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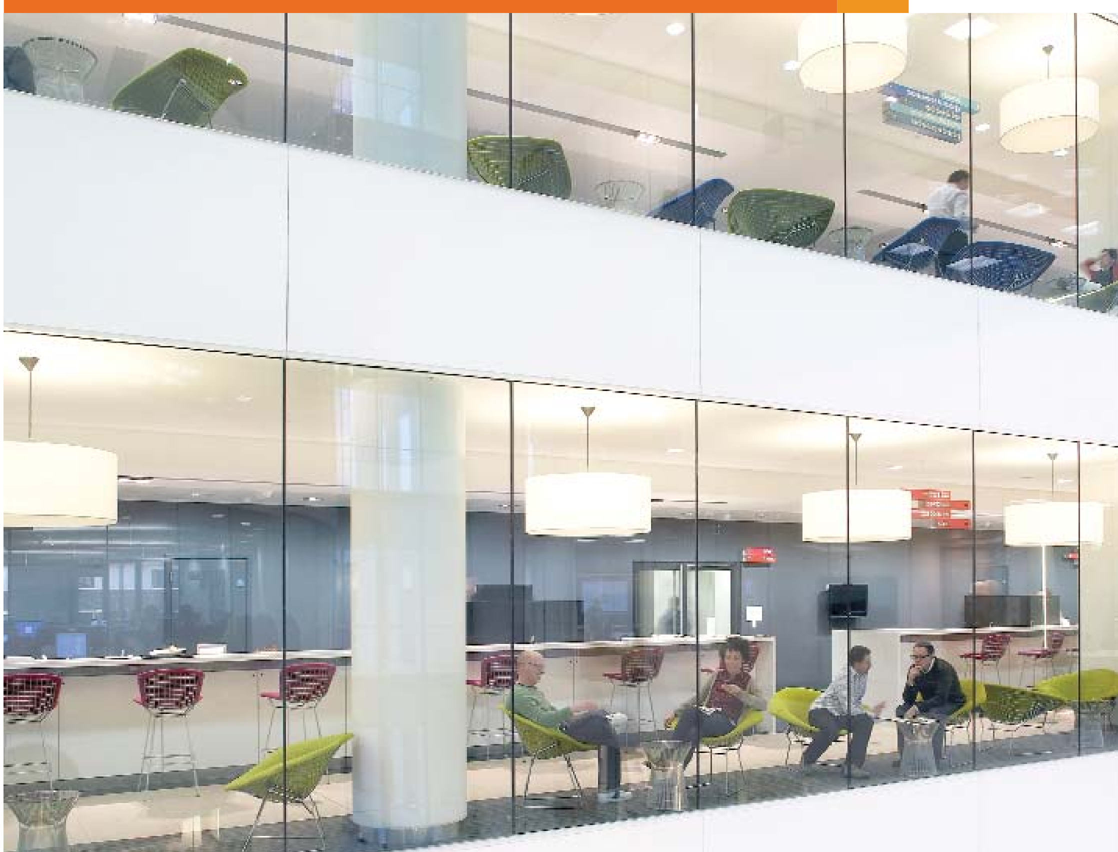
From black box to open book
US hedge fund trust and transparency

Our view, validated by conversations with US hedge fund investors, managers and other industry participants



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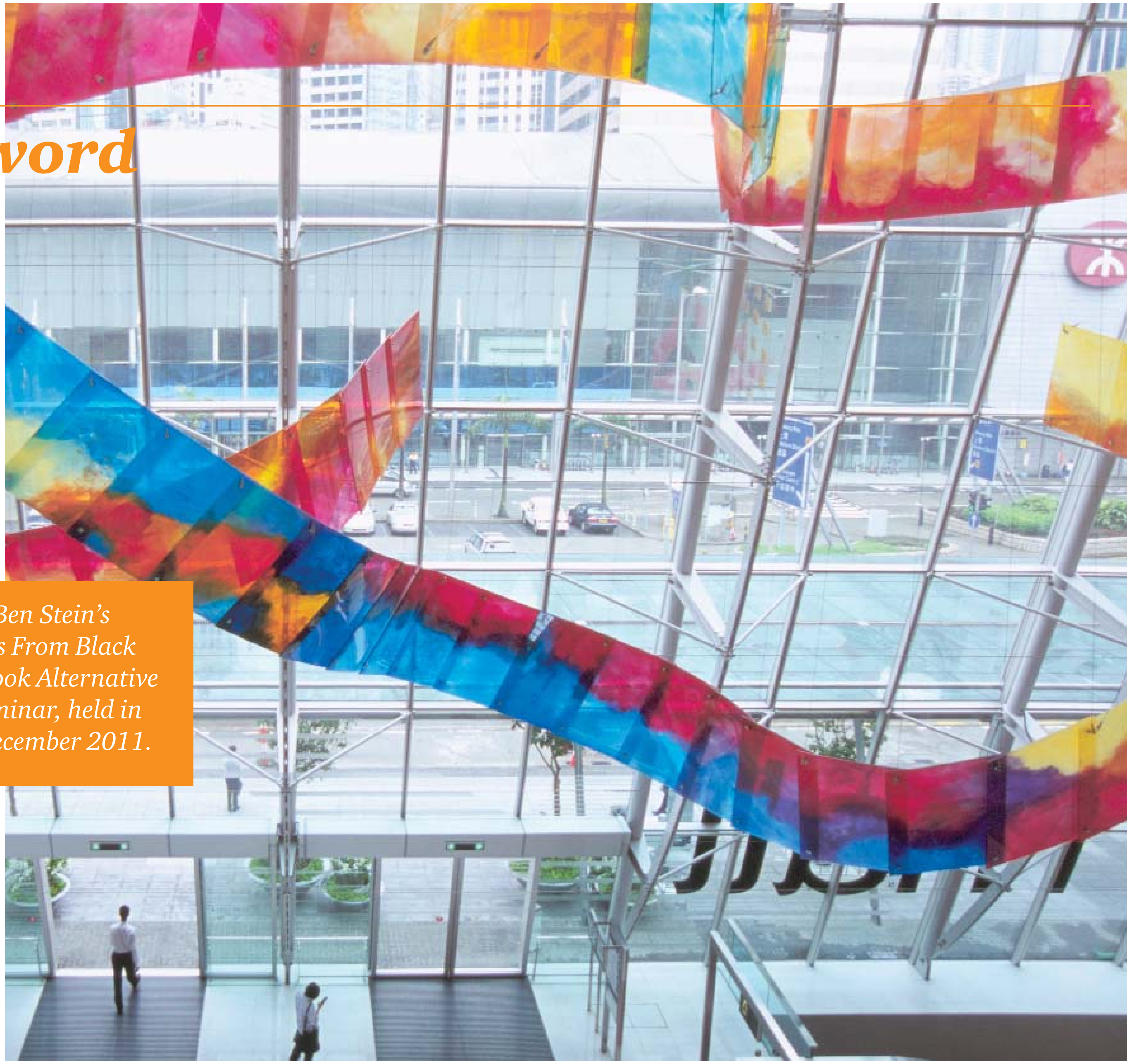
Foreword



Adapted from Ben Stein's speech at PwC's From Black Box to Open Book Alternative Investment Seminar, held in New York in December 2011.

Ben Stein

Ben Stein is a writer, actor, economist and lawyer

Without trust, there is no capitalism. Until a time in the 18th century when wool merchants, sea captains, land owners and nobility realized that they could place their money with others, and others would treat capital with respect, there was no capitalism. There could be wealthy families and there were. But until investors came to believe they could place their money with banks, there could be no aggregation of capital from many different investors to build and invest.

Capitalism was off and running when capital could be entrusted with third parties, fiduciaries, who would not steal the money, but would invest it and pass on the profits to investors.

But for capitalism to get started, there had to be trust. The human wish to steal had to be overridden by the belief that in the long run it would be more profitable, as well as honorable, to treat the trustors fairly and invest the trustors' money instead of just riding away with it.

Trust is still the fundamental building block of capitalism. When there is trust that investors' money will be honestly accounted for, handled with care and transparency, and the proceeds from its use returned to the investors when wanted, there will be growth. But when trust is betrayed and investors are cheated and mistreated, money stops flowing, or flows less, and the whole basis of commerce teeters in the balance.

This failure of trust has happened over and over since the 18th century. On many occasions there have been bubbles in real estate, railroads, canals, technology and government debt—and when they burst, the results have been calamitous.

So trust lies at the heart of the modern economy. Without it there can be no growth because there is no confidence. And without trust, asset managers—today's investment fiduciaries—can't gain the confidence of investors and raise capital to invest.

Contents

US hedge funds have significantly enhanced their transparency, controls and infrastructure, helping to win the trust of institutional investors that is critical for their future growth. Across the hedge fund value chain, a new framework is emerging that is improving investor protection. But this evolution remains a work in progress, with inefficiencies and areas for improvement yet to be addressed.

Executive summary

Transparency plays an important role in building investor trust in every part of the value chain. A "trust and transparency" framework is gradually emerging that will enable the sector to earn the trust needed to fulfill its growth potential.

