

From black box to open book

Hedge fund trust and transparency

Our view, validated by conversations with Europe's hedge fund investors, regulators, managers and other industry participants



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In the two years since the credit crisis, the European hedge fund industry has come under pressure to rebuild trust by improving corporate governance, strengthening operations and providing more transparency into the controls in place. We believe, however, that there is room for further improvements related to conflicts of interest and operational controls to allow the sector to truly fulfil its growth potential. As allocations to hedge funds increase, trust and transparency will now be crucial factors in winning investors' favour for allocations of assets.

Executive summary



- The hedge fund sector's future growth depends upon it rebuilding and retaining institutional investors' trust through high standards of corporate governance, robust operational controls and strengthened regulatory compliance.
- Transparency is a key to investor trust, providing comfort that there are appropriate controls across the hedge fund value chain – including the fund board, the manager, the administrator and the prime broker.
- Hedge fund boards should take decisions independently of hedge fund managers, and be able to articulate what their duties are and how they discharge them.
- Investors need absolute clarity that the fund's assets exist and a clear understanding of how they are used (e.g. via rehypothecation, securities lending, etc.). Prime brokers' operating models have already adapted and their transparency has been enhanced. We believe this trend towards transparency by prime brokers will continue and will leave 'non-conformers' at a competitive disadvantage.
- With managers under increasing pressure from European regulators to prove that asset valuation is performed completely independently of the investment function, the degree to which administrators or other appointed 'valuers' perform independent, third-party valuations will come under greater scrutiny.
- PwC believes that over the next five years hedge fund managers taking the steps necessary to regain and retain trust will be rewarded by significant inflows of institutional investor assets.

Trust and transparency defined

Trust is defined as to have faith or confidence; to place reliance on; to confide.¹

For hedge fund managers, trust relates to investors' faith and confidence in their governance, their operations and their investment activities.

Transparency into these areas provides confidence that trust is warranted.

¹ The Compact Oxford English Dictionary, Second Edition.

Introduction

This is a time of unprecedented opportunity for hedge fund managers, but only if they regain the trust of investors.



As institutional investors seek greater protection in their portfolios following the financial crisis, hedge fund managers with proven track records stand to benefit greatly. Yet in return investors are requiring far higher standards of governance and more robust operations, combined with greater transparency into operational controls, investment portfolio construction and performance.

We believe those hedge fund managers that rebuild trust by meeting investors' requirements will be best positioned to attract further assets from institutions – assuming that they also provide sustained investment returns. To rebuild trust, hedge fund managers are likely to have to relinquish some of their influence over funds by making fund boards more effective and autonomous, and ensuring that administrators and other service providers prioritise investors' interests. Investors and regulators are now going to demand that managers strengthen their own governance and operations, and demonstrate that they have done so by providing greater degrees of transparency.

'In five years' time, the hedge fund industry as we know it will be almost unrecognisable,' asserts PwC Partner, Olwyn Alexander. 'Given the tsunami of regulation managers are facing, together with investors' increasing demands, we are going to see a fundamental change in the way managers operate, the way

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Purpose of our research

In September and October, PwC conducted a series of interviews to explore the level of trust in the European hedge fund sector, and whether managers were providing the standards and transparency desired by investors and others.² During the credit crisis, 'gating' and other actions to limit redemptions damaged trust. As institutional investors become hedge funds' most important investor base, they are looking for reassurance that the highest standards of governance, operations and transparency will be observed.

As Henry Kenner, CEO of Arrowgrass Capital Partners LLP, explains: 'Institutional investors want to look in the mirror and essentially see themselves. They want to see compliance officers and teams of people producing accurate reporting.'

Our research shows that, since the depths of the credit crisis, significant improvements have been made in corporate governance, operational infrastructures and transparency. Changes have been introduced across the hedge fund value chain – including the board, hedge fund managers, prime brokers and administrators. However, there is still scope for improvement in certain areas.

² We interviewed more than 25 European hedge fund investors (pension funds and funds of funds), consultants, managers (large and small), administrators, prime brokers, regulators and industry associations.

