AIMA, K&L Gates LLP and Maples present

AIMA U.S. BRIEFING AND REGULATORY UPDATE — NEW YORK

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March 3, 2016

AIMA U.S. BRIEFING AND REGULATORY UPDATE — NEW YORK

AGENDA

3:00 p.m. Registration and Refreshments

3:30 p.m. Panel 1: U.S. Issues — Room 32A/B

- 2016 Exam Priorities / Enforcement Priorities
- Key findings of SEC Presence Exam Initiative
- Preliminary results of Never Before Examined Initiative
- Whistle-blower program
- FINCEN's Anti-Money Laundering Proposal for Investment advisors

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- **Jennifer Duggins**, Co-Head, Private Funds Unit, Office of Compliance Inspections and Examinations, Securities and Exchange Commission
- **Bruce Karpati**, Managing Director, Global Chief Compliance Officer, KKR
- **Cary Meer**, Partner, K&L Gates LLP
- **Amy Poster**, Contributing Writer, Institutional Investor

4:30 p.m. Panel 2: Global Issues — Room 32A/B

- Reporting – Increased reporting requirements from Regulators: can Form PF/Annex IV be Standardized?
- PR Challenges for the Hedge Fund Industry
- Asia – Outlook for the Asian Hedge Fund Industry, Asia's marketing passport, governance developments
- AIFMD

- **David Keily**, General Counsel, Visium
- **Gil Raviv**, General Counsel, Millennium Management LLC
- **Henry Smith**, Partner, Maples and Calder
- **Jiri Krol**, Deputy CEO and Global Head of Government Affairs, AIMA
- **Kher Sheng Lee**, Deputy Global Head of Government Affairs and Head of APAC Government Affairs, AIMA

5:30 p.m. Coffee Break

5:45 p.m. Breakout Discussions

Breakout 1: Annual Compliance Review — Tips and Insights — Room 32A/B

- **Edward Dartley**, Partner, K&L Gates
- **Christine Chang**, Chief Operating Officer and Chief Compliance Officer, Funds Solutions Advisors
- **Irshad Karim**, CCO, Lion Point Capital
- **Matthew Lombardi**, CCO, Tinicum Incorporated

Breakout 2: Emerging Managers — Legal and Operational Solutions — Room 31 D

- **Christina Bodden**, Partner, Maples and Calder
- **Melanie Rijkenberg**, Associate Director, PAAMCO
- **Nicole Restivo**, General Counsel, Key Square Capital
- **Peter Huber**, Global Head of Maples Fiduciary, Maples Fiduciary
- **Ramona Bowry**, Senior Vice President – Operational Due Diligence, Maples FS

Breakout 3: Latest Industry Research — Room 32E

- **Jiri Krol**, Deputy CEO and Global Head of Government Affairs, AIMA

6:45 p.m. Networking Reception

Panel 1: U.S. Issues

AIMA Briefing and Regulatory Update: U.S. Issues

March 3, 2016

Moderator: **Amy Poster**, Contributing Writer, Institutional Investor
Panelists: **Jennifer Duggins**, Co-Head, Private Funds Unit, Office of Compliance, Inspections and Examinations, SEC
Bruce Karpati, Managing Director, Global Chief Compliance Officer, KKR
Cary J. Meer, Partner, K&L Gates, New York and Washington, D.C.

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EXAMINATION TRENDS: FROM OCIE'S MOUTH TO YOUR EARS

"We collect information on everyone. We analyze information on everyone. I think people assume, if they're not the 9%, the other 91% are out there doing things off the radar screen. But the SEC has gotten very proficient through hiring and staffing and resourcing of financial engineers…"

— Drew Bowden, Former Director, OCIE

Source: *Exams Not the Only Scrutiny, OCIE Official Warns*, Compliance Reporter, October 31, 2012

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EXAMINATION TRENDS: OBSERVATIONS

- **45%** of respondents have undergone an SEC Exam
- **50%** of private equity managers that registered as a result of Dodd-Frank have had an SEC Exam
- **28%** of hedge fund managers that registered as a result of Dodd-Frank have had an SEC Exam

Source: *2015 Alternative Fund Manager Compliance Survey*, ACA Compliance Group, August 2015

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CONFLICTS, CONFLICTS, CONFLICTS

- In her February 26, 2015 remarks to the 17th Annual Investment Advisers Compliance Conference, Julie Riewe stated that, in nearly every matter in the Asset Management Unit, the unit is exploring whether the adviser discharged its fiduciary obligation to identify conflicts and (1) either eliminate them or (2) mitigate them and disclose them to boards or investors
- She said, “Over and over again we see advisers failing to properly identify and then address their conflicts”

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2016 EXAMINATION PRIORITIES: PRIVATE FUND ADVISERS

- Conflicts:
  - Fees and expenses
  - Valuation
  - Trade allocation
  - Use of affiliates
- Side-by-side management of accounts with performance fees vs. accounts without performance fees
- Compliance and controls
- Never before examined advisers
- Private placements – Rule 506(c)
- Excessive trading
- Product promotion/performance advertising
- Recidivist representatives and their employers
- Cybersecurity

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PRIVATE FUNDS UNIT

- Role of Private Funds Unit within OCIE
- Relationship with Asset Management Unit within the Division of Enforcement
- 2016 OCIE exams of private fund managers:
  - Hot button issues
  - Sweep exams
  - Conflicts
  - Recidivist practices
- Tips for making an examination run efficiently
- Examination don'ts

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PRIVATE FUNDS UNIT *(continued)*

- How has examination program changed as a result of:
  - Data analytics for illegal activity detection
  - Whistleblower program

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RESPONDING TO DEFICIENCY LETTERS

- Best practices
- Integration into compliance policies and procedures and annual review

CHAIR WHITE ON ENFORCEMENT

"Vigorous and comprehensive enforcement protects investors and reassures them that our financial markets operate with integrity and transparency, and the Commission continues that enforcement approach by bringing innovative cases holding executives and companies accountable for their wrongdoing, sending clear warnings to would-be violators"

Source: *SEC Announces Enforcement Results for FY 2015*, SEC Press Release, 2015-245 (October 22, 2015)

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RECEIPT OF UNAUTHORIZED OR INADEQUATELY DISCLOSED FEES

- *In re Blackstone Management Partners LLC et al.*, Investment Advisers Act of 1940 (“IAA”) Rel. No. 4219 (Oct. 7, 2015):
  - $39 million in disgorgement and civil money penalties settlement by investment adviser to private equity funds because (1) there was inadequate disclosure of “accelerated monitoring fees” and (2) the adviser negotiated fees for legal services for which the adviser received a greater discount than did the funds
    - Key Takeaway: Full transparency of fees and conflicts of interest is critical

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FAILURE TO DISCLOSE CONFLICTS OF INTEREST

- *In re BlackRock Advisors LLC and Bartholomew Battista*, IAA Rel. No. 4065 (Apr. 20, 2015):
  - In the first SEC case to charge a violation of Rule 38a-1 under the Investment Company Act (requiring the disclosure of “each material compliance matter” to the board), the Commission charged that an adviser to registered funds, private funds, and separately managed accounts should have disclosed to the registered fund’s board that one of the adviser’s portfolio managers had founded a company that formed a joint venture with a publicly owned company in which the fund had a significant interest. The Commission also charged the chief compliance officer with causing certain violations, which led to a dissent by Commissioner Daniel M. Gallagher. The adviser paid $12 million to settle the matter
    - Key Takeaway: Conflicts of interest created by outside business activities must either be eliminated or be disclosed to the board and advisory clients

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FAILURE TO DISCLOSE CONFLICTS OF INTEREST *(continued)*

- *In re Guggenheim Partners Investment Management LLC*, IAA Rel. No. 4163 (Aug. 10, 2015):
  - In an action alleging that an adviser to institutional clients, high-net-worth clients, and private funds failed to disclose a $50 million loan that a senior executive of the adviser had received from an advisory client, the adviser settled by paying a $20 million penalty. The Commission alleged that the adviser did not disclose the loan to the compliance department or clients
    - Key Takeaway: Advisers must be vigilant in disclosing conflicts

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FAILURE TO DISCLOSE CONFLICTS OF INTEREST *(continued)*

- In the Matter of JPMorgan Chase Bank, N.A. and J.P. Morgan Securities LLC, IAA Rel. 4295 (Dec. 18, 2015):
  - Broker-dealer and bank preferred to invest client assets in the firm's proprietary investment products without disclosing the preference
  - This included more expensive share classes of proprietary mutual funds and third-party hedge funds where the manager made payments to a J.P. Morgan affiliate
  - $127.5 million in disgorgement, $11.815 million in prejudgment interest and $127.5 million penalty
    - Key Takeaways: Review Form ADV disclosures of conflicts carefully, especially with respect to referrals to proprietary products

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MISREPRESENTATION OF INVESTMENT STRATEGY

- *In re UBS Willow Management LLC et al.*, Securities Act Rel. 9964 (Oct. 19, 2015):
  - The Commission charged that the adviser to a fund changed strategy from a long-credit investment strategy (investing in distressed debt) to a short-credit investment strategy (investing in credit default swaps) without updating the fund's offering memorandum to reflect the change. The adviser agreed to settle by paying $20.5 million in disgorgement, compensation, and civil money penalties
    - Key Takeaway: Advisers must provide investors and boards with accurate information about a fund's investment strategy

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CCO CASES

- IAA Rule 206(4)-7 requires investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Act and to appoint a chief compliance officer responsible for "administering" the policies and procedures
- *In re BlackRock Advisors, LLC*, IAA Rel. No. 4065 (Apr. 20, 2015):
  - Charged CCO with causing compliance-related violations related to outside business activities because he allegedly "knew or should have known" that the violations were not reported to the funds' boards in violation of Rule 38a-1(a)(4)(iii)(B)
  - The order states that, as CCO, he was "responsible for the design and implementation of [the firm's] written policies and procedures," and "did not recommend written policies and procedures to assess and monitor [certain] outside activities and to disclose conflicts of interest to the funds' boards and to advisory clients"
  - The CCO was fined $60,000 and ordered to cease and desist from violating IAA 206(4), Rule 206(4)-7, and Investment Company Act Rule 38a-1

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CCO CASES *(continued)*

- *In re SFX Financial Advisory Management Enterprises, Inc.*, IAA Rel. No. 4116 (June 15, 2015):
  - In a case involving misappropriation of client assets, the Commission charged that the CCO failed to "effectively implement" a compliance policy requirement to review "cash flows in client accounts" and thereby "caused" the firm's violation of IAA Sections 206(4) and 206(4)-7
  - The compliance officer paid a fine of $25,000 and was ordered to cease and desist from violations of IAA Sections 206(4) and 207 and Rule 206(4)-7
- On June 18, 2015, Commissioner Gallagher issued a statement on why he dissented from those two decisions. He stated that CCOs are responsible for "administering" compliance policies and procedures but that responsibility for "implementation" rests with the adviser itself
- On June 29, 2015, Commissioner Luis A. Aguilar responded, stating that CCOs who do their jobs "competently, diligently, and in good faith" should not fear the SEC. He stated that between 2009 and 2014, the number of IAA cases brought against CCOs ranged from 6%-19%

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CCO CASES *(continued)*

- On October 24, 2015, Andrew ("Buddy") Donohue, Chair Mary Jo White's Chief of Staff, addressed the liability of chief compliance officers:
  - He repeated that the Commission is not "targeting" CCOs
  - He quoted earlier statements by Chair White that compliance officers who perform their responsibilities "diligently" need not fear enforcement action
  - He stated that SEC actions against compliance officers tend to involve compliance officers who:
    - Affirmatively participated in the underlying misconduct,
    - Helped mislead regulators, or
    - Had clear responsibility to implement compliance programs and "wholly failed to carry out that responsibility"
- Given the degree to which hindsight informs enforcement actions, the fact that the SEC says it is not "targeting" CCOs or charging CCOs who performed their responsibilities "diligently" may provide cold comfort
- Issues with outsourced CCOs

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LESSON LEARNED

- How do these enforcement cases affect fund formation and documentation?
  - Creation and updating of fund documents:
    - Conflicts resolution
    - Fee allocations and expenses
    - Disclosure requirements
  - Role of and use of advisory committees and independent client representatives to resolve conflicts
  - Fund governance (outside directors)
  - Obtaining investor consent
- Best practices with the enforcement division

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LESSONS LEARNED *(CONTINUED)*

- How do these enforcement cases affect …
  - Construction and review of compliance policies and procedures
  - Annual reviews
  - Data security and privacy

- Regulation and Compliance - ()

SEC and FINRA 2016 Exam Priorities: A Renewed Focus on Risk Management

This year, financial institutions across the U.S. will be subject to increased regulatory scrutiny of their risk management practices. Cybersecurity, liquidity management and anti-money laundering controls are among regulators' areas of focus.

Friday, February 05, 2016

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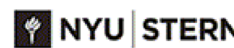

The need for more effective risk management is once again front and center, thanks to the recently released 2016 exam priorities of the Financial Industry Regulatory Authority (http://www.finra.org/industry/2016-regulatory-and-examination-priorities-letter) (FINRA) and the Securities and Exchange Commission's Office of Compliance, Inspection and Examinations (https://www.sec.gov/news/pressrelease/2016-4.html) (OCIE). FINRA's directives, in particular, focus mainly on firm culture and ethics, as well as on their impact on compliance and risk management practices.

The SEC provided more specific areas of concern, including protection of retail investors; lax cyber security controls; market risks related to technology; and anti-money laundering (AML) oversight. Moreover — driven by recent market events and the SEC's vigilance on retiree protection and retirement issues — exchange-traded funds (ETFs), pension advisors and liquidity controls have emerged as new focus areas.

Amy Poster

The regulators' annual examination agendas for 2016 seek to address various types of risks in a marketplace that is growing more and more complex. At the top of the list are suitability concerns for retail investors and seniors investing in complex investment products. In addition to overall market risks, cybersecurity risks and technology risks pose serious threats, not only to financial institutions but also to market order and efficiency.

While addressing current and developing issues (including unmanaged conflicts of interest) by both regulators, the exam agendas likewise provide a window to the general direction for enforcement activities. The SEC, for example, will continue to rely on surveillance tools and technology to gauge AML compliance and to detect market abuse and microcap fraud.

Let's now take a closer look at the key action items from both regulators' 2016 exam priorities.

FINRA's Priorities

1. Culture, Conflicts of Interest and Ethics

Firm culture and "tone at the top" not only influences overall behavior across a firm's hierarchy but also determines its general business attitude and its approach to conflicts of interest. FINRA is set to formalize its risk assessment of member firms' framework to develop, communicate and evaluate compliance conformance.

Five key indicators will be used in its assessment: (1) the value of control functions within the organization; (2) the policy of control breaches and tolerance; (3) how proactively risk and compliance events are sought; (4) the degree to which supervisors act as effective role models; and (5) and whether subcultures (which may exist in a branch, departments or trading desks) can be identified and addressed.

2. Supervision, Risk Management and Controls

The targeted examination of incentive structures and conflict mitigation in firms' retail brokerage businesses will continue into 2016. Reviews will primarily focus on conflict mitigation processes — e.g., compensation for registered representatives; approaches to sale of proprietary or affiliated products; and products for which a firm receives third-party payments.

FINRA will also closely monitor firms' research and investment banking groups. To ensure that the integrity of research recommendations remains unbiased, investment banking activities must be kept separate and independent from research.

Information leaks are another major problem. Both within and outside of firms, this has serious implications, especially when trading groups are involved. Insider trading and front running are two examples of illegal activities resulting from information leakage.

Position valuation also poses conflict of interest problems, particularly in cases where proprietary positions cannot be independently validated. FINRA expects to begin to examine the process and quality of sources for fair market valuation.

3. Technology

In recognition of the impact of technology — with respect to individual organizations and to the general stability of the markets — FINRA plans to renew its efforts to assess risk management and controls over technology infrastructure; hardware and software platforms; and IT personnel.

Cybersecurity threats persist, and firms need to prepare for a wide range of scenarios proactively. Vulnerabilities in key areas — such as customer accounts, online trading, asset transfer and vendor systems — can devastate organizations and result in market disruptions. As part of its cybersecurity exam agenda
(http://sites.edechert.com/10/6124/january-2016/2016-01-08-finra-letter-announces-

cybersecurity-as-2016-exam-priority(1)(1).asp?sid=5d438707-2984-4b61-96f3-c30a3ae7746c), FINRA will review governance, risk assessment, technical controls, incident response, vendor management, data loss prevention and staff training.

Over the past several years, technology glitches have resulted in market-disrupting events (e.g., Knight Capital Group's $440 million software error (http://www.bloomberg.com/news/articles/2012-10-17/knight-capital-reports-net-loss-as-software-error-takes-toll-1-)) that clearly underscore the significance of technology management. FINRA is consequently looking to be more circumspect when determining compliance on change management for algorithms, including proprietary and customer routing algorithms. Moreover, as part of its overall initiative on technology best practices, FINRA will require increased supervision and written policies and procedures for legacy systems and data quality.

4. Outsourcing

While recognizing the considerable cost savings of outsourcing operational functions to third-party providers, FINRA emphasizes that every firm is responsible for its own supervision and compliance with federal securities laws. FINRA will therefore review due diligence and risk assessment practices conducted by its member firms when evaluating services performed by third-party providers.

5. AML Controls

In recent years, high-profile enforcement actions against several investment banks have raised the bar on AML compliance. It should come as no surprise, then, that FINRA expects to more intensely scrutinize firms' compliance with suspicious activity monitoring requirements in 2016.

Firms are expected to adopt routine surveillance tools for data and systems that report customer accounts and activities. Special attention needs to be paid to transactions in high-risk accounts (such as cash movements), and firms are expected to develop a keen sense about when an activity should be flagged as suspicious. What's more, risk-based exemptions on the exclusion of certain customer activities must be fully understood and documented.

High-risk activity involving microcap securities will also merit a closer look. Compliance with registration provisions under the Securities Act of 1933 is FINRA's main focus in this area. Of particular importance to FINRA is reviewing firms' due

diligence practices related to deposits of large blocks of microcap securities. These reviews should determine compliance or exemptions related to deposits, and should include both physical and electronic deposits.

6. Liquidity

In 2008, poor liquidity management led to the demise of venerable institutions like Bear Stearns and Lehman Brothers. The bankruptcies of these firms resulted in the largest federal bailout, triggering a worldwide financial crisis.

FINRA understands the importance of funding and liquidity risk management, and will test firms' liquidity planning and controls, as well as their overall marketwide risks and their contingency funding plans relative to their business models. Firms will need to demonstrate the efficiency of their stress testing frameworks and the adequacy of their contingency plans.

Scrutiny of high-frequency trading (HFT) is also on FINRA's 2016 "hit list."

Priorities of the SEC's OCIE

To safeguard investor interests and to maintain the efficiency of US capital markets, the SEC in 2016 will focus on three broad areas: (1) protecting retail investors and retirees; (2) assessing marketwide risks; and (3) detecting illegal activity through the use of data analytics.

The SEC emphasized this trio of priorities in its exam letter, and we'll now take a more in-depth look at each one:

1. Retail Investors and Investors Saving for Retirement

OCIE announced that it will continue several 2015 initiatives, including the multi-year retirement-targeted industry reviews and examinations (ReTIRE). ReTIRE aims to determine the reasonable basis for investment recommendations made to "retiree" investors, and is also expected to monitor conflicts of interest; supervision and compliance controls; and marketing and disclosure practices. In its exam agenda, OCIE cites several retirement issues — including the rollover of individual retirement accounts (IRAs) and the suitability of sales for variable annuities.

As part of its review of the retail sector, OCIE will also take a closer look at whether registered investment advisers and broker dealers are actually serving the best interests of investors via their fee arrangements and investment recommendations.

ETFs, meanwhile, will be among the new exam areas covered by OCIE. More specifically, OCIE will take a close look at the applicable exemptive relief of ETFs under the Securities Act of 1933 and the Investment Company Act of 1940. ETFs' unit creation and redemption process — as well as all sales strategies, trading practices and marketing disclosures connected to ETFs— will likewise be examined.

What's more, for all SEC-registered investment advisers and broker dealers, OCIE will also examine branch-office supervision over registered representatives and investment adviser representatives. Special attention will be paid to branch registered representatives that may be engaged in inappropriate trading.

As part of an effort to crack down on "pay to play" risks (e.g., undisclosed gifts and entertainment), OCIE will also more rigorously examine government entities and public pension advisers to municipalities in 2016.

2. Assessing Marketwide Risks

Seeking to uphold its mission to maintain market efficiency and to assist in capital formation, OCIE will attempt to identify "structural risks and trends." Cybersecurity, systems compliance and integrity (SCI), liquidity controls and the activities of clearing agencies are among the risks and trends that will be monitored most closely.

In 2015, OCIE initiated its first phase of cybersecurity compliance and reviews of controls for investment advisers and broker dealers. These practices will continue in 2016, but OCIE will also test the robustness and security of firms' SCI tools, to ensure that they are in compliance with written policies and procedures for certain marketwide risks. Risk assessment of primary and back-up data centers and technology infrastructure will also be tested.

Similar to FINRA, OCIE has raised its interest in examining the liquidity controls of advisers to mutual funds, ETFs and private funds with exposures to illiquid fixed income securities. As new liquidity providers to the market, registered broker dealers will be also part of the reviews. Valuation, liquidity management, trading activity and regulatory capital are among the controls that will be reviewed.

As part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, clearing agencies (designated as systematically important financial institutions, or SIFIs) will be examined by the SEC's division of trading and markets.

3. Using Data Analytics to Identify Signals of Potential Illegal Activity

OCIE will continue to mine its data analytic capabilities to identify recidivist representatives and registrants with high-risk profiles — including those that seem more prone to money laundering, microcap fraud and excessive trading practices. These tools are expected to assist in detecting the promotion of new, complex and high-risk products that potentially could be used for suitability and fiduciary breaches.

AML program implementation will be under greater scrutiny, with OCIE paying particularly close attention to whether clearing agencies and broker-dealers comply with suspicious activity reporting (SAR) requirements. Data analytical tools will be used to review whether AML programs are consistent with firms' business models — as well as to determine whether a firm has filed incomplete or late SARs.

To determine if a firm has engaged in illegal activities (such as "pump-and-dump" schemes and/or market manipulation), OCIE plans to review broker-dealer and clearing agencies' operations closely. The regulator will also keep a close eye on firms and registered representatives that seemed to be engaged in excessive trading.

Other Initiatives

In addition to the three main areas we've already discussed, OCIE's 2016 exam agenda will also cover three initiatives — examinations of newly-registered municipal advisors; examinations of private placements; and "Regulation D" (http://www.federalreserve.gov/bankinforeg/regdcg.htm) compliance — that began in 2015. What's more, risk-based examinations of never-before-examined investment advisers and investment companies will continue in 2016.

For private fund advisers, OCIE will more closely scrutinize expenses, controls and disclosures associated with side-by-side management of performance-based and purely asset-based fee accounts. Record keeping, record retention and operational compliance by transfer agents will also merit exam attention.

Closing Thoughts

In response to the increased regulatory scrutiny, we can expect to see an uptick in risk management best practices. On the buy side, conflict mitigation will be near the top of the risk management agenda.

Cary Meer, a partner at the Washington D.C. office of KL Gates LLP, says that institutional investors are increasingly focusing on fund governance as a tool for mitigating conflicts. “For offshore funds, this includes having independent directors — or even a majority of independent directors — on fund boards. For private equity and other closed-ended private funds, this involves an increased use of the limited partner or advisory committee to address conflicts between the manager and the fund,” she says. “Managers are also adopting more robust procedures for review of investment and expense allocations, and for best execution.”

Amy Poster is a risk and regulatory consultant. She is also currently a contributing writer at Institutional Investor magazine. During the financial crisis, she served as senior policy adviser at the U.S. Department of the Treasury’s Office of the Special Inspector General-TARP. Prior to that job, she was the global valuation and risk controller for credit products at Credit Suisse.

Culture, Conflicts of Interest and Ethics

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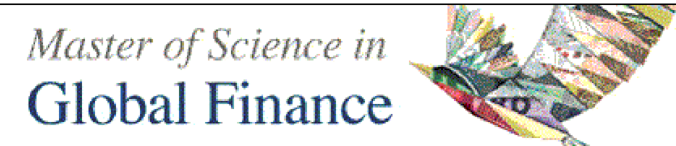

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Panel 2:
Global Issues

Global issues

Moderators: **Jiří Król**, Deputy CEO and Global Head of Government Affairs, AIMA | **Henry Smith**, Partner, Maples & Calder, Cayman Islands

Panellists: **David Keily**, General Counsel, Visium Funds

Kher Sheng Lee, Managing Director, Deputy Head of Government Affairs and Head of APAC Government Affairs, AIMA

Gil Raviv, General Counsel, Millennium Management LLC

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AIFMD: Third Country Passport Update

Henry Smith
March 2016

Overview

- The Alternative Investment Fund Managers Directive (AIFMD) introduces a new regime for regulating alternative investment fund managers and the marketing of alternative investment funds in the EU.
- Focus on marketing rules for US Managers of Cayman funds and European funds.
- Prior to introduction of AIFMD in July 2014:
  - National Private Placement Rules (NPPRs) with individual EU Member States
  - Reverse Solicitation
  - No Passport available for AIFs.

Phase 1: July 2014 (AIFMD Came Into Force)

- **EU Managers** regulated under AIFMD can market **EU funds** under the new AIFMD passport if they comply with the full scope of AIFMD.
- **EU Managers** managing **Cayman funds** – No passport, but can market under NPPRs but must comply with all AIFMD (other than as to appointing a prescribed depository, but must ensure cash management custody and oversight, "**depo-lite**").
- **US Managers** cannot market **US** or **Cayman funds** under the passport BUT can market under existing NPPRs (Cayman and US satisfied the 2 tests: (i) co-operation agreements with EU Regulators; and (ii) no FATF blacklisting) IF they comply with only certain limited provisions of AIFMD on:
  a) transparency and disclosure to investors and EU regulators; and
  b) assets stripping rules (more relevant to private equity funds).

Exemptions

- Reverse Solicitation
- Single Investor Funds
- Small Managers

Phase 2: From 2015 - 2018

- By 2015, ESMA was required to give an opinion to the European Commission/Parliament as to whether the passport can be extended to Third Countries.
- If the passport had been extended to Third Countries in 2015, Non- EU managers could choose to market under the **passport** OR **NPPRs** in parallel until 2018.
- To get the passport, the Directive requires the Third Countries in which the **fund and the fund manager** are based to have the following:
  1) not to be on the FATF blacklist;
  2) co-operation agreements with EU regulators; and
  3) tax information exchange agreements.
- Cayman checks these boxes.

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Phase 2: From 2015 – 2018 (cont'd)

- In July 2015, ESMA issued an opinion ("**2015 Opinion**") to the European Parliament, Council and Commission (**EC**) on whether the passport should be extended to non-EU jurisdictions.
- ESMA has taken a "**country-by-country**" approach. The 2015 Opinion included an assessment for six jurisdictions, with a positive recommendation to two of those (with a third subject to certain conditions). ESMA deferred its decision in respect of the other three jurisdictions assessed, being **Hong Kong, Singapore** and the **US**, for various reasons.
- In its 2015 Opinion, ESMA also **recommended the deferral** of the extension of the AIFMD passport to all non-EU jurisdictions until a larger number of jurisdictions had been assessed. **So despite the 2015 Opinion, there is no European Parliament / EC Decision yet to turn on the passport for any Third Country.**

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Phase 2: From 2015 – 2018 (cont'd)

- The Cayman Islands should be well placed to receive a favorable assessment from ESMA as part of the Second Opinion due in June 2016. On-going review of Hong Kong, Singapore and the US expected to be commented upon.
- ESMA and CIMA, the Cayman regulator, are in active discussions as part of this review. The Cayman Islands already satisfy the basic minimum requirements prescribed by the AIFMD (no FATF backlist, and have the requisite co-operation agreements and tax information exchange agreements).
- To further assist the review process, the Cayman Islands have been developing an AIFMD compliant opt-in regime.
- However, even if Cayman receives a positive assessment from ESMA, there is no certainty that the passport will be extended to <u>any</u> Third Countries. Following ESMA's assessment of a "sufficient number" of Third Countries, the EC has 3 months to decide whether to extend the passport to third countries at all.

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Finally Phase 3: From 2018 and Beyond

- If the passport is extended to Third Countries, then **NPPRs** are currently set to be **discontinued**.
- If the passport is not extended, then **NPPRs** continue **indefinitely**.

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Where Does this Leave Us Now?

- For now the status quo remains, as we see how the EU decides if and when it will turn on the passport for Third Countries and turn off the NPPRs.
- US Managers can market their Cayman funds into the EU under the existing NPPRs and are expected to be able to continue doing so for at least the next few years.
- If you need an EU passport now, consider establishing an EU AIFMD and an EU fund (e.g. in Ireland) or consider a "hosted' AIFMD manager option.

Brexit

What is Brexit?

- Brexit refers to a potential British exit from the European Union
- The UK electorate will vote on 23 June to decide whether to leave the European Union or stay in with revised membership terms
- The UK government has negotiated a number of key revisions to its membership of the EU:
  - Formal recognition that there is more than one currency in the EU
  - The EU will increase efforts to enhance competitiveness and reduce the regulatory burden on businesses
  - Restrictions on access to in-work benefits for non-UK nationals
  - Exemption from the principle of ‘ever closer union’
  - A ‘red card’ procedure which allows EU Member State national Parliaments to halt draft legislation if their concerns cannot be accommodated

What happens if the UK leaves the EU?

- The UK must formally notify the EU that it wishes to leave
- Membership of the EU will end after two years, and the UK will lose automatic benefit of access to the single market and EU free trade agreements
- The EU would be in charge of the timetable during the negotiations for a new model for the UK

Potential impact of Brexit on fund managers

- Potential loss of passporting rights into the EU for UK based firms
- Imposition of tariffs on capital and goods
- UK would be less encumbered by EU legislation e.g. the much discussed proposal for a Financial Transaction Tax
- Regulation is unlikely to decrease in the event of a Brexit
- If the UK wants to continue to do business with EU Member States following a Brexit, it will need to comply with EU regulations…
- …but the UK will no longer be able to negotiate, influence or challenge those decisions

Possible post-Brexit models

- EEA/EFTA arrangement
  - Would allow full access to the Internal Market
  - Would have to implement all EU laws relating to the internal market
  - UK would have freedom to set its own external trade policy
  - UK would be required to contribute to the EU budget
  - Free to regulate its own financial sector
  - Would have participation rights, but no voting rights or decision-making power where EU rules are concerned
- Bilateral agreement | bespoke solution
  - Acceptance of certain EU rules via bilateral agreements and trade treaties
  - Would allow partial access to the internal markets
  - Equivalence with EU rules would need to be maintained
  - Free movement provisions would still apply
  - Would be required to contribute to the EU budget

Possible post-Brexit models

- Passporting | Third country
  - UK firms will cease to benefit from the ability to provide and/or market services in the EU
  - Will need to use passporting option to gain access
  - Would need to follow EU legislation in order to access the Single Market
  - Would have no influence over policy but would have to comply with regulation
- Full sovereignty
  - UK and EU would trade under WTO rules
  - UK would be free to develop own rules
  - Most disruptive and, therefore, unlikely approach

MiFID II

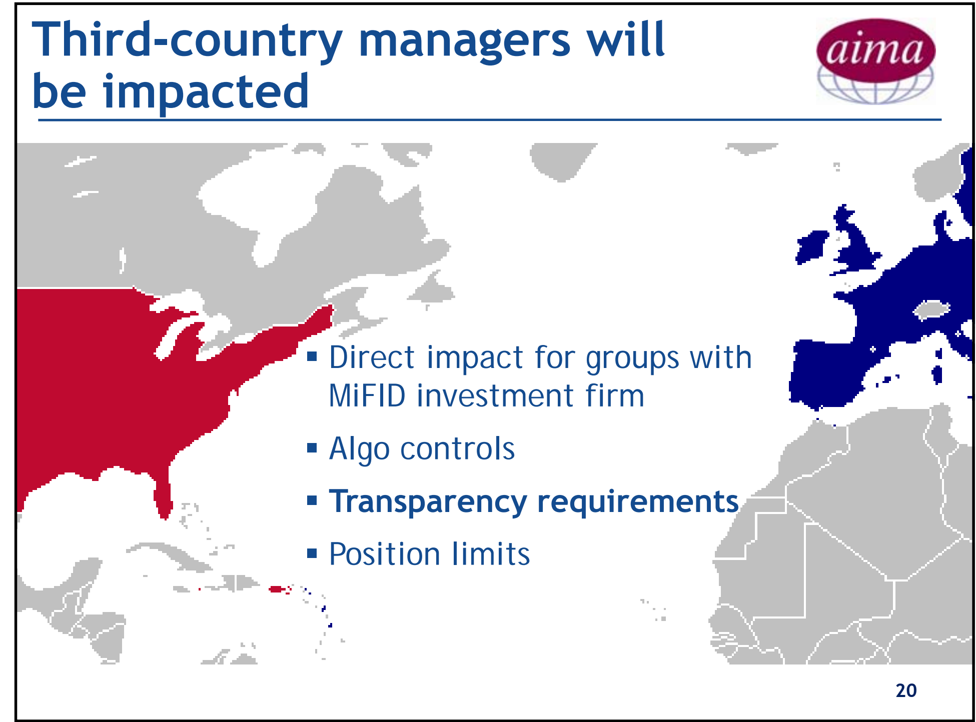
MiFID : Dealing commissions have dominated debate among managers

- Non-contentious aspect of primary legislation takes centre stage in debate about secondary rules
- Research Payment Account vs. Commission Sharing Agreement
- Will the industry outcry sway the European Commission?
- Problem of hard dollar payments to US brokers

Implementation challenges surfacing

- Managers being brought in scope of obligation to report transactions to regulator – any product admitted to trading
- Scope to rely on broker to report limited – impractical requirements in respect of documenting the relationship, data provision and back-up reporting lines
- 65 reporting fields proposed by ESMA
- New rules in respect of taping telephone conversations – concern about expected level of monitoring

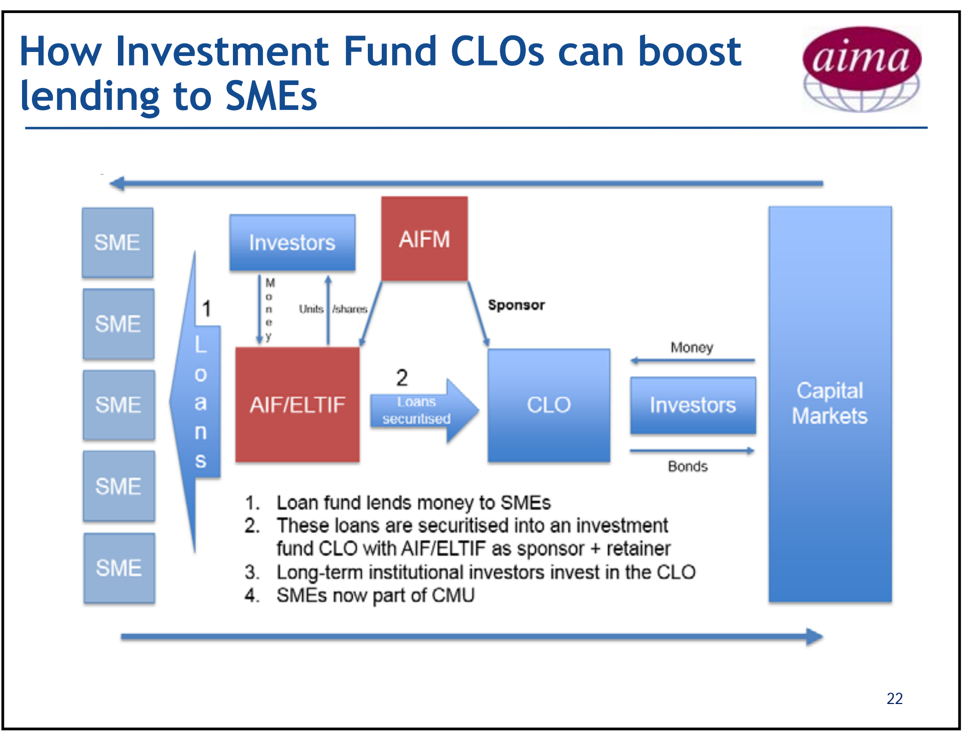
Third-country managers will be impacted



- Direct impact for groups with MiFID investment firm
- Algo controls
- **Transparency requirements**
- Position limits

Securitisation Regulation

How Investment Fund CLOs can boost lending to SMEs



What needs to change?

- **The current definition of sponsor should be adjusted to allow EU AIFMs, other non-CRD IV investment managers and UCITS management companies to be the retaining party.**
- **Without this change, only Banks will be able to act as sponsor and the CLO market will remain concentrated in the banking sector.**
  - The purpose of risk retention rules is to ensure that loans are not packaged and sold by originators, which absent 'skin in the game', could be done with undue regard for underlying risk.
  - The CLO manager is effectively, for the purposes of risk management, the originator and sponsor, as they select and package up the loans to be securitised and sold.
  - They should also therefore be the 5% retaining party to ensure they are incentivised to select and manage the performance of the loans
  - The manager is then under a specific set of incentives both to package loans with due attention to risk, as well as to manage the portfolio of those loans to maximise returns to both them and, more importantly, their investors.

