

Supporting the creation of value

Asset Management News

Investors' view of value has become wider. Performance still comes first, but factors such as competitive fees, strong infrastructure and transparency matter more than ever.

June 2011



Contents

03 Introduction

Supporting the creation of value

- 04 Hedge fund infrastructure moves from cost to benefit
- 06 Cutting costs to create portfolio value
- 07 Active ETFs prove intriguing
- 08 Infrastructure investors learn the importance of getting their due diligence right
- 10 Recruit, retain, motivate
- 12 Impact of the credit crisis on risk management practices
- 14 Alternatives performance principles near completion

Updates

- 16 Private equity through the SEC's lens
- 17 Time to analyse AIFMD's impacts
- 18 Planning for FATCA
- 20 Foreign asset managers optimistic in Japan

Visit us online at
www.pwc.com/amnews

Introduction



Kees Hage
Managing Editor
Asset Management News
PwC (Luxembourg)
+352 49 48 48 2059
kees.hage@lu.pwc.com

One of the main lessons of the financial crisis is that the creation of value is no longer only about hiring the best financial minds. For sure, this remains the most important way of doing so, but value today has a wider context. It is also about optimising costs, having sound infrastructure, risk management and a number of other issues.

The crisis left a legacy of economic weakness, while also revealing a number of operational and other limitations. Encouraged by investors and, to a certain extent, regulators, asset managers now need to adapt to this new environment.

In this edition of Asset Management News, we address some of the relevant topics. Evidently, faint economic growth is likely to constrain financial market returns. Consequently, managers might wish to optimise their cost bases. As we explain in the following pages, there are a number of ways in which this can be done.

Furthermore, hedge fund managers are under pressure from investors and regulators to enhance their operational infrastructures. We have recently published a point of view explaining the benefits of doing this, which we profile later in this issue.

Investors and other stakeholders now view value as being about more than portfolio performance. We have clear views about how asset managers can create this value.

Hedge fund infrastructure moves from cost to benefit

The hedge fund sector is strengthening its infrastructure, both in response to regulators' and investors' demands and to prepare for future growth.



Michael Greenstein

PwC (US)
+1 646 471 3070
michael.s.greenstein@us.pwc.com



Damian Neylin

PwC (Ireland)
+353 1 792 6551
damian.neylin@ie.pwc.com

At a time when hedge fund investors, legislators and regulators are seeking improved governance, controls and transparency, having strong infrastructure is critical. While these new demands mean that employing the right people, repeatable processes and scalable technology have become more critical than ever, high-quality infrastructure will also benefit managers by preparing them for the next stage in their growth.

As we explain in our point of view paper, *Hedge Funds 2.0 – Infrastructure: From Cost to Benefit*, following the financial crisis firms in the hedge fund sector must make sure they have sufficiently robust infrastructure to comply with emerging regulations. In particular, the Dodd-Frank Act in the US and the Alternative Investment Fund Managers Directive in Europe will force managers to enhance controls and to establish processes for generating information for regulatory compliance.

Yet stronger infrastructure will also help to prepare the way for attracting assets from institutional investors. The manager's investment capabilities will always be the primary factor in any investment decision, but infrastructure now also plays an important part.

People

Reflecting the role of infrastructure, the hedge fund sector is recruiting more experienced and specialised talent for its compliance, risk management and other middle and back-office functions. Remuneration for compliance and risk management staff is rising significantly, reflecting increasing demand for their skills.

At the fund level, the sector is seeking to strengthen fund governance, and is likely to recruit experienced professionals as board directors and valuation experts.

Processes and controls

Hedge fund managers and their service providers are introducing more systematic control processes as they seek to address investors' and regulators' concerns. In particular, they are focusing on controls surrounding the fund's assets, including existence and safekeeping.

Regulators in both the US and Europe are concerned about controls governing valuations. Indeed, surveys we have carried out recently show that managers need to make sure that their valuation processes meet with regulators' expectations before registering under the new sets of regulation.

Technology

Finally, with investors and regulators asking for greater transparency, managers and their service providers need to deliver high-quality and versatile information. To do so, they must have efficient access to data.

Managers and administrators are commonly reviewing their technology infrastructures and asking whether they are adequate for their evolving needs. When doing so, they should make data requirements the priority, as this will drive the design of systems and processes that will give a desirable outcome.



Conclusion

The sector is now working hard to develop infrastructure that meets stakeholders' emerging expectations. With the details of regulations still being defined in both the US and Europe, it is not yet completely clear exactly what systems and controls will need to be in place, and what processes and procedures will be required. But it is apparent that much needs to be done in a comparatively short space of time.

The cost of building stronger infrastructure could well be substantial, but it will prepare hedge fund managers and service providers to make the most of the sector's potential growth.

At a time when hedge fund investors, legislators and regulators are seeking improved governance, controls and transparency, having strong infrastructure is critical.

2%

20%

Quite a number of fund launches no longer command the historic 2% and 20% fee structure.

Cutting costs to create portfolio value

As asset managers seek the most productive ways to provide investment returns, cutting costs in the management company gives an opportunity to reduce fees, so enhancing net returns.



Peter Seethaler

PwC (Germany)
+49 69 9585 3436
peter.seethaler@de.pwc.com



Janet Hanson

PwC (US)
+1 704 350-8110
janet.l.hanson@us.pwc.com

At a time when many asset managers are favouring multi-boutique type investment teams as the most productive way of generating investment returns, they are also under pressure to cut costs in their operating models. While talented portfolio managers working in semi-autonomous teams have the greatest part to play in boosting investors' gains, lower costs give the scope to cut fees and, correspondingly, to enhance net performance.

Recent events show that fund fees are under pressure, even in some of the sector's growth areas, such as alternatives and exchange-traded funds (ETFs). In the European Undertakings for Collective Investment in Transferable Securities (UCITS) hedge fund sector, for example, quite a number of fund launches no longer command the historic 2% and 20% fee structure. And there are signs of fierce price competition among ETF providers.