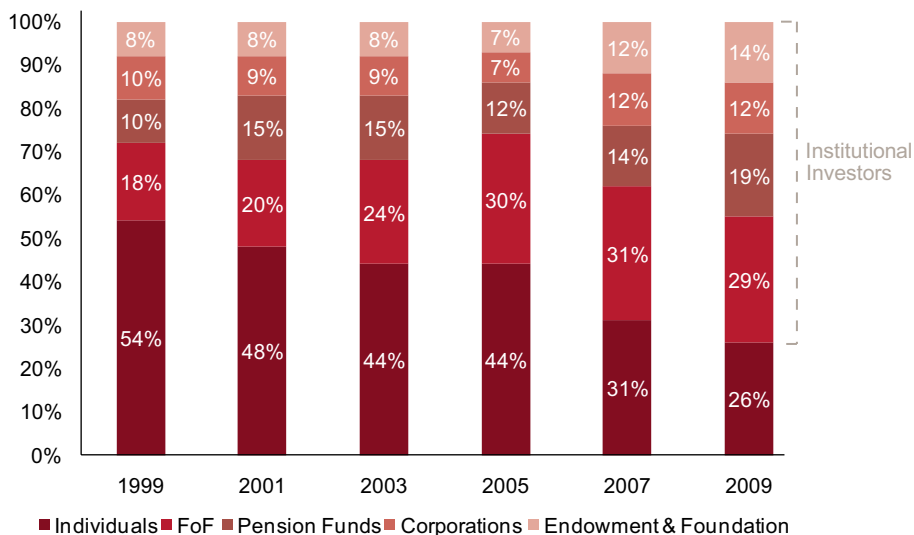
How can high standards of trust and transparency be implemented?

Above all, there are three measures that can help to rebuild trust in Europe's hedge fund industry. Firstly, the fund board should be able to take decisions, perhaps in consultation with, but ultimately independently of, the manager. Secondly, to ensure complete segregation of duties, the fund administrator's/valuer's role in valuing assets should be completely transparent, especially at a time when European regulators are demanding that the valuation function is independent of the manager's investment team. Thirdly, managers should start to view transparency as a source of competitive advantage.³

Changes to the industry's structure

Data shows how important winning investors' trust has become, as institutional investors' influence over the hedge fund sector has grown. According to Hennessee Group LLC, institutional investors owned 56% of global hedge fund assets at the end of 2005, but this had risen to 74% at the end of 2009.⁴

Global hedge fund by source of capital



Source: Hennessee Group LLC

Much of the money flowing back into the sector is being allocated to the larger managers – which typically have the best governance, operations and transparency – indicating institutions' preference for managers they can trust. Europe's top 20 hedge fund managers now manage over US\$190 billion out of the continent's US\$382 billion, according to HedgeFund Intelligence (HFI), exceeding 50% market share for the first time since the 1990s when the industry was much smaller.

3. While the general themes of enhanced governance, robust operations, controls transparency and strengthened regulatory compliance also apply in the United States, various structural and other differences exist which impact the degree to which these measures apply in that market.

4. Source: Hennessee Group LLC.

Looking to the future

Soon, a wave of regulation will make even greater demands of European hedge fund managers' operations and transparency. Europe's Alternative Investment Fund Managers Directive (AIFMD), the US Wall Street Reform and Consumer Protection Act (Dodd-Frank) and the US Foreign Account Tax Compliance Act (FATCA), when combined, will make Europe's hedge fund managers among the most heavily regulated in the world.

Hedge fund managers must recognise the opportunity they have to increase assets – providing they regain investors' trust. Transparency has an essential part to play in doing so. Portfolio transparency and controls transparency not only inform investors but also improve the ability of fund boards to discharge their duties by giving them greater insight into the activities of hedge fund managers and other service providers.

The fund

Investors are seeking greater predictability in the ways that funds are managed, in particular seeking to avoid practices such as surprise side pockets and unplanned 'gating'. Some are calling for stronger fund boards, with clearer descriptions of boards' duties. Others are investing in regulated UCITS hedge funds, managed accounts or onshore qualified funds, due to the greater levels of transparency offered.