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The US hedge fund sector is an integral part of capital markets, yet it has developed in a different way to the broader asset management industry. While its investment processes are highly developed, its governance and operations are less so. In the past few years, hedge funds have reacted to the institutionalization of their investor base, and increasing regulation, by enhancing infrastructure and further aligning interests with investors, in an evolution we describe as 'from black box to open book'. A 'trust and transparency' framework is gradually emerging, but it needs to be completed before the sector earns the trust needed to fulfill its growth potential.

In order to understand the measures that hedge fund managers need to take to meet institutional investors' expectations for transparency, governance and operations, we have interviewed senior executives from approximately 40 leading US hedge fund managers, investors, service providers and other participants in the value chain. We found a sector that has made significant improvements in the four years since the financial crisis. Even so, specific areas remain where stronger practices would benefit the sector.

In particular, we believe that focusing on the following five key factors would help to enhance trust:

- Pro-active partnership and alignment of interests across the value chain.
- Standardization of investor reporting and operational due diligence, balanced with the necessary level of customization.
- Institutional-quality infrastructure and controls.
- Robust processes underlying the valuation and safekeeping of assets.
- High standards of fund and corporate governance.

In today's challenging investment environment, hedge funds are attracting institutional investors with the prospect of relatively high returns and minimal correlation to other asset classes. But these investors also expect a first-rate quality of reporting and infrastructure and a high-touch level of service.

This shift in the investor base is changing the nature of the sector. Hedge fund managers are evolving into more mainstream client service organizations. Each member of the hedge fund value chain—manager, administrator, prime broker and custodian, auditor and director—is subtly adapting to this new paradigm. Investors themselves are also taking part in this evolution, forming closer relationships with managers that foster trust.

In the future, being a "trusted advisor" will differentiate a hedge fund manager; ranking below investment performance but being critically important nonetheless. In this paper, we explore how each member of the hedge fund value chain can strengthen trust in the sector. We examine the current shortcomings, potential improvements and the future outlook. By continuing to enhance the current value chain framework, hedge funds can claim "trusted advisor" status and be rewarded by significant long-term inflows of institutional investor capital.

In the world of hedge funds, we judge that the following elements breed trust: transparency, credibility, reliability and alignment of interest, all combined with low self-orientation.

These relationships are depicted in the equation below:

The "trusted hedge fund advisor" equation[1]

$$TA = \frac{T+C+R+AI}{SO}$$

TA = Trusted Hedge Fund Advisor
T = Transparency
C = Credibility
R = Reliability
AI = Alignment of Interest
SO = Self-Orientation

- Transparency is the single biggest contributor to a trusting relationship; it plays an important part in building investor trust in every part of the value chain.
- Credibility fosters trust based on the manager's words, skills, expertise and experience—and also based on the quality of the manager's key personnel and that of its service providers.
- Reliability relates to the predictability of the manager's actions in terms of its strategy, performance, communications and controls.
- Alignment of interest conveys the manager's commitment to investors' needs, including an appropriate level of transparency, and in some cases a degree of collaboration that verges on partnership.
- Self-orientation affects trust profoundly. A low level of self-orientation (or self interest)—defined as having the right behaviors, proper structure and effective governance—builds trust significantly. By contrast, a manager that puts its own interests before its investors' will erode trust.

1 The above equation is based on the well known "trusted advisor" equation (Source: http://trustedadvisor.com) but modified to suit the hedge fund industry.

Five key factors to enhance trust

- Pro-active partnership and alignment of interests across the value chain.
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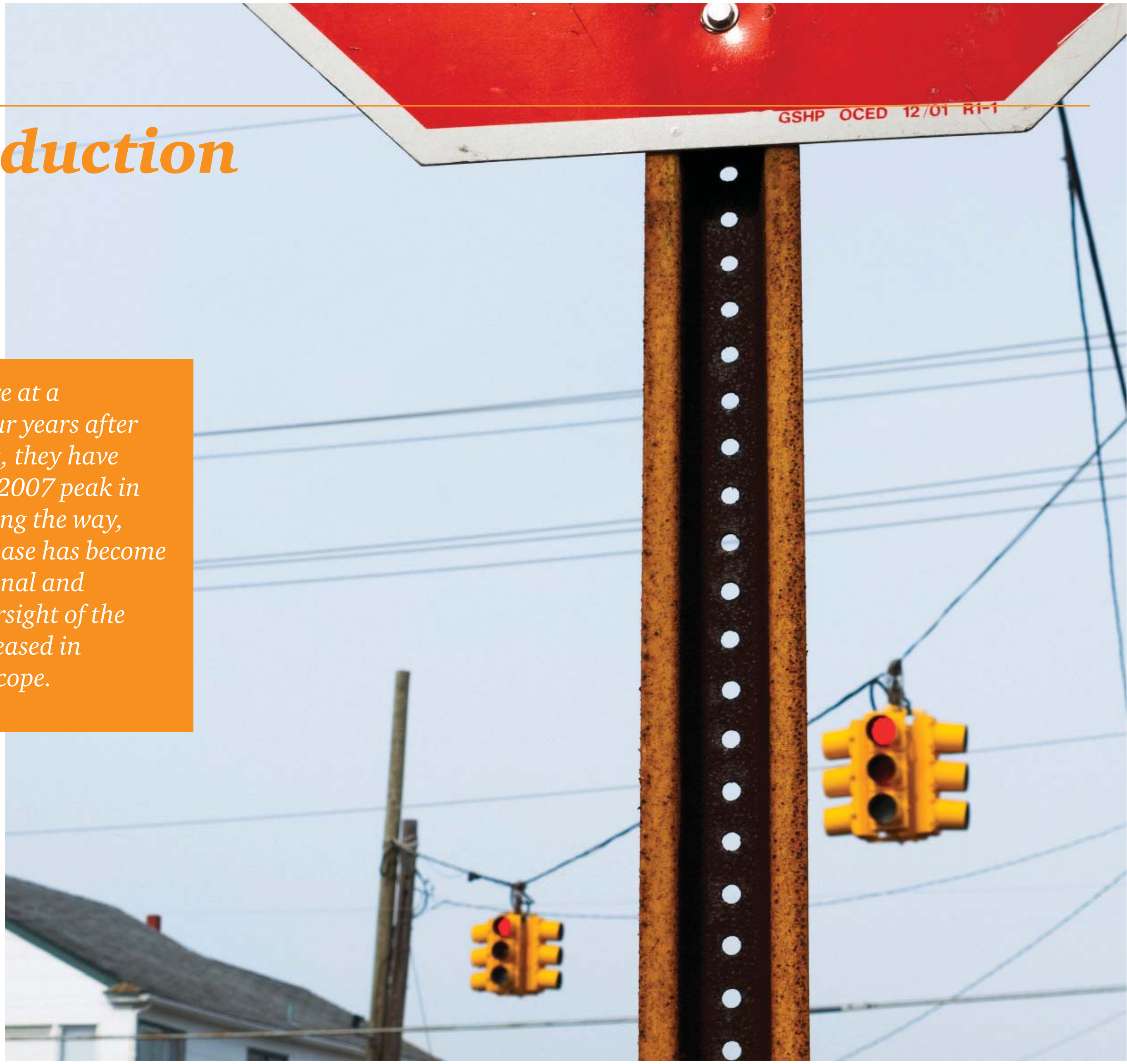
- Institutional-quality infrastructure and controls.
- Robust processes underlying the valuation and safekeeping of assets.
- High standards of fund and corporate governance.

Introduction

Hedge funds are at a crossroads. Four years after the credit crisis, they have regained their 2007 peak in assets. But, along the way, their investor base has become more institutional and regulatory oversight of the sector has increased in intensity and scope.



"Members of the hedge fund sector are welcoming regulatory reforms, broader operational controls and compliance practices that encourage the flow of institutional assets to our industry."

Richard H. Baker, President and Chief Executive Officer of the Managed Funds Association (MFA)

Hedge funds are at a crossroads. Four years after the credit crisis, they have regained their 2007 peak in assets. But, along the way, their investor base has become more institutional and regulatory oversight of the sector has increased in intensity and scope. Institutional investors such as pension funds, endowments and sovereign wealth funds have become critical to the sector's future and are requiring enhanced standards of operational risk management and transparency.

"Members of the hedge fund sector are welcoming regulatory reforms, broader operational controls and compliance practices that encourage the flow of institutional assets to our industry," says Richard H. Baker, President and Chief Executive Officer of the Managed Funds Association (MFA). "Institutional investor assets now represent the majority of the sector's global assets, and the sector has made a strong effort to respond to their requests for greater transparency and more detailed reporting."

As has always been the case, strong risk-adjusted investment performance is what really differentiates a hedge fund manager. But now many investors are giving strong operations similar importance. So, they will not invest with a manager unless they can be sure of a certain standard of operational infrastructure, controls and transparency. Showing the increasing importance accorded to operations, investors ranked operational robustness as equally important to performance track record in allocation decisions for the first time in the Goldman Sachs Global Hedge Fund Investor Survey 2012.

Both managers and investors are in agreement on this point. "Our investment approach differentiates our firm. That is what opens doors and gets meetings.

The fact that we have great operational infrastructure by itself will not be the driver for investors to invest, but often is the tipping point," explains Jim Rowen, Chief Operating Officer, Renaissance Technologies.

In our US 'Trust & Transparency' point of view—which follows similar exercises in Europe (released in November 2010)[2] and Asia (released in April 2012)[3]—we set out to understand the most effective ways for the US hedge fund sector to enhance investor confidence and the effect of these measures on its outlook. Our study revealed a US hedge fund sector that's more mature than those in other regions but nonetheless is encountering similar challenges.

