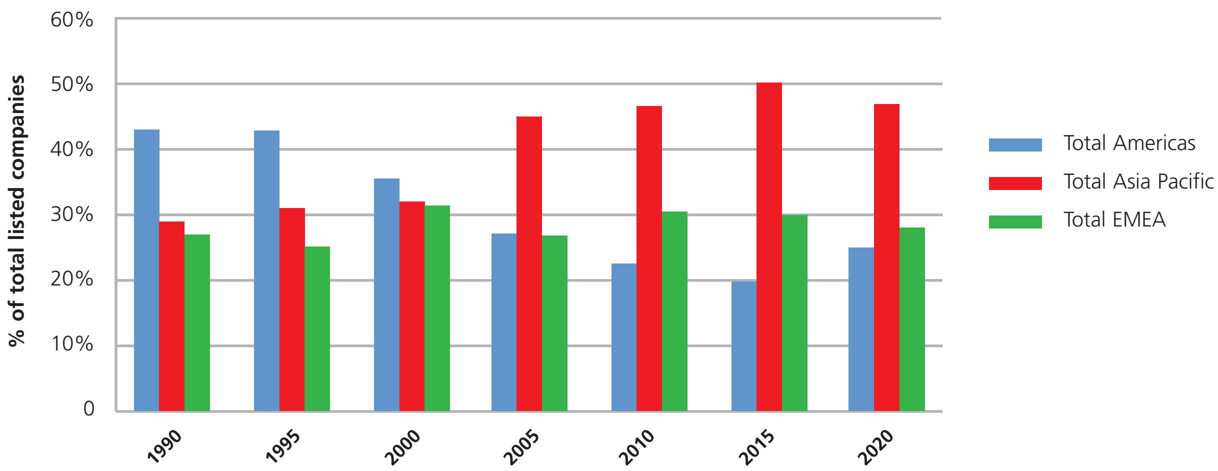


Table 15: Proportion of listed companies in the world, by exchange region among WFE members. WFE data to 2010, then Jomati projections to 2020.

This latter point is not impossible. Hong Kong has already suggested it is open for offers from abroad. As seen in table 15, Asia's share of world listings is already larger than the Americas or EMEA region and may keep growing to 2015. However, as South American economies mature, especially Brazil, we may also see a significant increase in listings there too by 2020. The US, UK and Western Europe is where many of the world's greatest banks and trading houses are based – Asia is where economic development is driving the demand for public listing. The coming together of Western and Eastern exchanges – and perhaps Southern ones too - only seems a matter of time.

[59] Asiaone.com, 11 April 2011, 'SGX chief disappointed at bourse merger veto.'

Law Firm Impact

- **Exchange Mergers** – these will be truly landmark deals for the firms that see their clients consummate a merger. They produce high level complex work that can only help to cement a firm's reputation as a major player in global financial markets. However, it may also require the firm to have a strong international capability[60] - especially on regulatory and competition matters, given the likelihood of protectionist objections.
- **Practice limits outside US and EU** – whether it be Singapore, China, India, Brazil or a range of other developing markets, local Bar rules limit or entirely prevent the offering of local legal advice by foreign firms, which will reduce the benefits of developing securities practices in some growth markets. Some firms, such as those with a licence to practise Singapore law, or that have local Hong Kong capability, may be able to gain far more work, including if and when exchanges in Asia merge. Such scenarios also underline the benefits of forming tie-ups with Chinese law firms – although they may require a novel structure to operate due to local Bar rules.
- **Regulatory Benefits** – As securities markets mature in developing nations so too will each nation's regulatory framework, handing opportunities to law firms. Local law firms will have obvious advantages, but international firms that offer a complete picture of global securities regulation may prove themselves to be more valuable – and credible – especially as investors in developing markets become increasingly international.
- **Cross-border Securities Litigation** – with more multiple listings, more exchange mergers and more companies listing in developing markets – but often with investors in the West participating - there is far greater scope for complex litigation. This will be especially complicated by the very different regulatory standards, on matters such as transparency and financial disclosure, that exist around the world.
- **Less Fees in Asia Drive US/UK Mergers** – One aspect of Asian securities work is that the level of fees for IPOs is generally lower than in the US and UK. Naturally, this erodes profitability and increases the need for firms operating there to increase market share. However, Hong Kong in particular is one of the most fiercely competitive legal markets in the world. This suggests that in order to build market share, and volume, in the increasingly important Asia-Pacific region US and UK law firms may need to merge to gain market share – rather than pitting themselves against each other. Merging with firms in Australia and other Asia-Pacific nations may also help build market share.

[60] Legal Week, 9 Feb 2011, Allen & Overy was advising TMX and Freshfields was advising the LSE on the aborted bid. Also, the NYSE on its planned merger with Deutsche Bourse has divided up advice around a number of jurisdictions, using, among others, Milbank Tweed Hadley & McCloy in Germany and Wachtell Lipton Rosen & Katz in the US. (Milbank Press Release, 16th February 2011.)

Chapter Four: New Forms of Finance

Sharia Finance: Special Interest

Not every law firm client in the world thinks about finance in the same way, especially if they are Muslim. Sharia law does not permit interest payments, nor investments in 'un-Islamic' businesses. To some firms this may appear as a niche market, which perhaps explains to some extent why some US law firms that could have built market share here have not. But, those firms dismissing Sharia finance may need to think again, especially if they genuinely seek to be a global law firm. It is important to appreciate not all Muslims who are also investors approach finance in the same way – no more than all investors who are also 'Christians' would think the same way either – but the growth of Islam and predominantly Islamic countries will have a growing impact on global finance. As can be seen in table 16A, the world is currently around 23% Muslim – which equates to around 1.54 billion people.

Region	% of Region Muslim
Asia-Pacific	24.1
Middle East-North Africa	91.2
Sub-Saharan Africa	30.1
Europe	5.2
Americas	0.5
World Total	22.9

Table 16A: Pew Institute data for total Muslim population by region.

