

Infrastructure: From Cost to Benefit Hedge Funds 2.0

*Preparing the next
generation of hedge funds
for growth.*



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At a time when hedge fund investors, legislators and regulators are seeking improved governance, controls and transparency, strong infrastructure is critical. These demands are raising the bar, and having the right people, repeatable processes and scalable technology has become more important than ever. With investor appetite for hedge fund strategies increasing, high-quality infrastructure will benefit managers by preparing them for the next stage in their growth.

Executive summary

- In the aftermath of the financial crisis, firms in the hedge fund sector are strengthening their infrastructures in response to investor demands and new regulations. Such is the pace of change, with some new regulations still being defined, that many sector participants need to adapt their infrastructures – across the areas of people, processes and technology – to their emerging regulatory and business requirements.
- During due diligence, institutional investors are carefully checking that there are appropriate controls across the hedge fund value chain – from the fund board, to the manager, prime broker and administrator. As a result, having a strong and robust infrastructure is becoming a prerequisite for raising assets.
- New regulations in the US and Europe are driving specific infrastructure enhancements in areas such as compliance, risk management, valuation, tax and investor reporting. Although many details of new regulations remain unclear, the bar has been raised. We are already witnessing ‘survival of the fittest’ in the rejuvenated hedge fund world.
- Competition for high-quality tax, risk and compliance staff is rising, demonstrating the importance of having experienced people with good credentials. Remuneration for these individuals is increasing, reflecting trends in the investment banking industry. New regulations in Europe are also affecting the structure of remuneration.
- Internal control reports are becoming more popular across the industry’s value chain. They are now standard for administrators and will soon be for prime brokers. A growing number of managers are now commissioning them, perhaps gaining an advantage over those that do not, by enhancing investors’ trust in operational controls. In doing so, they are satisfying investors’ ‘trust but verify’ mantra.
- Rising confidence in hedge fund infrastructure is helping the sector to return to growth. Making appropriate infrastructure enhancements gives benefits to all parts of the sector – managers, prime brokers, administrators and even investors. Benefits range from being able to respond efficiently to today’s and tomorrow’s new compliance, tax and investor reporting requirements, to being able to better compete for institutional assets, and introducing the formality around controls and processes which all businesses need as they expand.
- In summary, the strengthening of hedge fund infrastructure marks a new stage in the sector’s evolution.

Infrastructure defined

A collective term for the subordinate parts of an undertaking; substructure, foundation¹. For hedge fund managers and their service providers, infrastructure describes the people, processes and technology that facilitate operations.

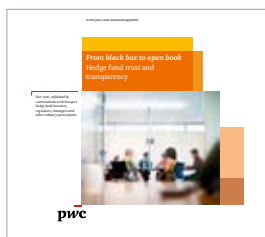
¹ The Compact Oxford English Dictionary, Second Edition.



‘Institutional investors are seeking greater protection in their portfolios, and hedge fund managers with proven track records stand to benefit greatly.’

PwC From Black Box to Open Book, Hedge Fund Trust and Transparency, October 2010.

Why stronger infrastructure matters



From Black Box to Open Book, Hedge Fund Trust and Transparency, October 2010.

Following interviews across the European hedge fund sector, we report that improvements relating to conflicts of interest and operational controls will allow the sector to fulfil its growth potential.

The recent credit crisis ushered in a new phase in the evolution of the hedge fund industry. Even though some hedge funds performed poorly and others did not survive as markets plunged, the sector proved resilient.

This resilience won the interest of new institutional investors who seek the potential for both protection in times of crisis and an attractive return profile over different economic cycles. But their interest comes at the price of broad transparency into various aspects of managers' operations, business and controls. Awakened by the severity of the crisis, regulators moved to regulate hedge fund managers, along with other unregulated alternative asset managers. Finally, tax authorities near and far stepped up their scrutiny in search of much-needed revenue, paying renewed attention to offshore structures.