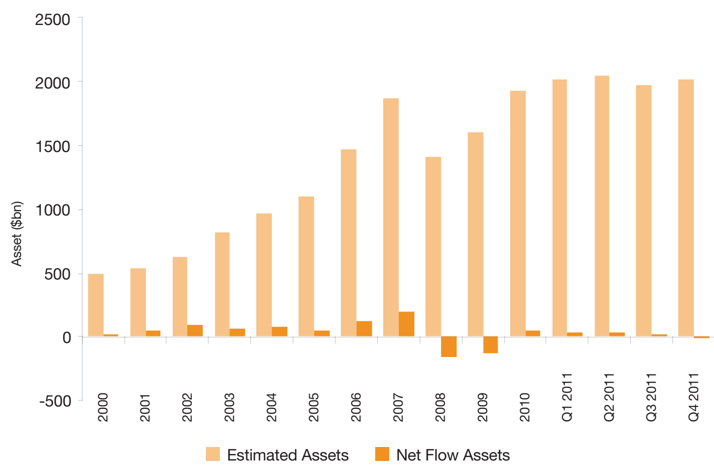
2 http://www.pwc.com/gx/en/asset-management/assets/pwc-hf-trust-and-transparency.pdf.
3 http://www.pwchk.com/home/eng/am_hedge_fund_trust_apr2012.html.

"The US hedge fund sector is the most mature regionally, but also one that still holds significant growth opportunities for managers," asserts Mike Greenstein, Global Alternative Investments Leader at PwC. "Seizing those opportunities means understanding and accommodating the requirements of regulators and leading institutional investors—both of which can be exceptionally demanding in the operational standards they require."

As hedge fund managers have improved their operations and enhanced transparency, institutional investors have rewarded them by increasing allocations. Institutions account for two thirds of hedge fund assets today compared to less than a fifth in 2003, according to Deutsche Bank's Tenth Annual Alternative Investment Survey.[4] Eighty percent of the institutions in the survey either grew or maintained their hedge fund assets under management in 2011.

Helped by rising institutional investment, the sector regained its previous high of US $ 2 trillion in assets at the end of 2011, previously reached at the end of 2007, according to Chicago-based Hedge Fund Research, Inc (HFRI). This was in spite of volatile performance that saw the HFRI Fund Weighted Composite Index decline by -4.8%, only the third calendar year decline since 1990.[5]

Estimated asset growth/net asset flow hedge fund industry 2000—Q4 2011



Source: HFR Global Hedge Fund Industry Report, Year End 2011

"The US hedge fund sector is the most mature regionally, but also one that still holds significant growth opportunities for managers."

Mike Greenstein, PwC's Global Alternative Investments Leader

4 Deutsche Bank Tenth Annual Investment Survey, published March 2012.
5 Hedge Funds Conclude Challenging 2011, Position For 2012; published January 9th 2012; www.hedgefundresearch.com.

"The US hedge fund sector's broad framework has emerged, yet it is still work in progress. US hedge funds and their service providers still have changes to make before their pace of evolution slows."

Mark Casella, PwC's US Alternative Investments Leader

In order to establish how far hedge funds had progressed on their journey 'from black box to open book', we interviewed senior executives from approximately 40 firms in the sector. Our interviewees included investors, consultants, managers, administrators, prime brokers, lawyers and directors. They ranged from the largest and most established managers, investors and service providers, to fast-emerging smaller organizations.

The interviews revealed a state of transformational evolution. Over the past four years, the sector's infrastructure, governance and transparency have significantly improved. For example, investor reporting has been enhanced, independent administrators are now standard and investor operational due diligence (ODD) is a fundamental part of investors' research.[6]

"2008 changed the sector significantly," says Todd Groome, Chairman of the Alternative Investment Management Association (AIMA) and a principal in Breton Hill Capital. "These changes have included both new regulatory requirements and increased demands from institutional investors. Since the early 2000s, we've seen increased institutional investor capital flows into hedge funds, and with this capital has come the increasing institutionalization of hedge fund operations and infrastructure. Following 2008, a much greater investor focus on liquidity, portfolio transparency, control and fund governance was clearly evident. Maybe more than most regulatory changes, the institutionalization of the sector is likely to bring profound changes, and will no doubt continue to evolve from here."

As this evolution progresses, the changes taking place need to be refined, accepted and standardized. "The US hedge fund sector's broad framework has emerged, yet it is still work in progress," explains Mark Casella, PwC's US Alternative Investments Leader. "US hedge funds and their service providers still have changes to make before their pace of evolution slows."

"Maybe more than most regulatory changes, the institutionalization of the sector is likely to bring profound changes, and will no doubt continue to evolve from here."

Todd Groome, Chairman of the Alternative Investment Management Association (AIMA) and Principal, Breton Hill Capital

6 Having a third-party administrator is the most important aspect of due diligence, according to The 2012 Credit Suisse Global Survey of Hedge Fund Investor Appetite and Activity.

Managers

Hedge fund managers have become far more open, communicating more information and providing greater access. They routinely provide investors with details of their control infrastructures during due diligence reviews and most have enhanced portfolio transparency. Yet transparency for its own sake is not always a good thing—there's a balance to be struck in the interests of both managers and investors.

Key points:

- *Managers and investors are striving to strike the right balance between useful and excessive transparency.*
- *Greater standardization of information is reducing the burden of transparency, but more standardization is needed.*
- *Managers have become more transparent, and are beginning to develop innovative ways of delivering transparency efficiently.*
- *Managers and investors are building mutual trust through closer partnerships.*
- *Entrepreneurialism and institutionalization have shown that they can co-exist.*
- *Managers are investing significantly in people, processes and technology.*

Finding the right transparency balance

Hedge fund managers have become far more open, communicating more information and providing greater access. They routinely provide investors with details of their control infrastructures during due diligence reviews and most have enhanced portfolio transparency. Yet transparency for its own sake is not always a good thing – there's a balance to be struck in the interests of both managers and investors.

While the increase in openness has gone a long way towards restoring trust, managers and investors have to strike the right balance between what's useful and what's excessive. Failure to do so could potentially damage portfolio returns, burden the manager with excessive costs and oblige the investor to comprehensively understand the data received. Managers understandably wish to safeguard certain position level information and to manage the cost of meeting requests for information. Investors wish to gain the best possible insight into portfolios and control infrastructures. By working together, managers and investors can agree what's practicable and useful.

Finding the most efficient ways to organize data and due diligence information helps managers and investors alike. Constantly meeting investors and sending them information takes up managers' time and resources. Managers can tackle this dilemma by standardizing as much information as possible. Managers and investors should both remember the 80/20 rule—that 80% of the benefit will come from 20% of the effort. By standardizing as much information as possible, managers and investors can spend more time focusing on the unique risks associated with an investment strategy and the manager's distinctive investment and operational capabilities.

Managers have responded to investors' requests for greater transparency in a variety of ways. The managers we interviewed all told us that they had devoted significant extra resources to meeting investor requests. RFPs and due diligence questionnaires (DDQs) have become longer and more detailed, and investors are requesting more information and access in both initial and ongoing due diligence reviews. At the same time, the Securities and Exchange Commission is requesting more disclosure in its Form PF and other forms of reporting.

In order to meet these requests, managers have no choice but to hire more people, invest in technology and automate processes. Much of the extra work falls to investor relations and fund accounting, but marketing departments are also being upgraded, with senior management spending more time focusing on this area. Furthermore, in order to satisfy the need for more and richer information, larger managers are building data warehouses. All of this is adding to expense at a time when both management and performance fees are under pressure.

"We have doubled the size of our operations and accounting group in the last three years," notes Joseph Wekselblatt, Chief Financial Officer at Angelo, Gordon & Co., the New York-based alternative investments manager, best known for its capabilities in credit, real estate and private equity. "Some of that was because we needed to expand our staff as we grew, some of it was getting involved in new asset classes—but a lot of it was to meet the increased demands for information."

While each fund manager is different and so some level of specific information will always be needed, the current volume of requests is proving very challenging for some managers. In line with the 80/20 rule, managers and investors can better standardize the basic information provided so that they can both focus on customizing the unique and valuable information that has real value for investors.

"A huge part of what investors do in operational due diligence is information gathering. Seventy percent of the questions investors ask are the same," says Adrian Sales, Head of Operational Due Diligence at Albourne Partners. "There's a huge overlap because there's already a significant body of information available setting out what operational risk is and what you should focus on - from the Hedge Fund Standards Board (HFSB), Alternative Investment Management Association (AIMA), MFA, President's Working Group etc. Anyone can build a DDQ. What the sector needs to focus on is how operational due diligence (ODD) can be more efficient, by developing a generally accepted list of questions/concerns, tools and reports to answer those in a scalable way. If investors can do ODD more efficiently then that frees up time to focus on the unique aspects of the manager's business and how risk is managed, instead of just information gathering."

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Forms of standardization are already emerging. Hedge fund managers are asking their administrators to disclose details of the information investors value most—existence and price verification of assets—through online reporting portals. And the 'operational due diligence day', where managers invite a number of institutional investors to hear presentations, is an emerging practice. These ODD days are an efficient use of managers' time and give investors the chance to hear their peers' questions.