By 2020 it is estimated Muslims will be 25% of a far larger global population. Notably, many of the key growth markets of the next ten years, which will have a growing middle class, have a predominately Muslim culture – North Africa, Turkey, Malaysia and Indonesia, not to mention the UAE and wider Gulf region (see table 16B).

Country	Estimated 2010 Muslim Population
Indonesia	204,847,000
India	177,286,000
Egypt	80,024,000
Nigeria	75,728,000
Turkey	74,660,000
Morocco	32,381,000
China	23,308,000
Malaysia	17,139,000
Russia	16,379,000
France	4,704,000
Germany	4,119,000
United Arab Emirates	3,577,000
United Kingdom	2,869,000
United States	2,595,000

Table 16B: Selection of Countries with a notable Muslim population. Pew Institute.

It is interesting to note China has a Muslim population more than six times larger than that of the UAE – although per capita income in the relatively small Emirates is far higher and use of Sharia-compliant financial products is very developed.

As Muslim investors increasingly participate in global financial markets, so too are markets developing new products. For example, India's Bombay Stock Exchange has launched[61] a share index for Sharia-compliant companies, in order to tap the investment potential of the country's 177 million Muslims. The Dow Jones has been operating its 'Islamic Market Titans 100 Index' for some years now. It also offers Islamic Market indexes in 69 countries, where each company has been screened to meet Sharia compliance. The NASDAQ also now offers a Sharia-compliant index.

In the UK, London firms have been quick to see the importance of the sector. London law firms have been part of pioneering work on innovative debt products, such as sukuk bonds, which have grown into a significant market. Clearly, not all commercial transactions with companies in these above countries will be Sharia-compliant. However, as global banks and businesses connect more with these markets the range of complex and high level work this sector touches will widen too, from sukuk sovereign bonds, to insurance, to advising multi-lateral development banks such as the Islamic Development Bank. There are also tax implications, with even France in 2009 revising rules that relate to Sharia-compliant products.

At present there are around $820bn in Sharia-compliant assets according to The Economist[62]. However, it is believed total potential future investments could be many trillions of dollars, especially as more Muslim investors and companies develop. The development of SWFs in Muslim countries will also play a part in boosting work flow in this area.

One other aspect worth considering is Turkey's possible future entry[63] into the EU. While many Turkish businesses and investors will integrate easily, some Turkish investors may also choose to pursue a Sharia-compliant strategy. Equally, the continued drive by emirates in the UAE, as well as Qatar, to become modern financial and trading centres not dependent on dwindling oil supplies will only drive the use and development of such products.

Micro-Finance: A Missed Opportunity?

According to the World Bank around 2.7 billion of the world's 6.9 billion people live on less than $2 day, i.e. 40% of all humanity. Understandably, many of these people are without a bank account[64] or relationship with any mainstream financial institution. The numbers who live above this level, but who are also without a bank account is unclear, but may be in the hundreds of millions. Sitting in the financial districts of London or New York it can seem a strange fact that perhaps a narrow majority of the world cannot gain credit except via the black market, meaning many cannot finance a business, home purchase, or purchase of plant or tools. Yet, at the same time many in the West bemoan the failure of poorer nations to 'pick themselves up by their bootstraps', while others argue charity hasn't helped[65]. The roots of credit and early banking[66] in the Renaissance were the 'starter engine' for the West's economic development. Without that culture of credit it is doubtful Europe would ever have been the centre for commerce it became. Yet, many nations today are without finance and so cannot develop – not because their people or SMEs do not want to – but because there is little reliable, or fairly priced credit available to support them.

[61] Sukuk.me, 27 December 2010.
[62] The Economist/The Banker, November 2009.
[63] Turkey's entry into the EU still seems some way off. However, business is not waiting and there are increasing EU/Turkey commercial and financial links. Clifford Chance opened in Istanbul in 2011.
[64] Although the majority of people in this situation are in Asia, Africa and other developing regions, back in 2007 a survey by the US Federal Reserve found that one in 12 American families - or around 30 million people - didn't have a bank account either. They were also most likely to be the poorest in US society. USA Today, 23 June, 2007.
[65] Dambisa Moyo, in her book 'Dead Aid'. See: http://www.dambisamoyo.com/biography.
[66] Italian bankers of the 14th Century such as the Bardi, Peruzzi and Medici underpinned the mercantile development of Europe, laying the foundations for far greater institutions that would follow.

Micro-finance – the idea of lending out small sums to help 'bankless' people to develop businesses - appears to offer a catalyst for economic development. Started in the 1970s – but with roots back to 19th Century Europe with credit unions – it is already a multi-billion dollar industry, but with enormous future growth potential. The last reliable figures show that in 2009 around 1,200 micro-finance 'funds' existed, with combined total assets of around $34bn. As with many areas of fund activity – it is also an extremely unconsolidated sector. The total number of individual borrowers is around 91 million – a good start, but a tiny fraction of those who might benefit from similar schemes.

Lenders gain a high rate of return, and most schemes are for profit. Some funds have even gone public, such as in India, and others have been backed by US investment banks. Therefore, we should not think of micro-finance as some form of aid, but rather a focussed business aimed at a huge consumer base few in the West consider worth targeting.