In Asia, recent events have added a twist to the need for stronger infrastructure. The earthquake in Japan has shown the importance of disaster recovery centres.

Investor scrutiny

As we reported in our recent point of view, *From Black Box to Open Book, Hedge Fund Trust and Transparency*, institutional investors are seeking greater protection in their portfolios, and hedge fund managers with proven track records stand to benefit greatly. The interviews we carried out when researching the study suggested institutional investors were increasing their allocations to hedge funds, but were also conducting deeper and more probing operational due diligence. Investors are requiring far higher standards of governance and more reliable operations, combined with greater transparency into operational controls, tax risks, remuneration, investment portfolio construction and performance.

Underlining the influence of institutional investors, the Alternative Investment Management Association (AIMA) recently published a guide to investor preferences regarding operational infrastructure. AIMA states that institutional investors might have a greater influence than regulators over how managers operate going forward.

New regulations

The regulators' demands for infrastructure are specific. In the US, investment advisers to private funds must soon register with the Securities and Exchange Commission (SEC). Although the original registration deadline was 21 July 2011, the SEC is

2 A guide to institutional investors' views and preferences regarding hedge fund operational infrastructures. AIMA Steering Committee, May 2011.

extending this to first quarter 2012. As the leaders of our regulatory practice explain in our A Closer Look series, upon registration managers must have an effective compliance programme, including a qualified chief compliance officer, commensurate with the size and complexity of the managers' operations to withstand the scrutiny of the SEC.

The new EU Alternative Investment Fund Managers Directive (AIFMD) does not ask managers to register with their respective national regulators until June 2013, but its requirements are just as onerous, as we explain in our AIFMD News series. From an infrastructure perspective, the European Securities & Markets Authority (ESMA) will make the AIFMD's precise implications clear when it publishes the Directive's detailed level 2 measures in the second half of 2011.

From a tax perspective, after 1 January 2013, the US Foreign Account Tax Compliance Act (FATCA) will impose a 30% US withholding tax on any US-sourced income and the gross proceeds from the sale of investments that produce US-sourced interest or dividends (withholdable payments) received by any offshore fund. A fund can avoid this tax by entering into an agreement with the US Government and complying with new documentation requirements, due diligence procedures and reporting obligations. FATCA compliance, particularly by offshore funds focused on alternative investments, presents substantial business and operational challenges, from the identification and documentation of investors, to the fund's portfolio and IT systems, which might affect multiple functions (tax, legal, back-office administration, operations, IT, etc.) and take substantial time and resources to address.

Beyond these headline regulations, the US Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), and the EU European Market Infrastructure Regulation will both have an impact on hedge funds' derivatives clearing, by introducing separate systems for the US and Europe. The European Commission also proposes to introduce new legislation, governing short selling.

The hedge fund sector as a whole has much to gain from its enhanced respectability. But managers and their service providers will only benefit if they give investors and regulators the stronger infrastructure – spanning people, processes and technology – that they are now demanding.



AIFMD News.

Our European regulatory practice leaders report developments in the AIFMD's legislative progress and suggestions for action.

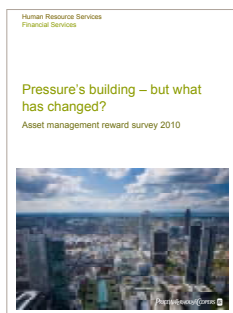
A Closer Look.

Our regulatory practice leaders scrutinise how the Dodd-Frank Wall Street Reform and Consumer Protection Act will impact different market segments, including hedge funds. This ongoing series monitors developments and provides additional insight and analysis.

Becoming FATCA Compliant, Why Asset Managers Should Prepare Now, May 2011.

We explain the substantial business and operational challenges posed by FATCA, and the steps that asset managers can take to prepare now.

People



Pressure's Building – But what has Changed? October 2010.

Our fifth annual survey of compensation in UK and European asset management reveals how regulation is affecting remuneration levels and structures.