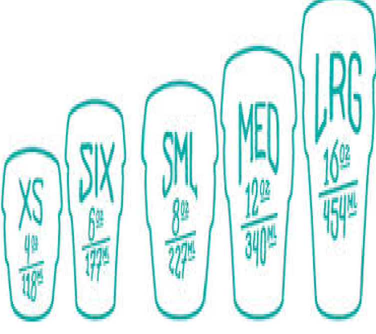
Other securitisation problems

- Defining the scope properly – excluding non EU AIFMs
- Definition of securitisation – unnecessarily broad
- Due diligence obligations on investors too onerous
- Allowing for out of scope transactions
- Definition of STS securitisation
  - Actively managed CLOs
  - Synthetic securitisations

Remuneration

Remuneration: Proportionality is key

- Asset managers have been able to dis-apply pay-out process rules under CRD III, CRD IV and AIFMD depending on:
  - the size, internal organisation and
  - the nature, scope and
  - the complexity of their activities



But proportionality is at risk…

- New EBA guidelines would permit dis-applications of some requirements but not the bonus cap
- EBA has asked the Commission to revise the text of CRD IV to permit this as they think current text limits to upward proportionality only, i.e. no dis-application
- Although ESMA stuck to its original understanding of proportionality when developing the draft UCITS V remuneration guidelines, there is currently a risk that they will follow the approach taken by the EBA

Effect of EBA guidelines

Who?	Would the full remuneration code apply?
CRD IV investment firm	✓
Companies within a CRD IV group (inc. AIFMs and UCITS mancos)	✓
AIFMs and UCITS mancos NOT in a CRD IV group	AT PRESENT ✖
UK BIPRU firms NOT in a CRD IV group	✖

MAPLES

PR Challenges for the Hedge Fund Industry

Henry Smith
March 2016

MAPLES

PR Challenges for The Hedge Fund Industry

- Views of popular media, political candidates and public opinion continue to shape and challenge the industry's PR image.
- Showtime's "Billions", movies like "Too Big Too Fail".
- 2016 US Presidential Election – one example of press coverage:
  - *"Hillary Clinton, Bernie Sanders, and Donald Trump have little in common, but they have one point of agreement: to make hedge funds the political punching bag of 2016. Democratic socialist Sanders offers an "average folk vs. hedge-fund manager" dichotomy at his rallies. Republican Trump claims, "The hedge-fund guys are getting away with murder. They make a fortune, they pay no tax. It's ridiculous, OK?"*

MAPLES

Common Myths about Hedge and Private Equity Funds

- They are secretive
- Only there to enrich the wealthy
- They are unregulated, non-compliant and helped cause the global financial crisis
- They cause jobs losses by asset stripping companies
- They are based in secretive offshore tax havens
- They do not pay their fair share of taxes
- They perform poorly against major market indices.

AIMA has been working hard to prepare materials to make the case for hedge funds and address these myths. See AIMA's website:

> *"The Case for the Hedge Funds: A Compendium of Thought Leadership Reports"*

Key Messages

Here are some key messages to help us counter the myths:

1. **The Hedge Fund industry benefits the global economy:**
   - The alternative investment fund industry creates an estimated 300,000 jobs (240,000 in US, 50,000 in Europe, 10,000 in Asia)
   - The industry creates taxable revenue (e.g. estimated in the region of US$8bn in Europe)
   - Hedge and private equity funds are useful capital allocators and help finance infrastructure projects in developed and developing countries (e.g. ship building, hospitals, power plants, roads)
   - Hedge and private equity funds benefit everyone with a pension fund (30% of assets in the industry are thought to now come from pension funds)
   - Performance of hedge funds is not designed to track long only index funds performance but to outperform on a risk adjusted basis and provides diversification.

Key Messages (cont'd)

2. Hedge Funds are not unregulated:

- Most managers are regulated
- Other service providers (administrators, custodians, prime brokers) are often regulated
- Funds regulated in main fund domiciles - Cayman Islands, Ireland, BVI
- Industry spends US$3bn on compliance costs (5-10% of operating costs on compliance)
- Governance continues to improve (80% of funds now have independent directors).

Key Messages (cont'd)

3. Hedge Funds are based in jurisdictions like Cayman for good sound business reasons:

- Sound legal regime for global investors - stakeholders can come together in a neutral jurisdiction with no extra additional tax cost
- Investors pay taxes in home jurisdiction – FATCA, Common Reporting Standards require transparent automatic tax information exchange
- Cayman is compliant on FATF reviews of AML/KYC legislation
- Both Republican and Democratic Parties have in the past confirmed this in explaining their candidates' investments in Cayman based hedge and private funds.

MAPLES

Key Messages (cont'd)

4. **Short selling is not inherently wrong:**
   - provides investors with hedge protection
   - brings liquidity to the markets

5. **Hedge Funds did not cause the Great Financial Crisis:**
   - started in the regulated banking industry
   - no hedge fund was too big to fail or got bailed out
   - common leverage for a hedge fund is 1-2 times assets (as opposed to up to 30-40 times in the regulated banking industry).

Breakout 1: Annual Compliance Review — Tips and Insights

Annual Compliance Review - Tips and Insights

March 3, 2016

Ed Dartley, Partner, K&L Gates LLP

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Legal Framework

- SEC requires all registered advisers to "review, no less than annually, the adequacy of the policies and procedures [reasonably designed to prevent violation...of the [Advisers] Act and the rules the Commission has adopted under the Act] and the effectiveness of their implementation."
  - Similar requirements for all registered investment companies.
- First compliance review must be completed within eighteen months of the effective date of the compliance procedures, and annually thereafter.

SEC Examiners Review

SEC examiners will typically scrutinize a firm's annual review in nine broad areas:

- Who conducted review?
- What was reviewed?
- When was review conducted?
- How was review conducted?
- What were findings from review work?
- What recommendations were made?
- What is current status of implementing recommendations?
- What documentation was created/retained to reflect work done?
- What was involvement of senior management in review?

SEC Examiners Review

SEC examiners typically review the following documents:

- Exception reports and management's response
- Evidence of testing: transactional, periodic and forensic
- Completed compliance checklists
- Reconciliations
- Work papers
- Documentation of problem and follow-up resolution
- Periodic assessments of control and compliance processes
- Internal audit reports

The Annual Review: Preliminary Considerations

- How you conduct your annual review depends on the size and strategy of your firm, and other considerations, but there are some common practices.
- One common tool is a **"risk assessment"** — but what does that mean?
- Another effective practice is **one-on-one meetings** with your colleagues who are on the ground dealing with the business issues that the policies are designed to address.
- **Timing** is everything — choose a time of the year when people can devote the necessary time and resources.

Planning Tool: The Risk Assessment

Develop a **written testing plan** tailored to your Firm in the form of a testing summary or testing matrix. Plan should also include a review of the **adequacy and effectiveness of implementation**.

- Inventory compliance obligations under federal securities laws and pursuant to disclosures to investors
- Identify conflicts of interest
- Match existing compliance practices to inventory of obligations
- Assess effectiveness of compliance functions
- Identify additional compliance procedures that are warranted

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Risk Assessment: Key Considerations

- **Compliance matters** that arose during the year (and the Adviser's response)
- Possible changes to address changes to the Adviser's operations and **changes in the law**
- Interim reviews to respond to significant compliance events, changes to business arrangements, and regulatory developments
- Best practice to be in writing
- **In examinations, SEC staff will ask to review the report of the Chief Compliance Officer ("CCO") regarding the annual review and the log of compliance violations and responses**

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Risk Assessment: Key Areas for Review

- Portfolio Management/Trading
- Proxy voting
- Codes of Ethics and Insider Trading
- Custody
- Conflicts of Interest
- Fees and Expenses
- Privacy
- Cybersecurity and Business Continuity
- Marketing Materials
- Regulatory Filings and Disclosures
- Books and Records
- Valuation and Pricing

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One-on-One Meetings

- Effective way to examine the firm's **"culture of compliance"**.
- Allows firm to identify **compliance gaps** due to changed business practices or changes in law.
- Provides confirmation of **compliance** with violation reporting.
- Get the perspective of business persons **"on the ground"**.
- Confirm that the firm's **business practices have not changed** in a manner that should cause the firm's policies and procedures to change.

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Annual Review Timing

- Focusing on a particular time of the year for most of the testing, but spreading out certain types of testing throughout the year will help maximize the effectiveness of the review.
  - **Transactional Testing** — testing at the time of the review.
  - **Periodic Testing** — testing at intervals throughout the year.
  - **Forensic Testing** — testing over a specific period of time to determine whether there are systemic compliance deficiencies or whether the system is being compromised through activities that would otherwise go undetected.

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Memorializing the Results – The Paper Trail

- How much backup should be kept?
  - Checklists?
  - Risk assessment spreadsheets/worksheets?
  - Interview notes?
- How to memorialize your annual review — another firm-specific question.
- Factors that will guide this decision:
  - Complexity of the firm's business lines
  - Client expectations for a copy, especially among institutional clients
  - Comfort level of the principals
  - Regulatory considerations, including providing annual review documentation in regulatory exams

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What To Do With The Results

- Meet with the principals of the firm and give them a download — getting the attention of the business people to focus on the issues is key
- A thorough briefing helps with the proverbial **"tone at the top"**, and protects you as well.
- Be sure to hit the main points and give them the good, the bad, and the ugly (with hopefully not much falling into the last two categories).
- Avoid briefing by memo or email — narratives should be limited to the Annual Review report, if any.

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Preserving Confidentiality

- **Results of annual compliance review may contain sensitive information**. Take steps to preserve confidentiality of reports on a compliance audit.
- For GC/CCOs, what is privileged and what is not?
  - The lines can blur, especially in an annual review.
  - GCs need to pay particular attention to what they communicate in emails or in writing.
  - Are face-to-face interviews privileged?

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When Problems are Detected

- What happens when a routine annual review uncovers an issue that requires legal investigation?
  - Proper investigation of alleged violation
  - Cease any violative conduct
  - Consider need for disclosure to clients or regulators
  - Report employee's misconduct to a regulator
  - Consider whether enhancements to compliance procedures are necessary

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Deficient Annual Reviews

- "[f]ailure of an adviser or fund to have adequate compliance policies and procedures in place **will constitute a violation of our rules independent of any other securities law violation**."
  - Statutory obligation to supervise
  - Control person liability
  - Directors' Duty of Care
- Conversely, a robust annual review process can be a defense to certain claims.

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Some Conclusions

- In planning your annual review, consider compliance matters during the year, changes in law, changes in business practices, and include the perspective of business people "on the ground".
- Tailor your process documentation (checklists, spreadsheets, etc.) to what fits with your firm and for you personally—there are many methods for executing an effective annual review.
- Maintain appropriate records of the annual review process, guided by the specifics of your firm and client base.
- A robust annual review process is more than a regulatory requirement, it can be an effective defense to a future regulatory issue.

Breakout 2: Emerging Managers — Legal and Operational Solutions

Hedge Fund Seeding: A Compelling Alternative

Mark Jurish, C.E.O. and C.I.O. at Larch Lane Advisors LLC
Peter Brady, Director of Marketing at Larch Lane Advisors LLC
Todd Williams, Director of Seeding Strategies at Larch Lane Advisors LLC

Overview of Hedge Fund Seeding

Many factors influence the success of a new hedge fund, including a sound investment strategy, a high-caliber team, robust operational infrastructure and qualified service providers. However, even with these qualities, there is no guarantee a fund will attract sufficient assets for survival. Most managers can't launch with a large enough asset base to cover organizational expenses and be considered credible by institutional investors. There are distinct advantages for managers who can attract substantial client assets at inception:

- Increased focus on investment performance;
- An early build-out of personnel and operational resources; and
- Ability to take a longer term business and investment approach.

Historically, barriers to entry for new hedge funds were quite low. Today, they are much higher. Investors expect greater transparency, more client service, well-known third-party service providers and high-quality back office systems and personnel. As a result, the break-even asset level is much higher.

Managers have several options at the hedge fund's inception:

- Self-fund with the expectation they will attract capital once they have a quality track record.
- Maintain a bare-bones operation, delaying new hires and support systems.
- Seek a strategic partner who provides a critical mass of capital in exchange for economic participation in the manager's business.

If structured properly, the strategic partner approach can be highly beneficial to the manager and to investors who provide the seed capital.

1.1. Seeding Relationship Benefits Managers and Investors

By providing early-stage capital, seeders are instrumental in the development of start-up hedge funds. A strategic and significant seed investment can help a start-up hedge fund attract outside capital, perhaps serving as a "stamp of approval" and validating the firm's viability. When an emerging manager has critical mass from a seeder, others are more willing to invest because they no longer represent too large a share of the manager's assets. Also, many allocators have minimum asset level requirements that make it difficult for managers below a certain AUM level (typically \$50 million or \$100 million) to attract new investors.

In addition to capital, seeders may offer managers strategic support in other areas, depending on the legal and economic arrangements between the seeder and the fund and/or the new manager. These may include assistance on business development, marketing, risk management and governance, as well as guidance on business issues faced by new managers. The seeder's support lets the manager focus primarily on fund performance at a critical juncture in the hedge fund's life cycle.

Seeders benefit as well. Providing early capital typically entitles seeders (both direct seeders and investors in seeding vehicles) to share in the hedge fund's revenue ("enhanced economics"). This participation can be quite profitable and takes a number of different forms, which we discuss below (see "Enhanced Economics of Hedge Fund Seeding"). Seeders can also gain other advantages such as early exposure to emerging managers, rights to future capacity, seeding rights for

future funds, full transparency, risk controls and the potential right to monetize their profit participation at a future date.

1.2. Early Exposure to Emerging Managers

A number of research studies show that emerging hedge funds have consistently outperformed more established hedge funds, both on an absolute and a risk-adjusted basis. Hedge Fund Research (HFR) found that over the 10-year period between 1994 and 2004, funds with less than a three-year track record outperformed older funds by over 5% annually, with nearly identical volatility. Outperformance was most pronounced during a fund's first two years. (On a cautionary note, that same research also found a somewhat higher mortality rate for new funds, primarily due to operational risks (HFR Asset Management, [2005])). Similarly, a 2009 study by PerTrac Financial Solutions finds that younger and smaller funds have outperformed larger and older funds over the long term (Jones, [1996-2008]). Specifically, PerTrac shows funds with less than $100 million in AUM outperformed funds with over $500 million in AUM by 377 basis points annually between 1996 and 2008, with only slightly higher volatility. During the same period, funds with less than a two-year track record outperformed funds with over a four-year track record by 562 basis points annually with lower volatility.

Neither the PerTrac study nor the HFR study made meaningful adjustments for survivorship or backfill biases. Survivorship bias occurs when funds that go out of business are excluded from an analysis. Backfill bias can occur when managers are able to retroactively report good initial performance and elect not to report poor initial performance. A 2008 study by Aggarwal and Jorion, made a number of adjustments to raw performance data to mitigate these biases. This study found returns lower than those in the PerTrac and HFR studies, but still reached the conclusion that managers generate "abnormal" performance of 2.3% during their first two years relative to later years (Aggarwal and Jorion, [2008]).

Thus, a number of independent studies have concluded that on average, emerging hedge fund managers outperform more established managers. Why? New managers may be highly motivated to outperform their peer group to attract assets and build a viable business. Emerging managers that are not too large also tend to be nimble. They are better able to make off-the-radar investments that are simply too small for multi-billion dollar managers to invest in, such as attractive small-cap companies.

By contrast, established managers typically have a more institutional investor base and institutional investors are normally not as performance-dependent. More established fund managers with larger AUM earn substantial management fees, even with average performance. Therefore, established fund managers may not be as motivated to outperform, especially if it requires them to maintain the risk profile that produced their historic performance. Lower risk tolerance often leads to average performance.

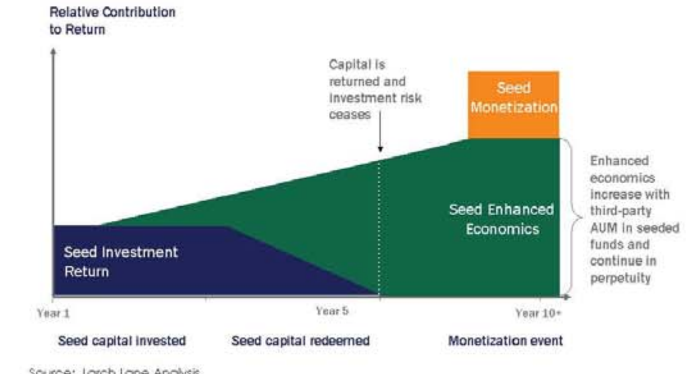
1.3. Enhanced Economics of Hedge Fund Seeding

A seeder's return potential is greater than that of other investors in a hedge fund because the seeder usually receives a portion of the hedge fund's revenue stream. Thus, the seeder's reward grows in sync with the hedge fund's asset growth. The exact nature of the enhanced return varies substantially based on the terms of the seeding agreement. A seeder's participation can range from a simple fee discount to a majority stake in the manager's firm. The net return on investment to a seeder is always higher than that of regular LP investors in the same fund. Not only does the seeder earn a portion of the fees collected when third-party funds are raised but even in unusual cases where no additional third-party assets are raised, the seeder generally receives an effective fee rebate through a share of the management and incentive fees applied to the seed capital.

1.4. Manager Performance Drives Dual Return Components

A seed investment incorporates two return components – investment performance and share of revenues – but it is important to note that both are manager-driven. Obviously, investment performance depends on manager skill. The revenue share component depends on third-party asset growth and, as with most investment vehicles, hedge fund asset growth tends to be highly correlated to performance. Managers with lackluster performance will deliver neither the investment returns, nor the asset growth necessary for a successful seed investment. Therefore, seeding only managers with the ability to generate attractive returns in a variety of market environments is essential.

Exhibit 1: Composition of a Seeder's Return Over Time



Source: Larch Lane Analysis

Exhibit 1 shows how the return composition of a successful seed investment shifts over time. Typically, in the first several years after seeding a fund, the vast majority of the investor's return comes from fund performance. Over time, as the fund's AUM grows, more of the return comes from enhanced economics. In many cases, the seeder continues to share in the fund's revenue even after redeeming the initial seed capital. These annuity-like payments may continue as long as the seeded manager continues to run a profitable firm. Also, depending on the deal terms, there may be a provision for the manager to buy out the seeder's interest or for the seeder to participate in a "monetization event" such as a sale or public offering of the fund. These can significantly enhance the seeder's return.

2. Where does this strategy fit in a portfolio?

Like hedge funds and private equity funds, a hedge fund seeding vehicle fits into a portfolio's alternative investment allocation. However, because seeding vehicles have characteristics of both hedge funds and private equity funds, determining their proper role in an institutional portfolio requires careful consideration of factors such as return potential, investment risk and liquidity. On an efficient frontier, we believe the risk/return profile of a seeding vehicle falls between funds of hedge funds and private equity funds.

2.1. Diversification Benefits

Whenever investors analyze a potential investment such as a hedge fund seeding strategy, it is important to consider the likely correlation of the investment to the rest of their portfolio. A group of early-stage hedge funds (ESFs) is likely to have a reasonably low correlation to an existing portfolio of more established hedge funds. ESFs typically hold portfolios that are substantially different than larger, more established hedge funds. For example, as discussed above, ESFs can invest in smaller, "less crowded" trades. Consequently, adding a hedge fund seeding strategy to an existing portfolio can potentially enhance returns and reduce overall portfolio risk.

2.2. Liquidity

There are several layers to a hedge fund seeding investment and each has a different liquidity profile. First, there is the liquidity of the seeding vehicle; next, the liquidity of the investment in the seeded hedge funds; and finally, the liquidity of the individual hedge funds' holdings.

Most hedge fund seeding vehicles require capital to be invested for an extended period, typically three to four years. This time frame is necessary because the seeding vehicle, in turn, commits capital to seeded managers for multiple years. If the seeding vehicle combines multiple seed investments in a single portfolio, it may take several years to identify and negotiate deals with a high-quality group of managers. In such cases, investors may agree to a staggered investment schedule, committing to an investment amount from which capital is drawn as seed deals are finalized. Specific liquidity terms vary depending on the structure of the seeding vehicle.

A seeding vehicle commits capital to individual hedge fund managers for a certain number of years and as those commitment periods expire, money is available to be reinvested or returned to investors in the seed vehicle. If reinvested, the money may be subject to the standard liquidity terms of the seeded hedge fund.

The fact that seeded hedge funds typically hold liquid securities distinguishes seeding vehicles from private equity funds, where the underlying investments are normally illiquid. The sponsor of the seeding vehicle can further improve liquidity by negotiating the right to redeem the seeded assets early if the seeded hedge fund violates certain terms, such as risk constraints or drawdown limits. For these reasons, a seeding investment is usually more liquid than a private equity fund and, in some cases, may even offer more liquidity than a typical hedge fund of funds.

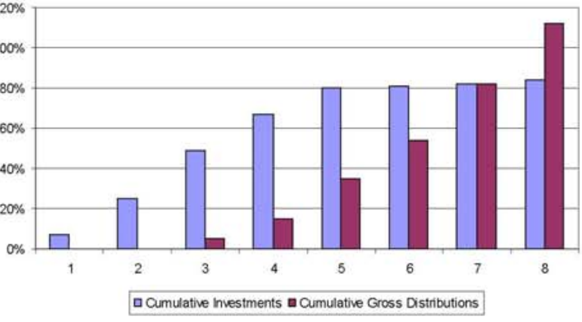
The ability of the seeder to request and enforce portfolio risk constraints provides added accountability and may improve overall liquidity. In 2008, some hedge fund managers strayed from their stated investment strategies, putting money into illiquid deals that exacerbated losses during the crisis. This is less likely to happen when the manager of a seeding vehicle is monitoring the portfolio and has the right to redeem from that fund if any risk constraints or other contractual terms are violated.

2.3. Cash Flow Comparison Highlights Liquidity Advantages

Another way to look at liquidity is to compare seeding vehicles to traditional private equity structures. Exhibit 2 shows the gross investments and distributions of a typical private equity fund using data from Prequin Hedge's Performance Analyst database, which includes empirical data for over 3,200 private equity funds worldwide. This private equity cash flow model shows that distributions exceeded the initial investment in year eight and, in fact, private equity vehicles typically tie up investor cash for seven to eight years. By comparison, hedge fund seeding vehicles typically return invested cash in three to five years.

Exhibit 3 shows how hedge fund seeding vehicles compare to other alternative investments in terms of liquidity,

Exhibit 2: Typical Gross Investments and Distributions for a Private Equity Fund



Source: Prequin Hedge: Private Equity Intelligence

Exhibit 3: Risk and Liquidity Characteristics of Various Alternative Investments

Strategy	Typical Lockup Period	Liquidity of Underlying Assets	Investment Risk (volatility)	Correlation to Traditional Assets
Venture Capital	6-10 years	Highly Illiquid	Medium	Low
Infrastructure	5-8 years	Highly Illiquid	High	Low
Mezzanine	5-8 years	Highly Illiquid	High	Medium
Hedge Fund Seeding	3-4 years	Varies	Low/Medium	Low/Medium
Passive Hedge Fund of Fund Investing	Varies	Varies	Low	Low/Medium

Source: Prequin Hedge, Larch Lane Analysis

investment risk and correlation to traditional investment assets.

We believe the added return from enhanced economics is more than enough to compensate hedge fund seed investors for reduced liquidity relative to direct hedge fund investing. In fact, we believe hedge fund seeding vehicles may offer higher return potential precisely because they fill a liquidity gap between private equity and traditional hedge funds. Investors who are willing to consider an opportunistic strategy that does not fit neatly into a pre-defined investment silo can reap ample rewards.

3. Common Seeding Models

Thus far, this paper has focused on seeding relationships in which the hedge fund manager provides a perpetual revenue share in exchange for seed capital. Other seeding models are available and though a detailed

discussion is beyond the scope of this paper, below is a brief summary of three common approaches:

3.1. Equity Ownership

The seeder provides capital in exchange for equity ownership in the manager's business and typically takes an active partnership role. Considerations in this arrangement include the deployment of the capital (which can be seeded into the manager's hedge fund or invested directly into the management company), the level and nature of the seeder's participation in the manager's business and the potential tax consequences of being an active participant, rather than a passive investor.

3.2. Revenue Sharing

The manager agrees to share a certain percentage of management and/or incentive fees in exchange for a

Exhibit 4: Comparison of Hedge Fund Seeding Models

Seed Model	Pros and Cons for Manager	Pros and Cons for Seeder
Equity Ownership	Pros Maintain independence and build franchise value Input and assistance in building the business	Pros Ability to exert control over manager's business Participate in manager's success while allowing manager some independence
	Cons No scale to hedge fund More intrusive than pure revenue sharing	Cons Capital covers management company expenses; more dependent on growth in third-party assets Potential liability and regulatory reporting issues Potential tax consequences of active participation
Revenue Sharing	Pros Maintain independence and build franchise value Autonomy over business/least intrusive Future funds and strategies may not be affected	Pros Capital exposed to investment strategy return potential Portfolio risk controls Independence from management company
	Cons Minimal support aside from capital Manager is typically responsible for management company expenses prior to calculation of revenue share	Cons Limited or no control over manager's business decisions No portfolio level control
Hedge Fund Platform	Pros Immediate access to significant capital Access to operational and marketing infrastructure Lower business risk	Pros Direct control and oversight over all aspects of manager's investment process and business Best liquidity profile
	Cons No independent business May not have complete investment autonomy Potential difficulty in separating from the platform provider	Cons Resource intensive No separation of liability

Source: Larch Lane Analysis

capital commitment. The investor does not explicitly obtain an ownership stake in the business. The revenue share can be structured as an allocation from the underlying hedge fund or as a payment from the management entity.

3.3 Platform Providers

A number of large, established hedge funds and financial institutions offer startup hedge funds a "turnkey" solution. The sponsor provides an investment platform, marketing and operational support and seed capital. In return, the platform provider typically receives a significant share of the manager's profits. These solutions let managers quickly begin implementing the strategy and focusing on investment performance and may give them an attractive base salary or draw, but the managers are not truly running the fund as an independent business.

In all seeding models, the manager and the seeder must negotiate a wide range of terms. Each model has advantages and disadvantages and the best solution depends on the preferences of the parties involved in the deal. Exhibit 4 summarizes the main considerations for the three seeding structures described above.

4. Case Study: The Life of a Seeding Transaction

Initiating, executing and monitoring a hedge fund seeding transaction is a complex undertaking. Experience is vital to a smooth and ultimately successful seed investment. While many fund of fund firms allocate capital to established hedge funds, the universe of dedicated seed capital providers is much smaller. The following case study presents a start-to-finish look at the life cycle of a seeding transaction.

4.1. Sourcing

A hedge fund seeding transaction begins the same as any other hedge fund investment. The first step is to identify prospective manager candidates. Sourcing prospects is an important component of the seed investment process and requires a strong network and specialized contact points outside the traditional hedge fund business.

4.2. Investment Process Due Diligence

No amount of revenue sharing or deal structuring makes up for mediocre investment results. First and foremost, the team that is being seeded has to be talented and have the ability to generate attractive returns.

Though similar to the investment due diligence process for traditional hedge fund investments, choosing funds to seed is more challenging because shorter track records are common and quantitative analysis more difficult. Effective selection must consider the management team's quality, investment experience and business management skills, the nature of the investment strategy and execution process, portfolio risks and the risk management process and trading capabilities. Developing a strong proof statement and conviction in the manager's ability to generate returns is critical.

4.3. Reference and Background Checking

Mark Twain is reported to have once said that history does not repeat itself, but it sure does rhyme a lot. We believe that saying applies to people as well. It is essential to engage in extensive reference checking because it indicates how an individual has behaved in the past, but more importantly, it provides indispensable insight into how the individual is likely to behave in the future, both in terms of investment acumen and integrity. References from peers, counterparts and clients quickly raise any warning flags such as exaggerated past performance or other integrity issues. Third party background checks should be performed on all principals of a potential seed manager.

4.4. Operational Due Diligence

Recently, some widely publicized hedge fund frauds have shaken investor confidence and underlined the importance of a strong operational infrastructure. A thorough operational review is critical to a hedge fund seeding decision for two key reasons: (1) more hedge funds fail due to poor business infrastructure than poor investment decisions, (Kundro and Feffer, [2004]), and (2) studies show that the higher failure rate of start-up managers compared to established managers is often due to business rather than investment issues (Christory, Daul, and Giraud, [2007]).

While ESFs may be held to different operational standards than established firms, the minimum acceptable standard for any hedge fund has risen. ESFs may not yet have dedicated, full-time compliance officers and technology professionals, but they are expected to have in place codified policies, controls and systems that are adequate for their current business and consistent with any legal or regulatory requirements to which they are subject. They are also expected to have relationships with reputable service providers. Seeded funds should meet minimum standards in the following areas:

- governance structure and decision making processes
- compliance policies and procedures, particularly valuation procedures
- day-to-day operations
- third-party service providers (audit, administration, prime brokerage, custodians, legal counsel)
- internal controls, particularly cash controls

4.5. Structuring a Transaction

While many seeders have their own standard agreement and structure, each seed transaction is unique based on the management team, the seeder's expectations and the investment strategy to be pursued. The categories discussed here pertain to most seed transactions regardless of structure.

Deal structuring negotiations serve as a useful extension of the due diligence process. How potential seed managers negotiate terms and the relative emphasis placed on particular terms provide insight into their business acumen and motivation. The negotiation process also provides a glimpse into the ongoing interactions after the seed investment is made.

Although there are many facets to every seeding transaction, here we focus on three primary features: economics, fund and management structures and risk controls.

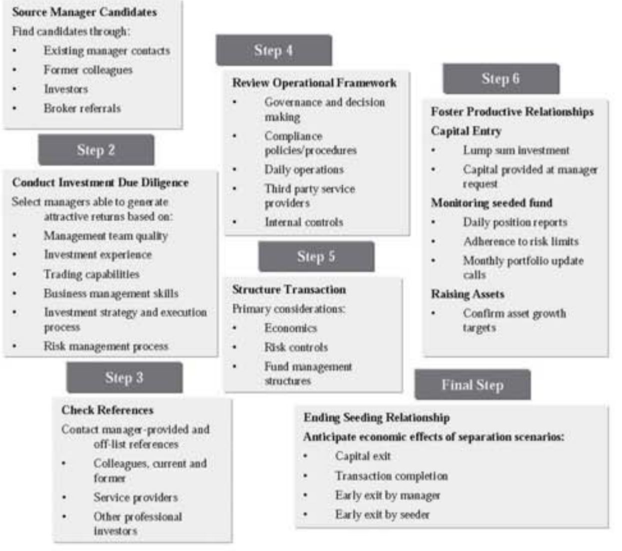
4.5.1. Economics

The economic terms of seed transactions are among the most sensitive and are generally kept confidential from the marketplace. Revenue shares range from 10% to 40% or more. Where a given seed transaction falls within that range depends on many factors including the amount of capital provided, liquidity terms, seed fund capacity, strategy, team experience and competition. Before 2008, a widely accepted rule of thumb was for a seeder to expect 1% of revenues for each $1 million of seed capital. Though this rule breaks down quickly as seed transactions reach and exceed $50 million, at smaller transaction sizes, the rule still seems to hold. In some instances, terms may be even more favorable to the seeder than the 1% per million rule of thumb.

4.5.2. Risk Controls

Controls on fund activities are intended to define the "bucket of risk" attached to the investment. Unlike investors in passive hedge funds where offering memoranda typically allow extremely broad latitude, seeders can

Exhibit 5: Executing a Successful Seed Investment



Source: Larch Lane Analysis

negotiate real limitations on the seeded fund's use of their capital. These risk controls are tailored to the strategy and the manager's particular investment approach. Examples can include exposure limits, position liquidity limits, allowable securities or instruments and VAR allowances.

Once controls are set, the seeded fund must provide reporting and transparency, while the seeder must continuously monitor to ensure that limits are adhered to. The relationship between a seeder and the seeded fund is an evolving one. Adjustments to risk constraints are possible as the seeder works collaboratively with management teams to respond to changing investment environments and opportunities.

4.6. Ongoing Relationship

Once the seed investment is made, the parties enter a multi-faceted business relationship. One facet is the continual monitoring of the seeded fund and management to ensure adherence with the agreement, particularly the risk parameters. Typically, management provides enhanced transparency into portfolio holdings and accounting records to facilitate monitoring. Because asset growth is necessary for a successful seed transaction, capital raising is a critical component of the ongoing seed relationship. In the platform model, marketing and capital

introductions are largely driven by the seeder, while seeders using other models can take a more passive role.

4.7. Ending the Seeding Relationship

All seed transactions must plan for the relationship's conclusion. Such planning includes (a) defining the circumstances or events that allow a party to separate, (b) outlining the economic effects of the separation and (c) specifying any continuing duties or obligations between the parties. Below are a few situations to be anticipated and their related issues.

4.7.1. Capital Exit

Seed capital is committed for a defined period of time to provide stability and promote the seeded fund's growth. By its nature, seed capital represents a significant portion of the fund's initial assets. If seed capital remains a significant portion of the fund's total assets at the expiration of the seed commitment, the seeder and manager must manage the liquidity event, possibly even maintaining seed capital investments beyond lock-up, to avoid weakening the fund or inhibiting its growth.

4.7.2. Completion of the Transaction

Seed relationships that terminate as a result of "normal" contemplated events (the exercise of a negotiated buy-out, the achievement of certain return hurdles or the term expiration) generally result in a clean separation of the parties, leaving few, if any, continuing obligations.

It is important to note that the term of the seed capital investment and the revenue participation are not necessarily tied. In many seeding models, the completion of an investment term and withdrawal of seed capital does not end the revenue sharing arrangement.

4.7.3. Early Termination by Manager

A manager could end the seed relationship for any number of reasons, including lack of investment opportunities for the specific strategy, lack of fund growth and insufficient revenue for the management team. This is a painful option for the manager and can be accomplished only through dissolution of the seeded fund and/or the management company. Typically, seeded managers are subject to non-compete restrictions.

4.7.4. Early Termination by Seeder

The primary method for a seeder to end a relationship is to withdraw capital due to occurrences such as breach of a covenant or risk constraint. In such situations, the seeder must consider the potential impact of the capital withdrawal. In many cases, the early withdrawal of seed capital leads to the demise of the fund, especially if it has not yet raised significant external capital. Therefore, the seeder must weigh the seriousness of the breach against the strength of the manager's strategy and the desire to continue participating in future economics.

5. Conclusion

The excess return potential from emerging hedge fund managers can provide attractive investment results. Seeders and investors in seeding vehicles earn higher returns than regular investors in the same hedge fund by sharing in the economics of the hedge fund manager. To the extent that a seeded fund attracts significant third-party assets, the seeder's revenue sharing rights can significantly enhance return.

Hedge fund seeding vehicles are a practical, professionally managed option for institutions and individuals seeking to profit from the many available seeding opportunities.

A hedge fund seeding vehicle is particularly appealing to investors who:

- want greater potential returns than those of a typical hedge fund portfolio
- need to diversify a large multi-manager portfolio
- want more transparency than is typically provided by a traditional hedge fund
- are looking for interesting co-investment opportunities
- want to capitalize on the hedge fund industry's growth, not just its return potential
- are interested in private equity-like returns with better liquidity

Our analysis suggests that seeding vehicles fall between hedge funds and private equity funds in terms of reward/risk and liquidity. Investors considering a seed investment strategy should have a multi-year investment horizon and be willing to tolerate some short-term volatility.

No seeding investments and no two seeding vehicles are identical. Every transaction is a highly structured, carefully negotiated deal. In the end, the success of individual seed investments and the performance of seeding vehicles depend on many factors, most notably, prudent manager selection, fair and informed negotiations and effective implementation. When evaluating a seeding vehicle, it is critical to carefully consider the sponsor's history because prior seeding experience adds value at every stage of the process.

In the aftermath of 2008's market upheaval, there is a tremendous shortage of capital available to new hedge funds. Meanwhile, the quality of new hedge funds seeking seed capital is significantly higher than we have seen in the recent past. Consequently, we find the current market environment extremely attractive for seeders. Investors who believe hedge funds will resume their growth trajectory and continue to play an important role in the investment landscape should consider a seeding vehicle as a way to capitalize on the industry's recovery.

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The evolving dynamics of the hedge fund industry
2015 Global Hedge Fund and Investor Survey
EY
Building a better working world

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Executive summary

Seismic shift. Profound transformation. These are words that have been used to describe the hedge fund industry in recent years. This year has not been without its turbulent moments, but it has also opened the doors to an environment of opportunity. As managers and investors continue to take on new challenges borne from regulatory and cost pressures, new operational considerations and the war on talent, those that consistently innovate and respond to market demands continue to grow. Efficiency is the name of the game, and embracing technology and data optimization is the new imperative. Change is inevitable, and as the standard operating model fades, we've come to realize that the very foundation of the industry is evolving. Challenges will abound, but new avenues will open up as well. From today's vantage point, an industry in its maturity is looking to the future with healthy optimism.