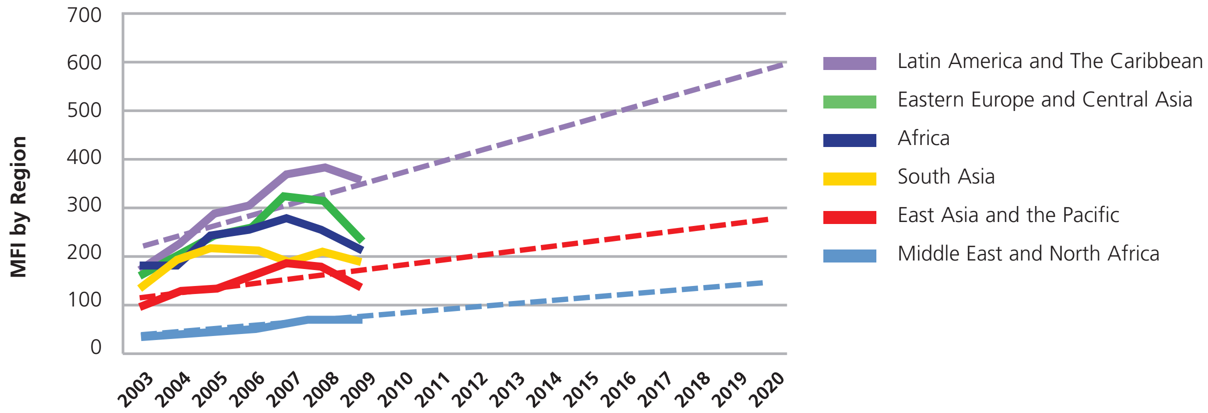


Table 17: Micro-Finance Initiatives (MFIs) 2003-2009 MIX Data[67], and Jomati projections.

As seen in table 17, the total number of funds dropped after the Crisis. In part this was due to a lack of funding and closure of some initiatives. But, we expect numbers to rise again, following their long term trend. The total assets held by these funds has kept on increasing, year on year too, with some regions seeing funds of around $7m in size – likely to move to around $20m in coming years. We may also see funds merging together and being consolidated, especially if major players in the financial world move in to 'roll up' the hundreds of disparate funds, as would make sense to eliminate shared costs.

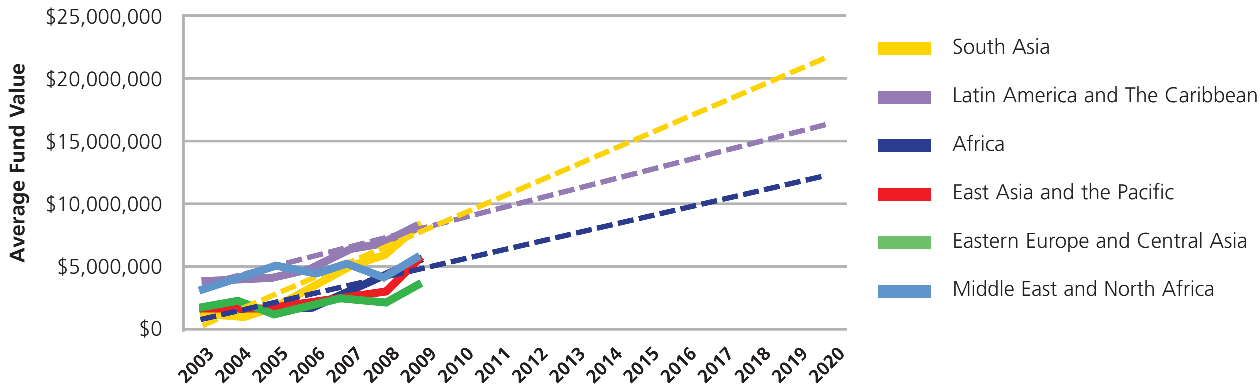


Table 18: Average Fund Value. (MFIs) 2003-2009 MIX Data, and Jomati projections.

[67] MIX: Micro Finance Information Exchange, www.themix.org.

However, MFIs are not in wholly benign territory. The sector is facing continued debate whether it is exploitative[68] and that some unscrupulous managers are charging what appear to be crushingly high rates of interest. Another key issue, and perhaps one that points towards the future evolution of micro-finance into something larger, is: does everyone who is poor want to set up their own business? The answer is obviously: no. Not everyone who has great credit in the West wants to, or has the aptitude, to start a successful business.

Assuming that everyone in the poorest nations also have this entrepreneurial drive is equally false. But, that does not mean they do not want to improve their lives, or play a part in a growing business and move up the economic ladder. Herein is an even larger opportunity for micro-finance: not to fund individuals who have nothing – but help fund SMEs that can employ people – moving them out of subsistence agricultural labour. One might say by way of analogy, if old micro-finance is a form of venture capitalism, what is needed now is 'private equity' aimed at a more corporate development strategy. Through this route we could see the evolution of whole new commercial banks in the developing world, and thereby new clients for the future.

We will also see continued developments in telephone-based banking linked to those with low incomes and may be MFI clients. These are linked because many of those who borrow from MFIs don't have a normal bank account, but may have a mobile phone. Telephone-based commerce has been a great success in some parts of Africa. As schemes such as M-Pesa[69] show, if you have a mobile phone – you can borrow and make transactions, with currency passing electronically between bank, customer and vendors. In Kenya in 2010, where the M-Pesa system is predominant, there were 9.5 million M-Pesa accounts compared to 8 million traditional bank accounts[70] - in a country of around 40 million. Harvard Business School estimates[71] there are 1 billion people who have mobiles phones but do not have a bank account – that's around 15% of the world. Clearly, M-Pesa has only just started to tap this market. The increasing numbers of Western law firms moving into Africa's financial sector may well see MFIs and the related mobile banking systems as too small to bother with for now, but they may need to be aware of these developments in the future.

Social Lending: A New Kind of Finance?

Social lending uses pooled capital accessed and lent via the internet. It is also termed 'peer-to-peer lending' or P2P lending. Lenders and borrowers can be individuals or businesses. The actual capital is still held in a 'traditional' bank, as these P2P groups do not have banking licences – and perhaps at this stage would not want to because of the extra costs and responsibilities involved. Management and staff are minimal – although one should not believe that these new credit businesses are amateurs. Many are run by former 'mainstream bankers' and they could be noteworthy players in the future – especially if they can gain scale.

One leader is Zopa.com[72], which states that since starting in 2005 it has lent $176m – which is a tiny sum for major banks – but it has started from zero. Also, in the last financial year lenders to Zopa made an annual return of 8.1% - good compared to any other standard, retail investment. Interestingly, Zopa.com also ensures it does not lend to 'sub-prime' candidates, and only gives credit to borrowers rated A* to C. Other P2P banks include: Prosper in the US, Smava in Germany and Communitae in Spain. Others include: Funding Circle, RateSetter and Yes-Secure.