Hedge fund managers are famously known as takers of calculated portfolio risks. Yet they are neither operational nor reputational risk takers. As a result, they are also focusing on their compliance, tax, financial reporting, legal, internal audit and even marketing functions, as they build out their organisations in order to satisfy investor scrutiny and to cope with emerging regulations. Doing so is giving them the platform and the right complement of skills and experience needed for the next generation.

Our 2010 UK Asset Management Reward Survey – covering the world's second largest hedge fund management centre – revealed compliance and risk as the area of strongest recruitment activity, with over 90% of survey respondents categorising it as either 'active' or 'very active'. The market for back-office staff was also healthy, with 60% to 70% of participants rating this area as either 'active' or 'very active'. By contrast,

approximately 50% of participants judged, reported they were 'not very active' or had 'no activity' in recruitment of portfolio managers, indicating that for now this was not the focus of their recruitment activity.

Such strong demand is feeding through to considerable wage inflation. In Europe, we have seen base salaries for experienced compliance staff double in recent years. Total compensation has not risen to such an extent because following trends in investment banking, bonuses are falling as a proportion of remuneration. What is more, the Financial Services Authority's recently published Remuneration Code, based on the EU Capital Requirements Directive, makes clear that variable remuneration for roles such as compliance professionals should be based on how well they perform their jobs – not the firm's profits.

By strengthening their human resources frameworks, hedge fund managers can not only satisfy investors' and regulators' emerging requirements, but also enhance the effectiveness of their control environments, the formality of their processes and their capacity for growth. They can offer many different strategies, diversify their own revenues across multiple products, and service varying investor types. As higher standards are asked of the middle and back offices, so generalist roles and 'double-hatting' are being replaced by specialist positions.

Investor relations' roles are also changing, as marketing, client service and communications professionals are added to service the growing universe of investors and fund types, especially Undertakings for Collective Investment in Transferable Securities (UCITS) in Europe.

Clearly, increased regulation is driving the need for an effective compliance function. The SEC requires hedge fund managers registering with it under the Investment Advisers Act of 1940 to appoint chief compliance officers (CCOs) with sufficient experience and resources to carry out effective compliance programmes. The CCO has to develop policies and procedures designed reasonably to prevent and detect violations of the law. Furthermore, the rising burden of regulation in Europe and, to a lesser extent, Asia, makes the strengthening of compliance resources inevitable.

There is also a greater need for legal and tax expertise to interpret and comply with new regulations and complex tax requirements, which might be met either internally or externally. Meanwhile, finance functions must address increased volume and complexity of financial reporting for funds and investment advisers under applicable accounting standards. As a result, the financial reporting function is employing more dedicated and trained financial reporting expertise as managers start to view



‘Compliance and risk was the area of strongest recruitment activity, with over 90% of survey respondents categorising it as either ‘active’ or ‘very active’.

PwC UK asset management reward survey, Pressure’s Building – But what has Changed? October 2010.

financial reporting as a discrete process, rather than the end result of other processes.

Tax capabilities often need to be improved so that they can respond quickly to investor enquiries, address myriad new tax rules and information reporting requirements, and respond to multi-jurisdictional tax audits. This requires hiring additional tax resources, or asking more of the existing resources. More and more, organisations are expecting the tax function also to serve as a part of the risk management function. To do this, they are attempting to integrate tax management into all of their processes, rather than just treating it as a ‘bolt-on’ function. For many managers, this requires both cultural change and improvement in the tax function’s efficiency.

Beyond the hedge fund manager, both lobbying by European institutional investors for stronger hedge fund boards and the regulators’ focus on independent valuation of illiquid assets are creating a demand for new skills and new services. According to our publication, From Black

Box to Open Book: Hedge Fund Trust and Transparency, as some institutional investors make independent boards a precondition for investing in offshore hedge funds, some funds have responded by appointing seasoned investment professionals to their boards, instead of professional directors.