Fund boards

Just as company boards are structured to represent the interests of investors rather than management, we believe that a majority of European hedge fund board members should be independent of all service providers.⁵ This would enable the board to act independently of the fund manager if necessary, so ensuring that investors' interests were always prioritised and protected – but would not preclude consulting with and involving the manager.

In line with sound corporate governance, certain institutional investors are focusing on fund boards, with some making an independent board a precondition for their investing. 'The board has moved up the agenda recently,' says Thomas Deinet, Executive Director of the Hedge Fund Standards Board (HFSB), which has played a leading role in addressing investors' concerns and helping to lift industry standards in Europe since it was established in summer 2008. 'There has been a lot of pressure. Some investors do not invest if they do not think the board acts in their interests.'

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Yet many hedge fund board members were not recruited to take such active board roles. Sometimes they simply perform corporate secretarial services and are rewarded commensurately. Furthermore, many professional board members have large numbers of directorships and do not always have sufficient time to assume extensive board duties. This is an area which we have seen European financial regulators focus on recently.

We support the recent call from the UK Universities Superannuation Scheme for stronger boards of directors.⁶ In order to ensure they have the time needed, directors should take on a limited number of directorships. In many cases, this may result in board directors' remuneration being increased to reflect the additional time they need to spend on the fund's affairs.

James Greig, a PwC Legal Partner, cautioned, however: 'We do recognise that the Alternative Investments Fund Managers Directive (AIFMD) will make this process of reinforcing the responsibilities of boards more tricky within the EU due to the directive's attribution of many investor-facing responsibilities directly to either managers or custodians. It will be interesting to see how fund boards and institutional investors respond, in their relationships with their managers and other service providers, to this new legislative imperative.'

5. There will need to be some careful work around board responsibilities to take account of the AIFMD, which does not recognise the board's role, but instead recognises that the manager in its conduct owes a duty to the investor to act in its best interests.

6. Good independent directors are critical, FTfm, 11 April 2010.

‘One should avoid confusing intentions and actual liquidity. When there is another international liquidity crisis, promised liquidity may prove unfounded for certain strategies used in a UCITS format.’

Christian Bartholin, a Member of the Executive Committee at HDF Finance

Fund structures

In Europe, UCITS hedge funds have been the most popular type of new fund structure to emerge since the onset of the crisis. Hedge fund managers have launched large numbers of UCITS funds in the past two years, tapping into demand from less sophisticated institutional investors and retail investors, who are both seeking hedge fund-type returns and the protection of a defined regulatory structure.

Investors are taking comfort from knowing that UCITS funds have limited leverage, restricted types of underlying investments and attractive liquidity terms. At the end of June 2010, according to HFI, there were 254 UCITS hedge funds, with US\$46.1 billion under management.

Christian Bartholin, a Member of the Executive Committee at HDF Finance, France’s oldest fund-of-funds company, counsels against taking indiscriminate comfort from UCITS’ fortnightly liquidity rule. He says: ‘One should avoid confusing intentions and actual liquidity. When there is another international liquidity crisis, promised liquidity may prove unfounded for certain strategies used in a UCITS format.’

Some regulators are also sceptical about the merits of UCITS hedge funds. Andrew Crain, Manager of the FSA’s Alternative Investments and Asset Management Team, asserts: ‘As we see the market for UCITS-type products with hedge fund attributes proliferate, there may be an increased risk of mis-selling or misunderstanding. Structural differences between UCITS products and the underlying hedge funds they are attempting to replicate can also lead to differences in both risk and return characteristics.’

Hedge fund managers should be sure that they will be able to honour UCITS liquidity promises, even in times of market crisis. They should also be careful not to market any fund strategies that are not in strict compliance with the UCITS rules and their spirit.

We believe that those managers that transparently disclose how UCITS funds actively manage liquidity, risk and compliance will build trust with investors, many of whom have become sceptical of the product offering.