[68] There is also a continued debate over the rate of interest many funds charge – ranging from 10% to well over 40% in some cases – risking the further impoverishment of people who are already very poor. The counter argument is that rates may be very high, but they are better than the loan sharks – although, this is seen by some, including Mohammed Yusuf, Nobel Prize winner, and a pioneer of the system in Bangladesh, as unfair.

[69] M-Pesa, wireless money transfer system, part of the Safaricom group, based in Kenya.

[70] Wired (UK Edition) August 2011: 'Switching On. Africa's Vast New Tech Opportunity.'

[71] June 13, 2011, Harvard Business School Newsletter.

[72] Set up by former members of Egg.com, an early UK internet bank.

The future for such businesses will almost certainly mean consolidation. But, from this grass-roots development may become far larger businesses with, by 2020, perhaps even global potential. After all, out of the credit unions of the 19th century eventually evolved many of Europe's larger financial institutions, such as the UK's building societies. We should not assume a grass-roots movement like this cannot grow into something important. But, for now, few major law firms will show an interest. However, by 2020, and with the right management, these P2P lending networks may have evolved into something significant. As with other new forms of finance, the critical issue is scale. The systems above are all valid – they just need the right management and advice to bring them onto a global footing.

Law Firm Impact

- **Innovation and First-Mover Advantage** – Law firms are constantly being urged to innovate and create new products for their clients. In some cases lessons learnt from frontier finance developments can be adapted for larger established banks and institutions. Law firms can also take a lead in helping clients in adapting products for a wider market in the developing world.
- **Sharia Law is a Growing Opportunity** – While some law firms have raced ahead and claimed market share in this area, other firms seem to have let this growth area get away from them. Handling sharia-compliant products does not always mean having offices in the Middle East either. As mentioned above, Asia has a large Muslim population, meanwhile the US and Europe also attract plenty of investment from Muslim investors – whether domiciled there or not. Compliant products will only grow in demand as world population rises in developing nations.
- **Micro-Finance: Is it just Pro Bono?** – In many cases micro finance projects will be too small for major law firms to engage with on a fee-paying basis. Aside from the occasional IPO, or major bank-led project there is little work at present that has a high deal value. However, taking on this work may do two things: first there is a natural social benefit to such work, but, secondly, it enables the firm to learn more about such projects that may in coming years evolve into something far more complex and ambitious (see below).
- **Emerging Market Banking** – economic development in even the poorest nations is racing ahead. We will see the creation of new banks, perhaps making use of Sharia-finance, micro-finance, social lending and mobile banking – or other hybrids, that will be aimed at the developing world's billions of people. All of this offers opportunities to law firms willing to take time to explore the new frontiers of the financial sector in search of future prospects. For example, business development efforts in some less profitable areas, such as MFIs, later may help build better regulatory and local business contacts that will be crucial for work on more mainstream projects, such as in infrastructure, as we move to 2020.

Chapter Five: Long Term Outlook

The Crisis Is Not Over

Bankers and lawyers yearn for corporate confidence[73] to boost their deal flow[74]. After all, the credit crunch started late summer 2007. Now, four years later surely we should be on 'the other side' by now? Sadly, this is not the case. Nor is this prolonged slump behaving like previous recessions[75]. There are many reasons why this is so, but there is one that is more important than any other: the level of public and private debt and the inability to drive the economy forward anymore by credit alone.

In this respect the Crisis is not over. One only has to consider the level of public debt in key European States to see this, (see table 19). While in the US, public debt has reached 100% of GDP and led the Government to the brink of Treasury note default and a ratings agency downgrade.

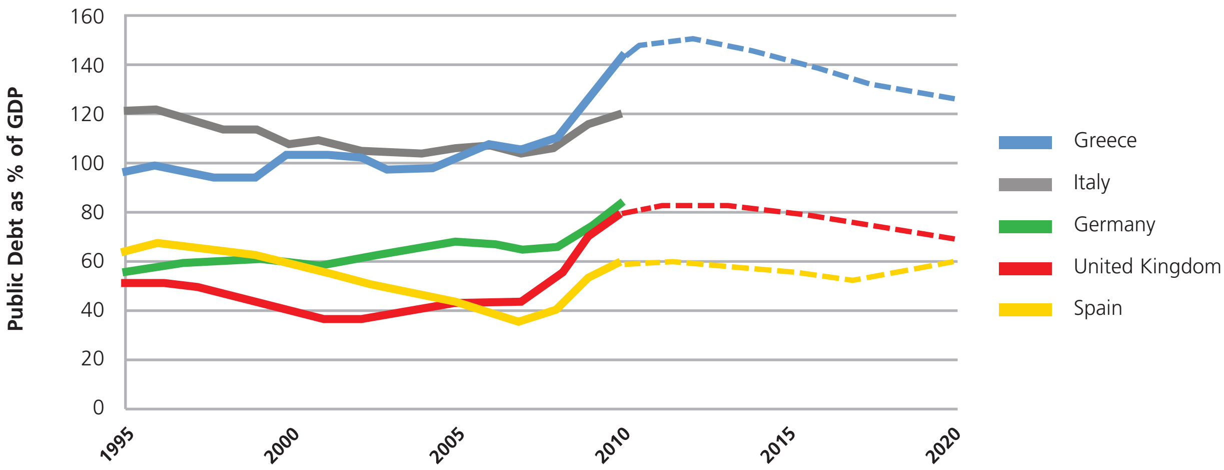


Table 19: Debt within Europe, (EU data from 1995 to 2010) followed by Jomati estimates.

Countries like the UK that prided themselves on low levels of public debt in the early 1990s now see themselves with public debt of 80% of GDP. While Spain, which saw its debt drop rapidly from 60% of GDP to 40% in the early 2000s – ironically due to the benefits of credit-driven growth – has now returned to a debt level of 60%. Meanwhile Greece is at around 140% of GDP and rising.