A number of sector initiatives are offering opportunities for standardization. In September 2011, an industry working group published the proposed Open Protocol Enabling Risk Aggregation (Open Protocol) standards, which offer consistent practices for collection, collation and conveying risk information. And AIMA's due diligence questionnaires, which have been in existence for many years, give a framework for a basic level of information that investors can supplement with more focused questions. Finally, the HFSB is currently seeking greater support for its standards in Asia and the US, extending their influence beyond Europe, where they're more firmly established. While interviewees expressed different degrees of familiarity with these efforts, most agreed that they're too fragmented and the sector needs a common framework for due diligence information and operational standards.

> *"The decision-making process around additional reporting such as internal control reports or agreed-upon procedures often focuses purely on the investor needs and requirements, but the beneficial impact that preparing for these standards can have on an organization's internal control environment is often overlooked."*
>
> Mike Gismondi, Chief Operating Officer, TPG-Axon Capital

Additionally, Service Organization Controls (SOC) reports (formerly referred to as SAS 70s)[7] are becoming another widely accepted and recognized aid to ODD. "These independent assurance reports give stakeholders insight into and confidence in the manager's control environment, leaving them the option of supplementing the standard information with their own probing," says Chris Thompson, a PwC Risk Assurance Partner. As such, they're a classical illustration of investors' 'trust but verify' approach to hedge funds.

Independent assurance or SOC reports are also a valuable benchmarking exercise. "The decision-making process around additional reporting such as internal control reports or agreed-upon procedures often focuses purely on the investor needs and requirements, but the beneficial impact that preparing for these standards can have on an organization's internal control environment is often overlooked," says Mike Gismondi, Chief Operating Officer at TPG-Axon Capital. These reports allow managers to take a disciplined review of their systems and processes, at least on an annual basis, and make evolutionary changes as needed.

"All of these practices go a long way to easing the manager's transparency burden," says Paula Smith, PwC's US Alternative Investments Assurance Leader. "But ultimately investors and managers alike need to approach transparency in a spirit of partnership." Investors need to be frank with managers about the level of transparency they require before investing; managers for their part need to explain what level of disclosure they believe is appropriate for both their investment strategy and their business.

Enhancing manager/ investor relationships

As managers seek to build trust with investors, they're giving far greater transparency into their businesses and often forging collaborative partnerships. By doing so, they're aligning their own interests and their investors' interests more closely.

Going beyond standard reporting and communication, managers are giving greater insights into investment decision-making processes and their daily operations. Some managers are forming such strong partnerships with their most significant investors that they're becoming virtual extensions of the investors' organizations, offering customized investment solutions and giving more open access to a range of individuals within their own firms.

We believe this redefinition of the manager/investor relationship demonstrates a growing mutual understanding between managers and investors. It's also an example of how the sector is changing as managers embrace what it means to be a fiduciary. Hedge fund managers are aiming to combine a principal's alignment of interests with an agent's behaviors and structures.

"As institutional investors seek better legal and operational structures for their alternative investments, issues relating to agency versus principal relationships enter the discussions," states Kenneth Phillips, Chief Executive Officer of HedgeMark International.

How far individual managers choose to progress with this new spirit of partnership depends on factors such as their size and culture, and how important particular investors are to them. At the most basic level, investors want total insight into how a manager thinks about markets, what risks are being taken and what's driving returns.

7 As of June 15, 2001, the American Institute of Certified Public Accountants (AICPA) replaced the internal controls reporting standard "SAS 70" with Statement of Standards for Attestation Engagements No. 16 (SSAE16), Reporting on Controls at a Service Organization (SOC). Some people still refer to all internal control reports as SAS 70, while others may use the newer reference SSAE16. For consistency, we will use the term "SOC" in this paper.

"From the back office perspective, one of the things I like to have is direct contact with personnel that are actually doing the work. And then I can have staff members who have channels open. What I do not want is broad corporate answers."

TJ Carlson, Chief Investment Officer, Kentucky Retirement Systems

Paul Roth, Founding Partner of the law firm Schulte Roth & Zabel, believes the new spirit of partnership is invaluable. "Managers and investors need to understand each other's needs," he says. "This reciprocal pathway builds trust and confidence."

To have such a "reciprocal pathway," hedge fund managers have to let down their guard and forge relationships with investors that go beyond the standard answers and presentations. This increases credibility and reliability and, in doing so, enhances trust.

"I would say that one of the things that helps me gain trust in a manager is when they can help me understand what the impact of specific types of events will be on their strategy, before they actually happen," explains TJ Carlson, Chief Investment Officer, at the Kentucky Retirement Systems. "That helps give me a lot of confidence. From the back office perspective, one of the things I like to have is direct access to the personnel that are actually doing the work. Then my staff members have more useful communication channels open. What I do not want is broad corporate answers."

But some hedge fund managers are taking collaboration to a new level, offering their significant investors 'white glove' services by customizing managed accounts to fit their specific investment objectives and helping them to manage their cash flows. One manager we spoke with was giving an investor advice about how to structure its asset allocation, not just for hedge funds but stretching across the entire portfolio. Another was sharing some of the research underlying investment decisions.

Of course, enhanced relationships don't replace formal checks and balances in due diligence and transparency reporting. As a minimum, institutional investors want verification of the quality of management controls and processes, robustness of compliance controls, existence of assets and price verification procedures. What's more, investors no longer regard being told how controls or processes work as sufficient. Extending the 'trust but verify' mantra further, they want to get out of the conference room to witness processes and controls in action. They want to see them and review them, all within the constraints of the time they have available and the access they are provided.

For the manager, meeting these expectations absorbs time and resources. Standardizing as much of their response as possible, and automating the collection of information through efficient infrastructure, creates more time for improving the quality of relationships. Managers also enhance the credibility of their responses by being prepared to demonstrate and verify what they say they do.

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Paul Roth, Founding Partner of the law firm Schulte Roth & Zabel

“While institutionalization of the back office is critical for sustainability of an investment firm, the front office must be entrepreneurial enough to achieve the returns investors seek. The relationship is like a slinky – the entrepreneurial front end should set the momentum and direction for the operational back end. A primary goal is to ensure that the two ends never get too far apart from each other.”

Jim Rowen, Chief Operating Officer, Renaissance Technologies

Reconciling entrepreneurialism and institutionalization

While entrepreneurialism must remain the essence of hedge fund management, winning investors’ trust increasingly requires ‘institutional-quality’ infrastructure. Entrepreneurialism and institutionalization might seem incompatible, but managers are proving that they’re not. To date, there’s no evidence to suggest that increasingly effective control environments constrain hedge fund traders’ dynamism.

Managers have grown their businesses in an environment with a high degree of multi-tasking and informal management practices—the flip side of which is less developed support functions, with fewer than normal bureaucratic processes. But investors and regulators are driving institutionalization of hedge fund functions such as tax, finance, HR, technology and marketing.

Like many of his peers, Jim Rowen, Chief Operating Officer of Renaissance Technologies, recognizes the need for both entrepreneurialism and institutionalization. “While institutionalization of the back office is critical for sustainability of an investment firm, the front office must be entrepreneurial enough to achieve the returns investors seek. The relationship is like a slinky—the entrepreneurial front end should set the momentum and direction for the operational back end. A primary goal is to ensure that the two ends never get too far apart from each other.”

For most investors, high-quality infrastructure is a prerequisite. Regulators, too, are driving specific infrastructure enhancements in areas such as compliance, risk management, valuation and investor reporting. The hedge fund managers we spoke to were responding by strengthening their infrastructures—upgrading their people, processes and technology. Yet others still need to adapt their infrastructures to emerging business requirements. Although infrastructure alone will never be a selling point, without it managers will not get the opportunity to differentiate themselves.

During our interview process, both managers and investors stressed the importance of high-quality infrastructure. “Institutional investors are rigorously checking that appropriate controls are in place across the hedge fund value chain,” observes Gary Meltzer, PwC’s US Asset Management Advisory Leader. “They want to see processes, controls, IT systems and people working together in a way that is robust, repeatable and verifiable.”

More probing ODD has encouraged change. It has obliged the sector to increase automation, improve processes and to communicate better. “Five years ago you asked some managers about their disaster recovery policy and they were just taking their tape home at the end of the day,” says Charles Cassidy, Head of Operational Due Diligence at Cambridge Associates, an investment consultancy firm. In the time since then, the ODD questions of consultants and investors have spurred substantial improvement, not only in the area of disaster recovery but across operations generally.

One aspect of this improvement is the increasing quality of middle and back office employees. Using the term ‘athletes’ to signify high-quality employees, one hedge fund manager told us how he previously used to only seek people of this caliber for the trading desk—but now he needed them throughout the firm. Generalist roles and ‘double-hatting’ are being replaced by specialist positions. Managers have a greater need for legal and tax expertise to interpret and comply with new regulations and tax requirements, as well as more client services specialists.

What’s more, the capabilities of the HR function often need to be upgraded. “Today’s hedge fund HR leaders are challenged with leading the transition to a new operating culture in parallel to fundamentally redesigning today’s hiring, development and management processes. This can catalyze the evolution of HR from order taker to a strategic business partner,” states Bhushan Sethi, PwC Financial Services People & Change Leader.