As you turn the pages of this, our ninth annual Global Hedge Fund and Investor Survey, *The evolving dynamics of the hedge fund industry,* we cannot help but reflect on the path that has led the industry to its present state, but more so, we look forward to what the future may bring.

First, we would like to extend sincere thanks to those managers and investors who provided viewpoints into the direction and development of this survey. Additionally, we would like to express our appreciation to the nearly 110 managers and over 55 investors who gave their time and insight to provide such robust results. We believe that this combination of perspectives provides invaluable observations — both commonalities and differences — that continue to drive and shape our industry.

Navigating evolution

The basic economic business model reflects four stages of evolution — start-up, rapid growth, maturity and decline, of which there are two paths, rebirth or demise. The hedge fund industry is in all four stages of this evolution. Start-up funds continue to penetrate the industry. Many funds are experiencing significant growth in their assets under management (AUM). And depending where funds are in the maturity timeline, institutionalization, industrialization or commercialization may be your current state. During this past year, as we have seen for many years, some funds decided to merge with others or close up shop and move on to new ventures. The dynamic nature of this industry has always fostered funds looking at themselves, assessing investors' needs and the effect of external forces, and remaking themselves in order to grow and stay strong.

There has been a multitude of challenges the industry has addressed in all stages of its evolution:

- **Meeting the performance promise:** the challenge to perform through a long-running bull market. Several post-crisis factors such as the prolonged low interest rate environment and other government intervention subsidizing traditional economic reality, as well as regulatory changes to managers and service providers have all impacted managers' operating and investment approaches.
- **Escalating stakeholder demands:** Investor and regulator demand for enhanced transparency, pressure on fees, and enhanced alignment of interests have amplified to levels not previously experienced.
- **The impact of regulatory change:** The magnitude of focus and change since the global financial crisis at local, national and global levels has placed a significant burden on people, operating models and technology capabilities.
- **Squeeze on operating margins:** Partially driven by stakeholder and regulatory considerations, the costs of running a business have escalated dramatically, creating increased barriers to entry for new participants while also straining the economics of even the largest managers.
- **Reputational:** Negative press from the one-off bad actors who fail to act in accordance with laws, as fiduciaries to their investors or with a lack of general business ethics. Conduct risk and responsibilities as a fiduciary underpin the focus on trust.

2015 stands in sharp contrast to the last decade; today, the concept or definition of a pure "hedge fund" has even been challenged. The blurring of activities and convergence with other segments within the asset management, and more broadly, financial services industry, have made it a significant challenge for hedge funds to brand themselves, and their benefits, clearly in the marketplace. Brand has never been more important as new money flows have been consistently going to the largest, well-known managers, not only in hedge funds but broader asset managers. Yet, start-up hedge funds are experiencing robust investor demand. The investor base has changed dramatically. Just a decade ago, investors were two-thirds high net worth and one-third institutional. Today, the reverse is true. How hedge funds are sold or distributed has changed as

well, and the impact of digital and social media will only accelerate further change. The focus on the investor and the "client experience" has never been greater and is clearly in the cross hairs of regulators, globally.

Key observations

This year, our survey focused on a variety of interesting themes, a few of which are briefly highlighted here.

Growth remains managers' top priority as most see it as the critical success factor in a lower margin environment. While universally highlighted by managers of all sizes, growth is occurring differently depending on where each manager is in its life cycle. Smaller and mid-size managers who are in their infancy tend to be looking to grow their client list and penetrate more investors with their core offerings. The largest managers who have achieved brand recognition within the industry continue to seek to expand their offerings; however, where in years past this meant launching of new alternative products (i.e. registered funds), there has been a shift in focus as managers have prioritized offering new strategies within traditional hedge fund vehicles. This is partially a result of the mixed operational and financial results of launching new products, but also a reflection on changing investor demands by market participants who are more sophisticated and want tailored exposures that align with their unique investment goals.

Managers are feeling the effects of recent bank regulations as they begin to impact their **prime brokerage relationships.** Various bank regulations, particularly those as a result of Basel III and Dodd-Frank, have kicked off a cycle in which we are only in the early innings; managers are experiencing re-pricing in addition to trade financing constraints with many of their counterparties. This has caused managers to evaluate the manner in which they obtain financing and, in some cases, make changes to their strategy. As managers and prime brokers continue to discuss their relationships we suspect this issue will continue to evolve and grow in significance in the coming years.

Additionally, in light of some of the challenges that managers are facing as a result of increasing costs, **technology and outsourcing** continue to be tools that managers are utilizing in an attempt to develop a more efficient and cost effective operating model. Data management and investments in technology remain as critical as ever in response to increasingly complex fund operations, heightened focus and scrutiny around cyber security as well as the ever growing number of regulatory and investor mandated reporting requirements. A well designed front to back office infrastructure not only yields efficiencies but, in the long run, will result in cost benefits.

With back office outsourcing at a saturation point, managers have begun to embrace more robust middle office solutions that have been introduced to the market in the last several years. These advanced offerings are allowing managers to scale their model as they grow in a cost efficient manner while permitting their internal resources to focus on more critical core activities. Many have commented as to the benefits obtained from pursuing this new frontier and anticipate the overall industry to move in this direction; this is no different than how the industry migrated to back office outsourcing earlier in its life cycle.

Looking forward

As the industry embarks on this next phase in its life cycle, one thing is abundantly clear. The road ahead will be fraught with twist and turns. The ground rules have changed, and acceptance and adaptation to this dynamic environment are the keys to survival. Changing investor demographics, convergence of products and strategies within asset management and other industries, and market reform in both emerging markets and developed markets alike are all providing the opportunity for disruptive innovation to drive growth.

At EY, we are enthusiastic about the future of the global hedge fund industry. We look forward to continuing to invest alongside the industry and support its efforts to enhance financial well-being for investors worldwide.

Strategic priorities — achieving growth

During 2015, the hedge fund industry continued its evolution, where common goals are not only maintaining, but growing market share in the face of a number of different challenges. Growth ambitions are certainly nothing new; however, we are finding that managers increasingly view growth as a necessity to counter many headwinds that are disrupting their traditional business model. The level of AUM necessary to thrive is not only higher than what would have been necessary in the past, but the timeline to achieve these critical thresholds is shorter than ever. Additionally, the need to attract and retain top talent is paramount to success. The good news is that asset flows to the industry remain healthy; however, competition for these assets is stronger than ever as managers compete to satisfy investor expectations for products, exposures and outcome-based solutions.

Strategic priorities of an evolving industry

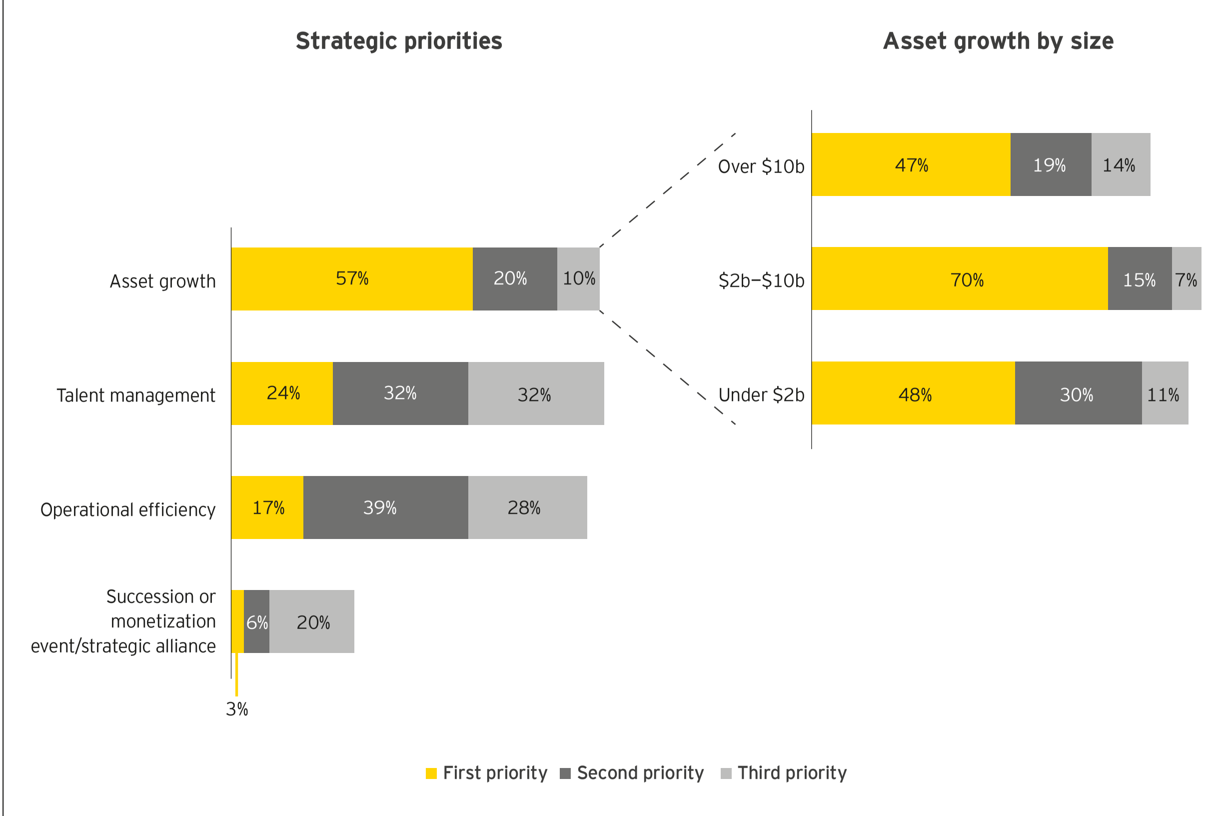
A majority of managers remain focused on asset growth as a strategic priority; however, those citing it as the top priority dropped significantly compared to 2013 when three out of four managers reported asset growth as the top priority. This reduction is partially driven by the success of the largest managers having implemented their growth strategies, whereas those mid-size managers with $2 billion to $10 billion of assets under management are still playing catch-up. Achieving growth remains a complicated proposition on account of increased competition, evolving investor demands and operating model constraints/margin considerations.

With their asset growth goals within reach, a higher proportion of the largest managers – one in three – noted that talent management is their new top strategic priority. They are seeking ways to attract and retain the best talent, not only in the front office where the pursuit of top investment talent remains paramount, but also in the back and middle office functions. This trend mirrors other industries (i.e., technology) where major firms differentiate themselves in their ability to identify, train and maintain top talent.

> " In order to continue our growth, we need to retain and continue to hire top talent. We're not looking for people with experience but rather people with potential. We are all competing for the top talent so it boils down to: do they join you or do they join them?"
>
> **(Over $10b, North America, Multi-strategy)**

Hedge funds' strategic priorities

Please rank the following in order of strategic priority to the firm.



Divergence in approaches to achieving growth

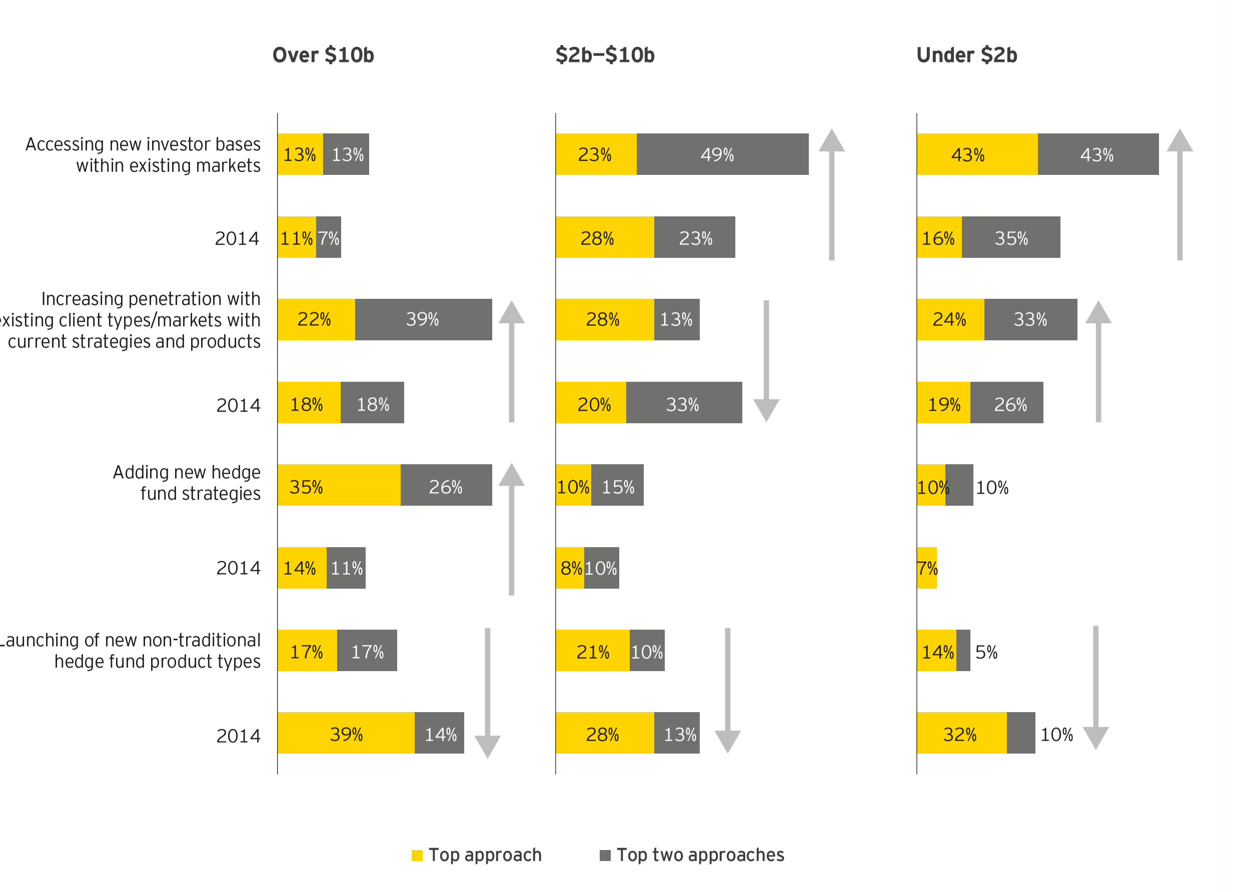
Growth can be achieved in a variety of fashions, and we find that managers tend to take different approaches based on their current size and point in their life cycle.

The smallest and mid-size managers are increasing their focus on accessing new investor bases. They are looking to expand their appeal beyond their core traditional hedge fund investors who generally have supported them from their launch date.

The largest managers, already having established a large clientele and brand in the market, are now focused on cross-selling products and becoming a "one stop shop" for investor needs. In prior years, this meant launching non-traditional hedge fund products. It appears that there may be less of an appetite to offer these non-traditional products as all participants highlighted a significant drop in new product launches. The largest managers are shifting their focus to offering new strategies. To execute this plan, they are not only hiring top talent to focus on offering new strategies, they are also driving consolidation of smaller managers.

Hedge funds

Please rank the top two approaches your organization is currently pursuing to achieve growth over the next three to five years.



Investor appetite for alternative products exists; however, traditional hedge fund managers are challenged by other market participants

In past years, managers identified new product development as the pathway to reaching new investors and growing AUM. Many hedge fund managers are finding challenges in this space as investors appear to use other asset managers to obtain these products.

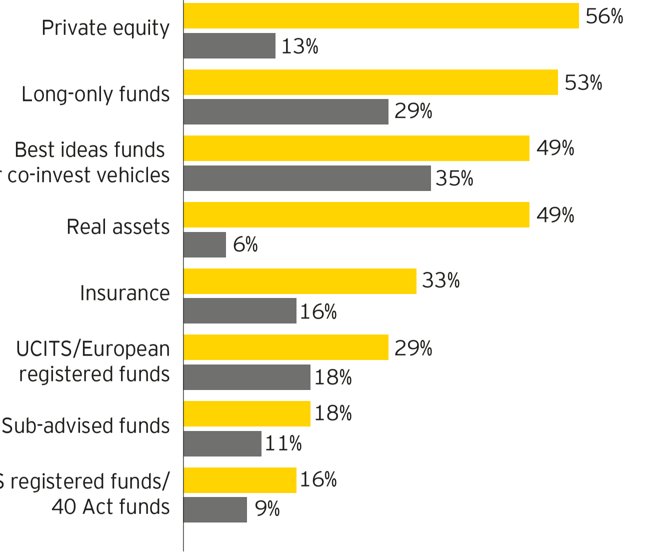
Certain of the products investors are most keen in having exposure to are not traditionally offered by hedge fund managers (i.e., private equity, real assets). Managers need to determine whether they are willing and able to compete with these alternative managers by making the required investments, including acquiring talent and building their brand. Alternatively, managers can solely focus where investors have demand for hedge fund products.

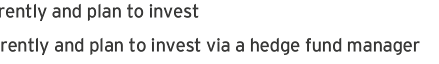
Additionally, a majority of investors remain committed to emerging managers. These new managers continue to receive a healthy proportion of new capital as they are viewed as nimble and able to deliver alpha by focusing on a core strategy.

As investors become more focused on actively managing their portfolio risk, there will be increased demand for customized solutions. Managers are at a crossroad and need to ask themselves whom they want to be. Should they choose to continue down this path, they will need to invest in people, infrastructure and brand. The investors will continue to evaluate whether managers can compete and meet their evolving requirements.

Investors

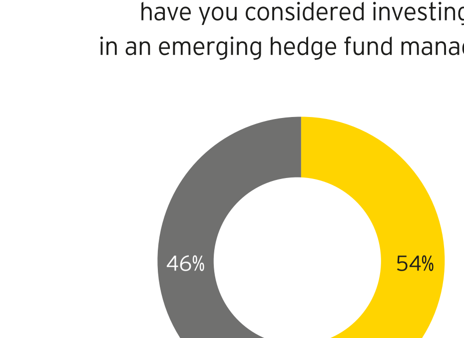
In which of the following non-traditional hedge fund products do you currently invest or plan to invest, through a hedge fund manager?





Investors

Do you currently invest in or have you considered investing in an emerging hedge fund manager?



> "We'll certainly be doing customized solutions. We'll certainly be doing separately managed accounts. Whether we're doing insurance, a full range of alternative products or whether we're doing private equity that's yet to be seen. If you want AUM growth, you need products to meet client needs."
>
> **($2b–$10b, Europe, Fixed Income/Credit)**

Product diversification helped managers commercialize, but it did not come without challenges

The largest managers were at the forefront of new product development. This has fueled their ability to transform from a standard hedge fund to a broader asset manager. However, they are now dealing with the ramifications of this expansion.

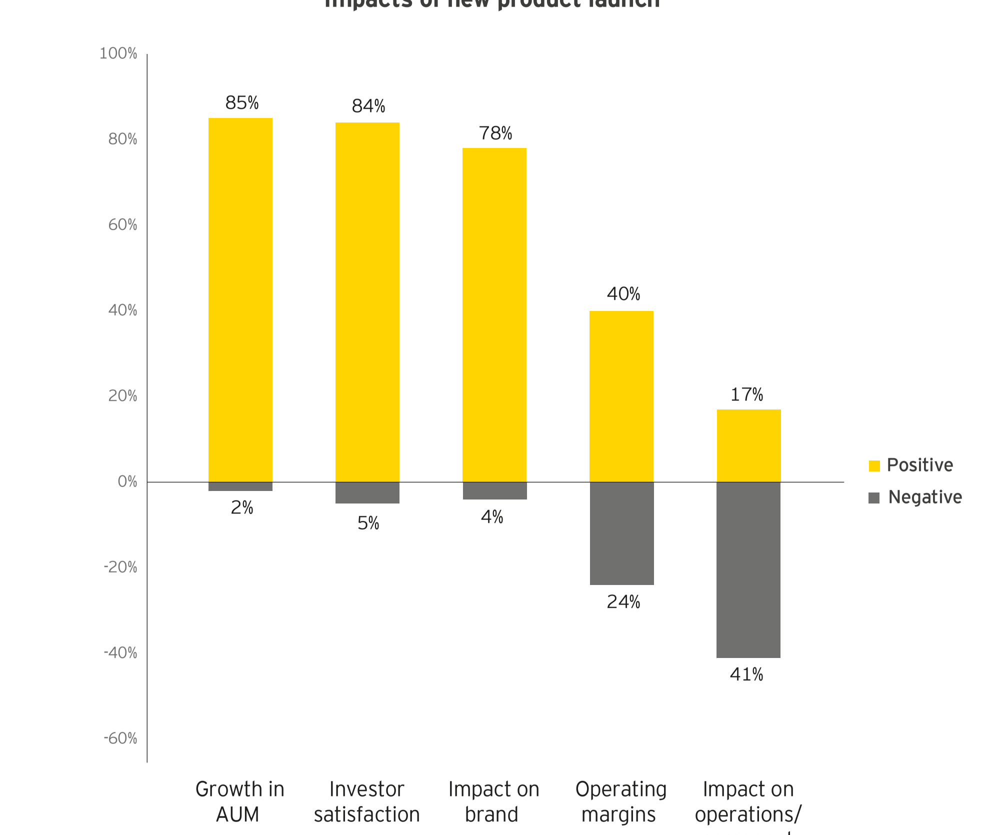
While offering new products was positive for investor interest and brand recognition, managers underestimated the bottom-line impact as there is a significant drop-off in margin satisfaction and an even heavier toll on the managers' talent. This may be a reason for the decline in new product development.

Thus, managers need to find a balance when launching new products – they may be successful in increasing AUM, but have questionable financial implications and strain the team supporting the products. This conundrum is challenging managers to question their current operating model and the investments needed in key areas, such as technology, in order to have successful product launches.

New products are hardly the only area contributing to margin compression ...

Hedge funds

If you have launched any products in the past two years, what has been the impact in the following areas?



Management fees continue to be under pressure, particularly for the smallest managers

… management fees also continue to be squeezed. Average management fees are over 50 basis points lower than the historical 2% as respondents reported an average rate of 1.45% for their flagship vehicle. The smallest managers who often lack the negotiating leverage of the larger managers and must make fee concessions for initial capital reported a lower average rate of 1.33%.

At the heart of the issue is a more sophisticated investor base and the competition for capital being at an all-time high, which has forced managers to negotiate the terms of investment more than ever. Management fees are the most preferred area to negotiate among managers and investors, and 60% of managers say they have already offered reduced management fees for large mandates.

Though managers do not prefer to negotiate incentive fees, 70% report that they would entertain concessions to the incentive such as imposing minimum hurdle rates, tiering of incentive rates, reinvestment of incentives and/or crystallization periods longer than a year.

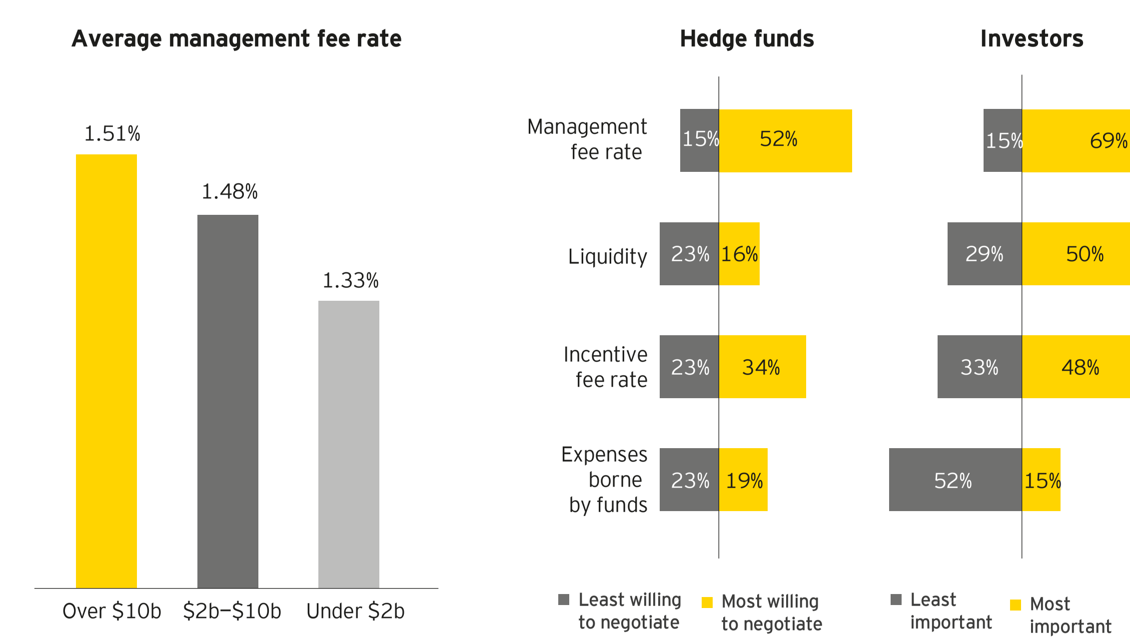
> "When we are deciding which manager to allocate to, we look for the type of portfolio they can put forward for us, how it can be tailored to our needs, governance, transparency and the returns they expect to generate."
>
> **(Pension Plan, Europe)**

Hedge funds

Based on pre- and post-operating ratios, what is your flagship fund's average management fee?

Hedge funds and investors

Which terms are you most willing to negotiate with investors? Which of the following terms do managers need to be most willing to negotiate?



Passing expenses through to the funds has reached its limit

In the past, a lever managers could pull in response to increasing expenses was to pass through certain costs to the funds. However, few managers expect to pass through more expenses to the funds going forward. This is partially in response to regulatory scrutiny, but more directly related to the fact that investors have been laser focused on individual types of expenses they are bearing in addition to the overall expense ratios of their funds.

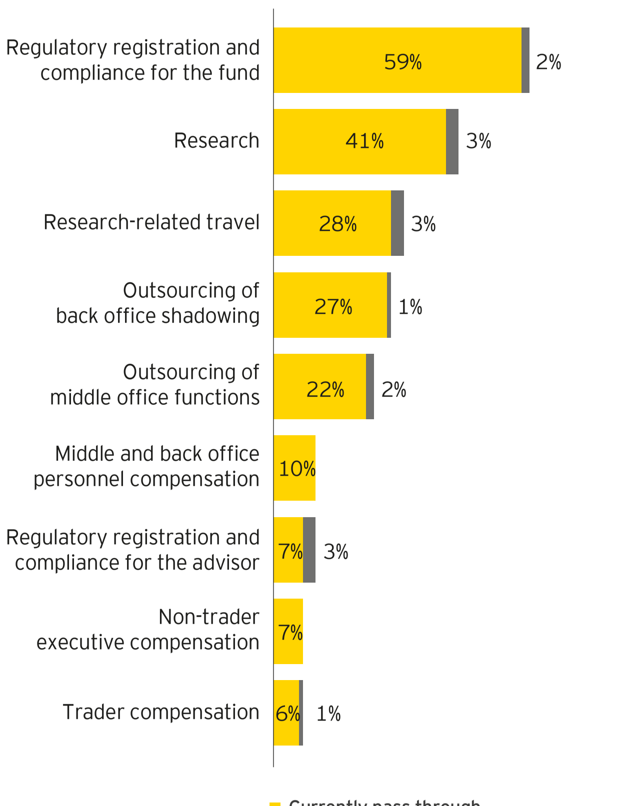
Not surprisingly, the smallest managers have fewer pass-through options and in almost all categories were bearing a substantially greater portion of the expenses as compared to their mid-size and larger peers. This cycle exacerbates the struggles that new managers have in successfully launching their businesses.

As further evidence of how far this dynamic has swung, nearly 30% of managers have negotiated caps on expense ratios and a further 17% say they would be willing to. This negotiation allows investors to fix the amount of expenses they will incur at an acceptable threshold while forcing the managers to further focus on managing their costs.

While the costs highlighted here are certainly not new, or surprising, for any manager or investor, the regulatory environment continues to prompt a number of new direct and indirect costs to the industry.

Hedge funds

Which types of expenses do you currently pass or intend to pass through to your flagship fund?



Hedge funds

For any of your offerings, have you negotiated a cap on expense ratios with any of your investors? If not, are you willing to negotiate a cap on expense ratios?

28%
17%
55%
Have negotiated
Willing to negotiate
Have not negotiated and unwilling to negotiate

Evolving prime brokerage relationships

Regulations enacted subsequent to the financial crisis intended to reduce market risk are directly impacting the manner in which prime brokers service the hedge fund industry. These regulations put in place as a result of the Dodd-Frank Act and Basel III have changed the basic ability of prime brokers to offer financing and maintain hedge fund assets. Increased focus on optimization, capital liquidity, funding and the balance sheet have impacted banks' capacity and economics, resulting in an evolution in how prime brokers view hedge fund relationships. Prime brokers have increased focus on balance sheet and collateral management, and are re-pricing clients when necessary. Relative to other challenges highlighted in this study that have been playing out for many years now, the evolving prime brokerage environment is in the growth phase of its life cycle. It will be a long time before we understand the full effects of the changes, though we do know the impact will be felt across the board — from prime brokers, to investment managers, to investors.

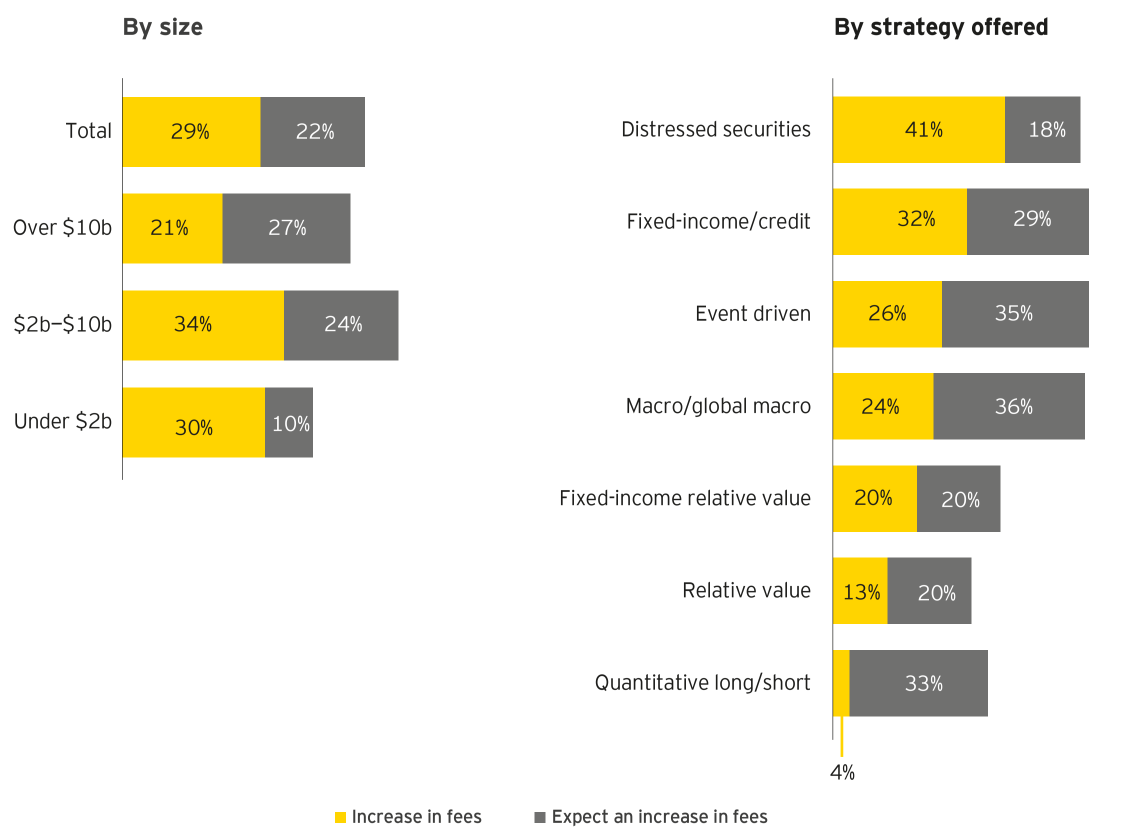
Managers face new pressures as prime brokerage fees increase

Our study identified that nearly 30% of managers have reported experiencing price increases from their prime brokers, with an almost equal number indicating that they anticipate price increases to occur in the next year.

A variety of factors will impact when and where in the re-pricing cycle managers will begin to feel these increases, but it is clear that this issue will impact a majority of managers regardless of size or strategy.

Those first reporting increases are managers who have a combination of balance sheet intensive strategies and trading in products that are traditionally not as profitable for prime brokers. On the opposite end of the spectrum, quantitative and equity long/short strategies appear to have been spared in this initial re-pricing as they tend to trade higher volume, high-quality liquid assets that result in lower net balance sheet exposure and/or greater internalization/optimization for the prime brokers. That said, these strategies are still anticipating price increases in the future as the cost of servicing all clients has risen and thus the current return on these assets is not optimal for the prime brokers.

> "Regulation is generally an issue – not only directly on hedge fund managers, but on the banks that they deal with. So getting access to financing and leverage is a risk facing hedge fund managers."
>
> **(Pension, Europe)**



Financing cost increases are substantial, directly impacting trade economics

The magnitude of trade financing price increases will vary depending on each manager's unique facts and circumstances, in particular, the types of assets the manager trades. However, what is clear is that all forms of financing are becoming more expensive — in some cases, being at or above 25%. These costs have a direct impact on overall trade economics and will cause managers to evaluate the feasibility of certain trades given these increased costs.

It is worth pointing out that the actual price increases reported by those managers initially impacted tend to be larger than those expected in the future by those managers spared from re-pricing initially. While this is partially driven by the prime brokers taking first action with those managers whose financing economics required the most improvement and, thus required larger increases, this expectation gap of more muted price increases is likely not going to be the reality.

Hedge funds

For each strategy you offer, have your prime brokers increased pricing in the past 12 months?
For each strategy you offer, do you expect your prime brokers to increase pricing in the next 12 months?

	Average % increase in prime broker pricing over past 12 months				Average % increase in prime broker pricing expected over next 12 months			
	Margin financing	Securities lending for "hard to borrows"	Repurchase agreements	Swaps clearing	Margin financing	Securities lending for "hard to borrows"	Repurchase agreements	Swaps clearing
Distressed securities	20%	15%	13%	25%	12%	8%	10%	8%
Fixed-income/ credit	31%	46%	21%	25%	9%	20%	10%	9%
Event driven	12%	12%	NA	NA	10%	9%	9%	5%
Macro/global macro	10%	5%	7%	5%	7%	5%	8%	7%
Fixed-income relative value	30%	NA	7%	13%	8%	13%	11%	11%
Equity long/ short	12%	25%	5%	5%	9%	10%	11%	7%
Quantitative long/short	NA	NA	NA	NA	6%	7%	5%	6%

NA — not applicable for the relevant strategy or insufficient response rates to be statistically meaningful.

One in five managers expects pricing increases to change the way they trade

When faced with price increases, managers can either bite the bullet and incur the cost or they can search for ways to shift their trading strategy. It is interesting to note that one in five managers embraced the latter resort and actually reported changing the way they execute their trading strategy.

In an industry geared toward supporting the trading behaviors and preferences of the front office, we are starting to see a clear shift in mindset. Managers, particularly fixed-income/credit and global macro, are responding that they have materially adjusted their operations so that trading is responsive to the new reality.

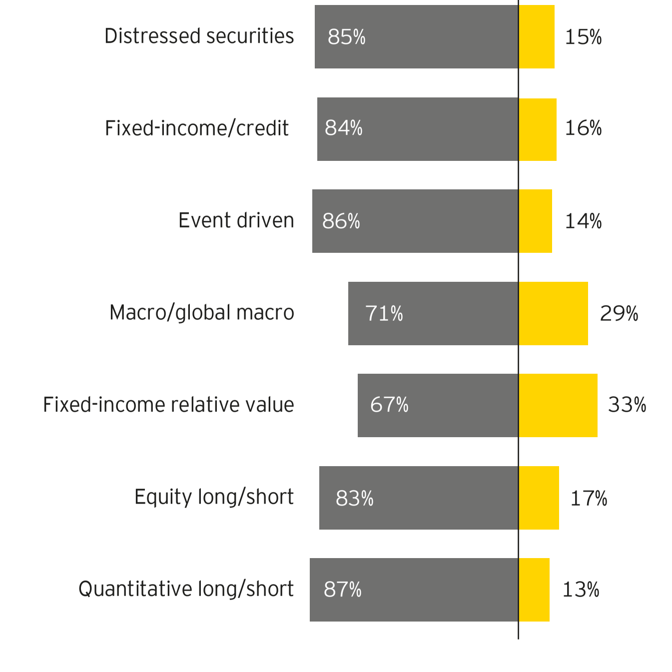
Whether it be moving toward swap-based trade execution, reducing repo financing or an overall reduction of leverage, managers of all strategies are having to make hard decisions about whether certain trades make sense given the associated costs.

"The impact of regulatory changes in the US and European Union will continue to impair the prime brokers, the availability of leverage and the liquidity of some of the capital markets."

(Over $10b, North America, Global Macro)

Hedge funds

Has the pricing increase or expected pricing increase caused you to change the way you trade?



In addition to outright re-pricing, prime brokers have suggested other changes in their relationships with funds

In addition to outright price increases, prime brokers have been having conversations about how to alter relationships so that managers better fit within their evolving business model.