Looked at historically, at least back to 1995, one could argue that the debt level now is painful, but not radically different to earlier years. For example, Greece has not had a public debt lower than around 95% of GDP in the last 15 years, i.e. long before it joined the Eurozone in 2001. Yet only recently, around the time of the Athens Olympics of 2004, the nation was seen as somewhat of a success. What has changed are three factors, and they will weigh heavily on the West – and law firms that operate here - for many years to come:

- Lack of cheap credit will continue while banks are both holding bad loans and needing to increase capital buffers, which in turn undermines growth and housing market prices over the long term.
- Weak tax receipts due to weak economic growth undermines the ability to fund the State – which pushes the need to issue more debt.

[73] One irony of the current malaise is that many large corprates have more cash on their balance sheet than ever before.This is due to: a need to build defensive cash buffers; reduce dependency on banks; the benefits of cost reduction programmes; and the lack of targets to takeover in such an uncertain economy.

[74] Legal Week/Merger Market 7 July 2011, H1 2011: 'Deal volumes fell across every geographic region compared with the same period in 2010... and... volumes dropped in the UK by 5.3% and US by 3% – taking it to around the same level as Q3 2009.'

[75] For example, unemployment has taken longer to build up after this crisis, but it is also taking far longer to reduce, indicating there are structural impediments to a return to growth.

- And this debt, because of the weak macro-economic and fiscal position raising continual fears of default, only becomes more expensive to service – further prolonging uncertainty in that nation's relationship with banks and investors, and thereby undercutting inbound investment that could reverse the position.

Or, simply put: too many Western economies look too weak to do anything other than scare foreign investors away. In countries where a large percentage of the workforce are in the public sector - which is especially true in Europe - the need to cut public sector jobs, freeze salaries and demand higher contributions to public pensions - undermines consumer spending and dents corporate profits further. One should add, as shown in Part One of this report, the population of Europe, whether due to migration or birth, will keep growing, adding to stresses on State funds as few new jobs are being created, but infrastructure, energy, educational and health demands will grow all the same.

The recent spectacle of possible defaults in the US and across Europe in Spain, Greece and Italy also undermine confidence in the West and worry Asian and Middle East investors about the counter-party risks among banks that hold public debt. Recent 'stress tests' in July this year also seemed to have had the opposite effect of reassuring investors – and rather helped to act as a reminder of just how much risk is still present, further dampening deal flow.

Moreover, when corporates and major banks do seek deal advice from UK and US law firms in the coming years, they will place their advisers under a level of pricing pressure that started in 2008 and has not abated[76]. Although profits per partner rebounded strongly in 2009/10 primarily because of severe cost cutting, partner de-equitization and that the previous year was so weak, the figures for 2010/11 have not been so strong. There is little else to cut and yet the price pressure remains. Many firms are now looking at a future where to see more than a 5% rise in profits per partner will be a major achievement – a factor that will be examined in our next report[77].

Currency Futures: An Unwanted Dollar?

The wrangle between Democrats and Republicans over what level of debt the US Government should shoulder and what kinds of public services its citizens should be taxed for is part of another debate with global ramifications. It links to a wider discussion on whether or not the US dollar should remain the reserve currency of the world – given the nation's problems balancing its budget. Signs that it may not be by 2020 are starting to mount. As the Financial Times pointed out[78] this year: "China has invested less than a quarter of its new currency reserves in US assets, far below its rate in previous years." The risk of US default, which was used as a political football this year – and will remain on investors minds to 2020 as new political and funding impasses develop – has no doubt been a factor in China's decision.

We are not monetary policy specialists, however, it is evident that a change in the dollar as a reserve currency within the next decade would not only have a profound impact on the ability of the US to issue debt and play havoc with American interest rates, it would alter the pattern of world trade and have a direct and indirect impact on major US and UK law firms.

[76] The longer term impact of the change in pricing, and other long term client changes in the legal sector, will be the subject of the next Jomati Consultants LLP report, to be published in January 2012.
[77] Ibid.
[78] July 21, 2011.

Loss of reserve status may seem extreme, but it is possible. One theory goes that with each passing economic era, so too passes the reserve currency of that era. For example, British Sterling could not keep its reserve status in the new post-War economic era dominated by America. The argument follows that since 2008 we are now in another economic era, one that will be dominated by China and a myriad of other growth markets. It is therefore time for the dollar to move aside, its job done.

This theory is supported by the work of adviser to the US Government in the 1940s and Harvard professor, Robert Triffin, who produced the following argument, known as the Triffin Paradox. It goes as follows:

- To supply the world's 'risk-free asset' – in today's case US Treasury notes - the country must run a current account deficit.
- In doing so the US becomes ever more indebted to foreigners: China, Brazil and other developing economies, oil exporters, plus Japan and the UK (see table 20).
- This American indebtedness feeds globalisation and feeds US growth too. But, foreign credit is never infinite. The 'risk-free asset' of US Treasuries eventually becomes no longer risk free as huge debts undermine US economic stability.
- Investors migrate away from the risky asset toward a new, or more varied group of reserve currencies, or materials such as gold, that are the new 'risk-free' asset.

Rank	Foreign Holders of US Treasuries	$bn US Treasuries (May 2011)
1	China and Hong Kong	$1,288
2	Japan	$912
3	UK	$346
4	Oil Exporters[79]	$230
5	Brazil	$211
6	Taiwan	$153
7	Caribbean Banking Centres	$148
8	Russia	$115
9	Switzerland	$108

Table 20: Foreign Holders of US Treasuries. US Government Data accurate as of May 2011.

The other key factor is when and if China allows the Yuan (Renminbi) to float free. At present it cannot be used as a reserve currency because of its fixed position. If let go, perhaps at a point when pressure on the dollar was even greater than today, it is possible we could witness an era-defining shift. In table 21A there is the scenario where the Yuan doesn't float, and the US does not default, but it faces continued pressure from ratings agencies – such as the August 2011 downgrade to AA+ by Standard & Poor. In table 21B, the Yuan is set free and there is no US default, but downgrades continue and fears over the dollar rapidly grow. In this second scenario the Yuan takes around 35% of reserve volume by 2020.