Asset management companies therefore have a strong incentive to look harder than ever for operating model efficiencies that will give them scope to compete on fees. Doing so means focusing not only on the back office, where cost cutting has tended to be particularly fruitful, but also on the middle office and even on the front office. And in Europe the new UCITS IV regulations could prove a catalyst for concentrating fund ranges on those strategies where managers have strong performance, so building scale. Making efficiencies such as these not only helps to reduce fund expense ratios, but also supports management companies' revenues, which are growing relatively slowly in this recovery.

Building fund scale

Many funds, especially in Europe, are subscale and therefore inefficient. Our experience suggests that 20–25% of funds typically earn 75–80% of all revenues. Indeed, many managers spend a lot of money supporting funds where they have neither scale nor the performance to attract fresh assets. The European Commission is seeking to address this situation in its UCITS IV regulations, which goes live in July 2011, and allows fund assets to be combined through master-feeder pooling and fund mergers.

Of the two initiatives, master-feeders are generally thought to be the most practical method of building scale due to tax reasons.

Increasing the size of funds also paves the way for parallel efficiencies from simplifying administration and custody. Reducing the complexity of fund administration systems yields savings – although this remains difficult to achieve in Europe – due to different regulatory environments. Similarly, trimming the number of custodians cuts custody costs and complexity.

Centralising the manager

Centralising the management company can yield substantial savings. A global investment firm could, for example, only have three regional hubs – for middle office, trading and investment – based in the US, Europe and Asia, respectively. Additionally, it might have just one portfolio management system globally, or at least only one per asset class. Risk management, too, could be centralised globally.

Finally, outsourcing still brings opportunities for cost reduction. According to recent surveys, approximately 75% of asset managers believe that there will be an increase in outsourcing. Back-office outsourcing has been popular for many years, but now it is being joined by middle-office functions, and even the front-office activities of research and risk management.

So, faced with the prospect of weak equity and bond markets, asset managers have other options for improving net returns for investors than simply seeking to boost portfolio management. Building fund scale and centralising management companies can also help. As investors carry on putting pressure on fees, then asset managers are increasingly likely to explore these options.

Active ETFs prove intriguing

New launches of active ETFs will show whether they can create value for investors and capture some of the success of their passive peers.



Janet Hanson

PwC (US)
+1 704 350-8110
janet.l.hanson@us.pwc.com



M. Nathaniel Gampel

PwC (US)
+646 471-7529
moshe.n.gampel@us.pwc.com

As the exchange-traded fund (ETF) market continues its dramatic climb, attention has increasingly been turning to what role active ETFs will play.¹ While active ETFs are still in their infancy, there are those who believe that they represent a potential paradigm shift in the world of investment management. In this article we will provide a brief profile of actively managed ETFs and describe where some believe the market may be headed. We will also identify a few of the potential hurdles limiting this asset class value to investors.

ETFs come in many forms and are part of a broader product set known as exchange-traded products (ETPs). Both active and passive ETFs trade on an exchange, like a share of stock, and give daily transparency into their holdings. ETFs also offer certain tax and cost advantages over traditional funds, due to their unique create/redeem process.

With over \$1.3 trillion in assets as of 31 March 2011,² the global ETF market remains largely dominated by passive products designed to track a particular index. While passive ETF products have been widely embraced, until now, many traditional fund managers have resisted the actively managed ETF market. Fund managers' main reason for being reluctant is that, unlike traditional mutual funds, ETFs have to reveal their holdings on a daily basis. This creates a potential opportunity for 'front-running' of an active ETF portfolio.

New launches planned

But recent events have begun to suggest market sentiment is changing. In the US, a number of large investment managers have obtained the Securities and

Exchange Commission exemptive relief that is needed before launching and announced plans to introduce actively managed ETFs. While the promise of actively managed ETFs is intriguing, they still have much to prove to investors. For example, active ETFs have only existed for three years and so lack a consistent track record. Investors should also recognise that while the benefits of the ETF structure apply to both active and passive funds, active ETFs tend to rebalance more frequently and require active fund management oversight, which can lead to higher costs compared to passive index-based ETFs. This, accordingly, can impact the perceived pricing advantage of ETFs.

To date, there has been limited demand for active ETFs outside of the US, particularly in Europe where the ETF market is dominated by institutional investors who generally prefer passive products. But a few sponsors have recently announced plans to launch active ETFs in Europe, which will likely be monitored closely by investors and the competition.

Impact on expense ratios

As advisers to many fund managers and securities servicers, we have also observed the incremental processes and systems' costs related to managing active ETFs. As active ETFs are still a relatively new product and continue to increase in popularity, the corresponding cost increase can impact fund expense ratios and is something to watch in the future.

No one can deny the historic impact ETFs have had on the investment management market. While there is potential for actively managed ETFs to follow a similar trajectory, a number of market and operational shifts must still occur to ensure there is growth in supply, variety and demand. Active ETFs must also prove over a longer period of time that they can offer value and diversification in an increasingly crowded marketplace. With that said, one thing is for certain, the market is watching.

¹ See webcast:
<http://www.meetpwc.com/rsvp/invitation/invitation.asp?id=/m2c53c-18BDK83BMO9DK>.

² Source: BlackRock ETF Landscape Industry Review, 31 March 2011.

Infrastructure investors learn the importance of getting their due diligence right

Following some harsh lessons of the recent recession, infrastructure funds are mindful that due diligence is essential in a sector where just one failure can seriously impair fund performance.



Colin Smith

PwC (UK)
+44 (0)20 7804 9991
colin.d.smith@uk.pwc.com

After some turbulent times caused by the credit crisis, infrastructure funds are once again attracting assets. Yet those remaining in the market have learned how important rigorous due diligence – with a thorough understanding of their assets' risk/return profiles and the right capital structure – is for meeting investors' return expectations in this supposedly low-risk asset class.

In the run-up to 2007–2008, intense competition for assets caused some investors to overlook some of the more basic tenets of infrastructure investing. Therefore, when recession struck, there were some unpleasant surprises when the envisaged stable cash flows from toll roads, airports and other assets were not realised.