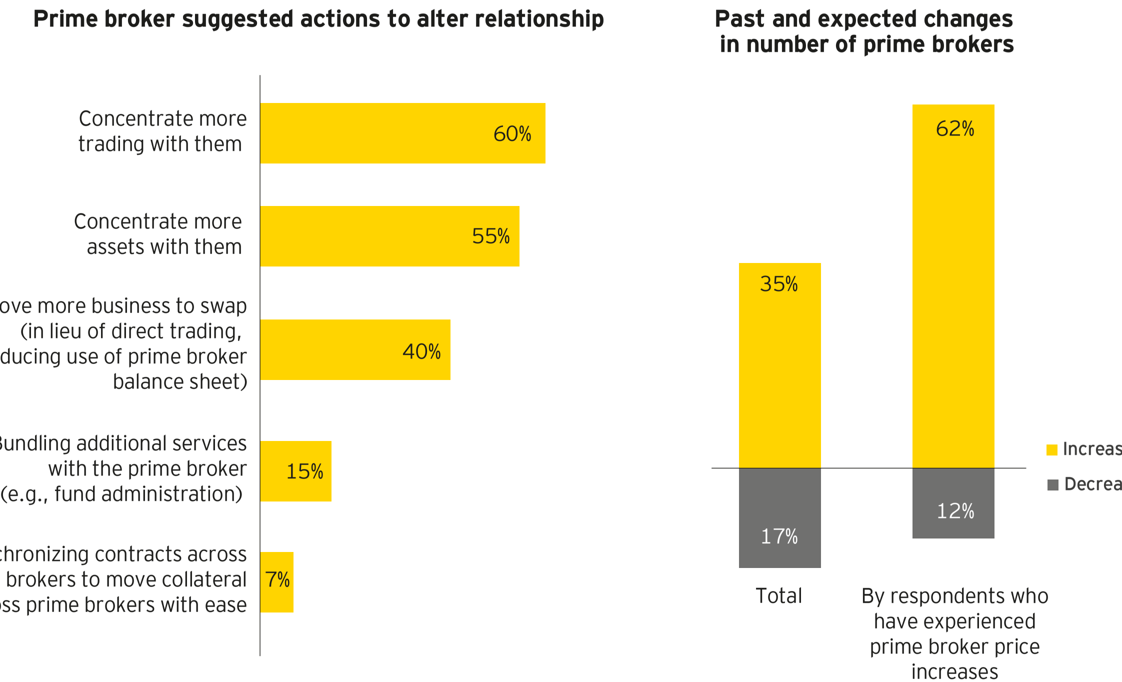
The prime brokers' preference is for managers to concentrate more business with them to maximize cross-selling revenues. However, managers are taking the opposite approach by continuing to add relationships. New entrants to the market have provided managers additional options to complement their existing relationships. While a third of all managers have increased their relationships, 60% of those managers impacted by re-pricing have expanded. This expansion is driven by the fact that managers are larger and more complex than ever with increased financing needs. As many prime brokers have less capacity to offer, the primary solution for managers is to increase relationships.

Whereas after the 2008 crisis we witnessed an expansion of the number of prime broker relationships as managers wanted to mitigate counterparty credit risk, now we are seeing an expansion of relationships to mitigate counterparty capacity risk.

> "There seems to be less willingness on the part of the prime brokers to provide services and to focus only on their major clients."
>
> **($2b–$10b, North America, Multi-strategy)**

Hedge funds

Which actions have prime brokers requested you take? Did you or are you planning to increase, decrease or keep constant the number of prime brokers you worked with over the past 12 months?



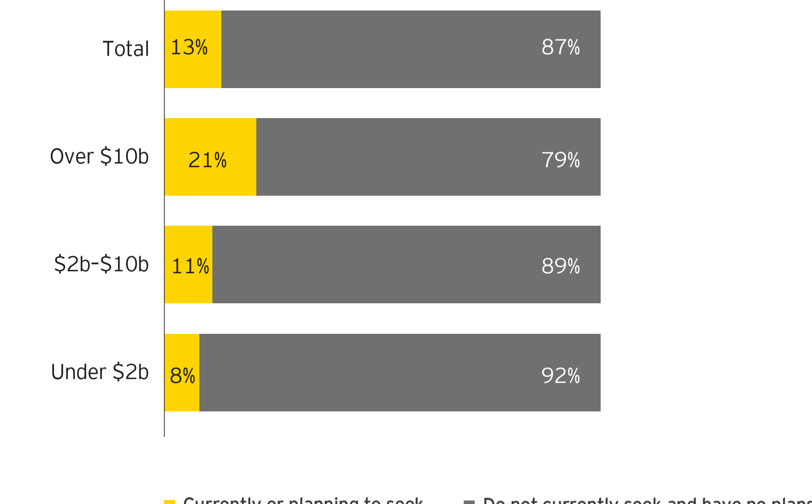
One in five of the largest managers is seeking financing from non-traditional sources

In addition to the new boutique prime brokers entering the industry, we are beginning to see an appetite from managers to seek financing from other non-traditional sources, whether it be from institutional investors and sovereign wealth funds, custodians or even other hedge funds. While the percentages are not large, going back two to three years, these financing means likely would have been non-existent.

The biggest managers tend to be on the leading edge of many of the industry's innovations, so the fact that just under a quarter responded "yes" could be an indication that this trend is only beginning and that we will continue to see managers seek fresh and inventive ways to finance their operations. Whether this holds true will depend equally on whether there is sufficient supply from these alternative counterparties in addition to whether managers will provide the demand. This trend creates both risk and opportunity. The lack of traditional financing options could continue to cause liquidity constraints and hinder managers' ability to finance their strategies in a cost-efficient manner. New entrants will view this as an opportunity to enter an industry once dominated by global investment banks and capture market share by providing the industry's financing needs.

Hedge funds

Are you currently seeking or do you plan to seek financing from non-traditional sources in the next two years?



"A shift in providers in the counterparty space may happen in the next 2+ years if things don't improve for the banks. We are not sure that banks, on an ongoing basis, are going to be overly interested in doing business in prime brokerage if it continues to be a low return business due to the regulatory environment. But prime brokerage is needed, so there may be other, new possibilities popping up: independents from the banks, some counter-parties get larger, some consolidation; all leading to higher costs and probably fewer people in the business."

(Over $10b, North America, Equity Long/Short)

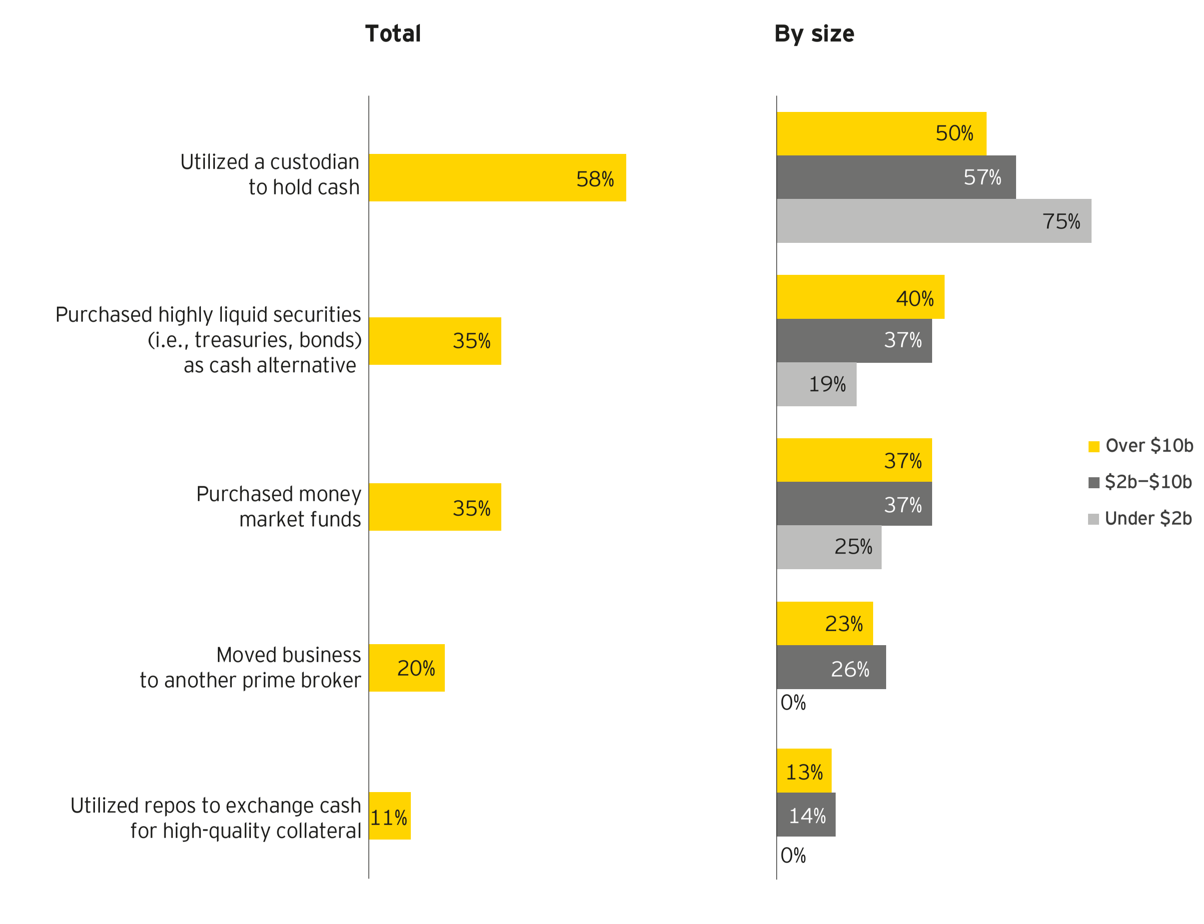
Cash is not king (for the prime brokers) requiring action by managers

A final complexity that managers need to address is that many prime brokers are reluctant to hold cash as a result of how such balances are classified toward the banks' capital reserves.

A majority of managers have responded by moving cash to custodians while a third have reported purchasing cash equivalents such as treasuries or money market funds.

While these alternatives are available to all, the results show that the smaller managers tend to primarily utilize custodians rather than other mechanisms. This suggests that smaller managers have made the determination that these other tools are not an effective solution (whether from a cost or operational perspective).

The increasing complexity of financing and cash management activities and managing a growing number of relationships with prime brokers comes at an increased cost of building out an infrastructure and personnel to handle these responsibilities.



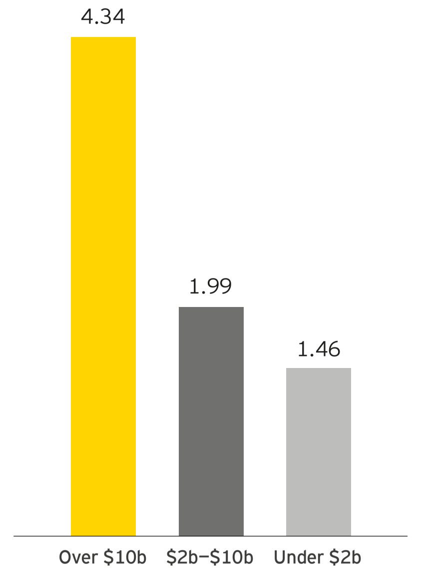
Centralized treasury has become an integral process in managing the overall business

As a result of the changing prime broker landscape, the need to better manage counterparty risk and collateral, as well as other treasury functions, has become an increasingly critical component of a manager's operations. Managers have responded by having individuals dedicated to this function to help optimize their activities and conduct business in the most economically sound way possible. The largest managers, due to necessity and the means to implement, have responded the most quickly and have built out groups that can focus on these efforts.

Though it is not surprising that the smallest managers have not yet developed these groups – they are less complex and/or focused on growing their businesses – mid-sized managers could benefit from the support of a more robust treasury team. It does seem noteworthy that half of all managers do not currently have a central treasury function. Given the evolving environment we have been describing, we believe this will be a critical area of focus to build out in the immediate future.

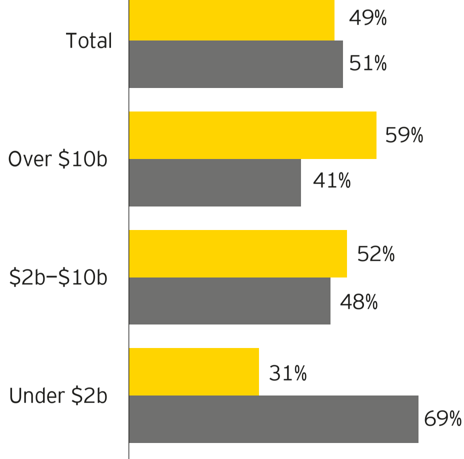
Hedge funds

How many full-time equivalents are dedicated to managing financing and collateral?



Average number of full time equivalents

Does your firm have a central treasury group? If not, is your firm planning to set up a central treasury group?



Technology investments and middle office outsourcing

Top-line revenues remain under attack in the form of fee concessions and a permanent departure from the "2 and 20" industry model. Further, trade economics are being pinched in the form of increased financing costs, taking a further bite out of the revenues of a manager. Last, the costs of the business are certainly not declining, creating a dramatic squeeze on the margins that a manager yields.

This has caused the AUM break-even point to exponentially increase compared to earlier days in the hedge fund industry's life cycle. In 2015, an asset base of $500 million is often a minimum amount required to support the costs to run an increasingly complex business. So what does it take to be successful and profitable?

Managers need to be more focused than ever on the financial considerations of running an effective business. That means understanding the implications of a lower revenue environment while being cognizant of ways in which the operating infrastructure can be optimized to gain efficiencies and also the impact that successful investments, particularly in technology, can have on the business.

Investments in technology can help integrate front to back office reporting capabilities, leading to more timely and less manually intensive exercises. Additionally, while back office outsourcing is near a saturation point, the middle office offerings from various participants have become quite robust and customized to the asset management community. Leveraging these solutions is a cost-effective alternative for managers who would rather have their personnel focusing on other core activities.

Technology investment expenditures continue to steadily rise

As a proportion of a manager's overall expense budget, technology expenses have increased dramatically over the past several years. This trend is partly a function of many managers not properly investing historically and having to play catch-up. It is also fueled by the fact that today's technology environment and the impact it has on the business is rapidly evolving.

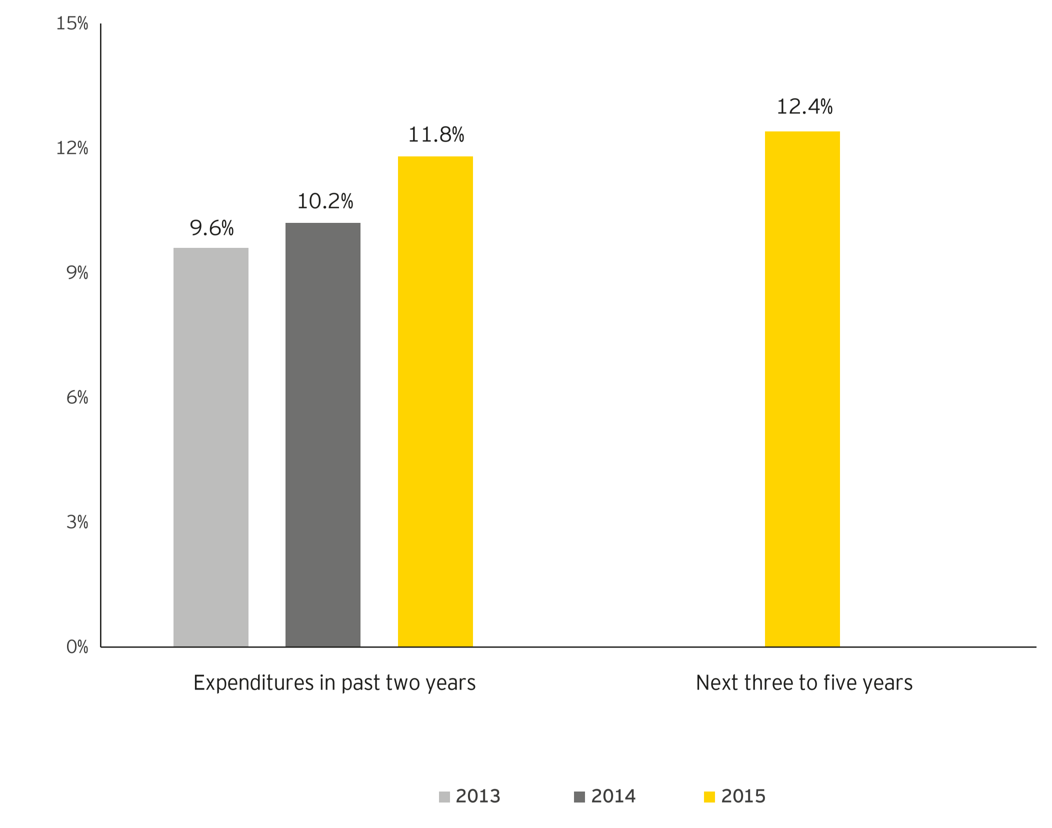
In today's environment, managers must scale their operations. This is challenging as the industry moves to more bespoke products and challenging regulatory demands.

The proposition of continued expansion of technology related costs is daunting; however, it is a reality of operating in a maturing industry. Whether it be driven by goals of developing tools that allow for more timely and customized investor necessitated reporting, regulatory reporting, risk management capabilities or being responsive to ever-present cybersecurity concerns, it is imperative that all organizations provide the appropriate attention to building out this area of the business.

> "We are looking for more customized accounts from our managers, which will really increase the need for improvement in their technology to adapt to the operational and reporting considerations."
>
> **(Fund of Funds, North America)**

Hedge funds

What percentage of your overall expense budget was allocated to major technology expenditures over the past two years? What percentage of your overall expense budget do you expect to allocate to major technology expenditures in the next three to five years?



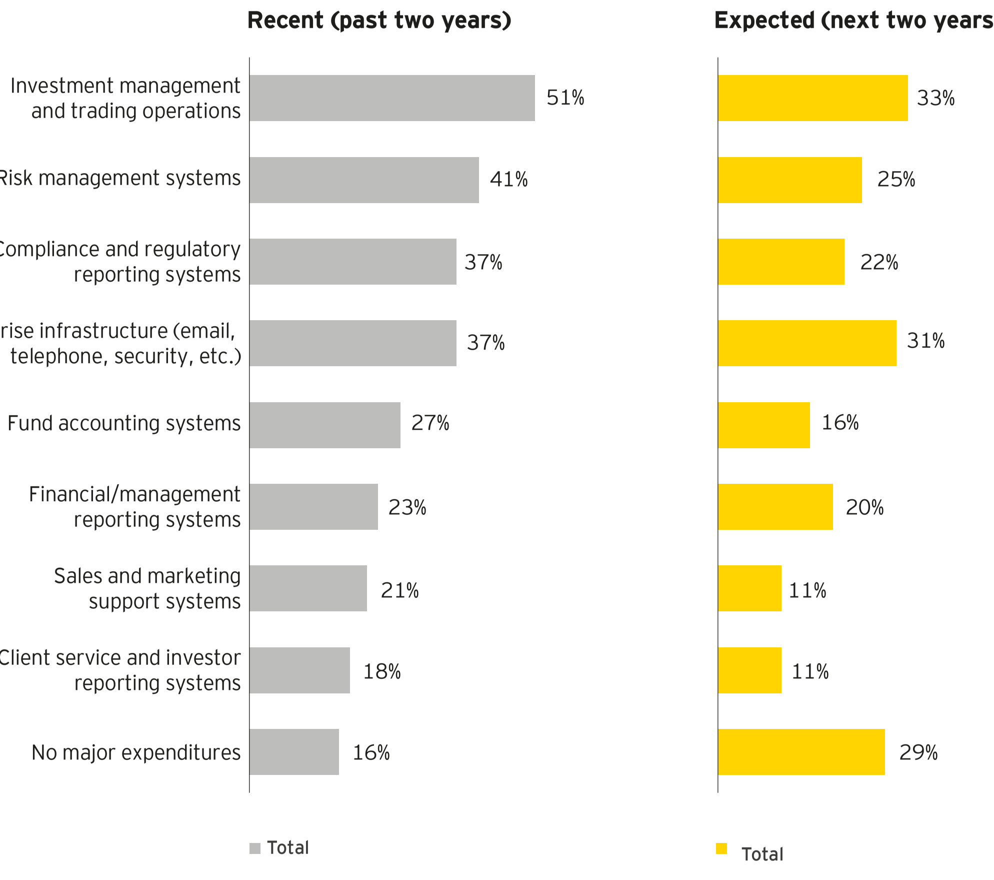
Managers are investing in technology to support a variety of business functions

Though the overall pace of investment in technology is anticipated to slow slightly in the future – 70% of managers expect to make major investments in the next two years, compared to over 80% who invested in the past two years – the magnitude of the spend is forecasted to increase. This is a result of greater business transformation projects, which result in larger front to back office efficiencies.

While there is diversity in the areas of investment, it is clear that managers broadly recognize the need to evolve their current capabilities and is noteworthy that only 16% have not made an investment in the past, and less than a third have no expectations for further expenditures.

Mid-size managers are outpacing both larger and smaller managers materially in expenditures in most business processes as they invest in infrastructure to support their growth ambitions.

> "We continue to build our infrastructure to scale and consider our outsourcing model. Your ultimate goal could be growth, but you cannot underestimate building the infrastructure and further enhancing your operational capabilities to achieve that."
>
> **($2b–$10b, North America, Global Macro)**



Data management and technology need to be advanced to provide seamless operations and to reduce reporting risk

Investment in data management and advanced reporting are vitally important for managers as they continue to grow. Data needs to flow seamlessly from manager to vendor and counterparties and back, to close any gaps between trading, risk and reporting.

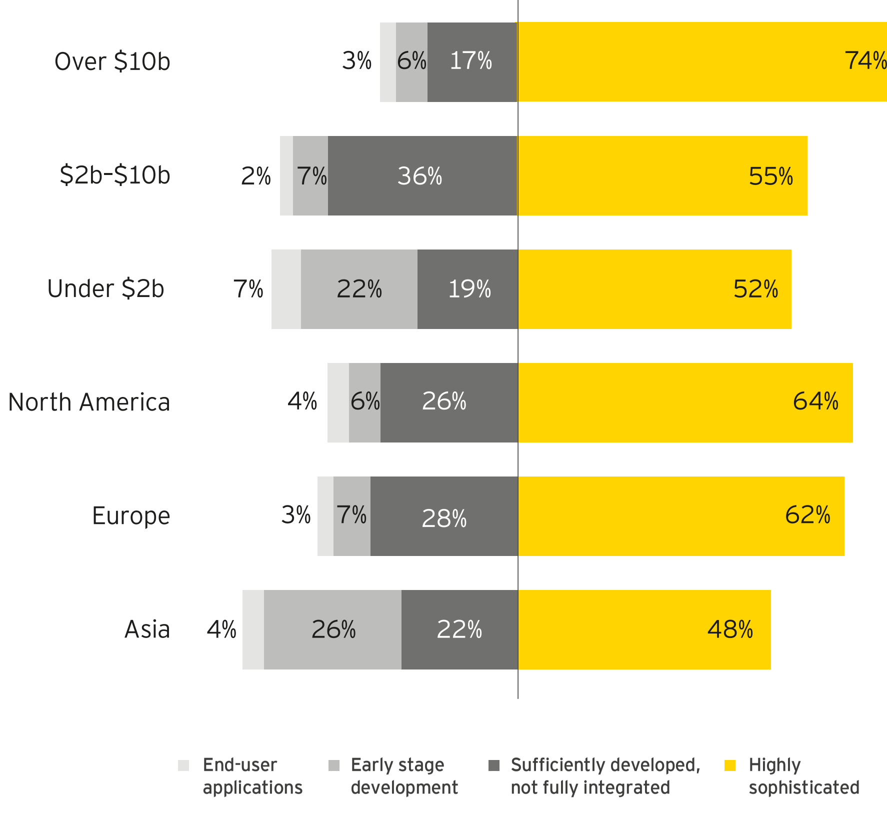
Given their recent investment, few managers would characterize their technology environment for data and reporting as in early stage development or leveraging end-user applications; over half of managers with less than $10 billion under management believe there is room for improvement. The most common issues these managers face is a lack of an integrated set of technologies in which data is easily managed.

As outsourcing becomes more prevalent and critical, an appropriate data and technology environment is a greater necessity.

Hedge funds

Along the following continuum, which of the following best describes your technology environment as it relates to data and reporting?

State of technology environment: data and reporting



Middle office outsourcing is an additional tool to optimize the operating model

In the face of increased costs and demands as a result of managers' ever-growing and complex businesses, middle office outsourcing remains an area that 6 in 10 managers have embraced.

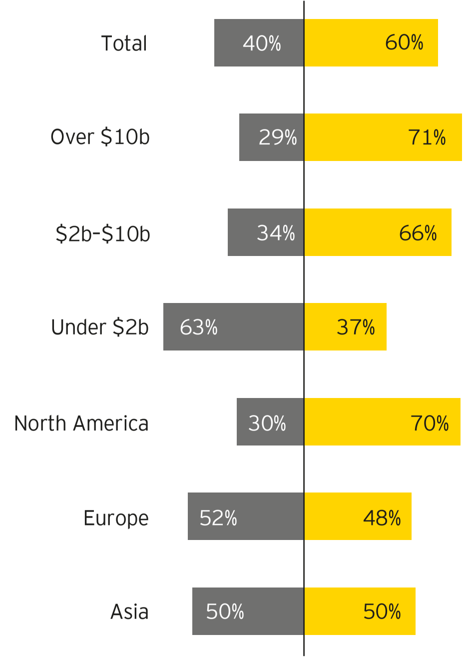
Middle office outsourcing continues to evolve with service offerings from new entrants – spin-outs from managers, banks and technology companies – with offerings that have provided serious competition to incumbent providers that continue to invest in this space.

Though smaller managers are likely to have less complex needs, they should evaluate whether the available solutions offer much-needed cost efficiencies, thus reducing their break-even point. For the two-thirds of smaller managers who have not looked to outsource, this could be a tool that helps reduce the operational and cost burden so they can focus on core capabilities.

> "We are going to continue to outsource more and spend in technology infrastructure."
>
> **(Under $2b, Asia, Equity Long/Short)**

Hedge funds

Are you currently outsourcing or considering outsourcing any of the following middle office functions?



Investor comfort with outsourcing far outpaces manager willingness to relinquish control

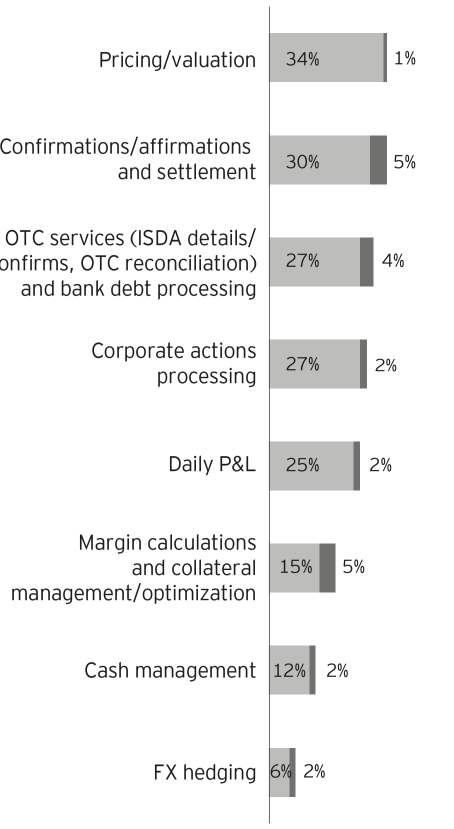
While the previous results indicate that a majority of managers are comfortable outsourcing areas of the middle office, these results show a greater reluctance among specific types of activities. Part of this inconsistency can be attributed to current outsource providers choosing to focus on niche areas of expertise while lacking quality full-service middle office offerings. Managers who are considering outsourcing middle office functions would be wise to put a holistic transition strategy in place even if they expect to make the move in stages. The interdependencies between functions — and the front office — should not be underestimated.

Broadly speaking, investors are accepting of outsourcing all of these functions. They show the most resistance to cash management and hedging, but even those are supported by 60% of investors. Managers should not resist outsourcing on the mistaken belief that investors are not comfortable with it. Investors are satisfied with the benefits that managers have reaped from using third parties to perform a majority of back office functions and are now encouraging their managers to be opportunistic in expanding to utilize specialists in performing as much of the middle office as possible.

> "We need to be able to implement the necessary controls and procedures to be able to handle the growth we have achieved via new products, including a number of different multi-strategy products. We need to invest in technology and reconsider which functions we outsource."
>
> **(Over $10b, North America, Equity Long/Short)**

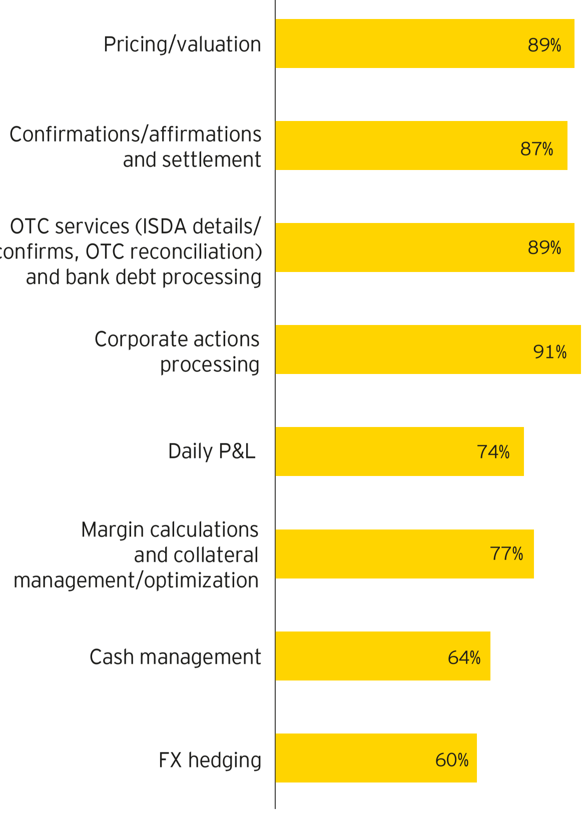
Hedge funds

Are you currently or considering outsourcing any of the following middle office functions?



Investors

Which of the following middle office functions are acceptable for your hedge fund managers to outsource to a third party?

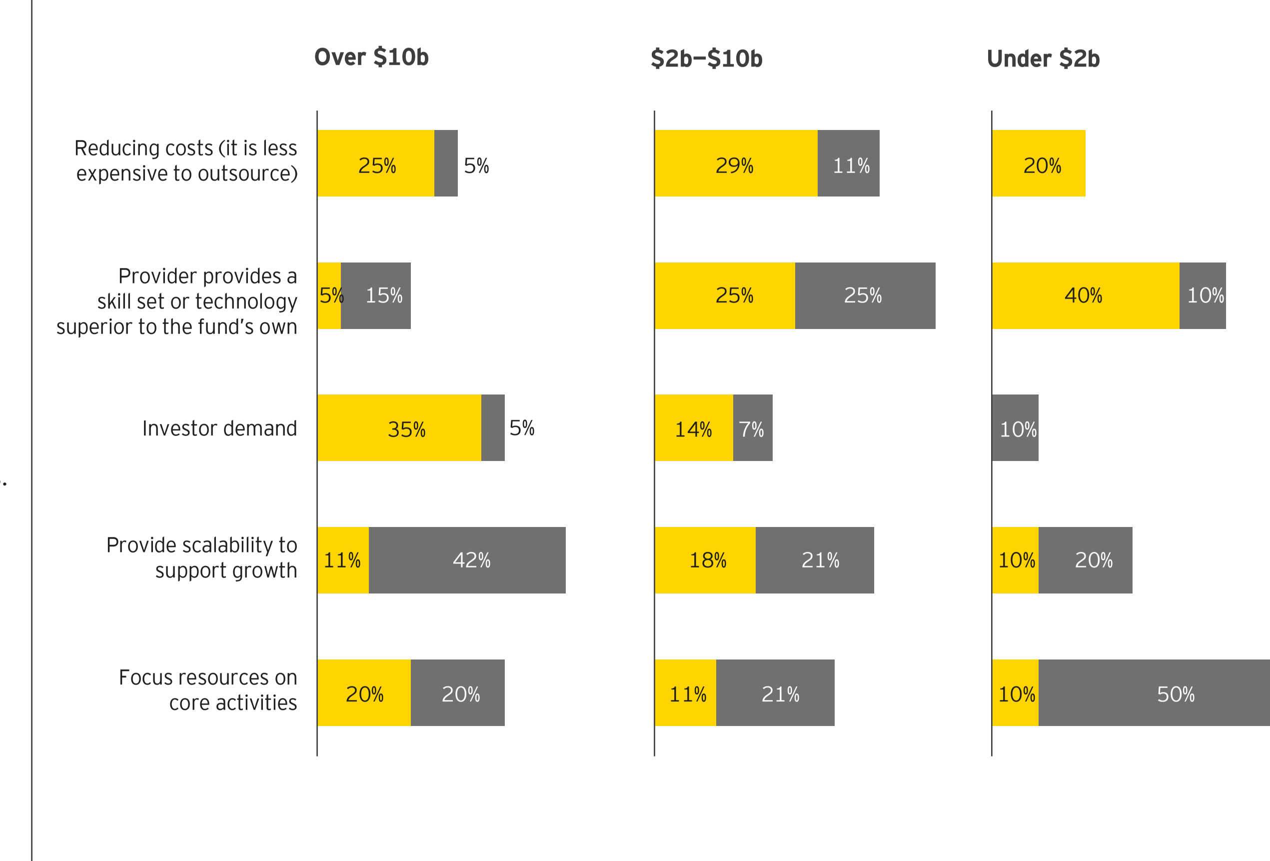


Cost savings is a key driver, but other factors are also providing impetus to outsource

All managers recognize the cost benefit associated with outsourcing as a key driver; however, it is interesting that other deciding factors tend to vary by size of the manager.

The largest managers point to investor demand and scalability as key drivers of outsourcing decisions. They likely recognize that investors are supportive of outsourcing as a means of separation of duties and independent oversight in addition to the size and scale of their business requiring external servicing. The technology solutions tend not to be a consideration for the large managers as these entities often have already made significant investment in their infrastructure and have the necessary tools to perform these functions.

Conversely, smaller and mid-size managers are motivated by the lure of skill sets and technology that is best in class. These managers need to move rapidly but have not yet built out their own systems or teams in these areas and can benefit from utilizing the services of a provider who has the requisite expertise.



Future landscape

"We will see a diversification of hedge funds with some managers moving back to the traditional concept of hedge funds while others become global, institutionalized, asset managers. At the moment, it's a mixture of the two where a number of firms are trying to be all things to all people. It's a question of how successful some of those firms will become."

(Pension Plan, Europe)

"Talent management will continue to be a major differentiator amongst firms. We will increasingly be competing not just amongst ourselves, but with the technology businesses in Silicon Valley. Attracting top talent will be difficult when you have the Googles, Facebooks and other start-up firms playing in the same talent pool."

(Over $10b, North America, Multi-strategy)

"We will continue to see a trend towards more multi-strategy offerings with increasing operational complexity. To stay relevant, managers will need to offer customized solutions to fit investors' evolving needs."

($2b-$10b, North America, Multi-strategy)

"Hedge funds are no longer a niche. Everything becomes mainstream, and I think opportunity is then greatly diminished. There are too many talented investors pursuing similar strategies. There is not sufficient innovation."

(Pension Plan, North America)

"The biggest trend is institutional managers are becoming retail and retail managers are becoming more institutional; the lines of what is hedge, mutual funds or retail, are blurring. Everyone is going into other peoples' areas so to speak. I think the lines of what's a hedge fund versus a mutual fund and how that is defined will become blurry."

(Over $10b, North America, Multi-strategy)

"There will be continued focus on the larger multi-product firms. Those are the guys who have survived the various cycles. Firms will continue to be taken out because they're not diversified and have only a focused product. The way the industry is developing, anyone who is that small and only focused on one product doesn't have the resilience to survive any downturn in their product. They can be very good at their product and it may be a very profitable product at any point in time. But, when there is that downturn and everyone pulls out of it, they can't continue to manage."