[79] Oil exporters are defined by US Treasury as: Ecuador, Venezuela, Indonesia, Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates, Algeria, Gabon, Libya and Nigeria.

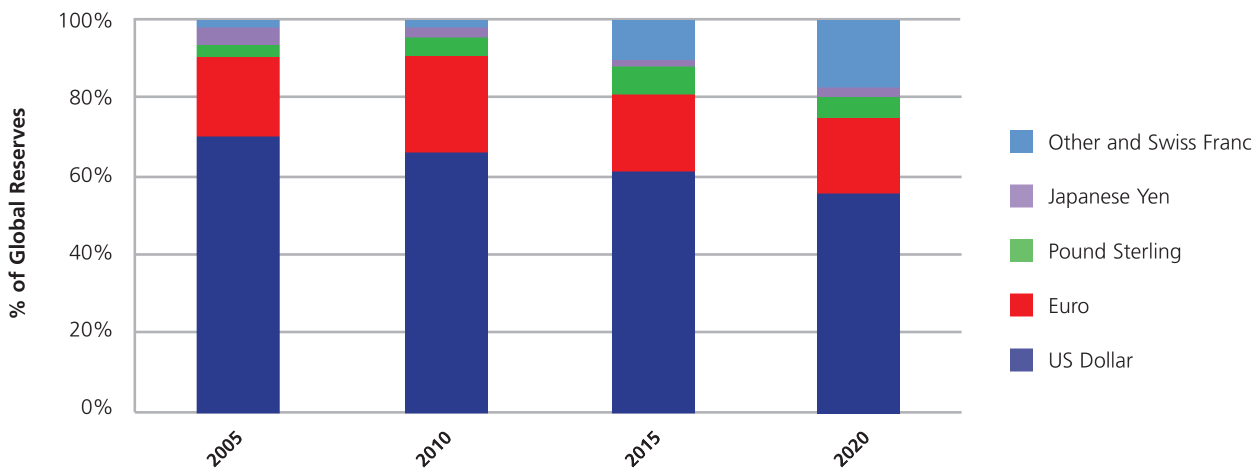


Table 21A: Reserve share with no Yuan float, but continued US downgrades and weak fiscal position. IMF to 2010, Jomati estimates to 2020.

As can be seen in these tables, from 2005 to 2010 the US had already dropped to around 65% of total global currency reserves. The Euro has filled the gap – which some may find peculiar given fears over sovereign default in the EU and fears of Euro collapse too. But, other currencies make up only a tiny proportion of alternative reserves – with 90% in either the US dollar or Euro. This is ironic, given that in 2011 there has been open debate about both US default, and the break-up of the Eurozone. The simple reason is the absence of large and stable alternatives. The question is whether a fundamental change, such as the Yuan floating free, would create the catalyst for the market to move rapidly to a different reserve currency pattern. Triffin's Paradox would suggest this is a likely outcome by 2020.

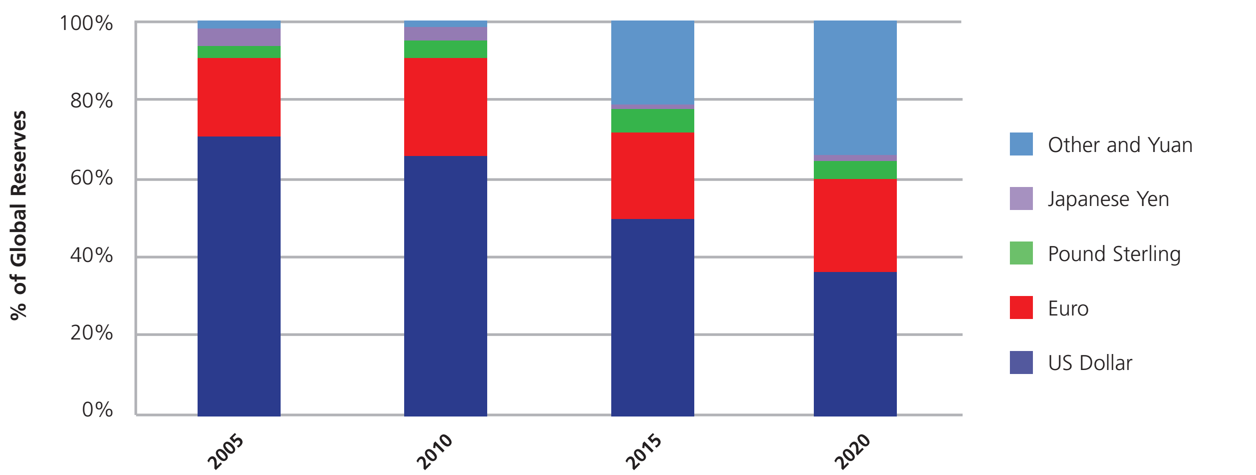


Table 21B: Reserve share, modelled if Yuan float occurred by 2015 and with US downgrades and continued weak fiscal position. IMF data to 2010, and 2015 to 2020 Jomati estimates.

The shockwaves of continued US downgrades[80] in coming years and continued fiscal weakness, and/or a floating Yuan could have the following impacts:

- **Loss of Appetite for US Debt** – A weakened US public purse cannot help a country that needs billions of dollars in infrastructure development, refitting of schools and hospitals, or development of new energy projects. Investors may estimate that even without a US default in the short term, it is becoming a risky long term option.
- **Rising Yuan** – Chinese economists have chosen to favour their exports with currency weakness and a fixed position. A rising Yuan would hurt exports – China's mainstay - but generate significant capital for public expenditure by selling bonds – perhaps needed by China to make the next developmental step, especially as the economy inevitably slows by 2020. Equally, China by 2015, or 2020, may feel its internal economy is mature enough to suffer a drop in export income as its larger corporates and banks move to buy up assets in other countries.
- **Weakened Dollar** – A weak dollar would be the most immediate effect of downgrades and the end of the dollar's main reserve position, as investors sold off their holdings. One side effect of this would be increased inbound investment as foreign institutions sought to buy up 'cheap' US assets.
- **But, It Could Trigger Interest Rates Rises** – In order to attract investment in the dollar, interest rates could rise rapidly in the US, stabilising demand for sovereign debt, but pushing many consumer, mortgage and commercial loan holders into bankruptcy.