Another structure that has gained popularity since the crisis is the traditional managed account. Some hedge fund managers have commented

that they prefer providing portfolio transparency to providing a managed account. This view was supported by institutional investors in our research, including Andre Konstantinow, Head of Manager Selection at Barclays Pension Fund. 'In general, the cost of running a managed account can be higher. The need for a managed account is frequently removed if there is adequate transparency,' he explained. Andre also cautioned, 'Even though a managed account gives greater transparency, it doesn't follow that you can sell the assets. When there is no market, there is no liquidity, even if you can get your hands on the assets.' However, he did recognise that some investors insist on a managed account, saying: 'For some, a managed account is a philosophy.'

There has also been increased interest in European onshore professional funds post crisis. Following AIFMD's implementation, we expect that there will be a bifurcation of the hedge fund industry, with managers large enough to cope with the logistics providing onshore European product for their Europe-based investors (and perhaps Asian retail investors also), managed by an AIFMD compliant manager, and

then perhaps an offshore (typically Cayman) vehicle for 'the rest of the world'. This will obviously lead to increased costs and inefficiencies in managing pools of money, but does allow managers to allocate the costs to those investors whose jurisdictions are mandating differing levels of regulatory requirements.

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‘On the investment risk side we have had quite a leap in transparency from many funds,’ says Sarah Fromson, Wellcome Trust’s Head of Risk. ‘They have improved transparency of investment risk exposures, and will tell you which counterparties they are trading with, quoting the split of levels 1, 2 and 3 assets. A number will work with risk aggregators, allowing positions to go to them on a disguised basis, generally monthly.’

Sarah Fromson, Head of Risk,
Wellcome Trust

Portfolio transparency

Portfolio transparency is an area where investors have exercised their muscle in the past few years. Investors want transparency both so that they can judge whether a fund’s portfolio composition is consistent with its prospectus, and so that they can aggregate the risk measures across all the funds they may hold.

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The degrees of position transparency that a manager is prepared to give vary from one to another, and often depend on the importance of the investor. At one extreme some managers give full position transparency daily to large institutional investors. Others provide monthly position or risk data to independent risk aggregators, which then calculate risk concentrations for investors.

At the most basic level, investors are seeking certainty that the fund will be managed in the way they expect. Régis Malcourant, PwC Partner, explains: ‘To establish trust, a fund’s prospectus needs to describe clearly how the fund is managed and then the fund needs to be managed in this way. It’s as simple as that. The fund’s investment policies, risk exposures and capital movements all need to be applied consistently over time, in the manner expected.’

The manager

Responding to investors' growing demands for better, higher quality corporate governance and operations, as well as transparency into these areas and investment activities, many hedge fund managers have recently made substantial improvements to their infrastructures.



One of the larger hedge fund managers we interviewed had, for example, substantially upgraded its governance structure in the previous 18 months, introducing committees overseeing market risk and liquidity; credit risk; operational risk; and valuation. Others reported adding large numbers of employees in the past few years in areas such as compliance, investor relations and risk management.

Now all managers are likely to need to enhance existing structures if they wish to attract investment from institutions and to withstand mounting regulatory scrutiny.

Governance

Governance is just as important for the hedge fund manager as for the fund. Hedge fund managers need to consider carefully the composition of their boards and to be sure the appropriate skill sets are included. Within the management company, the control environment needs to be formalised and to include committees tasked with undertaking appropriate monitoring of the manager's activities. Importantly, there must be clear delineation between investment and operational functions, especially in critical areas such as asset valuation and asset allocations across funds.

Remuneration should be structured to ensure that the manager's interests are aligned with the investors' interests. The Capital Requirements Directive and AIFMD require recognition of incentive-based remuneration over several years, to promote much greater alignment between risk management and reward. Managers with whom we spoke commented that some of their pension fund clients agreed with the principle that remuneration should be more closely linked to long-term risk-adjusted performance, rather than a single year's returns.

With investors and regulators demanding appropriate remuneration structures, hedge fund managers must strive to introduce packages that reflect best practice. Hermes, the UK investment manager that has a fund-of-hedge-fund business, has developed a remuneration structure for its asset management business that it believes aligns its teams to deliver sustainable performance for both clients and company over the long term. Investment team remuneration is tied to three-year investment performance metrics with a significant amount of bonus deferral. Participation in profits of the business is linked to investment performance and also only delivers material value if the strategy is built to be sustainable over the long term. 'We have the tools and the focus to make sure that

everyone is properly aligned to deliver sustainable out performance, both for clients and the business,' explains Rupert Clarke, Chief Executive Officer.