Because the infrastructure asset class's expected returns are relatively low (in the region of 9–12% per annum), they are vulnerable – just one investment disaster could seriously impair a fund's investment performance. This is in sharp contrast to private equity or venture capital funds, where higher returns on successes will make up for failures. Consequently, the initial exploration of an infrastructure asset's likely future performance is critical.

Rising risk profiles

During the early days of infrastructure investing, in the early 2000s, niche players, primarily from Australia and Canada, invested in low-risk utilities and transportation assets. They used their low costs of capital to beat private equity and corporate investors to deals, often paying themselves hefty success fees in the process. It wasn't long before this came to the attention of the investment banks, which launched their own infrastructure funds, with varied acquisition and investment models.

From 2005, competition became fierce for anything which appeared to have stable, long-term cash flows. Having acquired most of the UK's water companies, ports, airports and landfill waste companies, funds started to buy assets which, while not regulated or even asset-backed, resembled infrastructure in their business models. These 'infra-lite' transactions included car parks and motorway service stations. Perhaps inevitably, not all of them were successful long-term investments.

When the credit crunch hit, debt instantly dried up – and deal flow along with it. Those investors who were highly geared at parent-company level, and were reliant on success fees from infrastructure deals to service the debt, found their model wasn't sustainable in this harsh new world. One major infrastructure investor went into administration, another rationalised its infrastructure activities into its investment bank and others sought refuge with large pension funds.

Asset performance in recession

Additionally, certain assets proved more volatile than thought. Certain ports, for example, originally seen as stable long-term investments, were exposed as being either 'top-up' terminals (only used when more attractive facilities were full) or overreliant on individual commodities such as clinker for cement or steel. Ferry companies' passenger revenues fell

2006–2008

Ferry companies' passenger revenues fell in the downturn and motorway service sales fell as trucking volumes collapsed. Many of the issues faced were as a result of the 2006–2008 'deal fever' and might have been alleviated if multiples paid for, and leverage applied to, such assets had been lower.



in the downturn and motorway service sales fell as trucking volumes collapsed. Many of the issues faced were as a result of the 2006–2008 'deal fever' and might have been alleviated if multiples paid for, and leverage applied to, such assets had been lower.

By contrast, classic infrastructure assets such as regulated utilities have held their performance and values (two recent electricity network deals each commanded a 30% premium on regulated asset base), while major ports and airports rapidly bounced back from relatively shallow recessionary dips. As a consequence, there have been few distressed capital raisings in the sector.

With fund-raising gathering pace once more, the winning funds will be those with recognised teams, defined propositions and good investment track records. With a strong pipeline of high-quality assets, ongoing investment prospects appear positive, driven by the impact of increased regulation and by non-core disposals from still highly geared corporate balance sheets.

None of this, though, should hide the last decade's key lesson: the critical factors to long-term success are (i) understanding assets properly; and (ii) applying an appropriate return requirement and capital structure. There is no substitute for proper due diligence, getting to know assets and their management teams before making an investment decision.

Recruit, retain, motivate

Employing the best fund managers is akin to building a team of elite athletes: hiring and retaining them is a question of getting the size and structure of remuneration right, and motivating them is even less straightforward.



Tim Wright

PwC (UK)
+44 (0)20 7212 4427
tim.wright@uk.pwc.com

Recruit, retain, motivate – the three little words that form the basis for nearly every asset management firm’s remuneration policy. But if the aim of each policy is so similar, why is the compensation market so diverse, both in terms of the structure of remuneration and the quantum paid? The answer lies in the fact that rarely can a single remuneration arrangement achieve all three outcomes. Simply put, there is no silver bullet.

Although no individual fund manager thinks the same as another when it comes to remuneration and what constitutes a ‘fair’ package, their standpoints vary according to who they are:

the Partner – “I want to share in the value I create for my employer”

or

the Worker – “I want to be paid fairly for the job that I do”

In order to effectively recruit, retain and motivate, the employer needs to understand that each of these two schools of thought is looking for different things.

Recruit

Remuneration packages play a bigger role in recruiting than in retaining or motivating. When a fund manager is on the market, getting the package right will often bring them on board.

When an asset management firm is seeking to poach a fund manager from a competitor the situation is slightly different, but even in this case a generous remuneration package that meets the individual’s needs will go a long way towards securing the new hire.

A ‘partner’ type will typically want a performance fee or revenue-sharing arrangement together with equity participation, whereas a ‘worker’ type will need convincing that they will be paid at least as much, if not more, either in a discretionary manner or formulaically based on the level of investment return achieved.

Retain

While the remuneration package is all-important in recruitment, non-financial factors come to the fore in both retention and motivation.

In some situations it is impossible to retain an individual regardless of how much you pay them. This is particularly true for partner types, where quantum of remuneration is less important than the fairness of how you reward them relative to the value they generate.

Although no individual fund manager thinks the same as another when it comes to remuneration and what constitutes a ‘fair’ package, their standpoints vary according to who they are



Should a business be incredibly successful, these individuals will become commensurately wealthy through arrangements that share the value created. As a result, they might become so wealthy that future remuneration is insignificant and any financial retention effect disappears.

The worker, on the other hand, wants to be paid fairly compared to their peers, both within the organisation and the external market. The worker takes less notice of the business's financial fortunes, and looks to be paid well if they deliver returns and accept reduced reward where they fail to deliver.

This creates problems for asset managers coming out of recession. Often, fund managers are delivering investment returns that are not yet feeding through to the bottom line, either as a result of sluggish sales activity or poor performance in other products. Is it right to pay the worker their going rate at shareholder's expense?

Motivate

This is perhaps the biggest challenge of all. While recruiting and retaining are relatively easily linked to remuneration, motivation is a behaviour that can be neither assessed nor encouraged quantitatively.

It is easy in principle to maximise the motivational impact of remuneration for fund managers: link reward to performance in a manner that is simple, understandable and gives maximum alignment between the individual and shareholders.