Law Firm Impact

- **US/EU Business Migration** – If the Yuan became a stronger currency, greater revenues in China would have an extra benefit. For law firms, the Eastern pull on their expansion may be accelerated.
- **Chinese Law Firm Mergers** – In a world where the Yuan is free, US growth low, and the dollar weak, the impetus to seal a Chinese merger or other Asian mergers would be huge. Early-movers here may find they are leading the market – especially those able to link with the best Chinese law firms.
- **Greater Benefits of US/UK law firm Mergers and General Foreign Expansion** – If the dollar kept weakening, the benefits to US law firms of expanding abroad especially into stronger currency nations could be compelling in order to bill in harder currencies for work outside the US. Depending on how the UK economy evolved, this could help encourage further US/UK mergers.
- **Continued Bank Weaknesses** – Weak public finances will remain a drag on confidence in the banking sector because of counter-party risks. In turn this will hurt lending to corporate and general confidence. Law firms will therefore have to consider how they can boost incomes in a world where Western deal activity will not reach 2007 levels for many more years.
- **Coping With a Prolonged Bust** – UK and especially US law firms are learning how to deal with Boom/Bust cycles. But they have never had to operate in a prolonged 'Bust' scenario. As seen with some global firms, the strategy has been to boost expansion abroad to both follow clients and diversify their exposure to any one market[81]. This strategy may not be possible for all firms, but it may increase in use if the US and UK markets remain flat much longer.

[80] A US default is not accounted for, because it does not seem likely by 2020, despite the many headlines.
[81] How law firms can grow in such a market will be examined in our next report.

Conclusion

In our three 'New Frontier' reports about what the world will look like by 2020 we have sought to first consider the macro-economic forces in play and then consider how this will affect your clients, and then how it will affect law firms. Fundamental to the process of business evolution in the legal sector are the demands of clients, as law firms themselves can only serve client demand. Regardless of the quality of your offering – if client demand has shifted away from your best practice, or main geography, there is only one option: change too. While business development and marketing efforts can help grow market share, in the final analysis, law firms grow because they offer the right kind of expertise at the right time in an economy's development. That is to say, the offering of any firm, whether on the High Street or a global firm, can gradually slip out of favour through stasis, lack of review and detachment from the wider economic reality, rather than by any failure of service or quality.

On a day to day level the financial markets move faster than any other, but these daily movements rarely mean much for legal advisers. At the same time the great financial institutions, such as the major US investment banks, seem to hold such strong positions and have done so for so long, to be their legal adviser must be a comforting prospect. But, between these two extremes plenty of change is occurring that will matter, and this is far beyond the regulatory flood from Dodd-Frank or Basel III. Despite its apparent importance, it will – like all regulation – be absorbed into the masses of regulation that existed before. Naturally, lawyers focus on laws and regulation – that will always be their first reference point. But, it is the wider development of the global economy and the new forces within it that will reshape what clients do and where they do it, and in turn what law firms must do too.

We suggest that during this decade we will pass into a new economic era; one where the US and EU are still of massive importance, but also one where they can no longer be looked to for growth. Also, this era will be multi-polar and far more complex than in the past. The G8 has necessarily become the G20, in a decade it may well be the G30. In this new period, the old gatekeepers of such clubs like the UK, will see their own GDP shrink in comparison to rivals such as China or India. After all, the UK is less than 1% of world population, and the US is just 4%. When the rest of the globe was poor this didn't matter to such clubs. But, now it does. By 2020 it will matter even more.

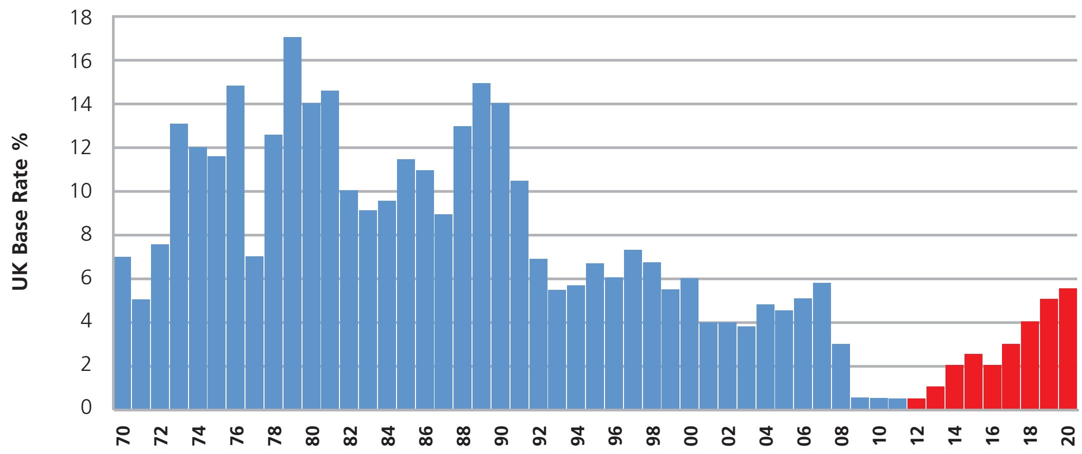
One might say that all roads may continue for some years to lead back to the 'Rome' of New York and London's great banks and institutions, but the 'empire' is larger now and it would be naïve to believe that the old centres in the West can maintain control of the economic change they helped create. Globalisation will only be a blessing to those in the West that can globalise with it. Those that expect the UK or US economies to reign supreme forever, when so many long term, macro-economic indicators are stacked against them are in for a shock.