'Clearly any restructuring of remuneration structures which are driven by regulatory change will have resulting tax consequences,' says Rob Mellor, PwC's UK Hedge Fund Leader. 'While it may be possible that the drive to 'equitise' remuneration will offer asset managers a chance to improve the overall tax position, careful planning and implementation will be required.'

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‘A few years ago performance, people and process determined the investment decision,’ says Adrian Sales, Head of Due Diligence at Albourne Partners Ltd, the specialist hedge fund consultancy. ‘Now these issues are by no means the sole criteria. You can’t assess them unless you know that a manager is running a well-controlled, sound business.’

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Operations and controls

Since the credit crisis, operations and the control environment have become more important to investors, as they have sought out managers with sound infrastructures. Now this is a primary, rather than secondary, due diligence issue.

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Investor due diligence is becoming far tougher. It may involve not only an initial meeting to understand the control environment but also monitoring over many months and, in some cases, testing.

‘Over the last few years due diligence reviews have become much more onerous. There is far more challenge,’ observes David Jackson, who joined BlueCrest Capital Management LLP, the rapidly growing multi-strategy manager, in 2009 as Head of Operational Risk & Internal Audit, a new position.

In addition to seeing a robustly structured and managed control environment, institutional investors and their consultants are concerned about the following issues surrounding operational risks:

- Valuation policies and procedures, including detailed documentation;
- Existence, safekeeping and controls surrounding the fund’s assets;
- Trading policies and procedures, including ethical guidelines;
- Compliance policies, supporting multiple regulatory demands.

Transparency into a manager’s control environment gives investors comfort that a hedge fund manager has adequate checks and balances in place. Pension funds are accustomed to receiving controls reports⁷ from their traditional managers and now, increasingly, require them from hedge fund managers. These reports give the investor the comfort of knowing that the manager’s board of directors has concluded that it has appropriate controls in place, and that an independent auditor has tested the operational effectiveness of the relevant controls over a period of time, usually a year, to concur with management’s view.

Such a report is still a competitive advantage in the hedge fund sector, but we expect it to become routine in future, as it is for administrators and will increasingly become for prime brokers. ‘We thought it was a massive added value to be transparent,’ says Arrowgrass’s Kenner, who has both commissioned a SAS 70 report and provided high levels of investment portfolio transparency. ‘If you want pension money you have to be transparent.’

Over the past 12 months, not only large managers but also smaller ones have begun to seek controls reports, or at least assess their readiness for such a report. Until recently, only managers with assets of US\$10bn or more would commission reports, yet now it is increasingly

7. For example, SAS 70 (now SSAE 16) and the international equivalent, ISAE 3402 or the UK standard, AAF 01/06.

common for managers with as little as US\$1bn to do so. Notably, it is usually managers with high growth aspirations that do so.

‘What I like about the SAS 70 is that the process forces a firm to look at itself introspectively, which leads to it making changes to institutionalise its processes, procedures and controls for the better,’ asserts Julian Mant, Principal at Mercer Investment Consulting. ‘We think the SAS 70 is a strong and powerful document.’ Even so, managers often only commission a report when required to do so by an existing or prospective institutional investor. Karen Sharpe, a PwC Director who specialises in controls reporting, says: ‘This is a risky strategy because our experience has shown that there is always some improvement to the controls needed to pass the rigour of the relevant standard and the reporting accountants’ independent inspection. It is far better to carry out an initial readiness review and gap analysis to bring the control environment up to the required standard before there is a deadline to meet.’ In other words, by establishing where controls weaknesses may exist, managers can address them before investors request them to do so.