The challenge is defining what constitutes performance in a consistent way and finding the right balance of financial reward, development opportunity, culture and working environment.

Impact of the credit crisis on risk management practices

In the aftermath of the credit crisis, risk management is becoming far more comprehensive and effective at protecting portfolio value.



Thierry López

PwC (Luxembourg)
+352 49 48 48 4141
thierry.lopez@lu.pwc.com



Benjamin Gauthier

PwC (Luxembourg)
+352 49 48 48 4137
b.gauthier@lu.pwc.com

The financial crisis, starting with the sub-primes during the summer of 2007, reached unexpected extremes with the collapse of Lehman Brothers in September 2008. Yet if one worthwhile consequence emerged from this tumultuous event, it is an improvement in risk management. Following the crisis, risk management processes that used to be considered 'nice to have' are now a 'must' for both finance professionals and regulators.

Changing risk management practices

The perception that some risks were not material or had low potential impacts has completely changed in the past few years.

For example, counterparty risk was not thought a potential danger when dealing with big institutions. Generally, a list of accepted counterparties was validated at the beginning of the year and that was the extent of evaluation. But after the Lehman collapse, the financial world realised that counterparty risk was one of the key risks to monitor. Today, collateral management practices and regular counterparty monitoring have spread throughout the asset management industry. The majority of the practitioners have carefully reviewed their International Swaps and Derivative Association agreements and their associated credit support annexes.

The financial crisis also showed how quickly liquidity risk can materialise. The industry, markets and regulators alike had severely underestimated this. As a result, new liquidity assessment and monitoring methods have been developed, focusing on both assets (portfolio) and liabilities (subscriptions/redemptions profile).

Comprehensive approach

Now, far beyond the evolution of stakeholders' sensitivity related to specific risks, the main change in the risk management is that the risk profile is now viewed in a holistic manner: The industry cannot afford any more to take into account just the most common risks and disregard the interrelationships between all the risks.

Greater transparency

Both retail and institutional investors are scrutinising funds more closely, requiring more transparency, which board members and risk managers must take into account. This inevitably reinforces risk management practices, especially as managers now have to listen carefully to investor and regulator expectations, and disclose more risk-related information.

Europe's risk regulations

Within Europe, the UCITS III Directive widened the scope of authorised investments and led to the creation of funds with more sophisticated profiles. This made it necessary for UCITS' managers to start adopting risk management processes and controls on top of compliance checks.

The European Commission is now using the UCITS IV Directive, which goes live this July, to add new risk requirements. Most importantly, managers must monitor liquidity risk (with a focus on stress tests relating to redemptions) and operational risk. They must also increase the frequency of market risk monitoring and update both the counterparty risk computation method – to align it with



Both retail and institutional investors are scrutinising funds more closely, requiring more transparency, which board members and risk managers must take into account.

financial reality– and leverage measurement. Risk information must be disclosed, not only in the prospectus, but also in the financial statements and in the Key Investor Information document.

Looking further ahead, Europe's Alternative Investment Fund Managers Directive (AIFMD) also has clear risk management requirements, which will effect a wide range of fund managers.

By looking at the details of the technical UCITS' recommendations made by the European Securities and Markets Authority (ESMA) – the Paris-based financial watchdog – there is a clear trend towards making sure risks are evaluated and monitored. We expect ESMA to demonstrate this when issuing AIFMD's level 2 and 3 guidelines.

Conclusion

So, encouraged by the regulators, risk management is evolving. Fund management's approach to risk is changing from being focused mainly on compliance to adopting a more risk-based approach, which is definitely more adapted to the protection of value in today's financial world.

Alternatives performance principles near completion

More hedge fund managers are likely to apply global GIPS for measuring track records in creating value after publication of guidance for alternatives managers set for later in 2011.



Damian Regan

PwC (UK)
+44 20 7804 9984
damian.regan@uk.pwc.com



Dimitri Senik

PwC (Switzerland)
+41 58 792 23 72
dimitri.senik@ch.pwc.com

Success in creating value can only be proved if it is properly measured. For several decades, the Global Investment Performance Standards (GIPS) have gained popularity among large traditional asset managers, but following the publication of new guidance later in the year, these are likely to be used more widely by 'hedge fund-type' strategies.

The deadline for feedback on the exposure draft of the Guidance Statement on Alternative Investment Strategies and Structures closed on 15 June 2011. The Working Group on Alternative Investment Strategies is now reviewing comments and aims to give specific recommendations about how to apply GIPS to non-traditional asset classes, including hedge funds and other alternative strategies, later in the year.

Wider use of GIPS among alternatives managers will improve the credibility of their performance data. Today, investors and regulators are keener than ever that asset managers use GIPS to give more transparency into performance. Furthermore, consultants and advisers, particularly those representing local authorities and public funds, are using GIPS as a filter during the selection process.

By focusing on 'hedge fund-type' strategies, the Alternative Strategies Guidance aims to close a gap in the GIPS' framework. The Working Group has been formulating this guidance since 2008 – throughout the financial crisis – and it addresses a lot of practical issues that the alternatives industry experienced. As a result, the Guidance will give a range of pragmatic and helpful solutions regarding the application of GIPS in the alternatives space.

Areas of focus

In particular, the Alternative Strategies Guidance addresses the following issues:

- Calculation of returns for structured investment vehicles. For example, calculation in the complex situations of currency hedging and cross-investments within a fund-of-fund structure, and also treatment of fees for the purpose of presenting gross and net-of-fees returns.
- Treatment of 'side-pockets'. GIPS guidance relating to when a side-pocket should be classified as 'non-discretionary' and excluded from the composite performance.
- Selection of appropriate benchmarks for alternative portfolios.
- Return calculation issues, e.g. presentation of leveraged vs. unleveraged returns for portfolios employing derivatives.
- Valuation issues typical for fund-of-hedge funds, such as delayed and infrequent valuations, use of estimated values and illiquidity.

15.06.11

The deadline for feedback on the exposure draft of the Guidance Statement on Alternative Investment Strategies and Structures closed on 15 June 2011.