($2b–$10b, Europe, Fixed Income/Credit)

Transformational change expected as managers are not content with their status quo

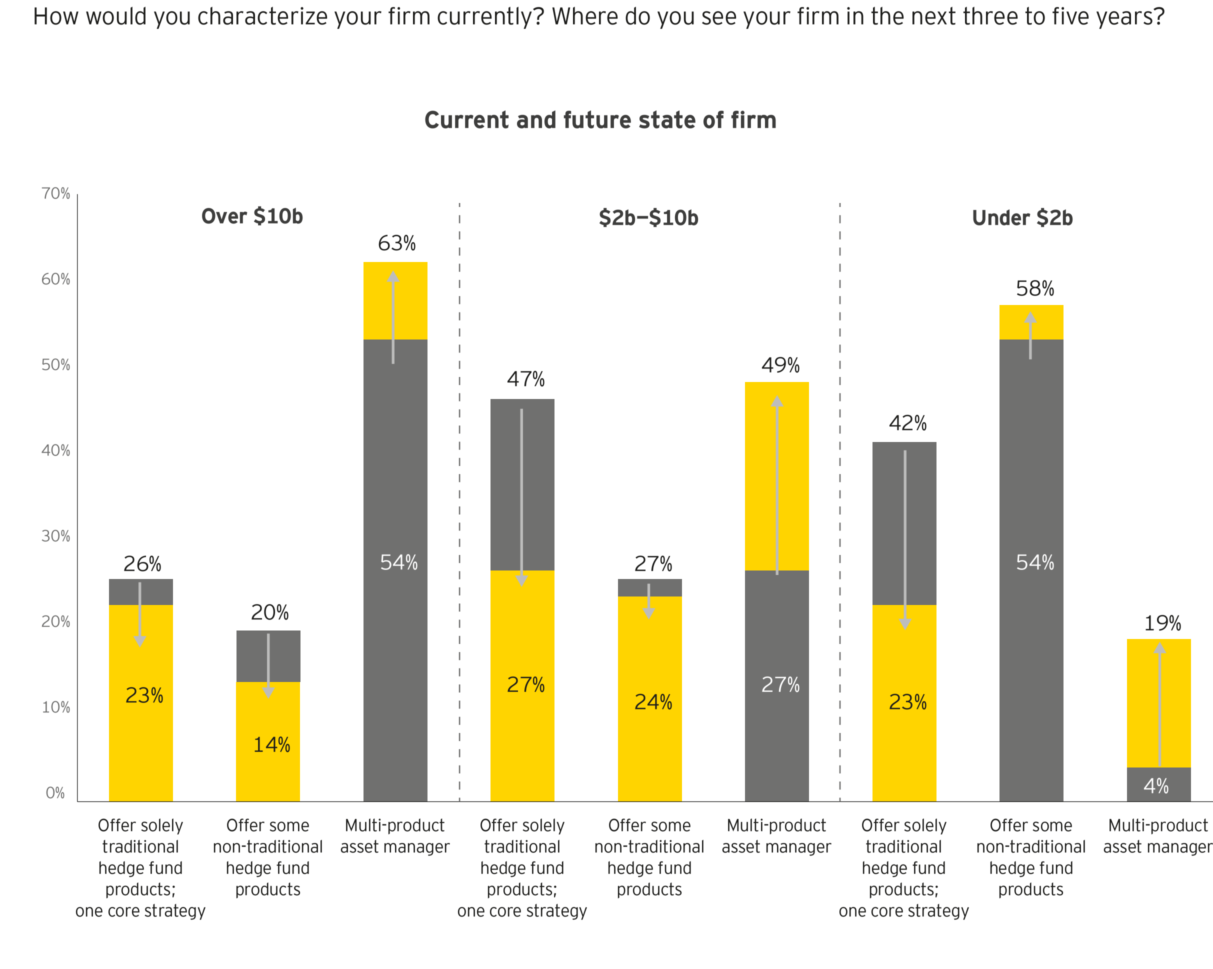
The largest managers now view themselves as alternative asset managers, offering multiple product types and strategies to meet all investor needs. Currently almost half of the mid-size managers are only offering a single strategy traditional hedge fund product, however, they realize taking the leap to a multi-product asset manager is the path forward in a maturing industry and half hope to emulate their larger peers and offer more products to appeal to a larger and more diverse investor base.

The smallest managers continue to fill a niche, and have more tempered expectations about where their organization will be in the near future. They remain focused on incremental growth while recognizing the efforts needed to succeed in this more expensive and challenging environment.

Delivering on transformation change goals requires the efforts and attention of the entire organization and will require commitments to operational, technology and personnel investments, all while not losing sight of delivering on client expectations.

Hedge funds

How would you characterize your firm currently? Where do you see your firm in the next three to five years?



Final thoughts

Mahatma Gandhi is credited with the phrase "The future depends on what you do today." While it is almost certain that he did not have hedge funds in mind, the concept is relevant nonetheless. Our industry has evolved dramatically and in no way represents the days of a generation earlier. Many of the hedge fund pioneers and larger managers have matured such that they have operations and brand recognition that more closely resemble global financial institutions. Investor expectations for the size, infrastructure and business model of emerging and mid-size managers are only slightly less modest; with institutional investors contributing a majority of the assets to the industry, these participants are demanding more robust and well-developed investments in the operational infrastructure of their managers. This transition did not take place overnight; however, those looking to achieve growth in the future need to embrace the new dynamics of the hedge fund environment by properly planning today to reap benefits down the road.

Managers must be willing to continue to understand the needs of a diverse investing universe, a universe for which the population has many distinct groups that each have different needs and desires. While offering products that appeal to their targeted investor base is a start, managers also need to understand the shifting economic landscape whereby they are generally earning less to manage these products but are also incurring more costs to operate. While issues such as fee compression have played out over several years, new battles can and will continue to arise. Changes coming through as a result of the shifting prime brokerage landscape are the latest challenges that managers are faced with addressing.

This altered landscape makes the present an interesting and exciting time in the industry. Many managers are embracing the evolving business and developing innovative solutions to position their firms to succeed while simultaneously creating a blueprint that others can follow. Legacy managers have been on the forefront of new product introductions as well as designing infrastructures that have the scale and sophistication to support the most complex and challenging of business environments. The next generation of managers continue to push forward with ingenious approaches to capturing market share and building businesses that will create their own legacy. The future will bring new challenges and threats, but the outlook by all is upbeat in anticipation of ongoing growth, fueled by investor demand.

Background and methodology

Background and methodology

The purpose of this study is to record the views and opinions of hedge fund managers and investors globally. Topics include managers' strategies to achieve growth, investor demand, changes in the prime brokerage relationship, middle office outsourcing, technology investments and the future landscape of the hedge fund industry.

From June to September 2015, Greenwich Associates conducted:

- 109 telephone interviews with hedge funds representing just over $1.4 trillion in assets under management
- 57 telephone interviews with institutional investors (fund of funds, pension funds, endowments and foundations) representing nearly $1.83 trillion in assets, with roughly $413 billion allocated to alternative investments

Hedge fund respondent profile	
Total	**109**
By geography	# of participants
North America	55
Europe	31
Asia	23
By AUM	# of participants
Over $10b	36
$2b-$10b	46
Under $2b	27

Investor respondent profile	
Total	**57**
By geography	# of participants
North America	30
Europe	24
Asia	3

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CLIENT ALERT

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Trends for Early-Stage Investing in Emerging Managers

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The current environment for early-stage investing with emerging managers reflects an increasing number and variety of early-stage investments firms, an increasing pool of talented emerging managers, and a growing number and variety of investment structures and terms.

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Ten years ago, “seeders” were few in number. Emerging hedge fund managers had few structural options and a limited group of institutional seeding firms to approach and with whom to negotiate. In the current market, however, surveys indicate that there is an increasing pool of talented emerging managers and an increasing number of new firms entering the early-stage investing arena, including funds of funds, dedicated seeding vehicles, endowments, foreign financial firms, family offices and even high-net-worth individuals.[1] Indeed, recent data indicates that, for the first time in years, capital flows to smaller funds are starting to exceed those to larger funds.[2] Though early-stage investing often refers to investing within the first six months after a fund’s launch, many early-stage investors are willing to invest on day one, which is typically referred to as “seeding.”

So we are clear, we are speaking of seed investment in the private fund that the emerging manager will manage, and not working capital seed investment in the manager itself. In that regard, all of the fiduciary and securities law protections associated with the management of “third party” money attach to the seed investments.

From the investor’s perspective, there are a number of investment structures now available to invest with emerging managers on preferential economic terms, thereby taking advantage of the increased returns and alpha often associated with such managers. Though the traditional industry nomenclature of early-stage investing can sometimes be confusing and overlapping, most early-stage investment structures involve a variation of one or more of the following features: discounted management fees and performance fees/allocations; customized investment terms; revenue sharing; and/or joint venture or partnership arrangements.

From the manager’s perspective, these new entrants to early-stage investing and broader structural options afford the manager with more flexibility in sourcing capital and growing the assets needed to build the requisite operational infrastructure to cope with an increased regulatory environment and the expanding due diligence requirements of pension plans, sovereign wealth funds and other larger institutional or later-stage investors.

Background and Increasing Pool of Emerging Managers

With the passage of the Dodd-Frank Act in 2010 and the subsequent adoption of enhanced Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission registration and reporting requirements, expanded regulatory examination efforts, new Foreign Account Tax Compliance Act regulations, and the implementation of the Alternative Investment Fund Managers Directive in Europe, among other things, the

regulatory barriers to entry for new private fund managers have increased significantly. In addition, the Madoff fraud, together with the demise of Lehman Brothers and other notable asset management and brokerage firms, have ushered in a new era of investor due diligence. Many investors now perform extensive operational as well as investment due diligence on private fund managers, which often involves lengthy questionnaires, meetings, background investigations, compliance and risk management reviews, on-site visits and other transparency requests. Many managers need more resources and infrastructure and a larger asset base (and correspondingly higher management fee revenues) to operate effectively in this environment.

Despite these obstacles, there appears to be an increasing pool of emerging managers seeking to launch new hedge funds and managed account products employing a variety of equity, fixed-income and commodity-based strategies. Some of this influx may be attributable to the Volcker Rule, which required banks to close down their proprietary trading desks, resulting in the spin-out of many high-caliber traders. In addition, many quality portfolio managers are leaving larger asset management firms to launch their own firms due to a perceived lack of growth opportunities at their existing firms and/or an entrepreneurial desire to build their own firms.

Types of Early-Stage Investing

The industry nomenclature for early-stage investing typically refers to various structure types, such as seeding, anchor investing, incubation platforms, acceleration capital and founders' share classes; timing benchmarks, such as day-one seed investing versus post-launch acceleration capital; product benchmarks, such as managed account platforms versus commingled funds; and whether the revenue sharing is contractual or via an equity stake in the management company. While such descriptions may have been useful when the universe of early-stage investors was small, they may not be as useful nowadays to investors and managers looking to cut through the morass to develop an effective early-stage investing or capital-raising strategy that is mutually beneficial. A goal-oriented view of early-stage investing, however, may be a more rational and clearer way to understand the universe of possible early-stage investment structures.

Discounted Fees

Many investors, typically smaller investors, such as high-net-worth individuals and single family offices, are content to invest early with managers they believe in (and perform varying levels of due diligence on) in exchange for a lower management fee and/or a lower incentive fee, normally between 1 percent and 1.5 percent for the management

fee and 10 percent and 15 percent for the incentive fee.[3] In the past, these arrangements were reflected in one-off side letter agreements. Now, these arrangements are typically reflected in founders' share classes, which are built into the fund's governing documents and provide for lower fee terms for all investors who come into the fund either before a certain date or before a certain asset threshold is reached. Indeed, recent surveys indicate that the majority of early-stage investors in funds invest through founders' share classes, which have been incorporated into the majority of new hedge fund launches.[4] In certain cases, the reduced fee terms of founders' shares may also be tied to longer lock-up periods.

Most of these investors are passive and do not have any control over or input into the management company. In fact, even modest control rights by an investor raise compliance and liability concerns. Initially, the manager must determine if the person exercising the rights needs to be listed on the manager's Form ADV regulatory filing with the SEC and/or registered with state securities authorities. Such status may also trigger increased disclosure in the fund's offering documents and potential liability concerns vis-à-vis other fund investors. Needless to say, most passive investors have no such interest in assuming these obligations and risks and, as a result, temper their demands for such control rights.

One drawback for managers of the discounted fee approach is that, despite the founders' economic incentive to invest early, the desired capital ramp-up may still take a substantial amount of time. Some managers may desire increased working capital for the management company at an earlier point in time in order to hire personnel and build infrastructure. To bridge this gap, some managers may entice some of these passive early investors to invest a small amount of working capital into the management company in return for a small equity stake, normally in the range of 1 percent to 10 percent (either in incentive fee revenues only or in both management and incentive fee revenues) for a working capital infusion, typically in the range of a few hundred thousand dollars to $1 million.

Customized Investment Terms

Certain strategic investors, most often family offices and endowments, but sometimes funds of funds and pensions as well, will seek to obtain a customized account or vehicle that is tailored to their institutional needs. For example, some of these investors seek a managed account or single investor fund relationship (*i.e.*, a "fund of one") in order to obtain a greater degree of transparency and control over their assets. A managed account arrangement may also be appropriate where the investor seeks to pursue a different

strategy or variation of the strategy the manager utilizes to manage the commingled fund. Due to the added administrative and compliance costs on the manager side, a managed account arrangement will often be extended only to larger investors (but not necessarily limited to day-one or seed investors) and will typically involve larger account sizes. The larger the managed account investment, the more likely the manager is to grant fee concessions, especially on the management fee side as the compensatory nature of such fees (as opposed to their status as a profit center) tends to decline as the account size increases. A first loss platform (*i.e.*, where the manager co-invests with the platform provider to leverage its own capital and earn a higher incentive fee on the platform provider's capital) is another example of a customized managed account structure.

Certain strategic investors may be willing to invest in a commingled fund with the right strategy fit but may want to make the fund terms more aligned with their interests. For example, certain early-stage investors have requested a number of modifications to many of the traditional terms and provisions contained in a fund's governing documents, including, but not limited to, the following types of customized arrangements:

Lower management fees (or tiered management fee structures) to remove or reduce the profit component from management fee revenues. Some managers have agreed to forego an asset-based management fee altogether in favor of an expense reimbursement formula intended to reimburse the manager for its operating and overhead costs and other management company expenses, subject to an agreed-upon budget and/or expense cap.

Certain categories of expenses shifted to the manager. Many early-stage fund investors have requested that certain research, marketing, consulting, insurance, travel, regulatory and/or similar categories of noninvestment-related expenses or expenses not directly tied to the fund's activities be paid by the manager rather than the fund. This is consistent with trends we have seen in the private equity space as well.

Extended incentive fee measurement periods intended to address investor concerns that they might pay significant incentive fees for short-term returns that could be offset by losses in subsequent periods. Such structures often involve a rolling two-to-three-year measurement period (sometimes combined with a hurdle rate) with partial vesting and a performance clawback for unvested portions to account for subsequent losses over the extended measurement period. Similarly, certain managers have adopted back-ended incentive fee structures whereby a portion of the incentive fee (typically one-half or greater)

is taken on redemption with performance measured from the date of investment through the date of redemption in order to create a more long-term alignment of interests with investors.

More negotiated limited partnership agreements, which may include, in addition to the above terms, more explicit time commitment undertakings from the principals, more extensive reporting to investors (including more detailed monthly and quarterly reports and notices of certain material events) and more limited manager indemnification rights. However, given the periodic liquidity offered by most open-end hedge funds, once the terms are set with the lead/founders investors, the terms tend to be set for all other investors in the fund.

Revenue-Sharing Arrangements

Certain early-stage investors will make a larger investment into a newly launched hedge fund in return for a percentage share of the manager's fee revenues (this can be structured as a gross or net revenue interest and may involve incentive fee revenues only or a combination of incentive and management fee revenues). Ticket sizes for these "seed capital" deals typically range from $50 million to $200 million for some of the larger fund launches and from $10 million to $50 million for some of the smaller deals.[5] The revenue-sharing percentage associated with such deals normally ranges from 10 percent to 30 percent and may be structured as either a contractual relationship or a direct equity interest in the management company.

Though revenue-sharing arrangements are frequently passive in nature with respect to the investor's involvement in day-to-day manager operations and investment decisions, an early-stage investor entering into such an arrangement in connection with a large early-stage or seed investment will typically demand a number of additional terms, including, but not limited to, some or all of the following: capacity rights for additional investment; veto rights over major fund management or operational decisions; enhanced reporting and liquidity terms; certain operating covenants and indemnities; restrictions on the manager's ability to retire or launch new products; and/or many of the customized investment terms described above.[6] As noted above, the more control exercised by the investor, the greater the risk of compliance entanglements for that investor.

In return for granting an investor a revenue share, a manager will often negotiate the above terms as well as other manager-friendly provisions, including lock-up periods (generally two–three years); sunset provisions (where the revenue-sharing interest gradually

decreases to zero over time); buyout rights (where the manager has the option to buyout the investor's revenue-sharing interest, typically at a multiple of three percent to six percent of trailing net revenues); and/or working capital investments into the management company. Though not always a part of early-stage revenue-sharing investment structures, many investors will contribute ancillary services or support to the manager in order to facilitate building infrastructure and growing assets. Such services may include office space or other facilities, technology and/or distribution support, as well as compliance consulting and other advisory services intended to enhance the manager's operational infrastructure. Though the early-stage investing market has traditionally been a buyer's market, the increased number of early-stage investment firms currently willing to provide early-stage capital in return for a revenue share has bred competition, thereby enabling some elite managers to negotiate more favorable investment terms and larger ticket sizes.

Joint Venture and Partnership Arrangements

Some early-stage investors seek to partner with emerging managers to jointly launch a new fund or investment platform. Family offices and funds of funds, in particular, are increasingly willing to undertake such ventures. These joint venture arrangements often involve a partnership, whereby the investor firm receives a larger revenue share (normally around 50 percent) and provides the manager with most of the operations, technology and infrastructure support noted above. The investor may also seek to customize the fund terms along the lines noted above or otherwise to suit the firm's own investor base.

In addition to the higher revenue-sharing participation normally associated with a joint venture relationship (which is typically embodied in a negotiated operating agreement for a jointly owned management company), the key differences between a joint venture relationship and a revenue-sharing/seed relationship are control and branding. Though these differences may be one of degree, a manager normally enters into a joint venture with an early-stage investment partner in return for a broader package of operational and marketing support, which often includes branding the fund under the partner's name and access to the partner's network of investors and distribution capabilities. Whereas these relationships may or may not involve a committed amount of capital to be invested in the fund, they often focus on the joint management, infrastructure support and capital-raising features. Accordingly, the investor partner will typically demand a much greater degree of transparency and control alongside the manager than would be found in a typical revenue-sharing or seed investment transaction.

Takeaways

The current environment for early-stage investing with emerging managers reflects an increasing number and variety of early-stage investments firms, an increasing pool of talented emerging managers, and a growing number and variety of investment structures and terms available to accommodate early-stage investment relationships. To the extent that these trends result in the increased availability of strategic capital for emerging managers, they should foster the growth of dynamic new asset management firms that provide more diverse investment options for all types of investors and a welcome alternative to larger established asset managers.

Endnotes

1 *See* Deutsche Bank Global Prime Finance 13th Annual Alternative Investment Survey [DB Survey]; InfoVest 21 Special Research Report: The Outlook for Start-Up Hedge Funds Including Seeding and Platforms [Invest21 Report].

2 The Hedge Fund Law Report, *Report Offers Insights in Seeding Landscape, Available Talent, Seeding Terms and Players*, Vol. 8, No. 1, January 8, 2015.

3 *See* DB Survey, *supra*, note 1.

4 *See* DB Survey, *supra*, note 1.

5 *See* Invest21 Report, *supra*, note 1.

6 Some forms of revenue-sharing arrangements may take the form of a multimanager platform or incubation model, whereby the firm (typically a larger asset management firm itself) provides the manager with a complete investment and operational infrastructure, including the management vehicle and investment capital. The manager is thereby enabled to focus its attention on trading and typically is compensated based on a share of the fund's revenues attributable to the manager's trading (in essence, a reverse revenue-sharing relationship), though the manager is often relegated to employee status and can be terminated upon short notice.

The evolution of the hedge fund industry

The perception has long been that those who invest in hedge funds are high net worth individuals – the very wealthy whose personal incomes amount to tens of millions if not hundreds of millions of dollars. That was largely true when hedge funds were first established over 60 years ago but it is no longer the case. Today, investors in hedge funds are more likely to be institutions such as university endowments, charitable foundations, public and private sector pension funds, sovereign wealth funds and insurers ; their capital investment being largely behind the industry's significant growth (over the past 15 years) which today includes over 10,000 hedge funds accounting for assets under management in excess of $3 trillion.

This changing demographic underpins an evolution that has taken place across the hedge fund landscape, in particular the role hedge funds play within investor portfolios. The new landscape of investors are more heterogeneous in nature than their predecessors, each of them having different aims and objectives. Consequently their mandates vary, which naturally lead to differences in the approach taken to the management of their portfolio with the possible inclusion of hedge funds performing different roles and thus satisfying different risk and return objectives.

As the investor demographic has become more heterogeneous, so too has the hedge fund strategy universe. While in the industry's formative years, there were just a handful of strategies available for investment (predominantly equity long/short and macro), today the hedge fund universe is populated with over 40 different strategies from which an investor can allocate to. Each of these provide their own unique risk and return characteristics with differing levels of risk-adjusted returns and correlations to public market indices, levels of volatility and degrees of downside protection.

Evolution is also central to the role hedge funds play within an investor portfolio. The old distinctions that have underpinned portfolio construction for at least the last 25 years are rapidly disappearing. Many of the most experienced hedge fund allocators worldwide no longer see hedge funds as belonging to a separate bucket – ring fenced somehow from the "traditional" assets in a portfolio – but as heterogeneous substitutes for long-only investments and diversifiers capable of transforming the risk and return characteristics of their entire portfolios.

Which hedge funds are substitutes and which are diversifiers? We reveal these and explore this evolution further in the latest paper of our trustee series of education[1], "Portfolio Transformers: Examining the role of hedge funds as substitutes and diversifiers". Using a statistical method known as cluster analysis, we are able to consolidate a universe of hedge fund returns data, equity indices returns data and fixed income returns data over the past 20 years, grouping them into separate clusters that share similar risk and return characteristics.

Our deployment of cluster analysis reverses the usual process of classifying hedge funds according to their stated strategy, but instead groups them according to their observed risk-adjusted returns, comparing them with the risk-adjusted returns of the traditional asset classes. The result (exhibit 2 below) splits the universe into two families of hedge fund strategies.

The first combines several hedge fund strategies that predominantly provide downside protection and reduce volatility risk within the total portfolio. Investors are now choosing to replace some of their long-only allocation with a hedge fund but not merely to substitute one for the other, but as a strategy to reduce the volatility of their overall portfolio holding and to best preserve its capital – the principal objective of any investment plan.

[1] In early 2015, AIMA and the Chartered Alternative Investment Analyst Association launched a new initiative seeking to help trustees and other fiduciaries better understand hedge funds.

Some hedge funds are simply too uncorrelated to the traditional asset management universe to be a straight swap, and the way they behave under certain market conditions is substantially different to the way the underlying asset class behaves. These hedge funds are not regarded therefore as substitutes but rather take on the role of acting as a diversifier to the total investment portfolio. All hedge funds offer diversification. Deploying certain hedge fund strategies in the role of a diversifier can help the investor to access new markets and investments that have the potential to produce out-performance and can offer a less correlated source of returns to a portfolio comprised of bonds and equities.

Exhibit 2: Hedge Fund Substitutes and Diversifiers within an Investor Portfolio

Substitutes	Diversifiers
Long short equity/credit	Global macro
Event driven	Managed futures/CTA
Fixed income arbitrage	Equity market neutral
Convertible arbitrage	
Emerging markets	

Source: ***Portfolio Transformers*****: *“Examining the role of hedge funds as substitutes and diversifiers in an investor portfolio”***, *October 2015,*

Given the individual funding obligation of a pension plan, budgeting for a university, philanthropic goals of an endowment, or insurance payment schedules, the liability streams of the most common hedge fund allocators today are as varied as the colours in a rainbow.

No investor can predict with 100% accuracy what liability stream they will need to fund in the future and amidst today’s environment of increasing volatility within financial markets, investors should consider a greater allocation to unconstrained strategies such as hedge funds.

In doing so, an allocation to hedge funds can match the many varied liability streams of its investors and help to bridge this uncertainty. The industry’s continued evolution coinciding with the variety, fluidity and sheer creativity of its investment strategies provides the flexibility for a relevant hedge fund investment to adapt to any uncertain liability stream. Hedge fund managers are being increasingly viewed as providing more active portfolio management – utilising a variety of hedging practices to reduce volatility and protect capital to help weather a variety of market oscillations with the industry returning a compound average growth rate of 10.6% versus equities and bonds reporting 6.6% and 6.2% respectively since 1990.

For every type of hedge fund that exists today, there are just as many solutions to investors’ particular requirements. This new thinking promises to transform the risk and return profiles of investor profiles. In that way, hedge funds and the industry have evolved into solution providers and portfolio transformers.

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Hedge fund insights: Tips from top investors and successful emerging managers

By Michael C. Patanella (Asset Management Sector Leader, Audit Partner) and Jim Marks (Managing Director, Tax; Asset Management)
Oct. 15, 2014

As the hedge fund industry continues to grow, attracting increasing levels of capital and renewed interest, many new funds are launching.

To help emerging managers get the insights to succeed, Grant Thornton LLP's Asset Management practice recently held an emerging hedge fund managers symposium, featuring open and frank advice from some of the industry's most dynamic and successful leaders.

"Launching and growing a new fund can be a daunting proposition, despite the health of the industry and a more settled economic climate," comments Michael Patanella, Asset Management Sector Leader at Grant Thornton. "We look forward to helping emerging managers navigate this critical time in the life cycle of their fund."

The economic news is good for the United States
We began with an economic outlook keynote presentation from Dr. Christopher Probyn, chief economist of State Street Global Advisors. Dr. Probyn is optimistic about U.S. economic growth, but sees a longer road to recovery for the European Union. Overall, he described improved market conditions, citing strong potential for continued improvement due to:

1. Less volatility in developing economies
2. Economic momentum in the developed world
3. Stable oil prices and spare capacity keeping inflation benign
4. Monetary policy not tightening in the United States, excluding Federal Reserve tapering

Investors speak out

Moderated by Kevin Lynch of Redan Capital, the first panel explored how institutional investors go about sourcing and selecting managers for their investments.

“As the hedge fund community struggles to match the performance of broader market indexes, it becomes critically important for emerging managers to hone their marketing message. Focus on the three or four key points that you want the investor to leave a meeting with. One of these points should be how an investment in the fund will fit in with and diversify the investor’s portfolio.”
Kevin Lynch, CFA, Managing Director, Redan Capital, LLC

“We are looking for a fund portfolio that produces a positive alpha of 200 basis points annualized over the first three to four years, with a t-ratio of 4.7. These first few years are critical for a new manager.”
David Berns, Head of Risk Management & Quantitative Research, Athena Capital

“A lot of research has shown that emerging managers generate better returns than the large funds. I think if you do your due diligence, you’ll see they definitely have their advantages. For example, a large fund is managing multiple billions of dollars so they’re not nimble; it’s harder to move money around.”
Ohm M. Srinivasan, Portfolio Manager & Managing Director, Atlantic Trust

“Large, institutional investors are looking for funds that can articulate their competitive advantage over other funds. The key is understanding what sets your fund apart.”
Sally M. Dungan, Chief Investment Officer, Tufts University Endowment

“What we are most interested in is investing with managers that are not correlated to the movement of the markets. Also, emerging managers should come to the table ready to negotiate fees — the days of putting two and 20 in a partnership agreement are long gone.”
Eric Nierenberg, Senior Investment Officer and Director of Hedge Funds and Low Volatility Strategies, Massachusetts Pension Reserves Investment Management Board (MassPRIM)

Lessons from successful emerging managers

The second panel gave some successful emerging managers a chance to share their perspective on how they broke out of the pack.

“From my perspective there are two key areas to look at — what you want to keep in-house versus what you want to outsource, and where your skills are and what you are best at.”
Matt Leffler, Portfolio Manager, Logan Stone Capital, LLC

“Emerging managers’ most important responsibility is their fiduciary responsibility, which is true for any other managers as well. Therefore, it’s critical for emerging managers to invest in their infrastructure;

this should be done in a balanced manner, in line with firm growth, in order to safeguard investors' assets. In a shrinking-fee environment, it may be tempting not to invest in infrastructure, but this could ultimately undermine investor confidence."
Michael Patanella, National Asset Management Sector Leader, Grant Thornton

"When you're just starting out, you want to partner with a marketer who is interested in growing alongside your fund. A good first indicator that you've found a match: when a provider is willing to take a percentage of new investments, rather than a flat fee upfront."
Thomas J. Wynn, Director, Monashee Capital Partners

"There is no substitute for focusing on company fundamentals right from the start. Part of that is putting together a team that will remain by your side through those first few years. If you've hired a great trader who doesn't believe in the fund, that trader is never going to be an asset to you."
Howard Rubin, Managing Member/Chief Operating Officer, Midwood Capital Management LLC

The conundrum of investing in emerging managers

Thu, 05/12/2013 - 12:00

*By Marianne Scordel – **A year ago, we explored what hedge fund investors might be looking to buy during the following twelve months, what their attitude towards managers at the smaller end of the spectrum was, and what investment strategies appealed the most.***

This year, Bougeville Consulting and Global Prime Partners decided to team up in this survey produced for Hedgeweek to try and understand what has changed, whether plans have come to fruition, and what, in the light of recent events and as a result of more structural factors, would determine investors' appetite towards emerging managers in the near future.

Global Prime Partners (GPP) is a boutique Prime Broker, focusing on servicing clients with AUM generally under USD100m. It is important for GPP to understand the potential for success of the firm's clients and potential clients, not just in terms of investment performance, but also as far as business development is concerned: AUM growth and stability of assets – mandates they are likely to win as well as those they are likely to lose, as a result of opportunity costs or early redemption.

Bougeville Consulting assists hedge fund managers with their business strategies. This consists in providing the ground work – including research into the costs and benefits – to enable them to make decisions relating to the opening of new businesses, the making of a new product, or the development of a new strategy – albeit seen from the support and the commercial opportunity angles rather than directly from the perspective of the investment strategy of the fund. The ultimate objective is always to meet current and future investors' legitimate expectations or alleviate potential concerns – hence our need to be, and to stay, aware of what our clients' clients really want.

Last year our study was seeking to understand investors' overall appetite, and, in doing so, we found that the evolving landscape for emerging managers was, in fact, difficult to predict. Among those surveyed, 70% of respondents pronounced themselves in favour of smaller funds – which, at the time, we had not defined precisely. However, many qualitative features – including survivorship bias, the "no one gets fired for buying IBM" rationale, and the diversity among smaller managers – were mentioned as potential obstacles to investing in those funds.

The resulting picture was uncertain; so, this year, we decided to drill down a little further into this aspect of hedge fund investing. We have articulated the findings around three main points:

- Over 60% of those surveyed rely on third parties for their operational due diligence. While the extent to which they do so varies, this nevertheless sheds light on last year's finding according to which

internal resources had not been increased for the purpose of performing ODD. It also provides a clue as to why the resulting investment decisions are less likely to be in favour of emerging funds.

- The environment – commercial, regulatory – has become more expensive and those costs are likely to have a relatively greater impact on emerging managers, thus adding to the risk of investing in a new venture. Having to bow to the pressure of lower fees, recently-established managers must now face the increased costs, and risks, relating to the new compliance environment.

- Finally, investment timeframe and commitment to partnership seems to be of paramount importance when it comes to choosing investment targets, be it in relation to the size of the fund or to the investment strategy followed.

– As far as the size of the fund is concerned, overall we have found that the longer the investment horizon, the more likely investors are to invest in emerging managers. This relationship becomes stronger when investors are managing proprietary assets rather than third parties. On the contrary, AUM is not a good proxy for target size preference.

– As to the investment strategy, 50% of the respondents clearly said they wanted to increase their exposure to equity as an asset class, and 25% were planning to decrease their exposure to CTAs over the next twelve months – both of which could give rise to a few questions given this year's market movements. Again here, data shows a positive correlation between investment horizon / investor type, on the one hand, and choice in asset classes, on the other hand.

The multi-faceted impact of the outsourcing of ODD

The investors surveyed manage or advise on asset allocation. Sizes at firm level range from USD200 million to over USD170 billion, with hedge fund investments of between USD200 million and USD2.5 billion. The average size is USD42 billion with hedge fund investments ranging from 1.5% to 100% of total AUM. Like last year, investors surveyed are from the UK, the EU ex-UK (including Germany, Spain, Scandinavia and the Netherlands), the Americas, Switzerland and the Middle East.

While last year 70% of respondents said they were broadly in favour of emerging funds, this year only 25% adopted a similar view. Where does the drop in numbers come from?

We do not believe that the change in individual respondents within our sample explains such a dramatic change in the results. The sample mean has remained fairly similar – USD42bn this year versus USD40bn last year – and the diversity of respondents – a balanced mix between wealth managers, superannuation (pension) schemes, funds of funds, multimanager funds, and family offices – is broadly identical. The main difference this year is that respondents are more concentrated around the mean in

terms of asset size, however this is unlikely to have a negative impact on investment in emerging funds for the following reasons:

• We have found that there is a weak correlation between AUM size and likelihood of investing in smaller funds.

• If anything, some of the largest investors are less likely to invest in smaller funds because their investment sizes would immediately make them the main investors, which they want to avoid – unless they do seeding and can take an equity stake into the management company also.

Among the respondents, 15% said they have “concentration limits”, as a result of which they cannot own more than a certain proportion of AUM – a 10% and a 20% limit were indicated as ceilings. The respondents who put forward that argument “against” investing in emerging managers were wealth managers, dealing both with wealthy individuals or endowments. With ticket sizes in the range of $10m to $30m,the ceilings could be reached fairly easily as far as the smallest managers are concerned. “We do not want to be caught with our pants down”, said one investor, to support his employer’s decision to avoid emerging managers, “so such an investment would be ok only if we believe a fund’s AUM will increase quickly”.

Investors with an increasing amount of AUM find investing in emerging hedge funds not so much dangerous as expensive: “Small funds make it difficult for us to achieve scale”, says one respondent.

• Conversely, some of the smallest investors tend to rely on the fund’s service providers for the purpose of Operational Due Diligence. Since smaller funds have less money to spend on outsourced functions – e.g. on a Prime Broker – the result is that smaller investors may tend to stay away from the space.

What explains the drop in numbers seems to be linked to that fact that this year, we asked the question in a more concrete way. Investors have not fundamentally changed their minds about emerging funds and overall still say they are open in principle. However, they pointed to a number of reasons as to why they are not planning to do so in practice. Most of those reasons have to do with the way emerging managers deal with the operating / business side of their ventures.

It can be argued that relying on service providers to perform ODD is a way of outsourcing that part of the investment process. Smaller investors tend to do this almost by default: they do not have enough resources to look into the (all important) details and, instead, tend to trust that a “big name” (e.g. in the Prime Brokerage area) in itself means that a fund is fit for purpose. Those respondents who invest via managed accounts or into UCITS – funds of funds primarily – also tend to rely on platform providers, a process that is made even easier for those who recently built in-house platforms for outside managers. It

has to be noted though that most of those surveyed do take the way managers outsource key functions into consideration – albeit to a greater or less extent and often in combination with other factors.

The most important points respondents made about emerging funds and their service providers are as follows, starting with views which are the most strongly-held and ending with those where comments did not constitute respondents' primary concerns:

- To outsource or not to outsource… is this really the question? – The overall comment is that "small funds do not have the means to have solid, scalable infrastructure". They have often recently come out of banks and are faced with the challenge of managing a business in addition to concentrating on their investment strategy: they find it hard to multitask and lack the expertise to deal with all the various areas relevant to their businesses; however, they often cannot afford hiring the talents required – whether to perform the work as a permanent member of staff or as an outsourced service provider.

- Prime Brokers and Compliance – These are the functions that seem to matter the most to investors, and some respondents say that these are "weaker at smaller funds than at larger funds, which, as far PB is concerned, can create a financing risk". While some investors "prefer an outsourced compliance function", which, at least gives some guarantees that the job is being done professionally, resource constraints result in investors passing on smaller funds because these two key functions are not dealt with appropriately.

- Documentation and marketing material – "Still a lot of people are using boilerplate documents, which allow managers to do anything", says a respondent. While similar comments come up spontaneously after a few minutes of speaking with a few hedge fund investors, one respondent, whose operations fit into the higher end of the sample in terms of AUM, volunteers to say that "fact sheets and presentations are sometimes incomprehensible even for larger funds! The difference is that [the larger funds] listen to us because they have marketing personnel internally". Smaller managers, who may be more likely to use third party marketers, find this exercise more difficult, and, according to another respondent who goes further in criticising funds' information he regularly reviews: "Emerging managers have little to lose; we do not know to what extent we should rely on their presentation". The nuance to this is the fact that documents coming from more established funds are sometimes old and… outdated.

- Corporate governance – Some investors complain that they do not see enough board independence, with director oversight often qualified as "poor".

- Conflicts of interest – "Larger firms have the resources to hire more back-office staff with segregation of roles and responsibilities, which is important in building appropriate checks and balances", says one respondent.

• … and why sometimes it just does not matter – Finally, one respondent indicated that while back offices must be "appropriately funded", they must first and foremost "have conviction about person". They explained such an approach was in-keeping with their value and long term model, which result in a partnership with the investment target and hence they are prepared to accept that a fund's operations will develop, grow and improve as the AUMs themselves also grow over time.