Therefore we salute the many US, UK and now Chinese, Australian and Canadian law firms that are embracing a global vision of the legal market and seeking to stake out their place within it. What started off in the 1990s as an experiment to create the first few 'global law firms' will by 2020 have become the standard model for a large segment of the world's top commercial lawyers. Whether these structures are fully profit-sharing, Swiss vereins, or some other as yet untried system, may not matter as much as having a global firm that can adapt to the wider macro-economic forces of the world.

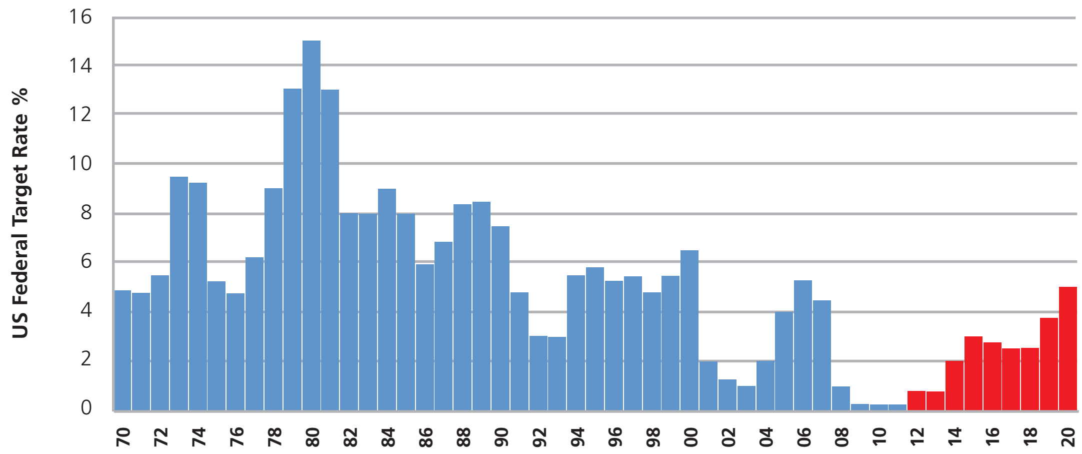
Finally, we hope above all that these reports have shown just how much the world can change in ten years. We also hope in future, through our reports, research and strategic advice, to help firms navigate the way ahead as they approach this now global legal market's new frontiers.

Appendices

Appendix A: Interest Rates



UK Base Rate: Year End 1970 to 2020, estimates by Jomati in red, data to June 2011 by RBS.



US Federal Target Rate: Year End 1970 to 2020, estimates by Jomati in red, data to June 2011 by RBS.

As can be seen, considering 'an average base rate' makes little sense over the longer term. By that reckoning, between 1970 and 2011 the average US mean would be 5.8%, yet, between 1970 and 2000, the average was around 7.1% - a level that many would regard as unsustainably high in the 21st Century's interconnected global economy. A return to such levels would seriously undermine the ability of American businesses to sell their goods abroad. The Jomati estimates are therefore just one scenario – but do seem possible. Also, a return to real (after inflation) interest rates could have a seriously negative impact on highly indebted Governments, corporates and individuals.

Appendix B: World's Strongest Banks

Rank	Name and Country
1	Oversea-Chinese Banking Corp. (Singapore)
2	Svenska Handelsbanken (Sweden)
3	National Bank of Canada
4	Canadian Imperial Bank of Commerce
5	DBS Group Holdings (Singapore)
6	United Overseas Bank (Singapore)
7	Fifth Third Banco (U.S.)
8	Banco Bradesco (Brazil)
9	UBS (Switzerland)
10	BOC Hong Kong (Hong Kong)
11	Banco Santander Brasil
12	Toronto-Dominion Bank
13	credit suisse group (Switzerland)
14	JPMorgan Chase (U.S.)
15	Standard Chartered (U.K.)
16	citigroup (U.S.)
17	Royal Bank of Canada
18	Hang Seng Bank (Hong Kong)
19	Bank of Montreal (Canada)
20	Sberbank (Russia)

(Red highlights show a US bank.)

Source: Bloomberg, May 2011, Rankings are based on a variety of factors, but the main deciding element is the ability of each bank to survive another financial crisis. In particular one can see that the banks that are the most well-capitalised are highly ranked. Although, perhaps it is slightly misleading to place citigroup in the list, as its existence today was only possible after being given a $25bn bailout, plus gigantic Public guarantees. One might add too that unless the US Government had stepped in when it did, JP Morgan Chase would not exist either.

Appendix C: Sovereign Wealth Funds

Rank	Assets US$bn	Fund name	Sovereign State	Region
1	$600	Abu Dhabi Investment Authority	UAE - Abu Dhabi	ME/Africa
2	$507	The Government Pension Fund - Global	Norway	Europe
3	$439	SAMA Foreign Holdings	Saudi Arabia	ME/Africa
4	$350	SAFE Investment Company	China	Asia
5	$322	China Investment Corporation	China	Asia
6	$295	Kuwait Investment Authority	Kuwait	ME/Africa
7	$291	Hong Kong Monetary Authority Investment Portfolio	Hong Kong	Asia
8	$185	Government of Singapore Investment Corporation	Singapore	Asia
9	$133	Temasek Holdings	Singapore	Asia
10	$130	National Social Security Fund	China	Asia
11	$87	National Wealth Fund	Russia	Europe
12	$85	Qatar Investment Authority	Qatar	ME/Africa
13	$67	Australian Future Fund	Australia	Asia
14	$64	Libyan Investment Authority	Libya	ME/Africa
15	$47	Revenue Regulation Fund	Algeria	ME/Africa
16	$40	Alaska Permanent Fund	USA - Alaska	US
17	$38	Strategic Investment Fund	France	Europe
18	$34	Kazakhstan National Fund	Kazakhstan	Asia
19	$32	National Pensions Reserve Fund	Ireland	Europe
20	$30	Korea Investment Corporation	South Korea	Asia
Total:	**$3,776**			

http://www.sovereignwealthfundsnews.com/ranking.php

Jomati Consultants LLP
3 Amen Lodge
Warwick Lane
London
EC4M 7BY

Tel: +44 (0) 20 7248 1045

www.jomati.com

jomati consultants LLP