Accuracy and comparability

GIPS make sure that historical performance is accurately and comparably measured by setting rules governing data input, performance calculations and presentation. On the one hand, they introduce a consistent methodology for generating performance figures, and on the other they limit the scope for cherry-picking the best strategies and time periods.

GIPS' performance histories are closely scrutinised. In the US, the Securities and Exchange Commission (SEC) vigorously polices claims of GIPS compliance, particularly where such claims might lead to false and misleading statements. Recent SEC regional seminars

and compliance alerts have highlighted the incomplete use of GIPS in calculations, along with failures to document their policies and inadequate procedures in establishing and maintaining compliance.

An answer to this is third-party verification. Such an assessment covers the whole firm's performance, rather than its individual portfolios, and also the whole period for which the firm claims to have been in compliance.

Wider use of GIPS by alternatives managers is likely to bring distinct advantages in marketing, by confirming the substance of firms' claims to have created value for investors.

Dimitri Senik is Co-Chair of the Working Group on Alternative Investment Strategies and member of the GIPS Executive Committee.

Private equity through the SEC's lens

With regulation imminent for private equity firms with activities in the US, understanding the SEC's likely perspective on some established practices can only bolster the brand.



Brendan McMahon

PwC (Jersey)
+44 1534 838234
brendan.mcmahon@je.pwc.com



Elizabeth Thedford

PwC (UK)
+44 20 7213 3931
elizabeth.b.x.thedford@uk.pwc.com

Private equity firms all over the world will soon need to see their activities through the lens of the US regulator, the Securities and Exchange Commission (SEC). And the SEC may well believe that what seemed perfectly respectable in the long era of self-regulation does not correspond with its view of acceptable behaviour.

With US endowments and other institutional US investors a major source of private equity capital, many firms around the globe will need to register with the SEC and comply with the Investment Advisers Act of 1940 by the first quarter of 2012. While many non-US advisers may be exempt from registration, these exemption rules are not yet final and many of the rules require increased transparency to the SEC and compliance with various aspects of the Act.

Moving from an unregulated to a regulated environment is a substantial challenge. Firms must appoint a competent chief compliance officer and give the officer appropriate resources. Additionally, the firm must implement effective compliance programmes, backed by policies, procedures, testing and records. Beyond building the compliance infrastructure, they need to review working practices established over many years.

The SEC has been improving its knowledge of private equity firm practices through training and recruiting industry specialists, so we expect it will view some practices as unacceptable, and therefore grounds for deficiency letters or enforcement actions.

Being thoroughly prepared for regulation by foreseeing the SEC's views can only boost a firm's standing, both with investors and other stakeholders. But failure to do so might lead to civil, or even criminal, compliance actions.

Practices to review

We believe that private equity firms should look at their practices in the context of a number of regulatory issues. In particular, they should look for potential conflicts of interest and make sure they identify, mitigate and disclose them. Firms should scrutinise the following practices for conflicts of interest:

- **Successive funds.** Using newer funds to support older funds' investments leads to potential conflicts of interest between the funds.
- **Allocation of investments.** When several funds operate in a similar area, firms should disclose to investors how they make allocation decisions. Similarly, when two funds both own

part of a portfolio company, the firm should disclose the valuation method for the company. Cross trades between funds should be executed using previously disclosed policies and procedures.

- **Expenses.** Expenses born by funds should be plainly disclosed, and the firm should not charge any additional expenses to the funds. Where there are co-investors in deals, expenses should be fairly allocated across all investors, especially in the case of broken deals.

Identifying all possible sources of material non-public information in order to prevent insider trading is another potentially troublesome area. Due to the complexity of the private equity business, there may be a number of potential sources. A compliance programme should include regular training on identification and mitigation of this risk.

Finally, the SEC requires that advisers keep all information needed to substantiate performance claims. Because private equity firms often use internal rates of return from previous funds for marketing purposes, they might have to keep performance data for long periods of time.

Preparing across the firm

When preparing for registration, private equity firms should be sure that they have re-evaluated all practices that might be judged non-compliant by the SEC. They also need to make employees across the firm aware of the implications of compliance.

Making sure that the whole firm behaves within the letter and spirit of regulations can only boost the brand. The SEC is not alone in its focus on controls – regulators and investors everywhere want to see strong compliance programmes and control environments. Having this infrastructure in place allows top management to focus on creating portfolio value.

Time to analyse AIFMD's impacts

A delay to AIFMD's legislative progress should not be seen as a reason to delay preparations for its impact – industry needs to take action now.



James Greig

PwC Legal (UK)
+44 20 7213 5766
james.greig@pwclegal.co.uk

Beleaguered by other regulatory changes and taking comfort in the seemingly distant implementation date, many firms seem to be rather detached from the reality of AIFMD.

Although it is a full two years until the European Union's (EU's) much-debated Alternative Investment Fund Managers Directive (AIFMD) comes into effect, currently anticipated to be in June 2013, the UK's Financial Services Authority is already quizzing firms about their readiness. So if alternative investment firms have not yet started carrying out impact analyses, now is the time.

Two recent announcements also serve as timely reminders that the AIFMD continues its legislative progress. Citing immense legislative workload, the European Commission allowed the European Securities and Markets Authority (ESMA) to delay its technical advice on the Directive for two months until November this year. And Switzerland's Federal Council in Berne is urging that Swiss legislation be brought into line with the Directive, securing Swiss alternative funds access to the EU market.

The ESMA delay will hold up definition of AIFMD's level 2 details (although we do expect some feedback on level 2 consultation in mid-July), but this should not be seen as a pretext for deferring preparations. For managers and service providers there is much to do. While the finer detail of the Directive is not decided, its general thrust is clear. Firms need to start analysing now how AIFMD will effect them, because for some the impact may be significant.

Beleaguered by other regulatory changes and taking comfort in the seemingly distant implementation date, many firms seem to be rather detached from the reality of AIFMD. Recent surveys have indicated that large numbers of firms are either unprepared for AIFMD implementation, or still want more information about the Directive.