Additionally, some of the biggest investors, who also admit "ODD is not [their] strongest point", have recourse to dedicated ODD service providers on which they rely for at least part of the process – with the remainder sometimes being done by their internal compliance teams. Based on our sample, the split among investor type is as follows:

• Family offices and funds of funds are the most reliant on external providers – either as providers they specifically mandate to do this job or via Prime Brokers' introduction and implicit recommendations.

• Wealth managers tend to "mix and match", trying to reach a balance between what is done in-house, on the one hand, and input from a specialist third party, on the other hand.

• The two pension funds interviewed are the only respondents saying they perform a very thorough ODD in-house, with dedicated teams working on this, which somehow confirms a point a fund of fund manager also made as part of this survey exercise: "The problem is that we are doing for our [pension fund] clients what they now know how to do", thus highlighting the fact that several pension funds of large companies or organisation now have in-house alternatives teams that do everything, including in some instances more of the ODD that many funds of funds no longer really do.

The environment: how much is it costing?

Investors say emerging funds may not have the appropriate level of resources to hire or to outsource properly, and this is compounded by the fact that the cost of doing business has increased over the recent period.

• AIFMD – Last year, the AIFMD was already on the cards, however it is not until late in the day that some of the players started to realise how expensive this would be. In addition to the direct cost of compliance comes the regulatory risk, and potential fines imposed by regulators, as a result of areas of uncertainty, such as those relating to marketing. Several respondents indicated that they are no longer sure as to what extent funds unknown to them – hence, many of the emerging funds – are allowed to approach them; some have taken the conservative approach that reverse enquiry might be preferable for now.

• UCITS – European conservatism really started with the beginning of the global financial crisis but

was enhanced by the recent regulatory developments, which is paradoxical if one considers that one of the stated intentions of the AIFMD was to protect investors and restore confidence in financial markets. While US investors are still adventurous, the tendency for Europeans is to demand more of the UCITS type of structures, which is creating more costs and constraints on hedge fund managers.

• The "F… word" – At a time when, even in the best case scenario, capital is scarce, it appears the "fee question" is creating an additional hurdle for emerging managers: several respondents say they would only consider investing in smaller managers if they are offered lower fees. A respondent even said he wanted different fees at milestone AUM, starting very low and increasing as the manager becomes more successful.

• How small is small? – Finally, last year we had not provided respondents with a definition of emerging managers, instead preferring to leave to door open to a qualitative discussion. In our conclusion, we had said that "several investors supportive of smaller funds say that they are now prepared to lower the minimum size of the funds into which they would invest. While this may sound like good news, the numbers provided ($100 and $200 million, both by private wealth managers) still seem rather high for a manager starting up". Again this year, one of the respondents explained that "clear winners start with $200m anyway", to justify he would not consider any fund with less than that amount in AUM.

Timeframe and percentage of "skin in the game"

While the above does not present an optimistic picture of the market for emerging managers, we did, throughout our investor survey, notice an interesting trend, namely the positive correlation between investment horizon and willingness to invest in emerging managers. The relationship is further strengthened when investors have a greater sense of ownership of the assets they manage.

Respondents made the following comments in relation to emerging funds and investment timeframe:

• "Long term viability of smaller funds may be a problem," said an investor, adding that "two-third of the new hedge funds fail". Yes, all agree that the potential returns are higher over time, provided one is prepared to stomach the risks involved: "we do not invest in emerging managers because of the huge level of uncertainty, however we are aware that we are missing out on alpha," says a respondent, echoing one of his counterparts who says they are now doing some work internally to relax the concentration rules mentioned above, which, in some cases, prevent investors from owning too high a share of AUM.

• While long term investors managing a proprietary portfolio may be prepared to bear that risk, others, in charge of assets coming from a greater number of third parties are faced with the question of

reporting on short term performance to clients who may be “less educated”

• This explains why 50% of the respondents say they want to increase their exposure to equity, which has performed well so far this year, while CTAs, who suffered this year in terms of performance, are not as much in favour as they were last year, with over 25% of the respondents planning to decrease their exposures to this strategy in the next twelve months. “This is very backward looking,” admits an investor – even though those buying equity include investors committed to specific strategies, such as event-driven, rather than to the asset class itself.

• Finally, as a point of methodology, it should be noted that last year’s sample included two seeders, which, by definition, do invest in emerging managers and do have a vested interest in the business, due to the equity stake. This year, these investors are no longer in the sample, however they have been replaced by another type of investor who does not have an equity stake but, instead, has adopted a “partnership approach” with the managers in whose fund they invest. Participating in the growth of a fund is no doubt rewarding, requires striking the right balance between proactive support and inhibiting interference, and takes, well, time…

The landscape for emerging funds does not look as rosy as one might like, past the initial enthusiasm that comes quite naturally with novelty. The one optimistic note though is that the investors committed to smaller managers look at the long term and, thus, provide a stable and strong base from which to grow.

Marianne Scordel founded Bougeville Consulting to assist alternative fund managers with their business strategy. This includes providing assistance to hedge fund managers in finding cost effective solutions to compulsory changes (e.g. those pertaining to the regulatory environment) and in enhancing commercial opportunities – adapting products, structures, or the marketing thereof. Prior to this, she worked for Nomura and for Barclays Capital. She is an Alumna of St Antony’s College, Oxford.

AIFMD passport and Cayman Islands funds

AIMA SPONSORING PARTNER

MAPLES

By Harjit Kaur, Partner, Maples and Calder

The announcement by the Chair of the European Securities and Markets Authority (ESMA), Steven Maijoor, in October 2015[1] that the Cayman Islands would be included in the second wave of jurisdictions to be assessed for the AIFMD passport is welcome news for managers of alternative investment funds, given the prevalence of the Cayman Islands as a jurisdiction for offshore hedge funds.

Third country passport - current state of play

In July 2015, ESMA issued an opinion and advice ("July Opinion") to the European Parliament, Council and Commission (EC) on the application of the AIFMD passport and whether it should be extended to non-EU jurisdictions.

As ESMA has taken a "country-by country" approach, the July Opinion included an assessment of six jurisdictions, with a positive recommendation to two of those (with a third subject to certain conditions). ESMA deferred its decision in respect of the other three jurisdictions assessed, being Hong Kong, Singapore and the US.

In its July Opinion, ESMA also recommended the deferral of the extension of the AIFMD passport to non-EU jurisdictions until a larger number of jurisdictions had been assessed by it. The EC appears to have indicated its agreement with this approach[2] and ESMA's opinion and advice on the second wave of jurisdictions ("Second Opinion") is expected in the first half of 2016. The Second Opinion is also expected to include ESMA's definitive conclusion on whether the AIFMD passport should be extended to Hong Kong, Singapore and the US.

Cayman Islands well placed for extension

The Cayman Islands is well placed to receive a favourable assessment from ESMA as part of the Second Opinion. Cayman Islands funds already satisfy the minimum requirements prescribed by the AIFMD in order to be marketed to the EU member states under the passport: the Cayman Islands has an extensive network of tax information exchange agreements in place with the various EU member states, and the Cayman Islands regulator, the Cayman Islands Monetary Authority, is a party to the requisite cooperation agreements with its counterparts in almost all of the EU member states.

Another element of ESMA's assessment of each non-EU jurisdiction is a review of its regulatory regime. The Cayman Islands has been developing an AIFMD compliant opt-in regime which will enable Cayman funds and managers to take full advantage of the AIFMD once the passport is extended to the Cayman Islands. In August, the necessary amendment laws required to implement the new opt-in regime were passed, and the relevant supporting regulations which will set out the detail (but which are expected to mirror the requirements of the AIFMD) are expected imminently. This, together with the fact that the Cayman Islands affords reciprocity of access for EU funds and managers to investors in the Cayman Islands, makes it very likely that it will receive a positive recommendation from ESMA.

The status quo and position with respect to NPPRs

Pending ESMA's assessment of a larger number of jurisdictions and the EC's subsequent decision on whether to extend the AIFMD passport to non-EU jurisdictions, the status quo remains. That is, Cayman funds, like all non-EU funds, may continue to be marketed into EU member states under the existing national private placement regimes (NPPRs).

Should the AIFMD passport be extended to non-EU jurisdictions, both the passport and the NPPRs are expected to function in parallel for at least three years, following which there would be another assessment by ESMA and the EC as to whether the NPPRs should cease to exist. Representatives of both ESMA and the

1 At the Economic and Monetary Affairs Committee ("ECON") session held on 13 October 2015.

2 At the ECON session held on 13 October 2015.

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EC[3] have indicated that the extension of the AIFMD passport to non-EU jurisdictions will not result in the automatic withdrawal of the NPPRs at the end of the three-year period, particularly in view of the fact that the assessment in respect of the AIFMD passport extension is being undertaken on a country-by-country basis. Managers content to market their Cayman funds into the EU under the existing NPPRs are expected to be able, therefore, to continue doing so for at least the next few years.

Practical considerations for managers of Cayman funds

Prior to passport extension
As ESMA's Second Opinion is not expected until mid-2016, and given that a decision on the third country passport will only be made after ESMA has assessed a larger number of jurisdictions, it is likely to be some time before the passport becomes available to non-EU jurisdictions. In the intervening period, managers of Cayman funds can continue to market their funds into the EU under the NPPRs.

Managers who wish to avail of the passport during this period will need to be based in the EU and would need to establish an EU fund (since only EU managers of EU funds are currently able to apply for a passport under the AIFMD). Becoming authorised as an alternative investment fund manager (AIFM) poses certain challenges, particularly for managers that are not already based in the EU, such as US managers. In particular, such managers would first need to establish a presence in a member state of the EU and deal with the challenges involved, including identifying office space and recruiting staff with the requisite skills. Becoming authorised as an AIFM also means that such managers would need to comply with all of the requirements of the AIFMD, which poses a significant compliance burden. In these situations, utilising the services of a third party service provider providing AIFM solutions (sometimes referred to as the "host AIFM") can be an attractive proposition.

Following passport extension
Once the AIFMD passport is extended to non-EU jurisdictions, existing EU managers that are already authorised as AIFMs will have the option to market their Cayman funds into the EU using the passport, although such managers would need to comply with all of the requirements of the AIFMD. In practice, this should be fairly straightforward and should only require compliance with the additional requirement to appoint a depositary in respect of such Cayman funds. This is because EU managers are currently required to comply with all of the requirements of the AIFMD other than the requirement to appointment a depositary in accordance with Article 21 of the AIFMD (provided one or more entities are appointed to perform the "depositary-lite" functions set out in Article 21(7)-21(9) of the AIFMD) in order to market Cayman funds into the EU under the NPPRs.

In respect of non-EU managers, provided the passport is also extended to the jurisdiction in which the manager is based, then such managers would also have the option to apply for a passport in respect of their Cayman funds. However, such managers would need to become authorised as an AIFM in their "member state of reference" (determined in accordance with the AIFMD), which can pose a significant regulatory and compliance burden. Non-EU managers based in jurisdictions to which the passport is not extended are unlikely to be able to apply for a passport. In both of these cases, utilising the services of a third party "host AIFM" may provide a neat solution.

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3 At the ECON session held on 13 October 2015.

The PR challenge for the hedge fund industry

AIMA SPONSORING PARTNER

MAPLES

By Henry Smith, Global Managing Partner, Maples and Calder

Political candidates in UK, US and EU election campaigns unfortunately tend to expound populist views that there is something inherently bad about hedge and private equity funds. Views that claim they are secretive and only there to enrich the wealthy; they are unregulated, non-compliant and helped cause the global financial crisis; they cause jobs losses by asset stripping companies; they are based in secretive offshore tax havens and do not pay their fair share of taxes; and perform poorly against major market indices. The mainstream media, certain NGOs and even Hollywood movies, by focusing on the excesses on Wall Street or the few instances where a major hedge fund has failed, unfairly hype these views.

It is a tough on-going challenge to change these general public perceptions, but it is worth persevering as in many cases, they are simply uninformed and wrong. They may also lead politicians and regulators to develop bad policy and disproportionate regulation to the ultimate cost of those same voters and constituents they seek to protect or represent, and can cause unintended damaging consequences to their economies.

AIMA continues to work hard to educate politicians, regulators and journalists about what really goes on in the industry. AIMA's excellent research papers pulled together in "The Case for the Hedge Funds: A Compendium of Thought Leadership Reports" are well worth reading. Here are some of key messages to help address these PR challenges:

The global financial crisis. Blaming hedge funds for the global financial crisis was unwarranted. Official reports prepared for international regulators and various authorities acknowledged that hedge funds did not cause the global financial crisis, which was triggered by failures in the regulated banking industries. Even the largest hedge and private equity funds are neither "too big to fail" nor represent a systemic risk to the markets. Leverage in most typical hedge funds rarely exceeds one to two times assets (as opposed to 40 times assets in the banking industry) and no hedge or private equity fund required a state funded bailout. Hedge funds in fact brought much needed liquidity to the markets after the crisis.

The benefits to the global economy. Critics claim hedge funds serve no useful purpose and are merely vehicles for wild speculation, only benefiting the wealthy, often attacking currencies and shorting companies into oblivion or stripping jobs to profit hedge or private equity funds. The reality is different. Hedge and private equity funds are an integral part of the asset management industry and contribute to the economy in many ways:

a. **Job creation and tax.** Hedge funds have created an estimated 300,000 jobs globally, including 240,000 in North America, 50,000 in Europe and 10,000 in Asia-Pacific. They contribute a sizable chuck of GDP in countries where the industries are located. This in turn generates significant taxable revenue for governments, for example, in Europe this is thought to be in excess of $8 billion; and that's before you get to the knock-on benefits to other industries - real estate, restaurants, car dealers, etc. where these jobs are located and the consequential tax revenue generated. Whilst it might be seen as politically attractive to raise further tax revenues from the funds or workers in the industry, governments need to be careful that they do not reach a tipping point where their financial centres become uncompetitive and risk losing financial services business, with all the consequential effects for the economies. Recent statements in the UK that hedge funds benefit from a special exemption on stamp duty, for example, are

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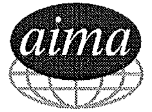

incorrect since other UK authorised funds operate under the same regime.

b. **Capital allocation.** Hedge and private equity funds are useful capital allocators and providers of market liquidity. Since the crisis, the hedge and private funds have stepped up to provide diversified funding sources to businesses to help them grow. They facilitate global capital investment flows into the major and developing economies and finance vital infrastructure projects and assets - such as commercial aircraft, ships, hospitals, roads, power plants in emerging market countries. Again, all of these are examples of how the industry helps economies create jobs and taxable revenues.

c. Short selling. Rather than being a problem, some politicians believe short sellers provide essential liquidity to the markets and can often be an early indicator of which companies or sectors of the economy are about to experience difficulties. Short selling gives investors an ability to hedge risk of being invested on a long-only basis.

d. Just for the wealthy. Much of the negative rhetoric assumes that hedge funds are simply for the wealthy or only benefit the fund managers, and ignore other major stakeholders. Securities laws in many countries may preclude non-accredited retail investors from investing directly in hedge funds, but about 30% of the over $2 trillion invested in hedge funds comes from pension funds. So everyone, through their pension funds, indirectly benefits from hedge fund investments and much needed portfolio diversification. Any politically driven increased costs, taxes or regulatory and compliance expenses have an indirect adverse consequence for the individual pensioners invested in those hedge funds.

Performance. Market commentators unfairly criticise hedge fund performance by benchmarking performance to the long-only major market indexes. Most hedge funds are not invested in portfolios to match the market indexes in that way. Investors can buy index funds if they want to do that. Hedge funds provide alternative investment opportunities and hedged, risk adjusted and less volatile returns. Long/short funds may underperform a long-only index in a bull market as they have to pay for the hedges. Over the longer periods hedge funds have been proven to outperform many asset classes on a risk adjusted basis. Long-only focused index investing carries significant performance risk and volatility - for example, investors in the NASDAQ index have only just regained their high-water mark from 2000 after 15 years.

Regulation and compliance. It is wrong for the media to say that hedge funds lack proper regulation and do not comply with the rules. That is simply not true. The vast majority of hedge fund managers are now regulated. Hedge funds domiciled in the Cayman Islands or the British Virgin Islands are also regulated. In addition, service providers around the hedge funds - custodians, prime brokers, fund administrators and Cayman Islands independent directors - are often subject to regulation. Collectively, the hedge funds have already invested more than $3 billion on compliance and individually spend anywhere between 5% and upwards of 10% of their operating costs on compliance. Governance in the hedge fund continues to improve and a large majority of hedge funds now have independent directors on their boards.

Tax havens and transparency. Those who allege hedge funds are secretive or non-transparent and based in offshore tax havens for nefarious purposes ignore some salient facts. Hedge funds can be limited considerably by securities laws from divulging much information to the media on marketing. This may foster their reputation for secrecy; but the reality is they must make numerous informational reports to their investors and regulators in the US and the EU, for example, by filing regularly Form PF and Annex IV information.

About 70% of all hedge funds and a large number of private equity funds are Cayman Islands

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companies for good reasons. The Cayman Islands government is often commended by the likes of the IMF, the Financial Stability Board, the FATF and governments for the way in which the Cayman Islands has promoted good governance and adopted international initiatives on AML/KYC and implemented good co-operation with international regulators (for example, in relation to the EU AIFMD), as well as committing to and implementing tax transparency initiatives such as FATCA, the European Savings Directive, a UK version of FATCA, the OECD Convention on Mutual Administrative Assistance in Tax Matters and the G5 countries' pilot project on the automatic exchange of tax information. The Cayman Islands' anti-money laundering/know-your-customer laws are rated as good as many major OECD members' laws.

Institutional investors recognise all this and, after copious due diligence, take comfort that the Cayman Islands investment funds in which they invest are established under internationally recognised legal principles which protect their rights and have been successfully tried and tested through even the most severe of financial crises.

Conclusion

These are few examples of how the industry might address the PR concerns and misconceptions. It's important we continue to educate policymakers so they only introduce workable and proportionate regulation and tax policy, which will not heap unnecessary cost on institutional investors or exclude pensions from the world's best alternative investment funds. Thousands of jobs in the industry and the well-being of millions of pensioners depend upon it.

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Investors keen to find talented minority and women hedge fund managers

James McEntee

David J. Katz said many emerging hedge fund firms cannot meet the strict track record and asset requirements demanded by institutional investors.

Institutional interest in portfolios of hedge funds managed by minority- and women-owned firms is rising, but finding enough talented managers to put large allocations to work is a challenge.

Asset owners earmarked $850 million for investment in dedicated minority- and women-owned hedge fund portfolios in 2014, with some searches extending into this year, *Pensions & Investments'* reporting shows.

But these programs have more difficulties than those focused on traditional investment strategies, sources said.

For one thing, the universe of hedge fund companies with substantial ownership by minorities or women numbers only 350, with the vast majority managing less than $250 million (often much less) with short performance track records and varying degrees of institutional infrastructure, said David J. Katz,

president and chief operating officer of hedge funds-of-funds and seeding specialist manager Larch Lane Advisors LLC, Rye Brook, N.Y.

Only 20 or so minority- or women-run hedge fund companies manage at least $1 billion, the most common minimum size criterion for institutions, Mr. Katz estimated. Size is important because many institutions can't let their investment represent more than 20% of a manager's total assets. Also, many firms in the minority-/women-owned universe have yet to hit the three-year track record required by institutional prospects.

“If you look at who comes out of the investment banks, bank proprietary trading desks and hedge funds to set up their own firms, there really are very few minority and women managers,” said Putri S. Pascualy, managing director and portfolio manager at hedge funds-of-funds manager Pacific Alternative Asset Management Co. LLC, Irvine, Calif.

“First and foremost, the manager has to be a superb investor, an institutionally oriented hedge fund manager with a good pedigree, experience and enough personal net worth to be able to live without a paycheck for a couple of years as the firm is built out. These are high bars.” If any of the remaining firms happens to be minority- or women-owned, “that's an extra cherry on the cupcake,” Ms. Pascualy said.

PAAMCO manages $9.5 billion in hedge funds-of-funds strategies, of which $1.5 billion is invested in emerging managers, including a high proportion of minority-/women-owned firms, she said.

Few tempted

Because of the complexity involved in investing in minority-/women-owned hedge funds, few institutional investors have been tempted to set up their own programs, turning instead to hedge funds-of-funds managers, sources said. Many institutions work around their high minimum AUM requirements by investing through a fund-of-funds vehicle.

Assets allocated to minority-/women-owned hedge funds-of-funds portfolios in the past year topped $850 million from a group of institutions including the $163.4 billion New York City Retirement Systems, in which three of the five pension funds in the system have such portfolios; $178.3 billion New York State Common Retirement Fund, Albany; and $29.4 billion Connecticut Retirement Plans & Trust Funds, Hartford.

The Illinois State Board of Investment, Chicago, recently hired funds-of-funds managers The Rock Creek Group LP and Appomattox Advisory Inc. to invest $100 million and $50 million, respectively, in minority-, women- and disabled- or veteran-owned emerging hedge fund managers, said William R. Atwood, executive director.

ISBI, which oversees $15.1 billion, is seeking to diversify its $1.5 billion hedge fund allocation, all in funds of funds, Mr. Atwood said. Pro rata funding for the two new customized portfolios will come from its existing hedge funds-of-funds mangers, including Rock Creek, which already had $577 million, as well

as Entrust Partners LLC with $564 million, and Mesirow Advanced Strategies Inc. with $375 million, Mr. Atwood said.

Marquette Associates, ISBI's investment consultant, assisted with the search.

Fierce competition

Competition among hedge funds-of-funds managers for capacity is fierce given the small number of minority-/women-owned firms that meet the optimal criteria Ms. Pascualy described.

Scott C. Schweighauser, partner and president of hedge funds-of-funds manager Aurora Investment Management LLC, Chicago, said he's seeing increased demand from corporate and public funds, endowments and foundations for minority- and/or women-owned hedge fund portfolios and an equally strong pipeline of up-and-coming hedge fund managers in which to invest.

“We had invested in a number of great minority- and women-owned hedge funds for years without considering their ownership structure at all. So when institutional investors began to ask us about dedicated mandates in this area, we already had managers in place and were tracking other promising companies,” Mr. Schweighauser said.

Aurora is one of the largest managers of pure-play minority- and women-owned firms, with $1 billion in the strategy.

One client is the $34.9 billion Illinois Municipal Retirement Fund, Oak Brook, which asked Aurora to create a dedicated minority-/women-owned portfolio within the $607 million hedge fund-of-funds mandate the firm has managed for the pension fund since 2012. As of Dec. 31, such firms managed $152.72 million, or about 25% of the overall account, said Megha Kauffman, an IMRF spokeswoman, in an e-mailed response to questions.

Progress Investment Management Co. LLC, San Francisco, on the other hand, is well-known as a manager of emerging managers, with $8.5 billion invested across all asset classes, including $100 million invested in a new minority-/women-owned focused hedge fund approach, said Andrew Finver, director of hedge fund research.

“We get an early jump on many new hedge fund managers because Progress is wellknown as an emerging manager specialist and they call us,” Mr. Finver said.

Mr. Finver said while other hedge funds-of-funds managers won't look at hedge funds with less than $250 million, Progress will consider smaller managers.

“It takes some work and expertise to get comfortable with investing with a $100 million manager, but it means that we can take a $100 million (minority-/women-owned) hedge fund mandate and spread it out in $10 million blocks to 10 managers, and that helps keep our investors from going over their 20% limit

of a manager's total AUM," Mr. Finver said. n

*Editorial Page Editor **Barry Burr** contributed to this story.*
Original Story Link: http://www.pionline.com/article/20150223/PRINT/302239992/investors-keen-to-find-talented-minority-and-women-hedge-fund-managers

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AIMA and CAIA launch series of hedge fund papers for pension fund trustees

28 January 2015

The Alternative Investment Management Association (AIMA), the global hedge fund association, and the CAIA Association, the global leader in alternative investment education, have jointly published the first of a series of educational papers about hedge funds for pension fund trustees and other fiduciaries at institutional investors.

The paper, titled “The Way Ahead: Helping trustees navigate the hedge fund sector”, sets out to give practical guidance about how existing investors have managed issues and challenges associated with their hedge fund investments as well as detailing the advantages of allocating to hedge funds.

The other papers in the series, to be released between now and Q1 2016, will cover such topics as hedge fund strategies, transparency and governance. They are being produced in collaboration with the AIMA Investor Steering Committee, a group of leading institutional investors globally with approximately $150 billion invested in hedge funds.

Among the findings of the first paper:

• Roughly one in every four dollars managed by the global hedge fund industry today – well over $700 billion in total – is invested by public and private pension plans, and this proportion is increasing

• Uncorrelated and risk-adjusted returns are among the most important objectives cited by investors who invest in hedge funds [1]

• Investors have earned a combined $1.5 trillion after fees from hedge funds in the last 10 years [2]

Jack Inglis, AIMA CEO, said: *“The global hedge fund industry has grown at approximately 10% a year since the financial crisis, and much of this growth can be attributed to increased allocations from public and private pensions. Hedge funds have become part of the mainstream, and today they manage over $700 billion from pensions worldwide and well over $2 trillion from institutional investors generally.*

“But at the same time, many trustees are asking questions about their existing or prospective hedge fund allocations. Rarely has there been such demand for a realistic assessment of the benefits – and also the risks – associated with hedge fund investing. We hope that this series of educational papers which we are producing with CAIA will be considered by trustees as a trusted source and help them to improve their understanding of hedge funds at this important time in the industry’s growth and development.”

William J. Kelly, Chief Executive Officer at the CAIA Association, said: *“The alternative investing industry has experienced tremendous growth over the past decade and now finds itself at something of a crossroads. Continued growth and acceptance will depend greatly on the ability to educate investors not just on the fundamentals of the products, but also on the role these funds are designed to provide within an overall portfolio.”*

The paper, "The Way Ahead: Helping trustees navigate the hedge fund sector", can be downloaded from the AIMA website. [3]

- Ends -

Notes for Editors
[1] Source: Preqin
[2] This data was provided by Hedge Fund Research for this paper
[3] www.aima.org/en/document-summary/index.cfm/docid/F4D1F5DA-B20A-4052-80D8CC894090C9A1

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About AIMA
The Alternative Investment Management Association (AIMA) is the global hedge fund industry association, with over 1,500 corporate members (and over 8,000 individual contacts) in over 50 countries. Members include hedge fund managers, fund of hedge funds managers, prime brokers, legal and accounting firms, investors, fund administrators and independent fund directors. AIMA's manager members collectively manage more than $1.5 trillion in assets. All AIMA members benefit from AIMA's active influence in policy development, its leadership in industry initiatives, including education and sound practice manuals, and its excellent reputation with regulators worldwide. AIMA is a dynamic organisation that reflects its members' interests and provides them with a vibrant global network. AIMA is committed to developing industry skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the industry's first and only specialised educational standard for alternative investment specialists. For further information, please visit AIMA's website, www.aima.org.

About the CAIA Association
The CAIA Association, a non-profit organization founded in 2002, is the world leader and authority in alternative investment education. The CAIA Association is best known for the CAIA Charter®, an internationally recognized credential granted upon successful completion of a rigorous two-level exam series, combined with relevant work experience. Earning the CAIA Charter is the gateway to becoming a member of the CAIA Association, a global network of over 7,000 alternative investment leaders located in 80+ countries, who have demonstrated a deep and thorough understanding of alternative investing. Having grown rapidly, the CAIA Association now supports vibrant chapters located in financial centers around the world and sponsors more than 120 educational and networking events each year. The CAIA Association also offers a continuing education program, where trustees can learn the Fundamentals of Alternative Investments in a 20 hour, video-based program. For more information, please visit CAIA.org.

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Derivatives clearing: why have clients lost the right to claim for their losses?

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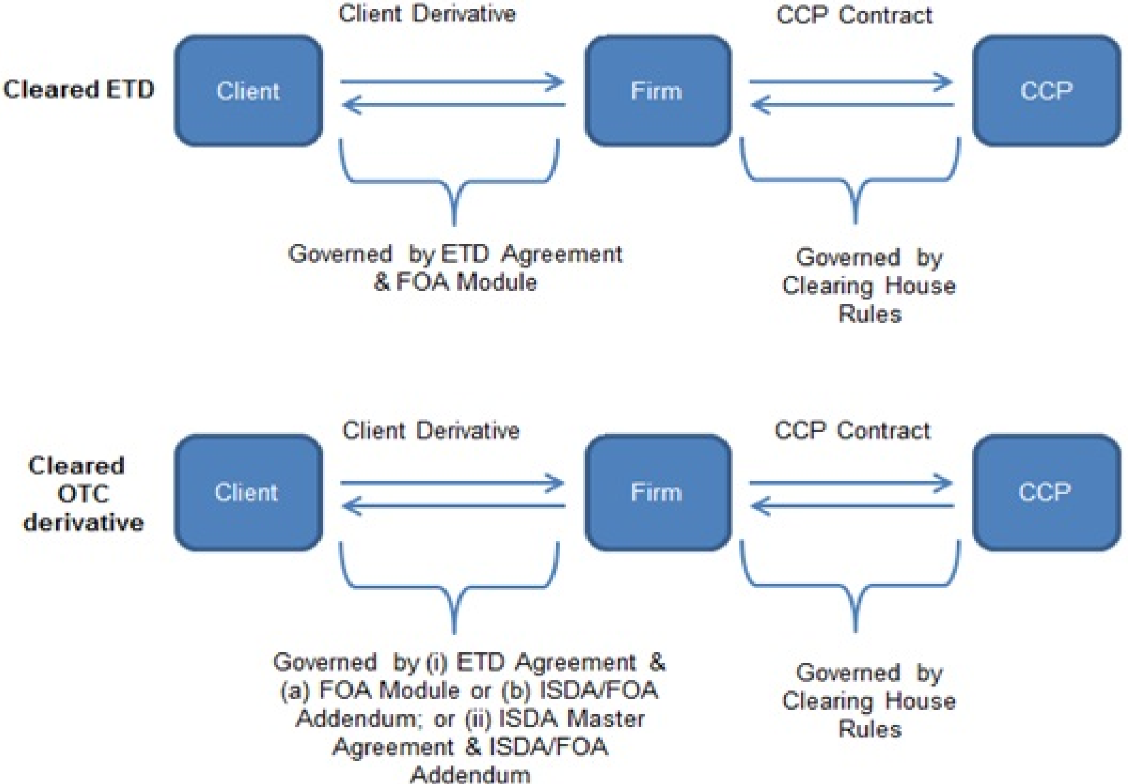
Q4 2015

The standard documents in use for OTC and exchange-traded derivatives central clearing in Europe oblige clients to surrender their standard contractual right to claim for compensation should their clearing member default. If following a clearing member default a client's derivatives are terminated by the central counterparty clearing house (CCP), then instead of being able to claim for the cost of being put in the position that the client would have been in had the clearing member not defaulted, the client is obliged to accept a CCP valuation that does not take the client's circumstances into account. This creates a significant risk of unrecoverable losses for clients, a result that is not needed for the proper functioning of the derivatives market, and which may add to the inevitable market stress should a major derivatives clearing member default. This situation should be remedied by restoring within the industry standard documents the client's right to claim for its full losses.

Background

In response to the requirements imposed by the European Market Infrastructure Regulation[1] (EMIR) with regard to the trading and clearing of derivatives, Europe-based clearing members and their derivatives clients are re-documenting their relationships. In this they have been assisted by two industry standard English law documents published in 2013, the *FOA Clearing Module*[2] (the "Module") published by FIA Europe (published under FIA Europe's prior name, the Futures and Options Association), which deals with clearing exchange-traded derivatives (ETDs) and OTC derivatives; and the *ISDA/FOA Client Cleared OTC Derivatives Addendum*[3] (the "Addendum") as jointly published by the International Swaps and Derivatives Association and FIA Europe, which covers clearing of OTC derivatives, but not ETDs. The clearing documents were published after a lengthy drafting process involving market participants.

The clearing documents cover the relationship between the clearing member and its client under "principal to principal" clearing relationships where the clearing member acts as an intermediary between two derivatives: a cleared derivative (the "CCP Contract") with a CCP; and a second, economically equivalent, derivative with the clearing member's client (the "Client Derivative"). The clearing documents are supplementary to the existing agreements used for ETD and OTC derivatives. The relationship is shown in the diagram below:



Central clearing of standardised derivatives was a commitment contained in the 2009 G-20 Leaders Statement at the Pittsburgh Summit, with the objective of reducing systemic risk in derivatives markets. Central clearing of derivatives creates a number of benefits, notably the possibility that, if a clearing member defaults, its clients can potentially transfer the cleared derivatives and associated collateral held at a CCP to an undefaulted clearing member (a process known as "porting"). If a major financial institution defaults and porting is successful, the significant credit losses that its derivative clients could otherwise incur on termination of derivatives may be avoided. This note focuses only on the consequences if porting fails, which would lead to the CCP having to terminate the derivatives associated with the defaulted clearing member's clients. If this occurs, the clearing documents needlessly create a risk of unrecoverable loss for clients.

The problem caused by clients not having the right to claim for their full losses

The clearing documents provide that if a clearing member defaults and its clients' cleared derivatives are terminated rather than porting to a new clearing member, when determining the amount that must be paid between the clearing member and a client for the terminated Client Derivative, the same value must be used as that which the CCP imposes on the clearing member for the CCP Contract[4]. This use of the CCP valuation creates a risk of significant unrecoverable losses for clients if the porting process doesn't succeed.

To give an example of how the concern arises (using Lehman Brothers to stand in for the client's counterparty):

- Suppose a client enters into a single derivative with Lehman Brothers under a standard ISDA master agreement, and the derivative is not centrally cleared. The derivative is acting as a hedge for the client. Lehman Brothers defaults at a time when the derivative has a mark-to-market value close to zero. The derivative terminates. The client replicates the derivative with another dealer as it needs to replace the hedge. The other dealer charges $10 to replicate the derivative. The client is out of pocket $10. The client claims $10 from the Lehman Brothers insolvency using the normal ISDA master agreement closeout mechanism.
- Now suppose that the derivative with Lehman Brothers is cleared through a CCP with Lehman

> Brothers as clearing member, and Lehman Brothers and its client are using the new clearing documents[5]. Lehman Brothers defaults and the derivative is terminated rather than porting to a new clearing member. As before, the client replicates the derivative with another dealer, and pays the dealer $10 to do so. Separately, the CCP runs an auction among undefaulted clearing members to enter into a derivative with the CCP to replace the terminated CCP Contract equivalent to the Client Derivative[6]. The winning auction bidder requires $25 to enter into the replacement derivative with the CCP, which the CCP must pay. Under the clearing house rules the insolvent Lehman Brothers must pay the CCP $25 for the terminated CCP Contract. Under the clearing documents' terms, the client must now pay Lehman Brothers $25 for the terminated Client Derivative. The client is now out of pocket $35, with no opportunity to recover from the insolvency estate.

The odd result of using the new clearing documents' terms for valuing terminated cleared derivatives is that Lehman Brothers is effectively insulated from the losses that its own default causes. Lehman Brothers has escaped liability for the $10 of losses it caused the client, and can pass on to the client the $25 loss that Lehman Brothers' default caused the CCP. Not only is this result not required by EMIR, it appears to run counter to the G-20 objective of reducing systemic risk in derivatives markets. It is contrary to normal contractual principles for claims for breach of contract and to the ordinary measure of creditor claims under bankruptcy law.

Answering the arguments put forward that clients should not have the right to recover losses

Various reasons have been put forward for the valuation approach adopted in the clearing documents. Considering them in an article may appear like attacking straw men, but it is better to address them here rather than leave arguments that are commonly put forward unanswered.

A number of dealers and other commentators argue that a firm clearing derivatives needs greater protections than a party to a bilateral derivative, as a clearing member acts as a service provider intermediary in facilitating access to the CCP. As a service provider they draw an analogy to a broker acting as a "riskless principal" in securities markets, where the intermediary broker acts as principal to trades with a buyer and a seller, and the market price is the same on both principal trades. However, it is not the case that a riskless principal in securities markets is insulated from losses in the way that the clearing documents provide. If an executing broker that was acting as a riskless principal in the OTC securities market were to default in the period between trade date and settlement date of the securities, it would face a claim from the intended buyer of those securities for the difference between settlement price and the price at which the buyer could buy elsewhere; and at the same time the broker would face a claim from the intended seller for the difference between settlement price and the price at which the seller could sell elsewhere. When trading OTC securities, there is no equivalent of the clearing documents' requirement that a defaulting clearing member face the same price on both sides of the cleared derivative.

Some dealers have voiced a concern that being liable for a client's losses acts as an undue disincentive to act as a clearing member. This concern is unjustified, as a service provider should not be incentivised to provide a service by a clause that on insolvency effectively provides for a transfer of wealth from its derivatives clients to its insolvency estate (the $25 payment in the example above), to subsequently be transferred from the insolvency estate to the service provider's other creditors – and conversely a service provider should not be discouraged from offering a service if its insolvency estate remains liable for the consequences of the service provider's fundamental breach of contract. Using the CCP's valuation on default of a clearing member subtracts value from the relationship between a clearing member and its clients, as it creates risks of unrecoverable loss for clients with no corresponding benefit to the clearing member.