Institutional investors are also increasingly looking for transparency into performance track records, and a growing number of requests for proposals ask for confirmation of compliance with GIPS (Global Investment Performance Standards). The standards themselves have recently been revised to enhance disclosures on fair value, risk and verification status with changes effective from 2011. While GIPS has not been taken up by hedge fund managers to the same extent as traditional managers to date, we believe that investor pressure is likely to increase.

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Compliance

New regulatory requirements arising from the introduction of the AIFMD and the widening net of the US Investment Advisors Act of 1940 (as a result of Dodd-Frank) are increasing compliance risk. With the full implications of these regulations only becoming clear in the last few months, many hedge fund managers will have to add considerable infrastructure in terms of qualified people and systems.

As a result of AIFMD, many managers will need to significantly improve transparency through internal and external reporting, covering gearing, liquidity, risk management and trading activity. Some larger hedge fund managers already have substantial infrastructures that address these issues, but many smaller managers may not.

‘Some of the risk management and documentation for the big hedge funds is very good,’ notes Grellan O’Kelly, Senior Regulator with responsibility for the Derivatives and Risk Management Policy Unit at the Central Bank of Ireland. ‘They describe the systems they have and why they are using a particular method of risk management for a particular fund. The big players generally have best-of-breed risk management systems.

‘But some of the smaller managers do their documentation and risk management on the back of an envelope. There are big questions to be asked of these guys. They will have to bear a large cost in systems and compliance people.’

Following Dodd-Frank, many European managers will need to register with the US Securities & Exchange Commission (SEC) by July 2011. Becoming registered with the SEC brings significant obligations, including disclosure to advisory clients of all material conflicts of interest, compliance with rules governing trading, advertising and performance reporting, and adherence to codes of ethics governing trading. Additionally, managers must have a chief compliance officer and an effective compliance programme. Once registered, managers will potentially be subject to intrusive and lengthy SEC supervisory visits.

Even as European regulations currently stand, national regulators would like to see improved practices in certain areas. A weakness noted in some of the UK FSA’s ARROW supervisory visits centres on post-trade controls used to detect market abuse.

‘What has not been consistent is the extent of back-testing,’ says the FSA’s Andrew Crain. ‘Firms’ control functions need, among other tests, to challenge the most profitable trades and those that occur in close proximity to a corporate action and to understand why these positions were taken. Was the outcome the result of the trader’s skill or does it look and feel wrong? If I can see this type of testing is done, then I have more comfort around the control framework in place.’

Clearly, hedge fund managers will have to devote even more resource to regulatory compliance. With regulators becoming increasingly unforgiving of regulatory breaches, managers need to invest in the systems and compliance staff required to provide necessary levels of controls, reporting and transparency.

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Andrew Crain, Manager of the FSA’s Alternative Investments and Asset Management Team

The prime broker

Investors, managers and boards of directors are demanding as much transparency as possible into asset security and rehypothecation of assets. 'With our counterparty agreements we have done a lot of work in getting segregation agreements up and in place,' says BlueCrest's Jackson. 'We want proof that brokers are segregating our assets.'

David Jackson, Head of Operational Risk & Internal Audit, BlueCrest Capital Management LLP



Spurred by the risks to hedge fund assets held in custody by prime brokers, as revealed by the Lehman Brothers collapse, prime brokerage operating models have evolved since the credit crisis. In the immediate aftermath of the Lehman insolvency there was a flight to quality. Prime brokers owned by safer banks with large balance sheets swiftly won market share, as hedge fund managers moved to reduce the risk of assets becoming mired in the administration of a collapsed broker-dealer.

In order to respond to hedge fund managers' and investors' concerns, prime brokers developed three competing operating models, all designed to improve transparency and risk management, and to protect unencumbered assets in the event of a crisis. Large banks with existing custody operations and strong balance sheets are promoting the 'one-stop-shop' and internal custody model, where assets are held in another company within the same group. Other prime brokers have developed special purpose/bankruptcy-remote vehicles; and others are proponents of the third-party model, where unencumbered assets are held by an independent custodian.

'The community has very much welcomed the introduction of independent controls reports to rebuild trust and transparency between prime brokers and investors.'