After all, many have thought they had a far more pressing deadline in the form of registration with the US Securities and

Exchange Commission (SEC), following the Dodd-Frank Wall Street Reform and Customer Protection Act, although the SEC now says it is considering postponing this until first quarter 2012.

Strategic and operational reviews

To start preparing, firms need to combine strategic level reviews with operational reviews of internal processes. In order to get a holistic picture, they should combine these with analyses of the Dodd-Frank legislation and the following other new regulatory regimes, which impact alternatives less directly:

- The Solvency II regime for insurers and its effect on their product needs and information requirements.
- The European Market Infrastructure Regulation and its effect on derivatives management and trading.
- The UCITS IV and V directives and their effect on retail hedge funds.

Critical issues

When analysing the impact of AIFMD, understanding how to manage liquidity and knowing the detailed risk profile of funds under management will be critical. Firms should be working out whether their existing resources and techniques are adequate to define their risks and to prepare economic and operational risk maps. It is quite possible that they will need additional resources to do this, as well as new methodologies.

Firms should also be working out in detail how their relationships with service providers will change. Those that have relied primarily on prime brokers for custody will need to form new relationships with depositaries. These depositaries will have significant regulatory responsibilities and liabilities. Naturally, they will charge accordingly.

Without doubt, the AIFMD, alongside other new regulations, will fundamentally affect firms' strategic plans for structuring and marketing products in the future. If firms find that major changes are either necessary or desirable, then the effort, time and costs involved are likely to be substantial. There is no time to waste.

Initiating a program now to identify and assess the critical business, tax, and operational impacts arising from FATCA will help to support compliance for January 1, 2013.

Planning for FATCA

Pleas from the asset management industry for a 'carve-out' for widely held investment funds have so far fallen on deaf ears, so it is time to prepare for FATCA's arrival.



Oscar Teunissen

PwC (US)
+1 646 471 3223
oscar.teunissen@us.pwc.com



Rob Bridson

PwC (UK)
+44 20 7804 7590
rob.bridson@uk.pwc.com



Debbie Payne

PwC (UK)
+44 20 7213 5443
debbie.a.payne@uk.pwc.com

Initiating a program now to identify and assess the critical business, tax, and operational impacts arising from FATCA will help to support compliance for January 1, 2013. Although, we understand, the US Treasury has received more comments about FATCA than any other tax legislation, only a further Act of Congress could change the effective date. Given that the US Treasury views the legislation as preventing tax evasion by US citizens, this is unlikely to happen.

The asset management industry has lobbied extensively for a 'carve-out' for 'widely held' investment funds. When the US Treasury issued Notice 2011-34, on 8 April 2011, it proposed only a limited exclusion for certain collective investment vehicles deemed compliant. While it is possible there may be further amendments – for example a case is being made for a 'grand-fathering' provision for widely held collective investment vehicles – this is creating uncertainty for the asset management industry.

Taking into account the time required following the issuance of a Notice by the US Treasury to allow for consultation and assessment of comments, it is unlikely that further Notices can be issued in advance of the draft regulations, if they are to be published by the end of 2011. This means that the scope for further lobbying is limited and, in reality, fund advisers of all types – including hedge, private equity and real estate – would be well advised to start preparing.

Most private investment funds will need to comply

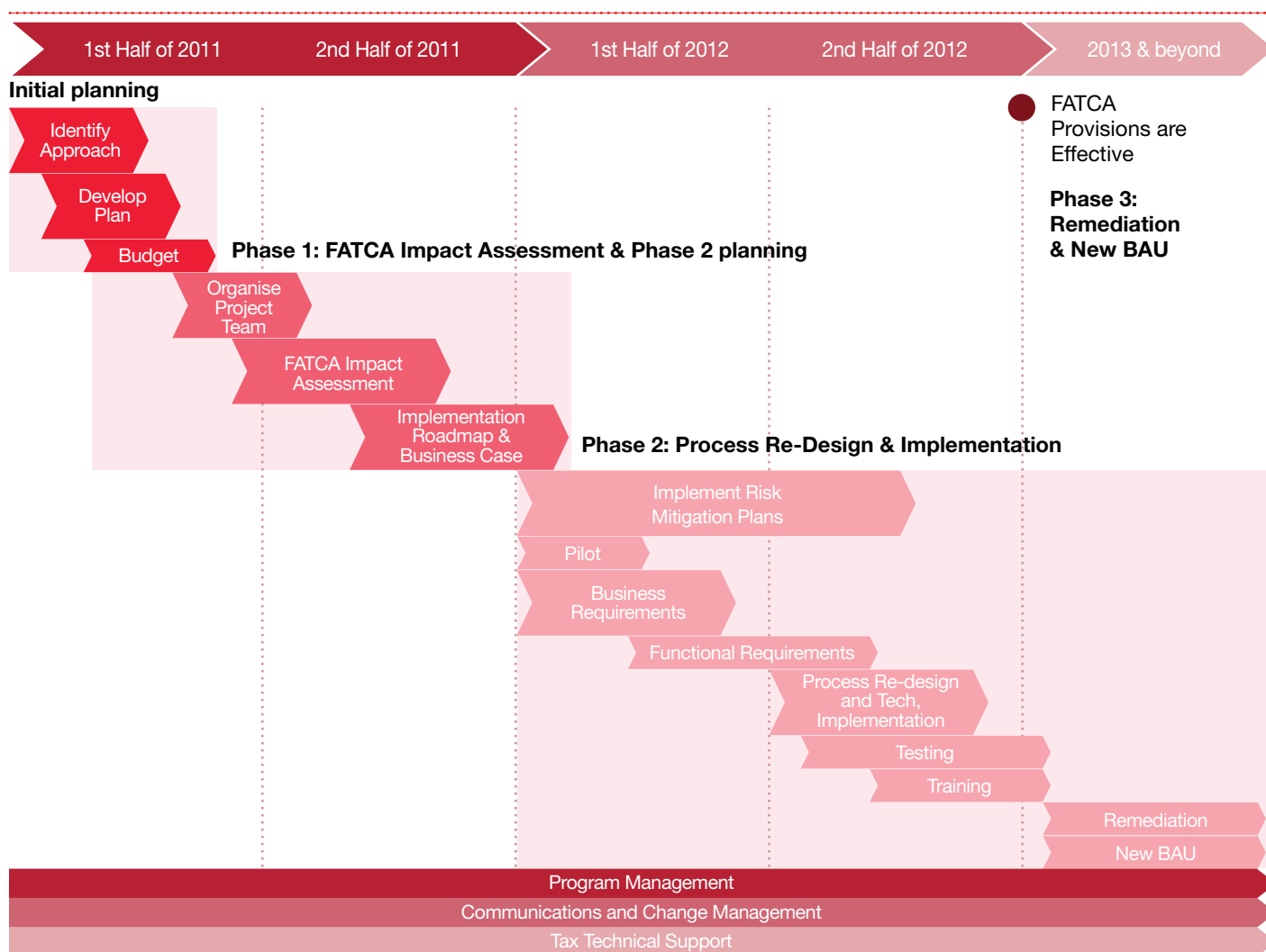
Based on the Notices, it appears likely that most private investment funds will be required to comply with FATCA in order to avoid suffering the 30% tax on withholdable payments, which includes the gross proceeds of the sale of US securities.