"Under pressure from investors, regulators and legislators, hedge fund managers globally are integrating their tax departments into the firm's operational risk management functions."

Will Taggart, PwC's Global Asset Management Tax Leader

Better systems, processes and controls are reducing reliance on individuals. In particular, managers are upgrading controls around traditional high-risk areas such as valuation and safeguarding of fund assets, as well as emerging risk areas such as regulatory compliance and tax compliance. The SEC's new Form PF is creating a huge need for data to meet its filing requirements, and the Foreign Account Tax Compliance Act (FATCA) will require managers to capture far more information about their investors.

Practices are evolving even in traditional risk areas like valuation. Regulators are increasingly signaling their expectation for managers (and auditors) to understand more about the models, inputs and assumptions used by third party pricing vendors. This need to "know your price" is particularly important for those securities that are more complex or less actively traded.

Tax, too, is becoming an important part of the manager's infrastructure. "Under pressure from investors, regulators and legislators, hedge fund managers globally are integrating their tax departments into the firm's operational risk management functions," says Will Taggart, PwC's Global Asset Management Tax Leader. "This requires the tax department to think and act differently. In an environment where investors are doing more thorough due diligence, tax does not escape." In particular, managers need to make sure that the information they input into data systems is high quality and designed to facilitate tax reporting.

Managers are investing in upgrading technology platforms in order to meet investors' and regulators' mounting demands for reporting. As firms have grown, they have often built information technology on a piecemeal basis. But in order to satisfy huge demands for data, some larger managers are building data warehouses that allow them to slice and dice information across strategies, funds and investors, as well as to drill down to more detailed data. As part of their technology upgrades, some managers are enhancing cyber security, acknowledging this as a key operational risk as data breaches and internet security continue to make the headlines.

Enhancements across these three areas—people, processes and technology—are reinforcing infrastructures, and have considerably reduced operational risk already. But the expense of institutional infrastructures is raising barriers to entry and in this sense might dampen the sector's entrepreneurial vigor and development of new talent. Investors view institutional quality in operations and the control environment as an important issue when discriminating between new launches. "Our research shows that investors have a marked preference for what we describe as 'The New Launch Core Four' attributes, namely pedigree, continuity, differentiation and institutional quality," says Robert Leonard, Global Head, Credit Suisse Capital Services.

While all firms need to meet a minimum standard, it's important to guard against a "one-size-fits-all" expectation given the diverse nature of the sector. The control environments of emerging managers might be less mature and proven than their established counterparts, but they're not necessarily less effective. They supplement their own credibility and reliability with that of their service providers.

Once again, transparency and openness hold the key, as they allow investors to judge whether the attractions of a manager's investment proposition outweigh heightened operational risk.

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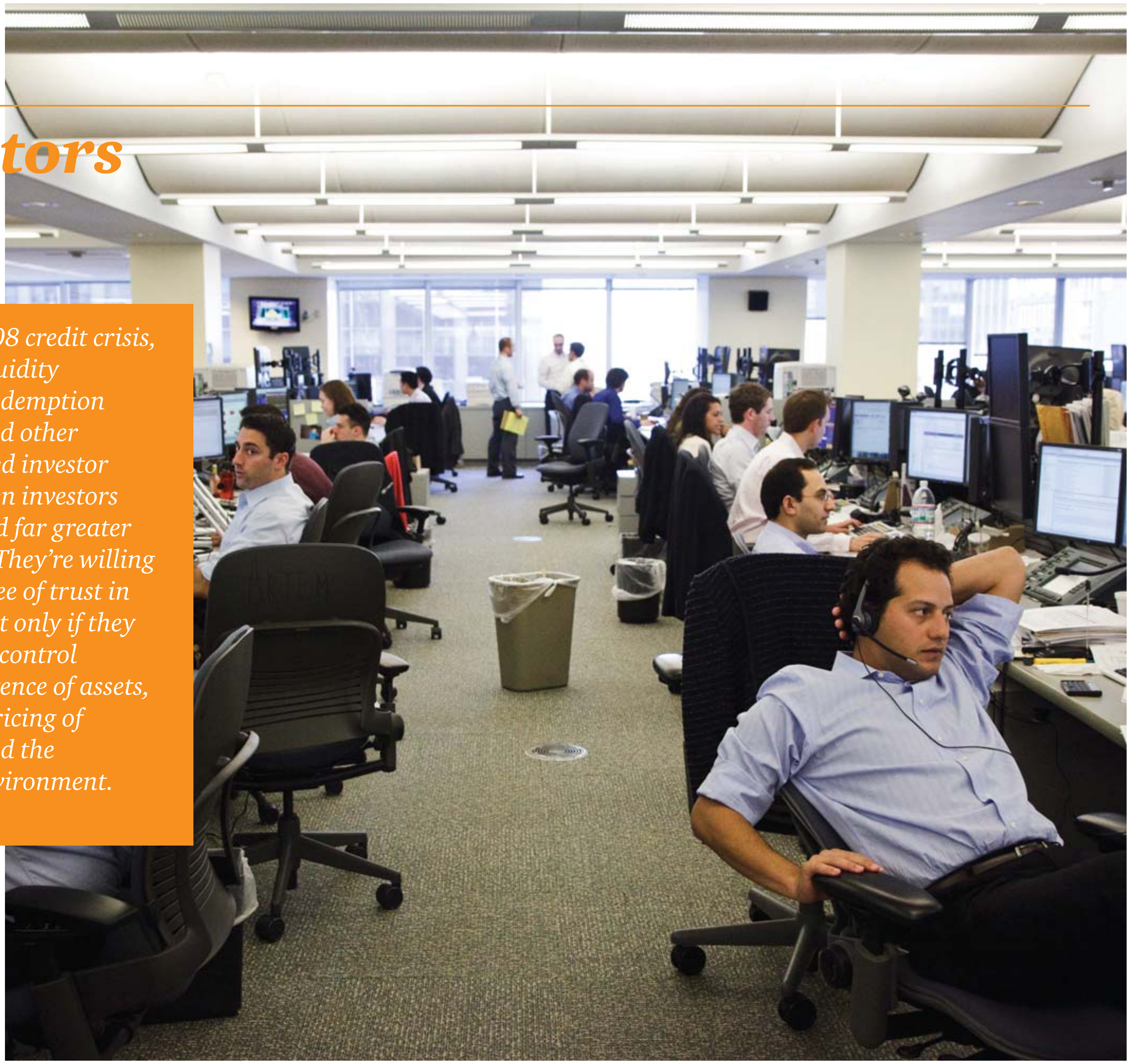
Robert Leonard, Global Head,
Credit Suisse Capital Services

How do you build trust?

- Standardize as much investor information as possible for efficiency; but concentrate on customizing the remainder to meet investors' specific needs.
- Build a spirit of proactive partnership with your investors.
- Think of yourself as providing a service rather than a product, and develop a highly responsive client service culture.
- Make sure your infrastructure is, and appears to be, fit for purpose.
- Enhance the credibility and reliability of your infrastructure—review whether it's as good as you think it is.
- Develop a strategy to push trusted, standardized information to your investors, reducing what they need to request themselves.

Investors



During the 2008 credit crisis, unexpected liquidity mismatches, redemption suspensions and other surprises eroded investor trust. Since then investors have demanded far greater transparency. They're willing to place a degree of trust in managers—but only if they can also verify control processes, existence of assets, independent pricing of investments and the compliance environment.

Key points

- *Investors have demanded and received far more transparency, which they regard as the prerequisite for trust.*
- *Operational due diligence reviews have become commonplace, although their quality still varies.*
- *Investors acknowledge that managers have to standardize some information to reduce the cost of transparency.*
- *Investors want to be sure that managers aren't too guarded and strike the right balance of transparency.*

Standardizing and customizing operational due diligence

During the 2008 credit crisis, unexpected liquidity mismatches, redemption suspensions and other surprises eroded investor trust. Since then investors have demanded far greater transparency. They're willing to place a degree of trust in managers – but only if they can also verify control processes, existence of assets, independent pricing of investments and the compliance environment.

ODD already existed but it has blossomed to bolster trust, shining a light into the sector's combination of portfolio complexity, opacity and partial regulation. As institutional investors such as pension funds grow their hedge fund teams and their use of consultants, so they are performing more rigorous ODD. Additionally, many funds-of-funds have made ODD a significant part of their value proposition.

As ODD has become more commonplace, so its nature has changed. What was originally a forensic accounting task has evolved into a more commercial, risk assessment exercise. Investors, either directly or through the use of ODD consultants, now conduct extensive reviews of all aspects of the manager's business practices, policies and procedures, and operational workflows. They review the entire value chain, from manager and fund through to prime broker, auditor, administrator and, increasingly, directors—not only reviewing paperwork, but also visiting or verifying the different parties.

While the more extensive exercise mitigates risk, it also takes far more time placing a considerable resource strain on managers. The ODD process is leading to managers standardizing fundamental information so that investors can spend more time monitoring and understanding risk. 'Due diligence days', internal control reporting and agreed-upon procedures are forms of standardization that some

"As investors, we have a responsibility to clearly articulate the standards of transparency we expect prior to investing with a manager . . . An upfront communication approach should be where it all starts."