Darren Ketteringham, Head of PwC's services to prime brokers

Prime brokers were quick to rebuild trust and increase transparency by commissioning independent third-party controls reports, initially in London and then in the United States, but now increasingly on a global basis with more activity in Hong Kong. These reports improve disclosure of prime brokers' controls activities and processes to their customers. The SAS 70 style of report has been found the most popular to date.

Darren Ketteringham, Head of PwC's services to prime brokers, commented: 'The three prime broker models are equally spread among the leading players, with no model being more pervasive or dominant at present. When I discuss the pros and cons of each model with hedge funds and investors, it is clear that they have a better understanding of risk management and that there is no bomb-proof model to guarantee protection and immediate return of their assets in a crisis scenario. The community has very much welcomed the introduction of independent controls reports to rebuild trust and transparency between prime brokers and investors.'

The administrator/valuer

Since the credit crisis, investors have focused more attention on the contractual responsibilities of administrators/valuers and how these responsibilities are carried out. They have stepped up due diligence procedures, seeking to understand administrators'/valuers' precise roles in asset valuations and validations, as well as the detail of controls and service level agreements.



‘The NAV is not the manager’s NAV, it belongs to the fund and its investors. Administrators are responsible for verifying the value of the assets and the calculation of the NAV, and should provide investors with requested transparency into the process.’

Jim Kelly, Chairman of HedgeServ

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Investors have always realised that hedge fund managers face conflicts of interest when they value assets and calculate NAVs, particularly due to managers’ performance-related fees. They are now recognising that the appointment of a third-party administrator does not guarantee an independent valuation process or NAV calculation. Many investors believe that trust can be greatly enhanced when these functions are sufficiently independent of the manager and/or there is transparency in the process.

Within Europe, the AIFMD is now making an independent valuation function

compulsory. While the directive does allow hedge fund managers to have an internal valuation function, it states that the manager must demonstrate that its internal valuer is independent of the investment management function. Some hedge fund managers may find demonstrating this difficult and will, therefore, have to appoint external valuers. But the AIFMD also stipulates that external valuers will face unlimited liability for their valuations. This uncapped risk may very well push pricing for such services higher.

The FSA’s Crain summarises why independent valuations are so important, stating: ‘There is a conflict of interest where managers are valuing assets and also taking a fee based on the value of those assets. That conflict must be adequately addressed.’⁸

Jim Kelly, Chairman of HedgeServ, an administrator, emphasises the importance of the administrator’s role in bringing

independence to the NAV calculation process, saying: ‘The NAV is not the manager’s NAV, it belongs to the fund and its investors. Administrators are responsible for verifying the value of the assets and the calculation of the NAV, and should provide investors with requested transparency into the process.’

Valuing illiquid assets is a contentious area because doing so often involves making difficult judgment calls. ‘To say that an administrator is in a better position to price complex securities than a hedge fund manager is perhaps too narrow a view,’ explains Robert Keogh, Managing Director, Goldman Sachs Bank (Europe).

European administrators, meanwhile, have started to offer far greater transparency to investors in monthly NAV reports. For example, they are providing detail covering areas such as: the existence of assets, third-party asset verification, breakdown of the custody of assets and split of asset type, including illiquid assets.

8. The SEC has recently shown its willingness to prosecute in the Palisades Fund case, where it is alleged the investment manager moved assets into side pockets, valued them at inflated prices in contravention of the stated valuation policy and charged fees on the basis of those valuations.

‘Accounting and valuation can be a complex area,’ he says. ‘If hard-to-value assets are involved and the manager is involved in the valuation process, investors need to be engaged and fully understand how that process works. The HFSB has a preference for structural independence in areas such as administration and valuation through independent parties.’

Thomas Deinet, Executive Director of the Hedge Fund Standards Board

Investor due diligence

HFSB’s Deinet encourages investors to explore how managers value assets or oversee the valuation process. ‘Accounting and valuation can be a complex area,’ he says. ‘If hard-to-value assets are involved and the manager is involved in the valuation process, investors need to be engaged and fully understand how that process works. The HFSB has a preference for structural independence in areas such as administration and valuation through independent parties.’