Valuing funds’ illiquid assets is a critical area where investors and regulators desire objectivity. Europe’s AIFMD stipulates that assets should be independently valued. The Directive allows managers to continue valuing assets internally, provided valuation teams are independent of the portfolio managers. For a variety of reasons, some managers might look to the fund administrators or others to fill the role. One way or another, the sector will have to continue to build the infrastructure to support the valuation of illiquid assets.

In summary, the hedge fund sector’s new era of enhanced governance and new regulation is leading it to focus on building its capabilities to continue to take portfolio-related risks while mitigating operational and reputational



risks. As the strengths of the middle and back-office functions grow, they will help the sector to take advantage of its growth opportunities.

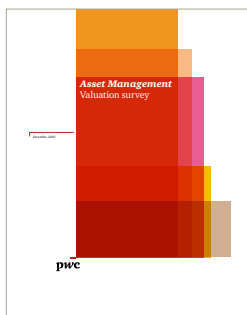
3. From Black Box to Open Book: Hedge Fund Trust and Transparency. PwC, October 2010.



Our point of view

- Compliance, risk management and other middle and back-office functions remain a focus of recruitment activity as the industry looks to draw experienced and specialised talent from more mature asset management and financial services organisations.
- Remuneration for compliance and risk management staff is rising significantly, reflecting increasing demand for their skills.
- In order to strengthen fund governance, the sector is likely to seek experienced professionals as board directors and valuation experts.
- Building out the skills base in an organisation will prepare hedge fund managers and service providers to take advantage of the sector's future growth.

Processes and controls



PwC 2010 Asset Management Valuation Survey, December 2010.

We publish the results of a survey into the valuation governance process at a time when firms have faced increasing valuation challenges and the SEC has identified valuation as an area of risk to investors.

Responding to the demands of institutional investors and regulators, the hedge fund sector is strengthening its processes and controls. Most commonly, hedge fund managers are applying existing control processes more systematically and making informal control processes more formal. Doing so reduces the reliance on individuals, which in turn, reduces the potential for control failures while also giving investors and regulators greater comfort.

Since the financial crisis, institutional investors have made rigorous controls and greater transparency a prerequisite for investing in hedge funds. The due diligence process is becoming more rigorous, more intrusive and more time-consuming. Investors are also scrutinising administrators' controls, seeking to understand their precise roles in valuing assets, as well as the details of service level agreements. As for prime brokers, investors want as much transparency as possible into safeguarding of assets.

Regulators are making more precise

demands, which are still unfolding as the details of new regulations are finalised. Within the US, the SEC requires hedge fund managers registering with it for the first time to adopt and implement written policies and procedures, and adopt a written code of ethics setting out standards for employee conduct. Surveillance procedures need to be developed to monitor that these are being observed.

In particular, investors and regulators want to see reliable policies and controls across the hedge funds value chain in the following areas:

- valuation policies and procedures, including contemporaneous documentation of valuation inputs, assumptions and methodologies
- controls surrounding the safeguarding of the fund's assets
- trading policies and procedures, including ethical guidelines
- compliance policies, supporting multiple regulatory demands.

Valuations are a concern of regulators in both Europe and the US. Our 2010 Asset Management Valuation Survey, conducted in the US, showed that almost all hedge fund managers surveyed (94%) had a valuation committee in place to manage and oversee valuation policies and procedures. That said, there was a lack of consistency in the materials that managers were providing to their valuation committees, and almost one-third were not supplying information

‘There is a lack of consistency in the materials that managers are providing to their valuation committees, and almost one third are not supplying information to the boards of their offshore funds. The survey revealed that managers need to focus on areas of the valuation process ahead of registration with the SEC.’

PwC 2010 Asset Management Valuation Survey, December 2010.



‘Among administrators and prime brokers, internal controls reports are now standard practice. Hedge fund managers are also using these reports, and many view them as a source of competitive advantage.’