For ETDs, if the clearing documents are not used, the typical master agreement used by clearing members gives clients no express rights should the clearing member default. Some dealers have argued

that there is no reason for clients to object to the valuation term in the clearing documents, since it is no worse than under those existing ETD agreements. One imperfect agreement should not be a justification to agree to another, but more importantly the argument put forward by those dealers is incorrect. Given the silence in the typical ETD agreement as to what occurs should a clearing member default, normal English law principles apply in determining the rights of the client. A clearing member's default and non-performance of its obligations would amount to a repudiatory breach of contract. The general rule under common law is that the measure of loss that a party can claim for breach of contract is the value that the contract would have had to that party had the breaching party performed, which can include the cost of entering into new transactions to replicate the terminated contract. In the circumstances of a clearing member default leading to client derivatives being terminated where the ETD agreement is silent on the treatment of the client claim, it would be open to the client to claim for the replacement cost of the derivatives as a measure of the cost to the client of putting itself in the same position as if the clearing member had performed.

Eurex Clearing AG, a major CCP, does require that clients which elect to use Eurex's Individual Clearing Model for an individual segregated account must use the Eurex termination values if derivatives fail to port on a clearing member default[7]. However, this is a rule that only applies to this account type at Eurex. The clearing documents apply this approach of using CCP termination values to all other account types at all CCPs, without the rules of the CCPs requiring this.

The clearing documents' use of the CCP termination levels may have been due to the reasonable concern that a clearing member cannot be seen to guarantee a CCP by giving a greater return to clients than the clearing member gets from the CCP, as this could lead to the CCP Contracts ceasing to be zero-risk weighted for regulatory capital under Article 306 of the EU Capital Requirements Regulation (CRR)[8]. However, Article 306 concerns losses caused by a CCP default, and not a clearing member agreeing to pay a client's losses caused by the clearing member's default.

Potential for systemic harm

More broadly, the obligation on a client to make an excessive payment to the insolvent clearing member has a needless negative impact on the financial system. In the example above, the $25 that the client has to pay the insolvent Lehman Brothers is cash that will not reappear until the bankruptcy estate makes a distribution in years to come. A major clearing member default would likely see the financial system in crisis, and in those circumstances the further loss of liquidity caused by excessive payments to the insolvency estate risks adding to the stress.

The potential for loss for clients between the price at which clearing members accept the risk of replacing terminated CCP Contracts through the CCP default auction process and the price at which a client is able to re-hedge the terminated Client Derivative should not be understated. The notional size of Lehman Brothers' derivatives book has been estimated as being approximately $35 trillion at the time of default[9]. A CCP that needs undefaulted clearing members to take the market risk of a significant percentage of a large defaulted clearing member's cleared derivatives in a time of system-wide distress would likely receive poor offers for replacement derivatives. Similarly a client seeking to re-establish a derivatives hedge immediately following its clearing member defaulting would face poor offers from dealers.

Conclusion

There are strong arguments in favour of restoring a client's normal contractual position of having the right to claim for its losses under the industry clearing documents. Restoring these rights would not involve clearing members suffering harm. Further, restoring these rights would be an improvement to the functioning of the financial system in the testing times of a clearing member default. FIA Europe and ISDA should engage market participants in a review of the clearing documents in this regard, one that would most appropriately lead to a restoration of the normal contractual right to claim for losses. In the interim, users of the clearing documents should seek to incorporate the client's contractual right to claim

for losses on a negotiated bilateral basis.

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[1] Regulation (EU) 648/2012

[2] The Module is available for subscribers to FIA Europe Documentation Library on www.foa.co.uk, and FIA Europe has confirmed to Macfarlanes that the Module is typically made available to non-subscribers on direct application to the Legal Documentation team at FIA Europe.

[3] The Client Cleared OTC Derivatives Addendum is available on http://www.isda.org/publications/isda-clearedswap.aspx .

[4] The relevant clauses that provide for the use of the CCP termination levels are clause 5.2.2(c) of the Module, and clause 8(b)(ii)(2) of the Addendum.

[5] Lehman Brothers may be party to a number of derivatives with a client that were originally agreed by the client with a third party executing broker, but then cleared by Lehman Brothers such that the client no longer faces the executing broker. This is a common feature of central clearing with CCPs, but also occurs with derivatives that are not centrally cleared - particularly where the party in the position of Lehman Brothers is acting as prime broker, interposing itself as intermediary between the client and the executing broker, and acting as principal counterparty to both. The principles described in this article apply equally whether the executing broker for the derivative was a third party or the party in the position of Lehman Brothers in the examples above.

[6] A default auction among undefaulted clearing members is a common means of dealing with the CCP's exposures under the CCP Contracts of a defaulted clearing member. For example, a default auction is provided for in Chapter 11 of Eurex Clearing AG's *Procedures Manual*, and in LCH Clearnet Limited's *Default Rules.*

[7] Imposed by the *Clearing Conditions* of Eurex in Chapter I, Part 3, Subpart C, Number 2.1.2(7).

[8] Regulation (EU) No 575/2013. Article 306.1(c) of CRR provides that "*where an institution is acting as a financial intermediary between a client and a CCP and the terms of the CCP-related transaction stipulate that the institution is not obligated to reimburse the client for any losses suffered due to changes in the value of that transaction in the event that the CCP defaults, the exposure value of the transaction with the CCP that corresponds to that CCP-related transaction is equal to zero.* "

[9] Kimberley Summe, *Misconceptions about Lehman Brothers' Bankruptcy and the Role Derivatives Played*, 64 Stanford Law Review Online 16 (28 November 2011).

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Finding catalyst-driven opportunities in a changing investment landscape

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Man GLG

Q4 2015

Introduction

The noun ‘catalyst’ is of Greek origin, being derived from the verb ‘katalyein’, which means to dissolve or become liquid. In the field of chemistry, a catalyst is a substance that increases the rate of chemical reaction without itself undergoing any permanent chemical change.

In everyday life, ‘catalyst’ has a simpler definition; something or someone that causes change. In the context of financial markets, it could be said that, over the summer of 2015, China was the catalyst for a change in investor sentiment. In fact, China’s role as a catalyst in this instance potentially satisfies both the scientific and everyday definitions.

In our view, Chinese woes can be said to have been an accelerant in the sense that the Yuan devaluation brought forward a spate of risk aversion. If investors had not had China to worry about in August, we believe, the prospect of the US Federal Reserve potentially raising interest rates in September might well have prompted a similar market reaction in early-to-mid September.

However, from the perspective that China was the only subject on the lips of investors, it can justifiably be said to have been that something that, of itself, precipitated an abrupt change in investor sentiment.

At the stock level, in our view, the most obvious catalyst for a substantial shift in valuations is merger and acquisition (M&A) activity. Consequently, we will begin by comparing the M&A environment in 2015 to preceding years, before describing the ways in which we seek to capitalize on catalyst-driven opportunities to benefit from market dislocations.

The best year for M&A since the crisis?

In 2015, we have seen a raft of statistics to suggest that new life has finally been breathed into the M&A market after a period of several lean years, which have been punctuated by a number of false dawns. Clearly, transaction volumes fell off the proverbial cliff in 2009, dropping around 60% from 2007 levels, as company management focused primarily on rebuilding balance sheets.

While the extended delay in the recovery of volumes has come as a surprise and disappointment to many, it may simply be, on reflection, the case that there have been too many reasons for CEOs not to commit balance sheet cash, with the global economy lurching from one miniature catastrophe to another. Consequently, what we really needed to see was a change of mind-set.

Six historic drivers of M&A

Driver	Rationale
Low growth	Difficult to grow organically
Low interest rates	Cost of capital is attractive
Low stock multiples	Cheap equity
Robust credit markets	Appetite for debt securities
Low volatility	Narrower bid/offer spreads
Strong corporate confidence	Increased willingness to act

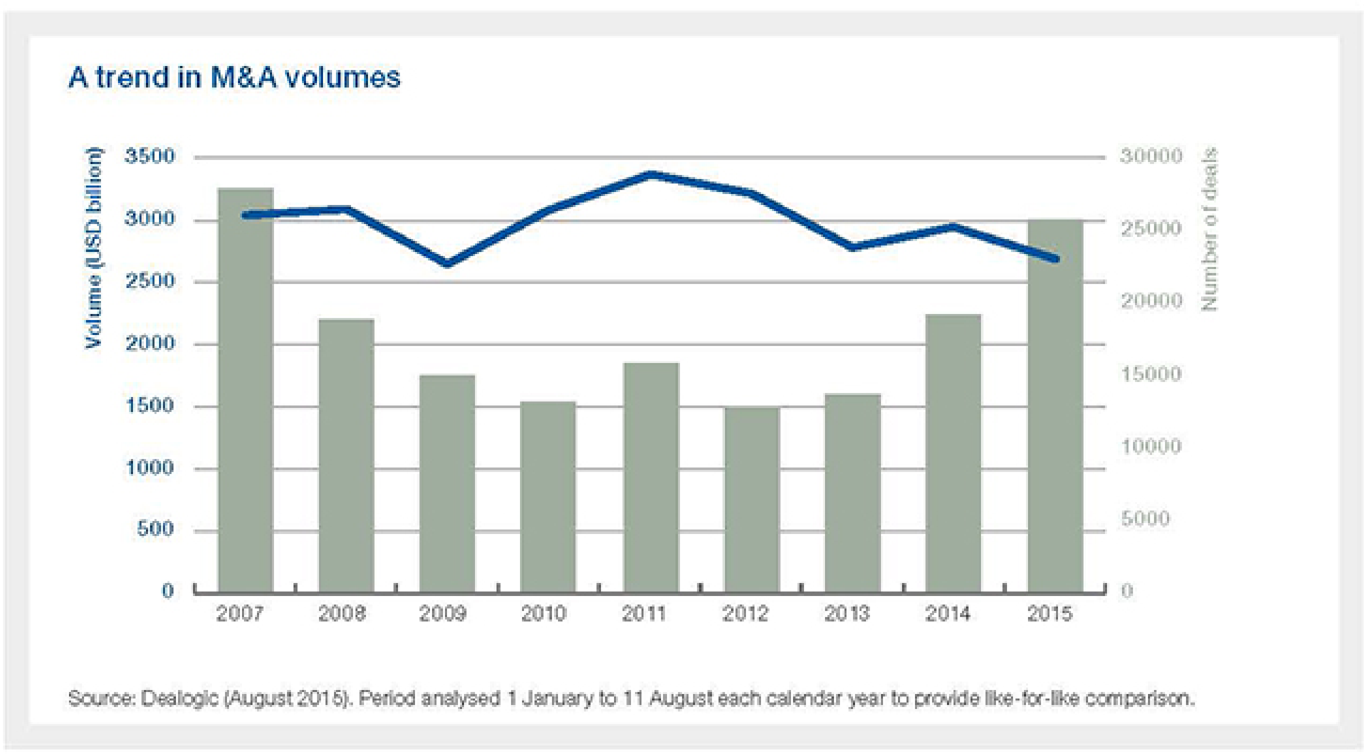
Source: Man database.

In the table above, we have identified six historic drivers of M&A activity alongside the relevant rationale. Ironically, it can be argued that, with rising volatility and widening credit spreads, the M&A environment may well have become less favourable recently than at any time in the preceding three years (although the summer sell-off in capital markets will at least have taken the froth off stock multiples and delivered cheaper equity).

However, we often refer to the ‘M&A cycle’ for the very reason that momentum is such a critical element. As the following chart demonstrates, we are currently seeing a positive trend in transaction volumes.

Indeed, according to a survey conducted by PricewaterhouseCoopers at the beginning of this year, no fewer than 54% of US CEOs were planning to complete an acquisition in 2015, while 51% of CEOs globally expected to enter a new strategic alliance.

Consequently, there is every reason to believe that M&A transactions will provide a good source of potential alpha in the period ahead. Nevertheless, it is important to point out that, in addition to capitalising on M&A situations, we seek to exploit a much broader range of opportunities through our catalyst-driven approach.



A more expansive view of the opportunity set…

'Event driven' funds per se are fabled for generating so-called 'telephone number' returns in the aftermath of the bursting of the technology bubble and the era of accounting scandals, such as those relating to Enron and Worldcom, that followed. 'Distressed situations' effectively became the new panacea for those seeking outsized investment returns.

As such, the event driven universe has been the subject of some disappointment and adverse press coverage in respect of the comparatively lean returns that have been generated during the last decade. However, event driven was actually the top performing hedge fund category in both 2012 and 20131.

Nevertheless, as we have already seen, opportunities to benefit from M&A activity dried up in the aftermath of the financial crisis, while the central bank 'medicine' of asset purchase programs and near-zero interest rate policy has effectively suppressed the default cycle. Consequently, the crowding of positions has proved a problem for some managers, particularly those specializing in just one of a number of event driven sub-strategies.

Our approach is more holistic in nature, as we seek to benefit from many identifiable catalysts with the potential to prompt a significant shift in asset prices. John Maynard Keynes once observed that the essence of successful investing is 'anticipating the anticipation of others' and that is very much the spirit of what we are trying to achieve.

Indeed, our primary source of investment ideas comes from events that have already been announced. We apply our own knowledge of sectors and situations to identify investment drivers that are not yet widely perceived. As such, we focus on 'soft' catalysts which we believe will unlock value (where long positions are taken) or create a sense of unease (on the short side).

In addition to M&A, the categories of announcements that could prompt further investigation and research on our part include, but are not restricted to, divestitures and changes to management teams, the corporate capital structure and the regulatory regime.

Aside from various announcements, we also seek sources of ideas from macroeconomic and thematic views, one-on-one meetings with corporate management teams and analysis of companies' competitive

positions.

With this expansive view of the opportunity set, we are confident that we should be able to tap into alpha sources, regardless of the trading backdrop. This sets us apart from the more specialized event driven strategies that may rely on harvesting returns at a particular stage in the macroeconomic, default or M&A cycles.

…ACROSS THE ENTIRE ECONOMIC CYCLE

Our aim is to find potential opportunities across the capital structure throughout the economic cycle. This, of course, means that we can take positions in credit as well as equities.

In this respect, it is important to point out that we always approach any given investment idea with the same underlying view developed from the soft catalyst angle. It is purely the case that we will deploy capital in the credit space where specific views can be expressed with a superior risk/ reward profile compared to holding the equity.

This flexibility provides us with additional room to manoeuvre in our efforts to opportunistically capitalize on market dislocations, the culmination of this process being deeply researched positions with low correlation to overall market movements and other traditional assets.

Consequently, given that we focus on a broad range of catalyst-driven opportunities in addition to M&A, we believe that our approach should deliver returns that are compelling from a portfolio diversification perspective as well as being attractive in their own right.

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Gearing up for MiFID II

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Q4 2015

The clock is now ticking for Europe's investment managers to get their operational systems in place in order to be compliant with new regulations including the Market Abuse Directive and Regulation (MAD/MAR) and the Markets in Financial Instruments Directive II (MiFID II).

While the implementation deadline of MiFID II may get pushed back from the initial January 2017 date, MAD/MAR becomes applicable in July 2016 and firms also have to implement record-keeping and market abuse prevention programmes under Dodd-Frank and global market conduct mandates.

Record-keeping of communications, voice recording and trade reconstruction are among the fundamental objectives of these regulations, and in particular of MiFID II. They will change the way an investment manager works, making them more accountable than ever before.

While my experience has been that many companies in Europe have been faster to begin formulating strategic solutions to the various reporting obligations than firms in the US, much remains to be done as the record-keeping rules up to this point haven't been as prescriptive in Europe as in the US.

In a recent survey which was conducted at a Bloomberg event, only 7% of attendees said their firm was ready to meet the record-keeping requirements. Nearly 50% of respondents said that their firms are only now in the process of formulating a plan and would not be ready to implement by January 2017, a deadline which might now be pushed back.

Records, including voice recordings of telephone conversations, will now have to be immediately available, stored in an accessible and searchable way and organised by both transaction and counterparty. Now it will be a question of whether you can retrieve the data in the way examinations require, rather than just of how it is stored.

Fund management firms will need to keep records of any conversation – email, chats, voice, documents and files - that relate to or are intended to result in a transaction, regardless of whether that transaction is made. Most record-keeping efforts currently underway only apply to trader calls.

One way to think of it - consider record-keeping as the underlying fabric tying businesses together. Besides trade reporting obligations, you can also use the system for market abuse monitoring and prevention by identifying behaviours and communication patterns. Managers will have to have a system for MAR in place that shows they are performing effective monitoring. For the industry overall, there should be an expectation you can report on exceptions and you have a documented process in place for such cases. The pre-trade workflow is the hardest to recreate and will require logging a deluge of communications, documents and meeting notes leading up to the trade.

Fund managers will also need to be efficient as they undertake record-keeping surrounding the best execution requirements. Investigating and documenting your best execution process will demand a new process be put in place.

The information that will need to be given to the investment client is increasing considerably. Managers

have to provide clients with the top five execution venues per asset class and a summary of the analysis and conclusions of the monitoring that was undertaken and execution achieved.

As such, fund managers need to think about how they are going to resource all the technological aspects for meeting these requirements – which parts can be done in-house and which can be outsourced?

While the obligations seem overwhelming, it is important to recognise that the compliance analytics that will be generated can be used to gain business insights on trading performance, client coverage and sentiment analysis, for example. Some managers look at the best execution requirements from a transaction cost analytics perspective to evaluate the particular performances of their traders, for example. From a trader's point of view, the vast quantity of information available pre-trade will enable them to make better decisions.

There are also efficiencies to be gained from having a combined reporting solution not only for MiFID II and MAR, but also for the European Market Infrastructure Regulation and Securities Financing Transactions Regulation, when that comes into force.

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Guide to political risk insurance for financial institutions

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Q4 2015

Political risk insurance (PRI) is a product designed to help mitigate the political uncertainties investors and lenders face when investing or lending into emerging markets. Typically clients are concerned about the long-term political stability of a country, and a PRI policy is designed to provide insureds with the comfort that even if the sociopolitical situation in the country implodes or a new government is elected on an anti-foreign investment platform, they can exit the country without losing the investment or debt.

The inception of political risk insurance was in the 1948 Marshall Plan – US Government promotion of US equity investments to rebuild post-war Europe in the form of political risk guarantees. This has developed over the years from government-backed schemes to promote national companies' overseas investments (which still exist in the form of export credit agencies) into a burgeoning private market based largely out of the London market.

Political risk insurance will cover the parent company's:

- fixed investments
- shareholding
- retained profits
- intercompany loans
- dividends to be paid by foreign subsidiary
- stock
- machinery

From a financial institution basis, the cover is most frequently bought to protect against a default by a borrower under a loan agreement or lease as a result of political risk events. As an example, Bank A lends $100m to an oil and gas company in Argentina and six months later the Argentinian government nationalises the company. Subsequently the borrower defaults as they no longer have the revenue to repay the loan.

The cover is also bought when financial institutions are prevented by a government from accessing security under a loan agreement and also where they are trading commodities as principal on their own balance sheet.

The groups within financial institutions that have the greatest need for the product are those operating

in the following areas:

- Project & export finance
- Commodity finance
- Trade finance
- Leasing
- Securitisations/capital markets
- Asset-based finance

Essentially any area where the bank's balance sheet is exposed to a credit risk.

What risks are covered?

Callout: Political risk insurance covers an act by government resulting in a loss where the government had no right to take that action.

Political risk insurance for lenders cover banks against the default of borrowers under a loan agreement (includes asset leasing) as a result of the following:

Confiscation – perils insured:

- Confiscation / expropriation / nationalisation
- Deprivation
- Forced divestiture
- Forced abandonment
- Selective discrimination
- Licence cancellation / revocation
- Currency inconvertibility / exchange transfer
- Embargo

Physical damage – perils insured:

- War on land
- Strikes / riots / civil commotion
- Terrorism and malicious damage

There is also the ability to cover arbitration award default in the event that insurers will not offer cover for license cancellation / revocation.

What risks are not covered?

Political risk insurance for lenders covers default by a borrower or loss to financial institution as a result of political events only. It does not cover loss resulting from the ordinary insolvency of a borrower or general commercial defaults by third parties. Comprehensive non-payment insurance (which I'll cover next week) covers insolvency and protracted payment default.

Exclusions under PRI policies include (but not limited to):

- Failure to maintain or secure necessary permits,
- Non-compliance with laws of the foreign country (in place at inception)
- Currency fluctuations
- Commodity price fluctuations
- Breach of the loan agreement by the insured
- Fraud

A PRI policy will not cover defective contracts - i.e. if the underlying investment agreement or concession agreement allows the government to take a 50% free hold at any time, then you can't claim under a PRI policy when the government executes this right.

It is important to note that the policy is designed to cover an act by government resulting in a loss where the government had no right to take that action. If a government acts in its role as legally appointed governing authority to improve public safety or environmental safety (which of course is seen by international arbiters to be reasonable) then insurers will be unwilling to respond positively.

It is important to note that, if a financial institution is lending to a sub sovereign or sovereign entity, then only comprehensive non-payment cover is appropriate as you will find it impossible to differentiate between the political and commercial actions of a sovereign or sub-sovereign entity (any company owned >50% by the government).

Market characteristics

Commercial/ private market insurers:

- Lloyd's
- Company markets

Others:

- Export credit agencies – for example SACE, the Italian export credit agency, COFACE who are the French export credit agency
- Multilaterals – MIGA (Multilateral Investment Guarantee Agency - part of the World Bank) ATI (African Trade Insurance)

Private markets vs export credit agencies:

- Flexibility
- Tenors
- Coverage
- Speed of response
- Documentation risk
- Local content rules
- Rating
- Down-payment /commercial loan
- Double trigger cover

Appropriate limits

As most PRI for lenders loss scenarios (apart from physical loss or damage as a result of political violence) are 100% of the policy limit, the limits need to reflect the full value of the loan or investment, unless the financial institution has the appetite to take some of the risk on their own book. If a loan, it is highly unlikely that the borrower will be able to suddenly make payments again further down the line following a government confiscation for example.

Pitfalls

It must be made clear to financial institutions that PRI for lenders is country risk mitigation only and does not provide cover against insolvency of a borrower. Wording negotiations can be complicated as there is much interpretation into what an appropriate act of a government is and what is political and what is commercial.

PRI isn't a cheaper version of comprehensive non-payment cover, it is only covering a portion of the risk.

There should be a cross border element to the transaction, i.e. UK bank lending to UK-listed company for the purpose of developing a project in Guinea Bissau. Insurers will not cover domestic political risk.

Emerging issues

Instances of outright expropriation by governments are less frequent today, however assets are still expropriated but by much more subtle means. This is what is known as "creeping expropriation". This normally takes the form of a number of small actions by the government, which individually cannot be seen to be an expropriation, but when seen as a whole they have the same effect as an outright expropriation.

Increasingly, resource-rich countries in emerging markets are flexing their muscles as they seek to take a greater share in the proceeds of strategic projects. This is known as resource nationalism – which is typically seen as when a State thinks that a foreign investor is not sharing the profits from an operation, especially when prices for the natural resource rise beyond the levels originally anticipated. In these cases, the State may seek to impose new terms or regulations on the investment or the foreign investors to improve the position of the State.

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MiFID II fallout: unbundling the research payments dilemma for fund managers

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Q4 2015

In September 2015, the European Securities and Markets Authority (ESMA) finally announced its long-awaited capital market reforms. With 1,500 pages to wade through and 28 new rules to digest, it's fair to say that fund managers have plenty on their plates. While many will be thankful for the level of granular detail regarding who needs to report on what to whom and when, the question of exactly how research will be paid for still remains.

It's a question that's likely to hang in the air for a while yet. Although expected in November, the latest chapter in the lengthening story is that the delegated acts probably won't appear from ESMA until at least February 2016 and perhaps even March, with rumours that the European Commission may send some of the rules back to the regulator.

Until then, much uncertainty surrounds how exactly fund managers go about paying for research. But one thing we know for sure is that investment managers must set their research budgets in advance either through Commission Sharing Arrangements (CSAs) or – in the event that the EC decides that managers have to pay for research separately – via a Research Payment Account (RPA).

There is currently a lack of clarity stemming from national regulators' differing interpretations of ESMA's take on CSAs, which enable fund managers to access research and execution from separate providers while paying for both through dealing commissions. Back in February, the UK's FCA argued that CSAs are linked to transacted volumes and therefore not allowed, as ESMA states that research costs should not be linked to the volume or value of execution services. Yet, other European regulators have argued CSAs will still be valid, and at the moment it looks as though the French are making headway with their push to convince the Commission to allow portfolio managers to keep using them. In any case, fund managers cannot afford to wait for the final results: there are fundamental questions that need addressing today.

The most pressing of these is exactly how fund managers will be affected. Regardless of whether CSAs survive, fund size is an important factor. If the cost of research goes up, smaller investment managers may be disadvantaged given the relative impact any increased expense would have on a small firm. Then there is the administrative burden of setting a research budget – deciding how much money to set aside will be challenging. However, larger players may find it easier as their budgets likely have more capacity to absorb any extra research costs.

As if this wasn't enough to think about, MiFID II now encompasses all asset classes, so confusion also remains over how firms should allocate research payments. For example, can an investment manager who consumes research for currency and bonds share the cost with an equity-focused colleague? If so, how should they allocate the cost? Additionally, fund managers will have to contend with extra expenses if research is unbundled as VAT costs will be piled on top.

One might think that once research has been allocated and costs factored in, fund managers would be all

set, but there are other points to consider. Since trading desks will gain greater discretion over which execution brokers to trade through, the quality of algorithmic and electronic trading will become even more important.

It may take time for these changes to filter through, but time is still very much of the essence for fund managers. Both ESMA and the Commission have made a case for delaying the January 2017 implementation date, but for now it remains hardcoded in the regulatory texts, and we don't yet know whether any delay will be wholesale or take a phased-in approach. The challenge for trading desks is to reevaluate the tools available to them now to ensure they achieve best execution.

So what immediate steps should fund managers take to prepare for this new and highly complex environment? Well, unbundling broker relationships to gain transparency and differentiate between execution and research is a good place to start. CSAs can certainly help with this. CSAs are designed to get the best research and execution from separate providers, without incurring additional costs or administration. Fund managers can also compare past research budgets with future expectations, as well as assess whether portfolio managers are consuming all the research they currently receive. We also believe that tools that allow fund level reporting will become increasingly important.

It would be unwise for fund managers to break from CSAs now, as we await the European Commission's final decision. As far as long term strategy, much will depend on whether the rules are implemented as a regulation or directive. If a regulation, they must be implemented uniformly across Europe, while a directive provides more flexibility to local policymakers and regulators in how they interpret and apply the rules. Regardless of the outcome, fund managers who are already tackling the key questions will be best positioned to demonstrate full transparency to clients.

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Moving centre stage: Alternative asset management in 2020

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Q4 2015

Over the past several years, rapid developments in the global economic environment have pushed asset management to the forefront of social and economic change. An important part of this change -- the need for increased and sustainable long-term investment returns -- has propelled the alternative asset classes to centre stage. To help alternative asset managers plan for the future, PwC's Asset Management practice has considered the likely changes in the alternative asset management industry landscape over the coming years and identified six key business imperatives for alternative asset managers. We have then examined how managers can implement and prosper from each of these six imperatives.

The landscape in 2020

What factors are driving this evolution? First, regulation will continue to hinder banks: for alternatives, this furthers significant opportunities such as hires from banks and the opportunity to further step into the funding gap. As the world population ages, retirement and healthcare will become critical issues that asset management can solve. Capital preservation and alpha generation will be key. In addition, asset managers will dominate the capital raising required to support growing urbanisation and cross-border trade: growing asset classes in infrastructure and real estate play into alternatives firms' areas of expertise. And lastly, asset managers will be at the centre of efforts by sovereign investors to invest and diversify their huge pools of assets; alternative firms are ideally positioned to partner with them.

As a result, alternative assets are expected to grow between now and 2020 to reach more than $13.6 trillion in our base-case scenario and $15.3 trillion in our high-case scenario. Assets under management in the SAAAME (South America, Asia, Africa and the Middle East) economies are set to grow faster than in the developed world as these economies mature. This growth will be evidenced by the projected emergence of 21 new sovereign investors, the vast majority of which will originate from SAAAME.

This growth in assets will be driven principally by three key trends: a government-incentivised shift to individual retirement plans; the increase of high-net-worth individuals from emerging populations; and the growth of sovereign investors. This creates the need for more tailored, outcome-based alternative products that provide capital preservation, but provide upside opportunities.

Alongside rising assets, there will also continue to be increased regulatory requirements, rising costs and pressure to reduce fees. Alternative firms do not escape this pressure, and will seek to respond proactively.

Furthermore, distribution will be redrawn, as regional and global platforms dominate. New markets and untapped investor types will open up if alternative firms can develop the products and access the distribution channels to tap them. By the early 2020s, four distinct regional fund distribution blocks will have been formed allowing products to be sold pan-regionally. These will be North Asia, South Asia, Latin America and Europe. However, these blocks benefit traditional firms more than alternatives firms, so distribution alliances will be critical for alternatives firms.

Meanwhile, alternatives will become mainstream. The term “alternative” - already strained to reflect a mix of different strategies, products and firms - becomes further flexed. The growth of liquid alternative products, either in the form of mutual funds or UCITS, continues to create greater integration between alternative and traditional asset management. By 2020, alternative asset management will become synonymous with “active asset management” and, increasingly, “multi-asset class solutions”.

As a result, a new breed of global manager will emerge. Traditional managers leverage their existing platforms, distribution capabilities and brands to develop full-service, multi-asset class alternative businesses. A few of today’s largest diversified alternative firms will become mega-managers in their own right, establishing a presence in all the key geographies and investor segments. The largest alternative firms will continue their growth trajectory and diversification through product, asset class and distribution expansion, fuelled by build, buy and borrow strategies. Specialist firms will seek “best-of-breed” status by producing sustained performance, while certain emerging firms will fight for shelf space.

And finally, by 2020, technology and data-informed decision-making will become mission-critical to drive investor engagement, data analytics, operational and cost efficiency, and regulatory and tax reporting. Data management and investment in technology have not always have been a top priority for alternative firms – but this will change.

Six key business imperatives

We believe that this evolving landscape will create six key business imperatives for alternative asset managers:

1. Choose your channels

Alternative firms by 2020 will adopt world-class ideas and practices from the broader financial services industry and from traditional asset managers. They will develop more sophisticated market strategies, more focused distribution channels and better recognised brands. Most alternative firms will work out exactly which investor channel or channels they want to target and develop relevant strategies and products. Some will focus more systematically on sovereign investors, pension funds, other sophisticated institutions and private wealth markets. Others will target emerging markets, and still others will pursue the potentially huge asset flows through liquid alternative products. A small number of mega-managers in the alternatives space will operate across all major geographies, channels and strategies.

2. Build, buy or borrow

Greater segmentation of investors will, in turn, drive greater segmentation of the managers themselves. Deciding which segment of the market to inhabit will require alternative firms to more consciously evaluate what they are as an organisation and where they want to be. They will typically aspire to be one

of the following types: diversified alternative firms, specialty firm or multi-strategy firm.

All these models exist today. The difference is that firms will by 2020 explicitly choose a growth strategy in order to remain competitive. To develop the chosen business model, firms will pursue one or more of three growth strategies: building, buying or borrowing. Builders grow by building out their internal organizations, leveraging and developing their existing capabilities and investment talent.

Buyers expand their alternative capabilities across asset classes and strategies by acquiring talent, track record and scale overnight. Borrowers partner with other institutions, including asset managers, wealth managers, private banks and funds-of funds, to expand their investment capabilities and distribution channels. These borrowing relationships include, but are not limited to, distribution arrangements, joint ventures and sub-advisory relationships.

3. More standardisation, more customisation

The polarisation of the alternatives industry into standardised and customised solutions, already in evidence in 2015, becomes even more marked by 2020. This shift responds to three key investor demands. The first is the ongoing demand by the largest institutional investors for made-to-order products, providing greater customisation and strategic alignment. The second is demand for next-generation commingled funds that are more focused on outcomes. The third is demand for liquid alternative funds in standardised formats as some institutional investors, as well as the mass affluent and newly wealthy, seek easy access to alternative strategies.

4. From institutional quality to industrial strength

Owners, investors and regulators will broaden their expectations from “institutional quality” to “industrial strength”. They will expect alternative firms to operate in a way that goes beyond the prerequisite quality standards to operate even more effectively and offer a broader range of capabilities. Having institutionalised their businesses, alternative firms will seek the higher standard of “industrial strength”.

Firms will revamp their operations in a cost-effective way that is not disruptive to their day-to-day business. This includes embedding more data-informed decision-making to estimate the impact of business mix changes and process improvement on costs and revenues. They will then implement these process improvements, eliminating operating inefficiencies by automating and outsourcing processes. Firms will look to transform labour-intensive functions like compliance, tax and investor servicing into ones that are more technology-enabled, scalable and integrated within the overall operating environment. To do this, larger firms will build in more resource bandwidth with change agents who will drive process improvement while core teams continue to drive day-to-day operations. Firms will also seek to better control operational risk, systematically identifying, prioritising and managing operational risks to target areas of potential vulnerability.

5. The right resources in the right places

By 2020, the shift to data-informed decision-making leads to improved organizational designs that can better deliver the right resources to the right places. Design elements that will be adopted by alternative firms include: centres of excellence to leverage expertise; dedicated teams to focus on underserved

areas; sourcing strategies to reduce costs for high-volume, repeatable processes; and location strategies to bolster a firm's presence in a particular jurisdiction or to reduce cost.

Many alternative firms will also make more effective use of right-sourcing strategies. In some cases, they will shift to using outsource providers or utility-like platforms where key skills or geographic coverage can be provided more cost-effectively, externally. In other cases, alternative firms will continue to use in-house support functions to take advantage of operating leverage benefits. Successful right-sourcing efforts are accompanied by more systematic and efficient internal oversight to bridge the gap between external service providers and internal resources.

6. It's not only about the data

Data and data-centricity are key business imperatives in 2015. By 2020, the focus of leading alternative firms will have largely moved on. They will have laid the necessary "plumbing", and accessing data across their organisations will be as natural as turning on a tap. To do this, they will adopt data standard protocols allowing all parts of the organisation to exchange information, creating a self-service model. These protocols will also speed information exchange with key counterparties and service providers.

The result will be a data-centric, self-service environment in which time is spent on the analysis and reporting of data, rather than on the manipulation of data. The resulting analytics enable alternative firms to better measure the strength of their operational processes and enhance key functional areas such as tax, compliance, reporting and investor servicing. The model will also help plug the current drain on resources in the manual and non-standardized areas of portfolio monitoring, operational due diligence and investor on-boarding.

This article was excerpted from "Alternative Asset Management 2020: Fast Forward to Center Stage." For the complete report, please visit www.pwc.com/alts2020.

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Investment manager performance linked rewards: draft legislation

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The UK Government has released draft legislation to implement the Summer 2015 Budget proposals to restrict the capital gains tax treatment of carried interest and other performance linked rewards received by fund managers.

Following on from the surprise consultation released in July 2015 as part of the Summer Budget, a consultation response document and draft legislation released on 9 December 2015 as part of the draft Finance Bill 2016 confirms that new rules will considerably widen the imposition of income tax on performance linked rewards received by investment managers.

HMRC has been open in confirming the intention that any return received by an investment manager which is calculated by reference to the performance of the underlying investments over a given period, or the life, of the fund should as a starting point be taxed as income, however it is structured. It is no surprise, therefore, that the legislation in the draft Finance Bill clauses makes it clear that the exceptions to income tax treatment will apply very narrowly and only where a fund has a long term investment profile, excluding a significant number of funds, even where they are currently "investing" rather than "trading" for tax purposes.

Investment managers affected by the provisions, which will come into force from 6 April 2016, should carefully consider whether any changes to their structures are advisable as a result of these changes.

Background

Not content with the recent changes to the taxation of salaried members, mixed membership partnerships, disguised investment management fees (DIMF) and carried interest, the Summer Budget saw the release by HMRC of a consultation on the taxation of performance linked rewards.

The consultation arose from concerns on the part of HMRC that investment managers outside the private equity and venture capital spheres were widely using carried interest and other arrangements to derive performance linked rewards as a return from the fund. Provided that the underlying fund vehicle is investing rather than trading for tax purposes, the performance linked interest in these circumstances would give rise to capital receipts charged to capital gains tax rather than income tax, reducing the amount of tax paid. In addition, amounts could be received as lower taxed dividend income, or potentially in untaxed form. A particular concern noted in the consultation was where such arrangements

replaced performance fees that were previously taxed as trading income.

The consultation proposed a specific tax regime for performance linked rewards payable to individuals performing investment management services (using the wide definition in the DIMF rules). The measures would only apply to those individuals, and would not affect the treatment of the fund or its investors, or indeed "genuine" co-investment by the individuals. The default position under such a regime would be that rewards would be charged to tax as income.

However, the consultation contained two proposals that sought to maintain the current capital gains treatment for "private equity carried interest". The first proposal was for a "white list" of activities that would be regarded as long-term investment activities. The second proposal instead focused on the average length of time for which a fund holds investments, with the proportion of the performance linked reward that would be taxed as a capital gain increasing in a series of 25% steps from 0% where the average holding period is less than six months to 100% where the period exceeds two years.