Charles Cassidy of Cambridge Associates

managers practice. The Rohatyn Group, a specialist emerging markets manager, has developed a standardized data library that addresses due diligence questions. Some of the investors we spoke to agreed that these standardized forms of information were a useful way of gathering the basic facts about managers' operations, allowing them to concentrate their own research on particular areas of risk.

Managers have become far better at delivering information that consistently explains operations, whether in the presentations they make to potential investors or in objectively verified forms such as SOC reports. Making standard information available to investors in this way means they don't have to request it and enhances trust.

But investors caution that the welcome move towards standardization and higher quality reporting should not detract from the spirit of partnership. Some ODD professionals noted that over the years it has become harder to get to the heart of the information they want. One ODD professional commented: "Managers are more used to ODD reviews, so they are more polished in their presentations and workflow charts. But some are also more guarded."

Investors need to explain what information they need and assure managers that they will use the information they receive wisely. "As investors, we have a responsibility to clearly articulate the standards of transparency we expect prior to investing with a manager," explains Charles Cassidy of Cambridge Associates. "We understand the reasons managers have for limiting disclosure and these need to be balanced with our needs to understand the strategy and ongoing performance attribution. We make it a point to discuss these issues as a part of our first meeting with a manager and if we can't agree on the level of transparency we will walk away. An upfront communication approach should be where it all starts."

Making ODD a two-way dialogue not only helps managers to focus on providing valuable information but also helps to strengthen the mutual understanding that underlies all productive partnerships.

How do you build trust?

- Develop smart, user-friendly ways of standardizing information.
- Be prepared but don't stick to a script.
- Build confidence in the information that you provide through demonstration and verification.
- Make ODD a two-way dialogue.
- Manager and investor should agree upon communications expectations from the outset.

Administrators

Administrators are both the hedge fund manager's partner and the investor's lookout. They play an important role in a 'trust but verify' world.

Key points

- *Independent administrators play an important role in a 'trust but verify' world.*
- *Administrators are offering a widening array of transparency reporting and other services.*
- *Transparency reporting, such as price and asset verification, is well received but there is opportunity for more standardization.*
- *Full shadowing of administrators is increasingly uneconomic at a time when some managers' profitability is under pressure.*
- *Administrators are working more closely with managers as business partners.*

Providing independent insight

Administrators occupy an important place in today's hedge fund value chain. As independent organizations, with responsibility for calculating the fund's net asset value (NAV), they are both the hedge fund manager's partner and the investor's lookout. Furthermore, with highly scalable information-processing technology platforms, they 'own the data' and are well-positioned to help managers furnish regulators and investors with the extra information they require.

To some extent, the administrator's value proposition has historically suffered from a lack of transparency and standardization—yet in a 'trust but verify' and transparency-dependent world, administrators have an important role to play. In the immediate aftermath of the credit crisis, investors insisted that hedge fund managers employ third-party administrators to oversee NAV calculations and perform other verification services. Since then, more and more transparency has been demanded, leading administrators to seize this business opportunity by offering a growing range of services, including advanced risk, regulatory and reporting services.

Investors told us they value services such as 'transparency reporting', which build trust in the sector. Yet the evolution to independent administration has been swift and there is room for refinement. Most interviewees questioned the administrators' ability to independently source the right inputs and make appropriate assumptions about hard-to-value investments when striking fund NAVs.

Many respondents, including administrators themselves, called for more standardization about how price and asset verification are determined and reported in transparency reports. This would give investors a better understanding of their verification practices and enhance comparability. Managers and investors alike viewed this as an important area with room for improvement. They called for solutions including potentially self-imposed and transparent standards, as well as standard tolerance levels when verifying prices.

While investors generally are calling for the administrators to play a greater role as third-party verifier of the fund's NAV, some of the managers we spoke to questioned to what extent investors are prepared to pay for this increased transparency.

Shadowing administration

While hedge fund managers acknowledge the growing role of independent administrators, they're not ready to dismantle the fund accounting systems they've built, and so duplication of activities is adding expense to the hedge fund value chain. For many hedge fund managers, turning over the business of fund accounting to external administrators has been hard to accept. Some of the managers we spoke to felt that the administrators have done a good job but don't get credit for it. Others lacked confidence in administrators' systems and ability to independently account for complex transactions and price hard-to-value securities, among other things. As a result, a lot of larger managers 'shadow' the administrator by keeping their in-house personnel and

"As the sector has evolved over the course of the last few years, the administrator's role has also evolved."

Jay Peller, Citco's Global Head of Marketing and Product Development

systems to check the administrators' results. In effect, they don't yet have enough confidence in the administrator to dismantle what they've built and rely entirely on the third-party fund administrator.

"We shadow the administration internally and the level of detail of our books and records is better," explained one manager. "But we recognize that investors want some independence into the process so we have reacted to market needs and appointed an administrator."

"The administrators don't really know how to value some complex derivatives. Anything that is listed and traded in a somewhat liquid fashion they are fine with. But once you get to the world of esoteric derivatives, illiquid/distressed debt positions etc., we have to direct them to the sources of pricing."

Managers have mixed views on the subject. Some feel very strongly that they will never rely solely on the administrator. Others expect to scale back what they've built over time as credibility is enhanced and confidence grows with positive experience. Administrators are seeking to win hedge fund managers' confidence by giving them greater transparency into their processes through 'workflow dashboards' that allow them to track the process of striking the NAV. They're also providing more visibility and access to the underlying data.

Some managers are moving from shadowing to vendor management as they approach their relationship with the administrators much more strategically and collaboratively. While some shadowing might always be necessary, not all of it is. There are other ways to control the administrator and this duplication of effort gives rise to extra expense at a time when managers are under more pressure economically.

Depending on the manager's size, strategy and complexity, many might always need to maintain some of their own books and records. In fact, in certain areas, it's the administrator who may be shadowing the manager. Over time managers are likely to move from full shadowing to 'shadowing lite'—a more strategic, risk-based approach. This approach should produce an effective control environment, with full accountability for the end result, as economically as possible.

Moving beyond fund administration

Like other members of the sector's value chain, administrators are working hard to adapt to the current environment. They've expanded their service offerings and invested in the specialist skills and technology to adapt their business models to deal with increased expectations and needs in areas such as valuation.

Administrators are moving from being just a "fund administrator" or "outsourced back-office" to more comprehensive "servicing" businesses, offering a range of other services as the calls for information grow. They're providing more middle-office services and risk reporting, and are beginning to facilitate regulatory filings.

"As the sector has evolved over the course of the last few years, the administrator's role has also evolved," remarks Jay Peller, Citco's Global Head of Marketing and Product Development. "Given the administrator's core function comprises independently processing and reconciling a fund's activities and data, the scope for managers and administrators to work cooperatively to meet these new requirements has expanded into areas that include facilitating transparency and risk reporting, and complying with regulatory rules."

As managers learn to rely more on administrators, they are increasingly treating them as partners. They are working together more openly, placing greater trust in one another. The role of the administrator is becoming more critical, but with this comes greater scrutiny.

How do you build trust?

- Make administrators the independent lookouts overseeing the fund's NAV.
- Provide more transparency into the role of the fund administrator and the procedures they perform.
- Encourage clarity and consistency in price and asset verification reporting.
- Evaluate the current shadowing approach and move towards a risk-based approach.
- Work collaboratively with the administrator in designing key performance indicators and other ways to assess and measure their performance.
- Demonstrate effective control over the information provided to administrators and the reporting that comes from them.

Prime brokers and custodians

Anxiety over the health of financial institutions in late 2011 once again raised concerns about the safety of assets held by prime brokers. As a result, hedge fund managers are seeking greater comfort over the security of their investors' assets.

Key points

- *Hedge funds are seeking greater security over assets through segregation of assets and tri-party custody.*
- *Prime brokers have a challenge to respond with innovative but safe ways to use collateral.*
- *There's an opportunity for more integrated reporting across prime brokers and custodians.*
- *Prime brokers have enhanced their controls transparency through their own SOC reports.*

Seeking greater asset security

Anxiety over the health of financial institutions in late 2011 once again raised concerns about the safety of assets held by prime brokers. As a result, hedge fund managers are seeking greater comfort over the security of their investors' assets. They are doing so in a variety of ways—by increasing their use of multiple prime brokers, by seeking more transparency into the segregation of assets in their prime brokerage accounts and by sending some assets into the safekeeping of third-party custodians.

Still greater transparency into levels of asset segregation and controls would help to build confidence over the safekeeping of assets. While prime brokers' reporting of asset segregation has improved in recent years, financial market volatility in the second half of 2011 led some commentators to question whether even current control architectures would protect assets.

Recent volatility serves as a reminder of counterparty risk. Managers need to look more deeply into the legal, regulatory and operational issues behind their brokerage and counterparty relationships. Just as investors are demanding more transparency from managers, so managers need to request more information from their counterparties.

Concern among hedge fund managers and their investors led to an upsurge in assets held by independent custodians in 2011. In particular, they want to hold cash with custodians, but they are increasingly also placing assets with them, in spite of the administrative complications of doing so. In the last few years, hedge funds have become a major part of the custodian's business. Relationships and technology have been built to bridge the administrative gap between prime brokers and custodians. In addition to multi-prime relationships, managers may also have one or two custody relationships.

"Hedge funds' approach to counterparty exposure has evolved dramatically in recent years. As a consequence, the role of the prime broker has evolved to ensure managers have a wide array of innovative collateral management solutions at their disposal. The ability to balance asset protection with efficient financing will continue to serve as a key differentiator for prime brokers."