Hedge fund administrators, already under pressure to deliver transparency over internal processes to clients, are now also interacting directly with investors. Investors now want to understand the true role of the ‘third-party’ administrator by observing its operations in action; they want to discuss the valuation process with the administrator; and they want to understand the controls in place and the level of independence from the manager, ensuring that the service goes beyond what has been described as ‘NAV Lite’.

Investors, therefore, are increasingly performing intensive due diligence on administrators. ‘There is a lot more investor due diligence and it is to a higher standard,’ notes Declan Quilligan, Managing Director at Citco Fund Services (Ireland). ‘It is time consuming for the Investor, Manager and Administrator and can sometimes lead to a longer lead in period before the Fund commences.’

Controls reports

A further pressure on the administrator has been increased requests for access to their controls reports. ‘There are two different pressures on administrators in relation to controls reporting,’ says John Cronin, who leads PwC Ireland’s Third Party Assurance practice, ‘and it’s all “downstream pressure”. There’s pressure from the manager and fund auditors for transparency into controls, and pressure from investors, via the manager.’

The pressure from the manager and the fund’s auditors for transparency into controls has generally been satisfied by a controls report, typically a SAS 70. However, as managers have outsourced more and more to the administrator, and the interest in the content of the controls report has increased, the existence of such a report may not be enough. Now reports need to include additional areas such as middle-office functions, transfer agency, collateral management and greater detail about valuation of complex or illiquid investments.

The second ‘downstream pressure’ is coming from the investors who are concerned about the existence and safekeeping of their investments. Investors are increasingly driving hedge fund managers to provide greater transparency around processes and controls – many of which are performed at their administrator.

A key impediment for many hedge fund administrators is the required investment in technology and technological expertise, if they are to deliver the level of independence and controls that might allow the hedge fund manager to outsource this function. Some large managers have built sophisticated fund accounting and valuation infrastructures which they regard as far superior to what the administrators can offer. Yet as long as managers have partial control over valuing assets and calculating NAVs, considerable potential for conflicts remains.

In time, we believe administrators will have little choice but to make the further investment in systems and people needed for them to properly fulfil their buffer role between the manager and the investors’ interests. However, as administrators take more control over asset values and the NAV, their fees may have to increase to reflect their extra duties, as well as their extra liabilities under the AIFMD.

‘There are two different pressures on administrators in relation to controls reporting,’ says John Cronin, who leads PwC Ireland’s Third Party Assurance practice, ‘and it’s all “downstream pressure”. There’s pressure from the manager and fund auditors for transparency into controls, and pressure from investors, via the manager.’

John Cronin leads PwC Ireland’s Third Party Assurance Practice

Conclusion

Investors' drive to rebuild trust in hedge funds, and the use of transparency to achieve this, is set to transform the hedge fund industry over the next five years.



When combined with increasing regulation, investors' demands are handing larger managers a competitive advantage, as they are best placed to provide robust infrastructures. For new managers, this is raising barriers to entry. Mercer's Julian Mant believes European managers now need approximately \$250m of assets to be viable, up from \$100m-\$150m a few years ago. Some smaller managers may question whether to carry on as independent entities or sell their businesses to bigger platforms.

The same investor and regulator demands are favouring the larger administrators. Patrick Hayes, Senior Managing Director of Operations at State Street/International Fund Services, reports record new business in 2009 and 2010, with much of this emanating from US hedge fund managers bowing to investor pressure and appointing third-party administrators to provide some of the services the managers had previously performed internally.

We believe that managers of all sizes must now do everything possible to provide the governance and controls investors and

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Damian Neylin, EMEA Hedge Fund Leader for PwC

regulators want. Above all, there must be transparency into all aspects of the fund, the hedge fund manager, the prime broker and fund administrator/valuer. Managers must move from the older 'black box' or opaque way of conducting their business to a new 'open book' policy to succeed in this new, highly regulated world.

'Hedge funds have moved out from their opaque environment of 10 to 15 years ago,' notes Damian Neylin, PwC's European Hedge Fund Leader. 'This transformation from niche to mainstream must be accompanied by meeting more traditional trust and transparency standards to ensure continued success.'

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