Draft legislation

Draft legislation, together with a consultation response document, has now been released to implement the new tax regime for performance linked rewards as part of the draft Finance Bill 2016, with a commencement date of 6 April 2016. As feared by many in the industry, the draft legislation providing for the exception to the imposition of income tax on performance linked rewards will be tightly defined and difficult to meet.

The draft legislation confirms that the Government will adopt a version of "option 2", providing an exception to the rules based on the length of time underlying investment are held, but in a much more onerous form. The Government has decided that the proposed holding periods set out in the consultation were too short and has considerably extended the holding periods required for the retention of capital gains tax treatment.

Under the new legislation, carried interest or other performance linked rewards received by investment managers that is not already taxed as trading or employment income will be subject to income tax treatment, unless it arises from assets held by a fund with an average holding period for its assets of at least three years. Where the holding period is more than three but less than four years, a sliding scale will determine the proportion of the return subject to income tax. Only if the average holding period is at least four years will capital gains tax treatment apply in full.

For these purposes, the average holding period will be based on the average holding period by the fund of investments held for the purposes of the scheme and by reference to which the carried interest is calculated. In turn, this is calculated on an investment by investment basis using the amount originally invested at the time the investment was made. The calculation is made at the time the carried interest arises. In this way, the legislation uses an average weighted holding period to determine the tax treatment of performance linked rewards such as carried interest.

In general, TCGA principles will be followed to identify whether and when a disposal of investments is made, including the reorganisation rules, but the share pooling rules will be disapplied and a "first in,

first out" (FIFO) basis will be used. This means that each holding will be made up of the most recently acquired instruments, making it very difficult to meet the four year holding period where there is any turnover in shares. Indeed, a large sale even if made for sound investment principles will have a negative effect on the fund's average holding period.

An exception is, however, made for an investment amounting to an increase in a controlling interest in a trading group, where the investment will be treated as made at the time the controlling interest was acquired. The BVCA has already indicated that it will be lobbying for more protection for the venture and growth capital sectors where minority stakes are the norm.

The consultation document does hold out the promise that HMRC will be "willing to discuss other situations where the provisions could be said to misrepresent the average holding period of a particular type of fund and to explore any unintended consequences".

"In particular, the government understands that the investment model used by many venture capital funds may result in the above test producing a shorter average holding period and income tax treatment even where the fund is undertaking long-term investment activity. HMRC is keen to engage with industry representatives so as to ensure the average holding period test accurately reflects the activity undertaken by venture capital funds."

For the purposes of determining the investments against which to measure the holding period, the legislation provides for intermediate holdings or holding structures to be disregarded. The definition of what amounts to an investment for these purposes is wide, but excludes cash awaiting investment or cash disposal proceeds that are to be distributed to investors as soon as reasonably practicable. Derivatives are included, although separate rules determine the value invested in a derivative. "Direct lending funds" are specifically excluded from capital gains tax treatment, unless additional strict conditions are met as to the composition of the fund's loan portfolio.

This method of calculation would, of course, mean that for new funds the first performance linked rewards would prima facie be taxed as income as the holding period will be less than three years. However, the legislation allows conditional capital treatment to be applied from the outset where it is reasonable to suppose that the conditions for the exemption would be met at the relevant later time. This will, at least, allow funds which do have clear long-term investment objectives (such as real estate and some private equity funds) to obtain capital gains tax treatment from the outset.

Finally, the legislation includes the obligatory anti-avoidance provision which provides that any arrangements which have as a main purpose the reduction in the proportion of carried interest which is subject to income tax treatment are to be disregarded.

Comment

The draft legislation makes it clear that very few hedge funds or other funds, except for private equity, real estate or infrastructure funds, will be able to qualify for continued capital gains treatment on carried interest or other performance linked rewards.

Even where funds do have a long term holding strategy sufficient to fall within the exception to the legislation, it will be necessary to consider whether the possible advantages outweigh the costs of a more complex structure, more difficult compliance and the risk that investment decisions will remove the advantage anyway. There is, in addition, the risk that managers may find themselves in a position of conflict, between maximising their investors' returns and seeking capital gains tax treatment.

The draft provisions will now undergo a further period of consultation leading up to Royal Assent of the Finance Act 2016. It is at least welcome that the consultation response document shows that HMRC is open to further discussion on the detailed calculation of the average holding period.

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The Senior Managers Regime: The need for greater accountability throughout financial services

Jérôme de Lavenère Lussan, CEO

Laven Partners

Q4 2015

Senior managers throughout the banking sector can be heard breathing a sigh of relief as the assumption of an individual's accountability will no longer to stem from a presumption of responsibility. The magnitude of this amendment to the proposed Senior Managers Regime silences many alarm-bells that have been attracting much media and industry speculation recently. Whilst the Treasury's announcement may have been welcomed by the banking sector's senior managers, who must abide by the new regime by March 2016, the rest of the financial services industry is jaw dropped. From 2018 the Senior Managers Regime is now proposed to be extended across the entire financial services industry thus ensuring a comprehensive and consistent approach across the business spectrum including hedge fund and private equity managers.

The Senior Managers Regime aims to combat the notorious 'bad behaviour' highlighted throughout the financial crises of 2008. Subsequent financial investigations revealed the lack of specific accountability for material failures. The UK Financial Conduct Authority (FCA) initially attempted to create a shift in behavioural culture through imposing fines unprecedented in size. However, these fines were paid through corporate institutions and little remedial action followed suit to discourage and prevent the offending behaviours being repeated.

The announcement to extend the Senior Managers Regime across the financial services was foreseeable. The Bank of England noted in June 2015 that the rules were likely to be extended to cover asset managers and other financial institutions, however no precise details were alluded to at this point. The Senior Managers Regime will replace the Approved Persons Regime. The Approved Persons Regime is deemed weak and has been under attack in recent years for its acknowledged gaps and failures. It enabled firms to avoid taking appropriate responsibility over assessing the fitness and proprietary of their staff as well as allowing there to be cavities in the enforcement powers available to the regulator.

One of the most prominent instances of the Approved Persons Regime not being satisfactory was demonstrated through the investigation into Paul Flowers, former chairman of the Co-op bank. Here, Mr Flowers was appointed in an Approved Persons' role despite a lack of senior banking experience. A safeguard was raised to counter this experience defect in the form of two deputy chairmen with relevant expertise who acted alongside Mr Flowers. Nevertheless, the appointee led the bank to require a £1.5 billion rescue injection. The inadequacies of Mr Flowers, who had been appointed following a 90-minute interview with the regulator, have been exposed further throughout the media, including for illegal drug use, public indecency as well as confusing the bank's actual assets to be £3 billion rather than the actual figure of £47 billion. The flaws in the Appointed Persons Regime that allowed for such an appointment have been brought to the attention of the regulator and more detrimentally to the public. Consequently the Senior Managers Regime will replace the outdated and ineffective Appointed Persons Regime. This is much desired by the rule-abiding institutions to begin to regain the public's trust in the financial services of the UK.

Senior managers across the entire financial services that held appointed positions previously will be grandfathered by 2018 into their applicable roles within the Senior Managers Regime. Approved persons below senior management level will now be captured under the Certification Regime. Here the identified staff will not hold senior functions as prescribed by the FCA and PRA, but will have responsibilities that are capable of causing significant harm to the business. These persons will no longer be subject to prior approval, but rather their firm will be required to conduct fitness and proprietary assessments and maintain annual reviews to ensure the individual's ongoing suitability for their role. The banking sector (that are subject to both the Senior Management and Certification Regimes earlier than the rest of the industry) have been given until March 2017 to ensure that their existing staff have completed the certification process. The Senior Managers Regime and the Certification Regime methods of providing ongoing supervisory assurance are far more rigorous than the Appointed Persons Regime and will focus on continuing appropriateness.

The Senior Managers Regime has overhauled the accountability of senior members of staff. The regime assigns specific responsibilities to certain senior individuals in key positions throughout the firm's hierarchy. Once identified, an individual's responsibilities are functionally mapped out and documented through a statement of responsibilities. This statement alongside the functionality map will be used to determine accountability if a material failure does arise. It is deemed that these increased specifically identified accountability measures will ensure that greater care and oversight is given prior to any potentially detrimental risk-taking decisions being made. Not only does the Senior Managers Regime bring along the requirement to prescribe specific responsibility functions throughout the firm, but it also introduces greater consequences for failures that subsequently occur on the identified individual's watch. The regulator may impose civil penalties that may affect an individual's future within the financial profession. They may withdraw an individual's approval for holding a specific function or they may determine an outcome that causes the individual to suffer public censure. Further the regulator is empowered to impose criminal sanctions to penalise an individual's misconduct and their reckless mismanagement of a firm.

The introduction of criminal liability is undoubtedly the element of the Senior Managers Regime that has caused the most contention and debate to date. Until recently, a senior manager would have been under the presumption of guilt upon a business failure. This conflicted with the tradition under English law that one is innocent until proven guilty. Many senior managers felt uneasy being burdened with the presumption of responsibility and it was highlighted throughout the industry that many senior individuals would not want to take such roles. This could have prevented high-quality talent from participating in the management of the UK's banks. Consequential solutions were already emerging throughout the industry, work-arounds such as renaming or creating new roles that did not fall within the scope of the Senior Managers Regime were being mooted as alternative methods of gaining senior management type exposure without such individuals attracting the burdensome risks.

Recognising the impracticalities of imposing this presumption upon senior managers, the Treasury have recently removed the reverse burden of proof. Although the regulator has been seen to down-play this amendment to the regime ahead of it coming into effect for banks as of 7 March 2016, the banking sector have not been shy in demonstrating their approval and their great relief. The FCA have noted that the presumption of responsibility element to the regime has received such significant industry focus that 'it risked districting senior management within firms from implementing both the spirit and letter of the regime.'[1] Further, following the extension of the regime across the financial services industry, the reverse burden of proof would have been disproportionate to apply to all firms now captured under the regime, recognising that many small firms have less complex hierarchies than the large institutions that the regimes were initially prescribed to apply to.

Despite this reversal on the burden of proof, senior management will still be under the same stringent obligations to ensure that they have taken all reasonable steps to prevent a breach. Formulating that reasonable steps were taken will be based on multiple considerations including the size, scale and

complexity of the firm, the individual circumstances including what knowledge the individual had or ought to have had, the individual's expertise and competence, what alternative steps could have been taken, as well as the individual's own prescribed responsibilities. In addition the suitability and appropriateness of any relevant delegations that were made will be scrutinised. Determining the above requirements will place heavy reliance on the quality of audit trails that are maintained to demonstrate that the relevant considerations and suitable due diligence took place.

Extending the Senior Managers Regime and the Certification Regime to apply equally to both banking professionals as it does to other financial professionals does have the effect of implementing a level playing field and creating one high standard of expectations for all to adhere to. However, there is much debate over the necessity of the extension of the regimes. Many non-banking professionals have been quick to point out in the wake of the financial crisis that it was large banking institutions that have been responsible for any identified misconduct, and that the other sectors have not demonstrated the propensity to act in a similar way. Conversely, if a high standard of behaviour is instilled across the entire financial industry, then it should make no difference to the institutions that have already been meeting such behaviour standards, if their actions are now required to meet such a prescription or otherwise. Introducing these regimes can be viewed as the initial steps in entrenching a culture of personal responsibility across the industry which in turn should help to rectify the current defect in consumer trust that the entire market continues to face.

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[1] Tracey McDermott, acting CE of the FCA

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Breakout 3: Latest Industry Research

Breakout 3: Latest Industry Research

Jiří Król

Deputy CEO, Global Head of Government Affairs

Representing the interests of the global hedge fund industry

Sound Practice Guides

- Comprehensive body of sound practices guidance for the hedge fund industry
- Since 2015, a number of guides have been published or updated, including:
  - Fund Directors' Guide
  - DDQ for Prime Brokers
  - GSP for Managers' Media Relations
  - GSP for Liquid Alternatives
  - GSP for Cyber Security
  - GSP for Operational Risk Management

GUIDE TO SOUND PRACTICES FOR CYBER SECURITY

Current Sound Practices Projects

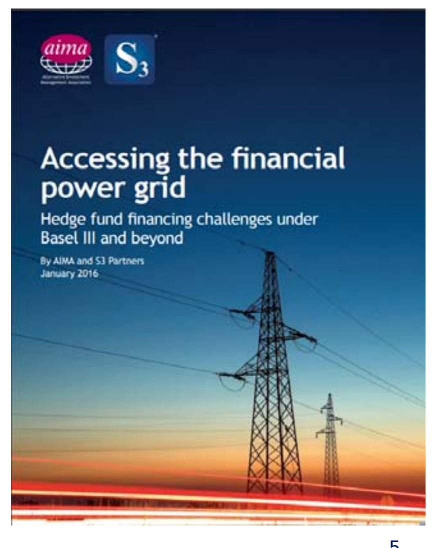
Project	Estimated Publication Date
Directors' DDQ	8 March 2016
Guide to Sound Practices for Investor Relations and Fundraising	15 June 2016
Guide to Sound Practices for Research	2Q 2016
Market ethics guidance	2Q/3Q 2016
Guide to Sound Practices for Selecting an Administrator (and related DDQ)	3Q 2016
Liquidity Risk Management Guide	3Q 2016
Modular DDQ	4Q 2016
Global Data Consistency Project	Ongoing throughout 2016
Guide to Sound Practices for AIFMD Depositaries	TBD

Research pipeline

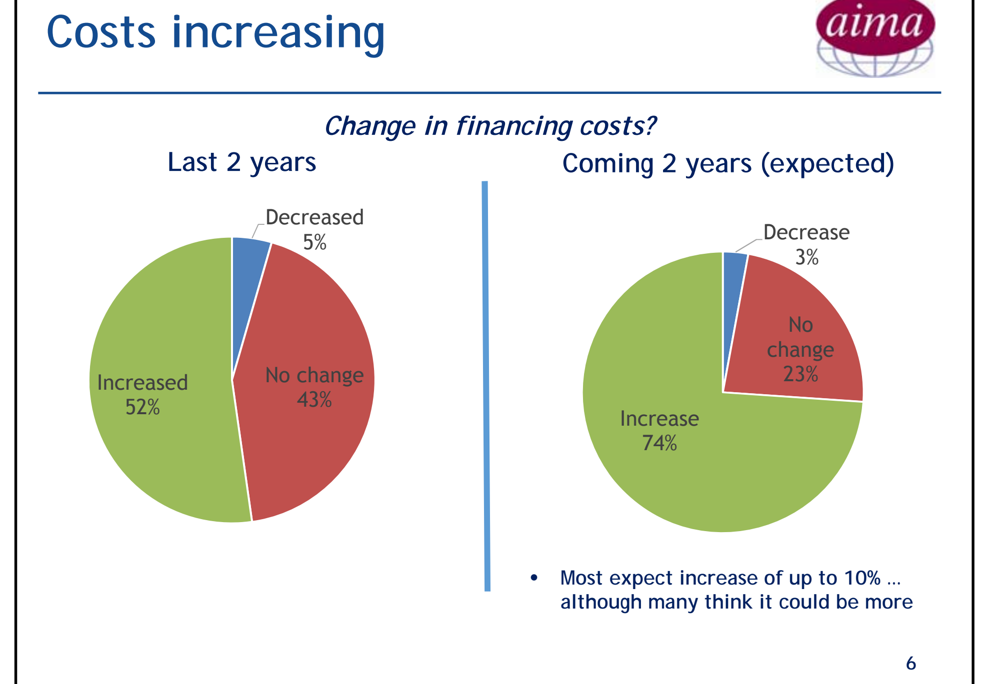
Project	Description/Status	Likely publication date
Policy and industry research		
Market Liquidity	Exploring aspects of market liquidity today, HF and corporate-end users experience of accessing liquidity in financial markets	Q1 - ongoing
Hedge Fund Performance	Analysing hedge fund performance versus other asset classes, mutual funds	Q1 -ongoing
Trustee Education Series	Paper 3 - Leverage. (Dispelling myths around hedge funds and their use of leverage)	Q2 2016
Alignment of Interests Study	This paper examines to what extent managers and investors are working together in meeting each other's expectations for a better alignment of interest and how it is reflected in the fund fee structure	Q2 2016
Private debt research	Follow-up paper to financing the economy, examining the increasing influence of direct lending and private debt finance	July 2016
Exploring the hedge fund DNA	Is there a particular set of characteristics that makes for a successful hedge fund business? We explore this question via a series of interviews of managers across varying size/styles etc.	September 2016

January 2016: Report on Basel III impact

August/September: AIMA/S3 survey of broad cross-section of 78 alternative asset managers, representing a diverse range of AUM size, investment strategies, and geography. The combined AUM of survey respondents exceeded $400bn.



Costs increasing



Relationship changing

2/3+	Asked to decrease free cash balances
1/3	Asked to move a portion of their book to swap
1/3	Asked to change type of collateral posted
5 - 15%	Some combination of terminate relationship, reduce leverage, focus on easier to finance securities and/or increase portfolio turnover

Trustee education series

Joint initiative between AIMA and CAIA to help trustees and other fiduciaries better understand and manage the risks and opportunities associated with hedge fund investing

Paper One - key takeaways:

- Provides overview of hedge fund investor universe
- Shows return and volatility comparisons between hedge fund returns and traditional asset classes
- Practical guidance about how existing investors have managed issues and challenges associated with their hedge fund investments

Trustee education series

Paper Two "Portfolio Transformers" was published in November 2015, and examines the role of hedge funds as substitutes and diversifiers in an investment portfolio

Key takeaways:

- The breadth of the hedge fund universe allows the investor to evaluate and classify hedge funds according to a series of risk factors and use different strategies in portfolio construction
- Institutional investors are moving away from the traditional portfolio of investing in bonds and equities and are increasingly using hedge funds as volatility dampeners
- Investors who believe that public markets will exhibit increasing uncertainty and volatility should consider increasing their allocations to unconstrained strategies

Contact

Alternative Investment Management Association

Tel: +44 (0)20 7822 8380

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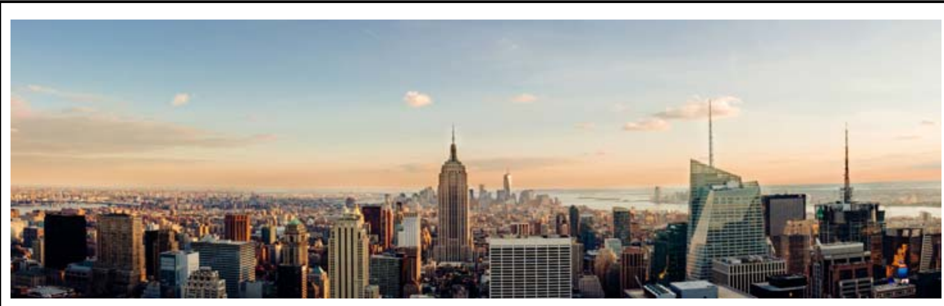
Representing the interests of the global hedge fund industry

Thank you!

Please join us for a Networking drinks reception

MAPLES

K&L GATES



AIMA US Briefing and Regulatory Update

Thursday, March 3rd 2016

MAPLES

K&L GATES

Representing the interests of the global hedge fund industry

Speaker Biographies

Speakers (Alphabetical Order)

Christina Bodden

Maples and Calder

Partner

Ms. Bodden is a partner in the Investment Funds group, specialising in the structuring of private equity funds and advising on the related downstream transactions. She also works extensively with major institutions and hedge fund managers and their onshore counsel, advising on the structuring and ongoing operation of all aspects of investment funds. Additionally, Christina has a particular expertise in hedge fund sideletter arrangements and fund restructurings. Christina joined the Investment Funds group of Maples and Calder in 2004 and was elected as a partner in 2012. Christina has been recognised as a leading lawyer by Legal 500. Christina is a co-founder of the Cayman Islands branch of 100 Women in Hedge Funds and serves both on their main local committee and their philanthropic sub-committee. She also sits on the 100 Women in Hedge Funds Advisory Council.

Christina is also a regional co-director of the Cayman Islands chapter of the Hedge Fund Association (HFA).

Ramona Bowry

Senior Vice President - Operational Due Diligence

Maples FS

Ms. Bowry is head of Maples Fiduciary's in-house operational due diligence ("ODD") service offering. Her primary focus is the performance of on-site ODD reviews of investment managers on whose funds Maples Fiduciary professionals serve as directors.

She is responsible for managing the ODD process across Maples Fiduciary's global teams, with the primary purpose to mitigate risk for Maples Fiduciary directors by critically assessing investment managers control environments. Prior to joining MaplesFS in 2012, Ramona was a founding partner, director and company secretary of A.R.C. Directors Ltd., a Cayman domiciled professional services firm specialising in the provision of non-executive directors to the alternative investment industry. During her tenure from 2005 to 2012, Ramona provided independent director services and was actively involved in the review and approval of the transactional documents used to govern trust and investment fund structures. Prior to that, Ramona was based in London where she was Director of Business Development at DPM Europe Ltd., an independent offshore hedge fund administrator now part of Bank of New York Mellon. Here she was responsible for promoting the firm's administration, risk and transparency services to the European hedge fund industry. Ramona began her career as a risk analyst for Bright Capital, a fund of hedge funds and subsidiary of Old Mutual plc, during which time she acquired a sophisticated knowledge and experience of hedge fund risk management techniques including the application of quantitative analysis and risk management software solutions. Ramona is a SFA Securities & Financial Derivatives representative. She holds a Bachelor of Science in Economics and

History from University College London.

Christine C. Chang

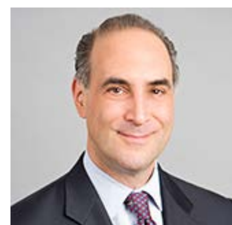
Fund Solutions Advisors

Chief Operating Officer, Chief Compliance Officer

Ms. Chang is a Chief Operating Officer and Chief Compliance Officer with 20 years of experience in the institutional and family office asset management space in both traditional and alternative investments. She has led senior management teams and built operational and regulatory infrastructure, in addition to strategic marketing and personally developing high net worth client relationships. Christine serves hedge funds, private equity funds, institutions building their investment advisory business, and family offices structuring investments.

Previously, Christine served as Chief Compliance Officer at Alternative Investment Management, an independent, privately-held investment management firm focused on hedge funds and private equity. She developed the firm's compliance program, registered the firm with the SEC, and managed audits including SEC presence exams. Prior to this, Christine was the Chief Operating Officer of New York Private Bank & Trust, the wealth management division of Emigrant Bank, where she built the infrastructure to support ultra-high net worth clients. She was Business Manager at MPI Professionals, LLC, a subsidiary of CGI Group, Inc. and consultant to financial services firms. Christine served at Credit Suisse in New York and London as: European Product Manager of Fixed Income Emerging Markets; Financial Analyst for the Global Head of Fixed Income; and Compensation Analyst in Human Resources. Christine began her career at Charles River Consultants, Inc. as a Project Manager in financial services technology consulting.

Christine serves as Chair of the board of Bottomless Closet. She is a member of High Water Women and the Trust and Estates Committee of SUNY College of Optometry's foundation. Christine is a mentor in Cornell's Alumni-Student Mentoring Program and a member of the Cornell Alumni Admissions Ambassador Network. She earned her B.A. from Cornell University



Edward Dartley

K&L Gates LLP

Partner

Mr. Dartley is a partner in the firm's New York office where he is a member of the Investment Management, Hedge Funds and Alternative Investments practice group. Mr. Dartley concentrates his practice on all facets of the asset management industry, with particular focuses on the alternative investment asset classes, private equity, and venture capital funds, and managed accounts, as well as regulatory, compliance and operational matters, compliance audits, and internal governance. He advises numerous emerging and middle market private equity clients on a wide range of issues facing that industry today. He also has extensive experience

advising clients in the direct marketplace (peer to-peer) industry.

Mr. Dartley also focuses his practice on advising energy-focused alternative asset managers and companies on a wide variety of matters, and has worked with industry players in both the traditional and alternative energy industries.

With over a decade of experience as in-house counsel and chief compliance officer with an asset management group of registered investment advisers and private equity fund managers, Mr. Dartley has deep in-house experience and a unique perspective on how asset management works from the inside. Mr. Dartley continues to utilize this experience by serving as general counsel to a number of clients of the firm.

Mr. Dartley also is a founding member of the Bloomberg Alternative Marketing Council, an advisory board founded by Bloomberg to define best practices in marketing for the alternatives industry. Prior to joining the firm, Mr. Dartley was a partner in the New York office of a national law firm. Prior to that, he was counsel and chief compliance officer with a registered investment advisor with several billion dollars under management.

Jennfer A. Duggins

Securities and Exchange Commission

Co-Head, Private Funds Unit, Office of Compliance Inspections and Examinations

Ms. Duggins, IACCP® is a Senior Specialized Examiner and Co-Head of the Private Funds Unit within the SEC's Office of Compliance Inspections and Examinations. Prior to joining the SEC, Jennifer was a Director in Regulatory Risk Consulting within the Advisory Practice of KPMG. Prior to joining KPMG, Jennifer was Senior Vice President and Chief Compliance Officer of Chilton Investment Company. Prior to Chilton, Jennifer was Vice President, Legal and Compliance at Andor Capital Management. Jennifer has served as a Faculty Member and Director of the Board of the National Society of Compliance Professionals (NSCP) and served as a CCO Roundtable Steering Committee Member with the Managed Funds Association during 2009 and 2010. Jennifer has a B.A. in History from New York University and is a May 2016 candidate for a M.S. in Human Resource Management from Sacred Heart University. Jennifer is also an Investment Adviser Certified Compliance Professional, IACCP®

Peter Huber

Maples Fiduciary

Global Head of Maples Fiduciary

Mr. Huber is Global Head of Maples Fiduciary, a division of MaplesFS, and works on a wide range of investment fund products, including multi-manager funds, hedge funds, private equity funds, unit trust structures and segregated portfolio companies. Prior to joining Maples Fiduciary, Peter was a director and Chief Investment Officer of Close Brothers, a British merchant bank located in the Cayman Islands, starting there in 2002. Prior to that, Peter was a director of a private client wealth management firm located in Canada which he co-founded in 1999. Peter began his career in

1990 with Ernst & Young in Canada and in the Cayman Islands. Peter is a Chartered Financial Analyst charter holder and a member of the Canadian Institute of Chartered Accountants. Peter graduated with a Master of Business Administration in Finance and Accounting from the University of Toronto in 1991 and received his undergraduate degree from Queen's University in Kingston, Canada in 1989. He has also completed the Canadian Securities Course, the Conducts and Practices Course and the Directors and Officers Course offered by the Canadian Securities Institute. He is a founding member of the Cayman Islands Directors Association ("CIDA") and a past elected member of the CIDA Executive Committee.

Irshad Karim
Lion Point Capital
Counsel and Compliance Officer

Mr. Karim is Counsel and Chief Compliance Officer at Lion Point Capital where he is responsible for all legal and compliance matters. Previously, Irshad served as General Counsel and Chief Compliance Officer for several private investment adviser firms, as well as a Managing Director at BlackRock where he had legal and compliance responsibilities for alternative investments. Irshad regularly speaks on legal and compliance matters relating to the hedge fund industry. Irshad holds a BA (summa cum laude) from New York University and a JD (cum laude) from Harvard Law School, where he was an Editor of the Harvard Law Review.

Bruce Karpati
KKR
Managing Director, Global Chief Compliance Officer

Mr. Karpati joined KKR in 2014 as the Firm's Global Chief Compliance Officer and Counsel. Prior to joining KKR, Mr. Karpati was the Chief Compliance Officer of Prudential Investments, the mutual fund and distribution business of Prudential Financial. Mr. Karpati was previously the National Chief of the SEC's Asset Management Unit, supervising a staff of 75 attorneys, industry experts, and other professionals. He joined the SEC as a staff attorney in 2000, was promoted to Branch Chief in 2002, Assistant Regional Director in 2005, and to Co-Chief of the SEC's Asset Management Unit in 2010. In 2007, he founded the SEC's Hedge Fund Working Group, a cross-office initiative to combat securities fraud in the hedge fund industry. Mr. Karpati earned his JD from the University at Buffalo Law School, and his Bachelor's degree in International Relations from Tufts University.

David Keily
Visium
General Counsel

Mr. Keily joined Visium Asset Management, LP as CCO in June 2011 and as General Counsel in August 2011. He was previously COO and before that Head of Marketing and Investor Relations at Catalyst Investment Management Co., LLC, where he worked from 2005 to 2011. From 2001 to 2005 David served as SVP, Marketing & Investor Relations at KBC Alternative Investment Management. Prior to that he worked at Wasserstein, Perella & Co. and at D.E. Shaw & Co. A native of the Southwest, his legal career began as an associate at Sacks Tierney P.A. in Phoenix. He has a J.D. from

Stanford University as well as a Ph.D and an A.B. in Slavic Languages and Literatures from Harvard University and Harvard College, respectively.

Jiri Krol
AIMA
Deputy CEO and Global Head of Government Affairs

Jiri Krol joined AIMA in April 2010, was appointed Director of Government and Regulatory Affairs in April 2011 and in May 2013 became Deputy CEO. Prior to joining AIMA, he worked at the European Commission, where he was responsible for the coordination of the Commission's policy towards the Financial Stability Board and the G20.

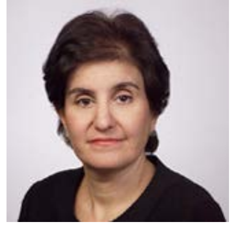
Jiri started his career at the Czech securities market regulator. He then moved to the European Commission's Internal Market Directorate-General, where he was responsible for the drafting and negotiation of the Markets in Financial Instruments Directive (MiFID) implementing measures. While at the Commission, he also worked on the Non-Equity Market Transparency and the Commodity Derivatives reviews.

Previously, Jiri was appointed Financial Markets Policy Director in the Czech Ministry of Finance in 2007. In 2009, he led the Czech European Union Presidency's work in the area of financial services, which involved finalising the Capital Requirements Directive (CRD II) and the Solvency II Directive as well as the Credit Rating Agencies regulation negotiations.

He studied international relations, economics and politics at Tufts University, London School of Economics and Sciences Po.

Matthew Lombardi
Tinicum Incorporated
Counsel and Compliance Officer

Mr. Lombardi joined Tinicum Incorporated, a private equity firm, in 2014 as the Firm's Chief Compliance Officer. Prior to joining Tinicum, Mr. Lombardi worked at UBS Investment Bank where he specialized in Finra and U.S. Securities & Exchange Commission regulatory examinations and worked on special projects. Mr. Lombardi was previously the Chief Compliance Officer at Newgate Capital Management LLC, a registered investment advisor. He earned his law degrees from Saint John's University School of Law and the University of Leeds, England School of Law and his Bachelor's degree in Business and Political Science from New York University.



Cary J. Meer
K&L Gates LLP
Partner

Ms. Meer is a partner in K&L Gates' New York City and Washington, D.C. offices and a member of the Investment Management and Hedge Fund practice groups.

Ms. Meer structures private funds as limited liability companies, limited partnerships, offshore corporations, common trust funds and business trusts, and prepares disclosure documents and organizational documents for such entities. She also advises

investment advisers, private fund managers and investment companies on compliance issues, including under the Investment Advisers Act of 1940 and whether their commodity interest-related trading or advice would require them to register as commodity pool operators or commodity trading advisors.

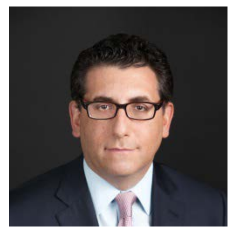
Amy Poster
Institutional Investor
Contributing Writer

Ms. Poster is a risk and regulatory subject matter expert and currently contributing writer to Institutional Investor magazine. Her practice focuses on enterprise risk management and risk culture, implementation of risk management programs, assessments for risk technology solutions, performance reporting analytics for broker/dealers and hedge funds, internal audit and controls.

Amy completed a term assignment as a Senior Policy Advisor at the US Department of Treasury, Office of the Special Inspector General- TARP, (SIGTARP), overseeing financial markets and domestic policy. She led critical audits on TARP recipients and Federal inter-agency investigations.

Prior to her role at SIGTARP, Amy was Director in Product Control at Credit Suisse, focusing on risk and valuation for global credit products within the Fixed Income Division. In addition, Amy led the set up and post-launch risk management of several credit and distressed funds within Credit Suisse' Alternative Capital Division. Earlier in her career, she designed and implemented risk and valuation programs at Donaldson, Lufkin, and Jenrette and Bear Stearns. She started as a business analyst at Lehman Brothers.

Amy is regularly published in Institutional Investor, Alpha, Money Management Intelligence, and the Global Association of Risk Professionals (GARP) Risk Professional magazines. She holds an MBA in Financial Management with Distinction from Pace University.



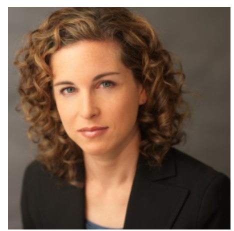
Gil Raviv
Millennium Management, LLC
Senior Managing Director, General Counsel

Mr. Raviv is a Senior Managing Director and the General Counsel of the General Partner and is responsible for overseeing the day-to-day legal affairs of Millennium. Mr. Raviv began his legal career at Fried, Frank, Harris, Shriver & Jacobson LLP in 1996 and became a partner in 2004. At Fried Frank, Mr. Raviv specialized in corporate and securities law, focusing primarily on the structuring and offering of hedge funds, funds of funds, private equity funds and a variety of other alternative investment products. Mr. Raviv received his JD from the University of Michigan Law School and his AB, magna cum laude, from Cornell University.

Nicole Restivo
Key Square Capital
General Counsel

Ms. Restivo joined Key Square Group LP (“Key Square”) as the General Counsel and Chief Compliance Officer in January 2016. Prior to joining Key Square, Nicole served as a Managing Director and the General Counsel for Fortress Investment Group LLC’s

Liquid Markets business from June 2010 to January 2016, overseeing legal matters for its global macro, event driven, commodities, and convexity strategies. From October 2006 to May 2010, Nicole served as Senior Counsel and Vice President for Ivy Asset Management LLC, a wholly owned subsidiary of The Bank of the New York, where she provided representation for the fund of funds and CDO platforms. Nicole began her career in 2002 at Skadden, Arps, Slate, Meagher & Flom LLP as a corporate associate focusing on investment management and structured finance. Nicole received her J.D. from Vanderbilt University Law School in 2002.



Melanie Rijkenberg

PAAMCO

Associate Director

Ms. Rijkenberg, CFA, CQF is an Associate Director working in Portfolio Management. She is currently focused on European capital markets and manager research and is responsible for certain institutional client relationships. She is a member of the firm's Strategy Allocation Committee, a group of research specialists developing global investment views. She joined PAAMCO's Irvine office in 2010 and moved to Europe to join the firm's London office in the spring of 2012. Prior to joining PAAMCO, Melanie was an Analyst in the Pension Advisory Group at Integrated Finance Limited, a New York based boutique investment bank, where she focused on the development of a proprietary pension product. From 2001 to 2003 Melanie competed on the US National Field Hockey Team. Melanie received her MBA from Columbia Business School, her Master of Science in Political Science from the University of Amsterdam and her BA in Psychology from Princeton University.

Kher Sheng Lee

AIMA

Deputy Global Head of Government Affairs and Head of APAC Government Affairs

Mr. Sheng joined AIMA in October 2015. Before AIMA, Kher Sheng was General Counsel with Azentus Capital Management where he was a founding member of the firm and sole counsel responsible for all legal, compliance, and regulatory matters.

He was the first Chair of AIMA's Sound Practices Committee and an inaugural member of the Asset Management Standing Committee. He was also Co-Chair of the Hong Kong Regulatory Committee and a member of various AIMA working groups in Hong Kong and globally. Kher Sheng is the founder and chair of the peer-to-peer buyside networking group The Asian Hedge Fund Legal and Regulatory Group a/k/a AsianHedgeLaw. He is commended by the Financial Times in the FT Asia-Pacific Innovative Lawyers 2015 (only in-house counsel flying solo to be recognised and win a place in the rankings) where the FT noted he "has played an important role developing asset management standards in Hong Kong". He is named to the Corporate Counsel 100: Asia Pacific 2014 by the global legal rankings publication Legal 500 which identifies "an array of the most influential and innovative in-house lawyers in Asia".

He received his LL.B (Hons) degree from the National University of Singapore law school, and is admitted to practise law in Singapore

(Advocate & Solicitor), Hong Kong (Solicitor) and England & Wales (Solicitor). He is also a Solicitor-Advocate with full rights of audience in all criminal and civil proceedings in the higher courts of England & Wales. Kher Sheng has lived and worked in Singapore, London and Hong Kong. He is a CFA and CAIA charterholder.

Henry Smith

Maples and Calder

Partner

Mr. Smith is a partner at Maples and Calder in the Cayman Islands, having previously served as the Global Managing Partner for six years. He has extensive experience in all aspects of offshore finance transactions, focusing on private equity funds, hedge funds and structured finance transactions. Henry joined Maples and Calder in 1994 and was elected as a partner in 1999. He previously worked for a major international law firm in London, New York and Tokyo. Henry has been named as a leading banking and private funds lawyer by Who's Who Legal and Legal 500. He has been ranked as an Eminent Practitioner by Chambers Global. Henry is a Director and Global Council Member of the Alternative Investment Management Association (AIMA) and a board director of Cayman Finance.