John Levene, Goldman Sachs' Head of US Prime Brokerage

"Hedge funds' approach to counterparty exposure has evolved dramatically in recent years," states John Levene, Goldman Sachs' Head of US prime brokerage. "As a consequence, the role of the prime broker has evolved to ensure managers have a wide array of innovative collateral management solutions at their disposal. This allows managers to effectively express their investment thesis, while still protecting investor assets. The ability to balance asset protection with efficient financing will continue to serve as a key differentiator for prime brokers."

But there are also challenges associated with hedge fund managers moving assets to independent custodians. Tri-party arrangements add operational complexity and make the servicing of some assets more difficult. What's more, the economic model for prime brokers is also impacted as the cost of leverage may increase due to these and other factors such as the level of regulatory capital that has to be assigned to prime brokerage.

Several of our interviewees called for more integrated reporting across service providers. "It would be ideal and efficient if administrators could transfer data through systems to custodians," said Brian Gavin, Chief Operating Officer of Blackstone Alternative Asset Management. "Progress has been made but finding a way to provide more consistent integrated reporting across such service providers would be extremely helpful."

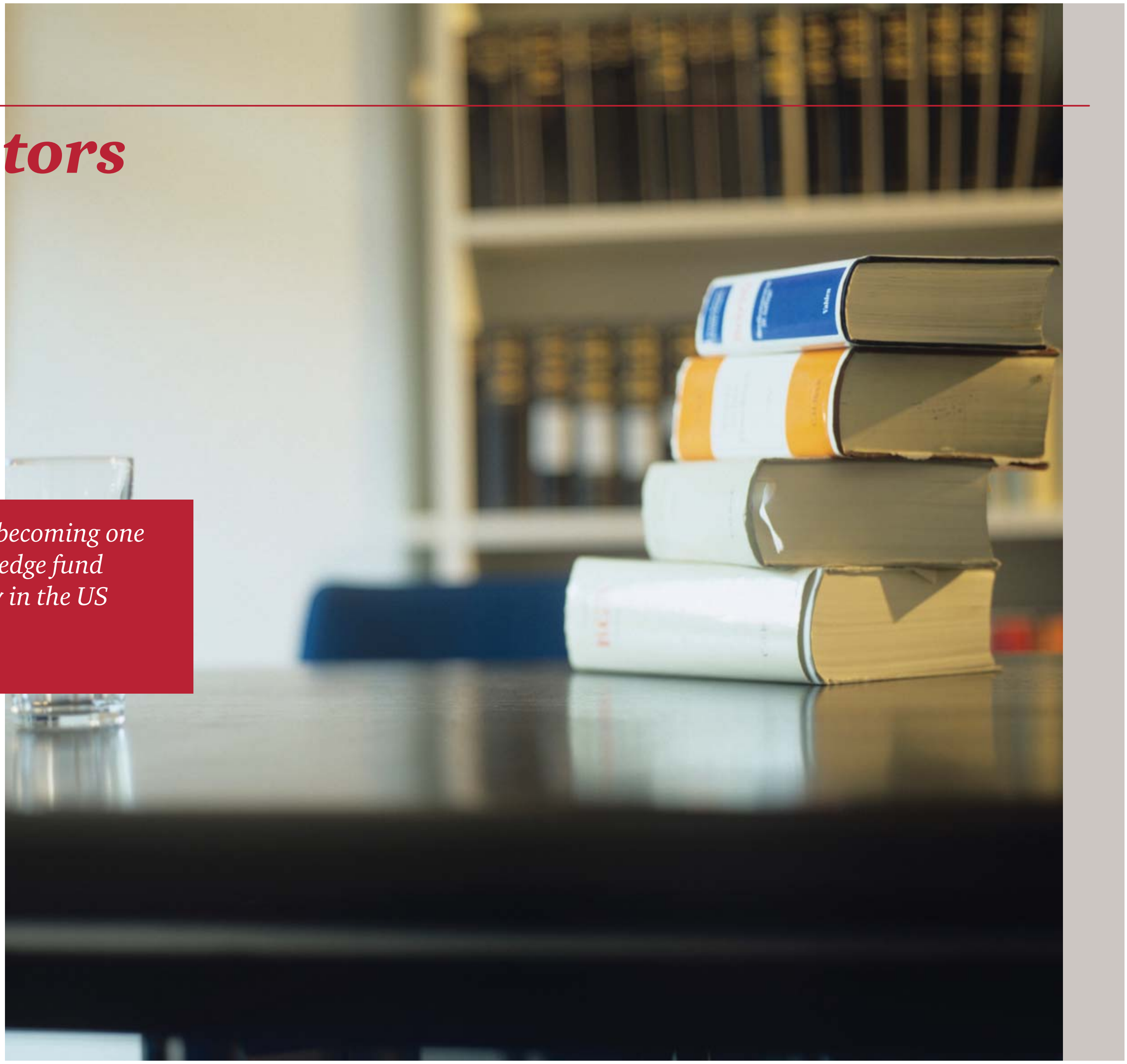
The need for greater control transparency has led many of the leading prime brokers to obtain their own SOC reports as they are increasingly the subject of ODD scrutiny. In the four years since Lehman Brothers, the independent assurance provided by these reports has helped inspire greater transparency and confidence.

The sector might decide to strike a balance. With greater use of custodians comes the risk of increased costs of leverage—indeed at a time when regulatory capital costs are increasing, some smaller hedge fund managers might find their access to leverage limited.

How do you build trust?

- Work with your prime broker to optimize the security of your portfolio.
- Be prepared to clearly articulate and demonstrate your strategy for safeguarding fund assets.
- Support more consistent data transfer across service providers.

Directors



Governance is becoming one of the hottest hedge fund topics, not only in the US but globally.

Key points

- *There's a growing debate about hedge fund governance and the role of directors.*
- *Governance standards are beginning to emerge as calls for independent oversight increase.*
- *Supply and demand dynamics may impact directorship service and cost models.*
- *Proposals for governance are beginning to extend to US limited partnership structures.*

"Sophisticated investors will appreciate that a quality independent director is somewhat like insurance; you only appreciate its value in times of stress."

Gary Linford, Managing Director of Highwater Ltd.

Protecting investors' interests

Governance is becoming one of the hottest hedge fund topics, not only in the US but globally. We're at the early stages of an important discussion about the role, capacity and accountability of directors. This is not just a debate for the managers. It's also an issue for fund domiciles such as the Cayman Islands, Dublin, Luxembourg and other jurisdictions.

Like administrators, the role of directors has been poorly defined and understood. As a result, you hear very mixed views on their role and effectiveness today. But we expect that to change. How fast it will change depends on the attitude of investors and managers, and on the performance of directors. "Institutional investors and other stakeholders want directors to be independent guardians of their assets - with the motivation, time and qualifications to perform this role," says Don Seymour, Managing Director of dms Offshore Investment Services Ltd.

In the wake of the recent Weavering Capital case and the Cayman Grand Court's verdict that its directors aided fraud[8], there is a debate about the best way to establish and operate independent bodies to protect investors' interests. Yet there is widespread agreement that there should be accepted norms for good governance across jurisdictions and structures.

Governance standards are beginning to slowly emerge. The Hedge Fund Standards Board (HFSB) has released guidance calling for a fund governing body comprising a majority of independent directors, who possess suitable experience and qualifications to hold the manager to account for its performance and conduct.[9] Additionally, the Irish Central Bank has recently issued guidance and the Cayman Islands Monetary Authority and other jurisdictions are reviewing whether to follow suit.

We believe that moves such as these will contribute to protecting investors. Good governance can enhance trust by decreasing the self-orientation of the manager. Furthermore, we think that offshore jurisdictions should establish codes of practice, against which directors could be held to account.

"Anyone can follow a template board agenda, sign what lawyers and auditors place before them and do the other director tasks that they believe to be their responsibility without adding value to the process," states Gary Linford, Managing Director of Highwater Ltd, which provides independent directors. "A quality independent director will use the good times to understand the fund, its service providers, investors, the conflicts inherent in the structure and to ensure that he or she has the tools and knowledge to deal with any difficult issues that may arise long after the launch documents are first approved.

"Sophisticated investors will appreciate that a quality independent director is somewhat like insurance; you only appreciate its value in times of stress. Fiduciary investors that promote corporate governance must take responsibility for the credibility of the directors of funds with which they invest."

8 Less is more for Cayman jumbo directors, Financial Times, November 20, 2011.
9 Hedge Fund Standards Board strengthens standards with international dimension. www.hfsb.org. February 17, 2011.

“Good governance is good business.”

Tom Kirkpatrick, Global Head of Client Relationship Management, GlobeOp Financial Services

The opacity of the governance process causes too few funds to appear to conform to best practice. In the past year, interest in fund governance has increased and the need for qualified hedge fund directors of offshore funds has grown. Yet the investors we interviewed echoed others’ doubts, asking whether directors really devote sufficient time and attention to their roles to be able to protect investors’ interests.

“I think the key issue today is the independence of the fund board of directors,” asserts Florence Lombard, Chief Executive of the Chartered Alternative Investment Analyst (CAIA) program. “I think investors and regulators want to see more independent oversight.”