PwC From Black Box to Open Book, Hedge Fund Trust and Transparency, October 2010

to the boards of their offshore funds. Furthermore, 60% of respondents managing funds without an outside board (i.e. partnerships) had no enterprise or valuation committee to oversee the valuation of investments. The SEC has indicated that it expects independent judgement to be exercised when assets are valued and priced. So managers need to make sure their valuation processes meet the regulator’s expectations ahead of registration.

The tax function is an area where systematic processes and controls are also becoming more important. Relevant details of investors should be collected from the moment they initially invest, in order to satisfy the new FATCA legislation. Furthermore, processes should be established and systems enhanced to capture systematically all trading data relevant to tax, both before and after the trade. Increasingly investors are inquiring about the extent of the tax departments ‘control’ of the tax function, and delving into specific tax positions taken. To address these inquiries, robust processes and controls are a must.

Signifying the increasing importance of transparency into controls processes, a growing number of industry participants

are commissioning internal controls’ reports. As we described in our recent point of view, From Black Box to Open Book: Hedge Fund Trust and Transparency, among administrators and prime brokers, these reports are now standard practice. Hedge fund managers are also increasingly using these reports, and many view them as a source of competitive advantage. Others are preparing for the day when these reports are standard, by going through readiness assessments or diagnostics so that they better understand the potential issues and timing for completion.

While many hedge fund managers are currently re-engineering their controls processes to meet the demands of investors and regulators, others are doing so because they believe this is a natural and necessary step in the growth of their businesses. With some hedge fund managers growing from small or medium-sized specialised businesses to broader financial services organisations, employing hundreds of people across multiple offices in different time zones, they view the introduction of formal controls and repeatable processes as a necessary step, as have other evolving financial organisations before them.





Our point of view

- Hedge fund managers and their service providers are introducing more systematic control processes as they seek to address investors' and regulators' concerns.
- Valuations are an area of particular concern for regulators in Europe and the US.
- Controls surrounding the fund's assets, including existence and safekeeping, remain an area of particular concern.
- Systematic controls and repeatable processes are also becoming more important in the tax and financial reporting functions.
- Establishing strong controls and processes is a necessary step in the growth of any financial institution.

Technology



The Road Ahead for US Hedge Funds, Summer 2010.

We discuss how industry evolution is creating significant complexity and has affected people, processes and technology, from the front office to the back.

Transparency into hedge fund governance, operations and investment activities provides confidence that trust is warranted. Efficient access to data enables managers and their service providers to deliver more high-quality and versatile information, covering everything from portfolio positions and trades to investor bases. At a time when some managers are expanding and diversifying into new strategies and fund structures, technology platforms also need to evolve.

Managers and administrators are commonly reviewing their technology infrastructures and asking whether they are adequate for their evolving needs. The fundamental question is: "If I had to build my technology infrastructure from scratch what would it look like?" Often the answer is: "Not like what I have today, especially when thinking about growth intentions."

Data requirements should be the priority when rethinking technology. By first deciding what data is needed to meet the

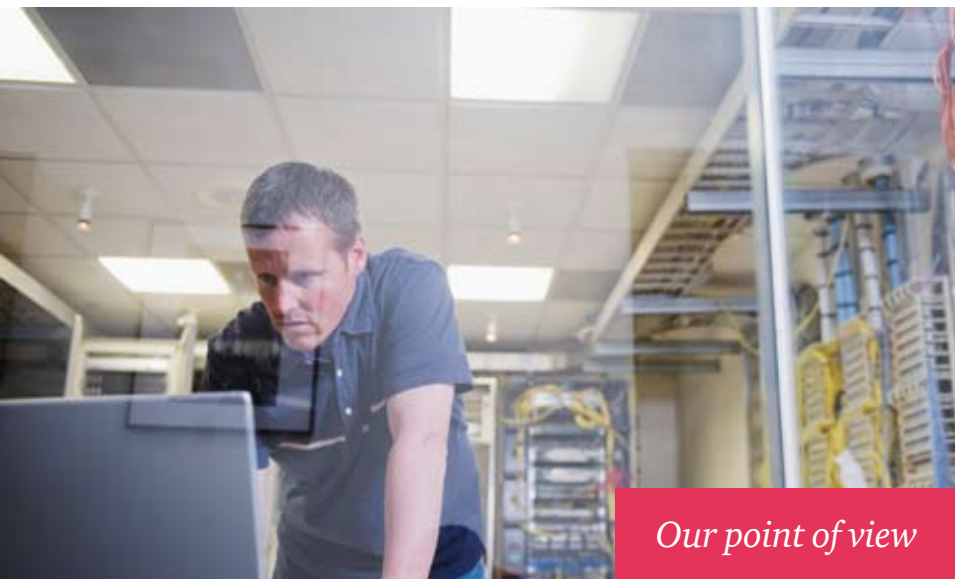
requirements of investors, regulators and tax authorities, not to mention internal constituents, it is possible to develop a data strategy that drives the design of systems and processes that will deliver the desirable outcome.