Those asset managers with no, or minimal, amounts of income from US sources that were considering ignoring FATCA should look at the guidance in Notice 2011-34 on 'Passthru payments' and reassess their positions. Under this rule, even a foreign financial institution (FFI) with no US investments could suffer US withholding. This is because participating FFIs may be required to withhold on 'Passthru payments' made to non-participating FFIs. This could be something as simple as depositing monies in an account with an institution that is an FFI.

Additionally, those funds that are treated as Deemed Compliant FFIs (DCFFIs) will still have to comply with standards and procedures prescribed in the final regulations. These will need to make sure that such funds do not have direct or indirect US investors. DCFFIs must apply for such status, obtain an identification number and certify every three years that they continue to satisfy the requirements for such treatment.

Analysis and planning

Overall, we conclude that asset managers need to start to analyse the business impact that FATCA will have on their funds and operational functions. This will allow them to be sure that they can move quickly once the regulations are published. Additionally, large institutional investors may want to see evidence that fund sponsors are preparing for FATCA before they will commit to further investment.

Figure 1: Overview of FATCA implementation approach

Source: PwC

FATCA compliance, particularly by offshore funds focused on alternative investments, will likely present substantial business and operational challenges, from the identification and documentation of investors, to the fund's portfolio and IT systems, which may effect multiple functions (tax, legal, back-office administration, operations, IT, etc.) and take substantial time and resources to address. Asset managers that complete a timely assessment of the critical business, tax and operational impacts to their funds and operational functions will increase their opportunity to address the issues through a complete, effective, timely and cost-efficient implementation programme. As a result, offshore funds with long or synthetic, direct or indirect,

exposures to US capital markets should begin to prepare for FATCA as soon as possible.

Conclusion

While there are many unanswered questions – and judgements will have to be made on how to interpret the regulations – asset managers must make sure that they prepare for the rules in consistent ways across their organisations. If organisations take different approaches in different territories, the Internal Revenue Service will ask why did you not get this right in every territory?

Initiating a programme now to identify and assess the critical business, tax and operational impacts arising from FATCA will permit full compliance by 1 January 2013 (the effective date of FATCA's new documentation requirements, due diligence procedures and reporting obligations).

70%

Domestic asset managers, which control 70% of assets, do not have the required skills to manage foreign securities.

Foreign asset managers optimistic in Japan

Our 2011 Japan Asset Management Survey shows foreign asset managers are optimistic about growing their businesses, as local investors seek out higher returns in overseas markets.



Takeshi Shimizu

PwC (Japan)
+81 (0)90 6515 1754
takeshi.shimizu@jp.pwc.com



Rajendra Singh

PwC (Japan)
+81 (0)80 3445 1002
rajendra.r.singh@jp.pwc.com

Asset managers are optimistic about growing their businesses in Japan's huge savings market, according to the PwC 2011 Japan Asset Management Survey.³ They are planning to take advantage of Japanese investors' growing appetite for higher return products rather than conservative domestic investments. In particular, investors are looking for foreign and emerging funds, especially in Asia.

But investing in foreign securities will effect the structure of Japan's JPY63.7 trillion⁴ investment trust management (ITM) market because domestic asset managers, which control 70% of assets, do not have the required skills to manage foreign securities. As a result, they will have to make specific arrangements such as the delegation of portfolio management to offshore asset managers, or the creation of funds of funds.

Asset managers' priorities

The survey showed that presence in Japan seems to be critical for foreign asset managers' distribution channels. But one of the foreign asset managers' priorities is to increase profitability, which has halved in five years, largely due to the decline in assets since the beginning of the global financial crisis. Asset managers are now looking at outsourcing and technology as an important business solution. The survey noted that domestic asset managers are also considering this option, even if outsourcing has been considered as a taboo in Japan, due to sensitivities around control and people loyalty.

In order to improve their margins, asset managers also want to rationalise their products, by closing or merging smaller funds. But the survey noted a growing frustration, due to barriers preventing this rationalisation, such as the high costs and practical issues afflicting the merger of funds.

Japan's strong regulation makes the profession conservative. With investor demand shifting and the financial industry evolving, market participants would like to be more innovative and would appreciate more flexibility from the regulator. As part of this issue, the dual net asset value (NAV) requirement (ITM accounts have to be maintained by both trust banks and asset managers) is hotly debated. Most asset managers in the survey said they would be ready to move to a single NAV model, together with a materiality threshold for correction of errors.

Earthquake's effect

The Great Tohoku Earthquake did not have a significant impact on the sector's assets under management, although it temporarily affected the market performance. Asset managers implemented business continuity plans and they were able to continue business as usual. But they are revisiting their plans in the light of the magnitude of the earthquake, and looking at relocating back-up sites far from Tokyo.