Establishing a workable form of governance is not straightforward. The question of capacity, competence and credentials is valid, but there are no easy answers. Even so, the debate is a step forward. The question of whether investors should participate on boards raises a number of issues related to preference, power and protection in the longer term.

In the offshore fund world, one of the reasons that hedge fund directors have so many directorships is that their remuneration is relatively low. Increasing remuneration on the condition that directors increase their commitment would mean charging more costs to the fund. Doing so might make independent directors an unaffordable luxury for smaller funds. In a world where many are being asked to do ‘more for less’, directors might ask to do ‘more for more’. “Managers and investors should demand more from fund directors, but they should also expect to pay more,” says William Jones, Founder and Managing Partner of ManagementPlus Group.

Standard practices need to be introduced covering what powers these directors have, the composition of the board, the role or involvement of investors, and the transparency and accountability given to investors.

Some sector participants believe that fund governance can never be fully effective until it covers the domestic funds managed by US managers. To this end, in February, the HFSB proposed a form of governance applicable to US limited partnerships, which generally do not have boards.[10] It proposed that where a fund doesn’t have an independent governing body in place to protect investors’ interests, there should be an obligation to ask for investor approval before taking certain actions that might involve a conflict of interest between manager and investor.

Among the hedge fund managers themselves, corporate governance is more mature as regulatory expectations and growing organizations establish committee structures and other mechanisms to help professionally manage the firm in a controlled way. For example, valuation committees are now commonplace, and we are seeing the beginning of internal audit functions and quasi-audit committees.

“Good governance is good business,” says Tom Kirkpatrick, Global Head of Client Relationship Management at GlobeOp Financial Services, referring to the value of sound corporate and fund governance in today’s hedge fund industry.

Will we ever get to the point where investors’ interests are routinely protected by standard sets of codes and practices? In the case of offshore funds, will investors ever elect directors? How can investors effectively hold directors accountable? And should there be more promulgated standards for directors?

We believe that fund boards along with standard codes and practices will become the norm, significantly bolstering hedge fund governance.

10 http://www.hfsb.org/sites/10188/files/hedge_fund_standards_-_february_2012.pdf.

How do you build trust?

- Revisit the composition of your Board of Directors in light of the current debate.
- Establish a Board Charter that codifies Directors' roles and responsibilities.
- Look into making directors more accountable to investors through more transparency reporting.
- Monitor the progress of the new discussion about governance of US domestic partnerships.

Auditors

As an independent party tasked with the role of auditing funds, the auditor plays an important role in the value chain.

Key points

- *Auditors play an important role in supporting the 'trust but verify' framework.*
- *The auditor enhances the credibility of a fund's financial statements and internal controls through opinion-based reporting.*
- *Investors we spoke to expressed frustration over their lack of access to certain information about the audit relationship and audit process.*
- *Enhanced quality communications between fund boards and auditors benefit investors.*

As an independent party tasked with the role of auditing funds, the auditor plays an important role in the value chain.

The role of the auditor attracted comments during our interviews and, at the risk of sounding self serving, we will address the auditor's role and some of the issues raised. As an independent party tasked with the role of auditing funds, the auditor plays an important role in the value chain: enhancing the credibility and reliability of the fund's financial statements through the issuance of audit reports. Additionally, auditors provide confidence on other matters by giving opinions about issues such as internal controls and performance reporting.

Investors we spoke to expressed frustration over their lack of access to certain information about the audit relationship and the audit process.

But as the boards of offshore funds become more active, which we expect will become the case, communications between directors and auditors will strengthen to the benefit of investors. The independence of audits lies at the heart of trust in the capital markets, and enhanced quality communications between fund directors and auditors will benefit investors and bolster trust still further.

As a provider of audit, tax and advisory services, audit firms enhance value in a number of ways. Notably, auditors deliver value through the independent assessments and judgments made when performing audits, which means that investors can confidently rely on the financial statements that accompany the audit report. A high-quality audit requires well-executed procedures, combined with technical expertise and an independence of mind, which together enable the auditor to act with integrity and exercise objectivity and professional skepticism.

But audit firms contribute in ways beyond financial statement assurance. Like other participants in the value chain, audit firms have invested in people, processes and technology to keep pace with the dynamic hedge fund environment. With broad talent pools and global networks, audit firms are well positioned to give management valuable insights – while adhering to applicable independence requirements – about how to enhance value and build trust in areas such as controls, valuation, regulatory compliance, tax planning and compliance, operations and technology.

More and more, the relationship between hedge fund managers and audit firms has moved beyond an annual exercise required to meet reporting requirements.

Outlook

As investors push to minimize operational risk in the hedge fund sector, they're driving institutionalization of the sector that is preparing it for sustainable future growth.

As investors push to minimize operational risk in the hedge fund sector, they're driving institutionalization of the sector that is preparing it for sustainable future growth. The demands of investors and regulators for more transparency and better controls are adding significant cost to hedge fund managers' operations — making scalable operations important. But they're also creating a safer and more sustainable sector that can access a broader range of investors.

"Four years on from the credit crisis, the sector's future blueprint is already set in terms of greater transparency, improving governance, better controls and stronger underlying infrastructures," explains PwC's Casella. "Opportunities for improvement remain in some areas, but they are likely to be addressed in the future."

Yet while the changes discussed in this paper will enable the sector to grow, they will have significant consequences. Among hedge fund managers, barriers to entry will rise and there could be further segmentation among managers. Among service providers we are seeing consolidation of administrators and changes to the prime broker model could increase the cost of leverage.

While the 2008 credit crisis accelerated the sector's evolution, institutionalization had already been happening. The quality of people, controls and processes was already increasing, but investment in these areas has accelerated in the past four years, in part following the earlier evolution of other sectors of the asset management industry.

In the future, hedge fund managers and administrators will continue the process of standardizing their responses to ODD questions as they seek to reduce the costs of transparency and controls. For this reason, we anticipate a shift from a "pull" system to a "push" system whereby proactive and innovative practices such as due diligence days, different delivery mechanisms and standardization of reporting will increase.

The sector will also resolve remaining areas of weakness. Under pressure from investors, the sector's fund managers and offshore domiciles will improve fund governance. New practices may also emerge regarding how administrators verify funds' underlying assets and prices.

As institutional investors make strong operational controls and transparency a condition of investment, so they will only invest with the hedge fund managers with infrastructures that make the grade. Emergence of more institutional-type managers will also prepare the way for convergence with regulated products. To some extent, convergence is already happening—both through institutional investors such as pension plans and through retail investment products—but it will accelerate, driven by the managers that have strong brands, infrastructure and distribution.

But as the sector gets larger and operational risk diminishes, investment performance remains paramount. Should today's managers not deliver, a new set of entrepreneurial managers might well emerge—offering an 'alternative' to the alternatives. Institutional quality infrastructure should remain a focus in order to meet the increasing investor and regulator demands; but not at the cost of a manager's entrepreneurial spirit.

"Four years on from the credit crisis, the sector's future blueprint is already set in terms of greater transparency, improving governance, better controls and stronger underlying infrastructures. Opportunities for improvement remain in some areas, but they are likely to be addressed in the future."

Mark Casella, PwC's US Alternative Investments Leader

Conclusion

The US hedge fund sector is in a period of rapid evolution as it completes the transition from "black box to open book." Yet this evolution is unfinished.

"By concentrating on the areas highlighted in this paper, hedge fund managers will be able to demonstrate the high credibility, reliability and alignment of interest, all combined with low self-orientation, that lie at the core of being a trusted hedge fund manager."

Mike Greenstein, PwC's Global Alternative Investments Leader

The US hedge fund sector is in a period of rapid evolution as it completes the transition from "black box to open book." Yet this evolution is unfinished. In some areas further refinements are needed to improve investor protection and generally the process of giving investors and their proxies transparency has to be made more efficient in order to avoid excessive costs.

For a sector that thrives on exploiting inefficiencies in financial markets, the hedge fund sector is sometimes inefficient itself. Duplication in areas such as 'shadow accounting' can be minimized and due diligence reporting can benefit from further standardization.

The sector's transition will bring challenges as managers adapt to investors' and regulators' growing demands and the costs that accompany them. Yet managers also have opportunities for growth from 'big-ticket' institutional capital investment that are far greater than ever before.

What's more, the growing culture of compliance and institutionalization is not completely incompatible with the dynamism and entrepreneurialism that gives hedge funds their edge. While risk is being squeezed out of the middle and back office operations, investors accept that the front office will need to continue to take risk in order to maximize returns.

In order to complete its evolution, win the trust of institutional investors and regulators, and in turn fulfill its growth potential, we believe the sector needs to refine and improve the transition it has started. In order to do so it needs to focus on the five key factors we highlighted at the beginning of this report.

Concludes Mike Greenstein, Global Alternative Investments Leader at PwC: "By concentrating on the areas highlighted in this paper, hedge fund managers will be able to demonstrate the high credibility, reliability and alignment of interest, all combined with low self-orientation, that lie at the core of being a trusted hedge fund manager."

Five key factors

- *Pro-active partnership and alignment of interests across the value chain.*
- *Standardization of investor reporting and ODD, balanced with the necessary level of customization.*
- *Institutional-quality infrastructure and controls.*
- *Robust processes underlying the valuation and safekeeping of assets.*
- *High standards of fund and corporate governance.*

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