As firms have grown, they have often built information technology on a piecemeal basis. But with today's greater demands for information, having multiple technology systems means that gathering the data needed takes far longer than it should do. Quite simply, the old way of pulling data from multiple systems is inefficient and certainly not scalable.

Generally, managers and administrators should take an enterprise-wide approach to reviewing their data and technology. The right technology infrastructure enables firms to generate and analyse data quickly, using fewer people and reducing the scope for error. Generally, there are three main benefits:

- Automated systems, with straight-through processing, make firms more efficient and enhance control.
- A central information system (i.e. data warehouse) gives the ability to slice and dice information across funds and investors, as well as to drill down to more detailed data.
- Common applications (e.g. customer relationship management, fund accounting, reporting tools, etc.) can be used across business lines.

In response to investor requests for



‘The goal of IT is to provide a technology platform to facilitate the timely flow and transformation of information usable by a variety of functions for management information and reporting.’

PwC Alternatives Roadshow, *The Road Ahead for US Hedge Funds*, summer 2010

greater information, many administrators are making detailed portfolio and risk information available through web portals. Some have also adopted open architecture systems that give managers easy access to their fund data. For managers, use of investor web portals is evolving, with more data available, including tax information.

In summary, data is the prerequisite for satisfying today’s greater demand for information. Many firms have disparate platforms that have evolved over time and do not allow them to gather data efficiently and systematically. Addressing such technology infrastructure must be part of any firm’s future growth strategy.

Our point of view

- Efficient access to data enables managers and their service providers to deliver more high-quality and versatile information.
- Data requirements should be the priority when rethinking technology.
- Managers and administrators should take an enterprise-wide approach to reviewing their data and technology.
- Many administrators are making detailed portfolio and risk information available through web portals.
- Addressing technology issues must be part of any firm’s future growth strategy.

Conclusion



A second wind – The regulation, taxation and distribution of hedge funds around the globe. June 2010. In its conclusion, this document outlines 10 steps to unlock the door to new maturity.

With the benefit of hindsight, the credit crisis is proving a defining moment in the hedge fund sector's evolution. By revealing not only the strengths of its investment strategies, but also the vulnerabilities of its governance and operational model, the crisis prepared the sector for its next stage of growth.

The sector is now working hard to develop infrastructure that meets stakeholders' emerging expectations and position it for further growth. 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. What is apparent, however, is that much needs to be done in a comparatively short space of time.

The cost of building stronger infrastructure – across people, processes and technology – could well be substantial for some organisations, but, as we stated in our 2010 Hedge Fund White Paper, it is an investment that they need to make in order to grow and mature, as other financial sectors have found before. While this is already raising barriers to entry in the hedge fund sector and making scale an advantage, institutional investors appear ready to raise asset allocations to those managers with attractive investment performance backed by robust infrastructure.

For managers and service providers such as administrators, this is a defining point in their evolution. The decisions they take about developing their infrastructures today will determine the extent to which they will benefit from the sector's expansion tomorrow.

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