Even if deep changes in regulation and practice seem to be critical for the success of the industry in the longer term, asset managers are optimistic about their operations in Japan, thanks to the opportunities given by the huge financial assets held by households and the growing demand for higher return products.

³ Japan's financial assets held by non-financial institutions, governmental organisations, households and other not-for-profit organisations were worth over JPY2,789 trillion on 30 September 2010, according to the Bank of Japan, second only to the US.

⁴ Source: The Investment Trust Association, December 2010.



Global Asset Management contacts

Asset Management News is produced by experts in their particular field to address important issues affecting the asset management industry. If you would like to discuss any aspect of this document, please speak to your usual contact at PwC or a member of our global or territory leadership team.

Global Asset Management Leadership Team



Barry Benjamin

PwC (US)
Global Leader, Asset Management
+1 410 659 3400
barry.p.benjamin@us.pwc.com



Kees Hage

PwC (Luxembourg)
Global Leader, Real Estate
+352 49 48 48 2059
kees.hage@lu.pwc.com



John Parkhouse

PwC (Luxembourg)
European, Middle East & Africa Leader,
Asset Management
+352 49 48 48 2133
john.m.parkhouse@lu.pwc.com



Pars Purewal

PwC (UK)
UK Leader, Asset Management
+44 20 7212 4738
pars.s.purewal@uk.pwc.com



Brendan McMahon

PwC (Channel Islands)
Private Equity Leader,
Global Asset Management
+44 1534 838234
brendan.mcmahon@je.pwc.com



Robert Grome

PwC (Hong Kong)
Asia Pacific Leader, Asset Management
+852 2289 1133
robert.grome@hk.pwc.com



Will Taggart

PwC (US)
Global Tax Leader, Asset Management
+1 646 471 2780
william.taggart@us.pwc.com



Mike Greenstein

PwC (US)
Global Leader,
Alternative Investments
+1 646 471 3070
michael.s.greenstein@us.pwc.com

Territory Leaders

Argentina

Diego Sisto
+54 11 4850 4715

Australia

Andrew Wilson
+61 2 8266 3337

Austria

Thomas Strobach
+43 1 501 88 3640

Bahamas

Dawn Jones
+1 242 302 5300

Belgium

Emmanuèle Attout
+32 2 710 40 21

Bermuda

Andrew Brook
+1 441 299 7126

Brazil

João Manoel dos Santos
+55 11 3674 2224

Canada

Rajendra Kothari
+1 416 869 8678

Cayman Islands

Graeme Sunley
+1 345 914 8642

Channel Islands

Brendan McMahon
+44 1534 838234

Chile

Roberto Villanueva
+56 2 940 0070

China

Alex Wong
+86 21 2323 3171

Cyprus

Costas Mavrocordatos
+357 22 555 202

Czech Republic

Glen Lonie
+420 2 51 152 619

Denmark

Mikael Sørensen
+45 39 45 9269

Finland

Tuukka Lahkela
+358 9 2280 1333

France

Alain Le Barbanchon
+33 1 5657 1084

Germany

Peter Seethaler
+49 69 9585 3436

Gibraltar

Edgar Lavarello
+350 200 73520

Greece

Mary Psylla
+30 210 6874 543

Hong Kong SAR

Robert Grome
+852 2289 1133

Hungary

Arpad Balazs
+36 1 461 9163

India

Gautam Mehra
+91 22 6689 1155

Ireland (Republic of)

Damian Neylin
+353 1 792 6551

Isle of Man

Michael Simpson
+44 1624 689 689

Italy

Elisabetta Caldirola
+39 2 778 5380

Japan

Takeshi Shimizu
+81 90 6515 1754

South Korea (Republic of)

Jae-Hyeong Joo
+82 2 709 0622

Luxembourg

Didier Prime
+352 49 48 48 2127

Malaysia

Mohammad Faiz Azmi
+60 3 2173 0867

Malta

Joseph Camilleri
+356 2564 7603

Mexico

Jose Antonio Quesada
+52 55 5263 6000

Netherlands

Fred Gertsen
+31 10 407 6614

New Zealand

Paul Mersi
+64 4 462 7272

Norway

Geir Julsvoll
+47 95 26 05 40

Pakistan

Rashid Jafer
+92 21 2424500

Poland

Adam Celinski
+48 22 523 4330

Portugal

António Assis
+351 213 599 000

Russia

Richard Gregson
+7 495 967 6327

Singapore

Yeow Chee Keong
+65 6236 7298

Slovakia

Christiana Serugova
+421 2 59 350 614

South Africa (Republic of)

Pierre de Villiers
+27 11 797 5368

Spain

Enrique Fernandez Albarracin
+34 91 568 4504

Sweden

Susanne Sundvall
+46 8 555 332 73

Switzerland

Thomas Huber
+41 58 792 2436

Taiwan

James Huang
+886 2 2729 6666

Thailand

Anothai Leekitwattana
+66 2 344 1100

United Kingdom

Pars Purewal
+44 20 7212 4738

United States of America

Barry Benjamin
+1 410 659 3400

If you would like to receive copies of this newsletter or would like further information about PwC's asset management publications, please contact denise.cook@uk.pwc.com

Editor: Rupert Bruce

www.pwc.com/assetmanagement

This publication has been prepared for general guidance on matters of interest only, and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PricewaterhouseCoopers does not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.

© 2011 PwC. All rights reserved. Not for further distribution without the permission of PwC. "PwC" refers to the network of member firms of PricewaterhouseCoopers International Limited (PwCIL), or, as the context requires, individual member firms of the PwC network. Each member firm is a separate legal entity and does not act as agent of PwCIL or any other member firm. PwCIL does not provide any services to clients. PwCIL is not responsible or liable for the acts or omissions of any of its member firms nor can it control the exercise of their professional judgment or bind them in any way. No member firm is responsible or liable for the acts or omissions of any other member firm nor can it control the exercise of another member firm's professional judgment or bind another member firm or PwCIL in any way.