

# *From black box to open book*

## Hedge fund trust and transparency

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



# *Contents*

Executive summary	2
Introduction	4
The fund	8
The manager	14
The administrator	20
The prime broker	22
Conclusion	26
Contacts	28

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

# *Executive summary*



- As the world's leading pension funds, sovereign wealth funds and other institutional investors raise their investments in hedge funds, Asia's better managed and more transparent funds stand to benefit disproportionately within the region. Institutional investors tend to invest mainly with managers that have institutionalised corporate governance, infrastructure, operational controls and transparency.
- But potential for higher returns means that some investors may be willing to accept the greater operational risk implicit for those funds that have a less robust control environment. From a cultural perspective, Asian investors are more willing to trust managers. By contrast, Western institutional investors increasingly want independent verification of information provided by managers to assess its validity and accuracy.
- As a result, we believe a small number of larger funds will emerge that raise assets predominantly from institutional investors. When deciding whether to target institutional investors, hedge fund managers need to decide whether they are prepared to build institutionalised governance and infrastructure, and how much transparency they want to offer.
- Administrators, prime brokers and other service providers have an important role to play in helping managers to fulfil investors' requirements for trust and transparency. Administrators are being asked to provide increasing levels of information about the critical independent functions they perform for funds. Prime brokers are under pressure to protect investors' assets. How well they meet these expectations will affect their competitive position.
- Institutional investors will reward Asian hedge fund managers that are able to generate strong performance and offer institutionalised governance, controls and transparency with strong inflows. Other managers will continue to be able to raise capital from other sources. Some will opt to run smaller, leaner, more private businesses, while others may choose to invest in infrastructure and target institutional investors as they grow in size and can afford to over time.

## Trust and transparency defined

*Trust is defined as to have faith or confidence; to place reliance on; to confide.<sup>1</sup>*

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

*Transparency into these areas provides confidence that trust is warranted.*

<sup>1</sup> The Compact Oxford English Dictionary, Second Edition

# *Introduction*

*Asia's better managed and more transparent funds stand to benefit disproportionately within the region.*



Asia's hedge fund managers are facing a dilemma. Operating from the world's fastest-growing economies, with a broadening array of financial tools available to them, they have a strong investment story to tell. Yet in order to become billion-dollar managers, they need to raise assets from international institutional investors, many of them from the US and Europe, who expect the high standards of 'trust and transparency' typically associated with the largest international asset managers.

In recent years, and especially since the credit crisis, large institutional investors such as pension funds, insurance companies, sovereign wealth funds and endowments have become the biggest hedge fund investors. These institutions are increasingly adopting a 'trust, but verify' mentality. In other words, they will trust with their capital, but they will verify the claims made by hedge fund managers in marketing presentations and regular communications.

Institutional investors are requesting higher standards of governance and controls worldwide. Demonstrating the move towards uniform practices, the Hedge Fund Standards Board (HFSB) announced a drive in February 2012 to extend its support in Asia and North America. Backed by more than 50 of the leading international investors in hedge funds, the HFSB aims to create a framework of transparency, integrity and good governance.

*Our research shows that some Asian hedge fund managers are rising to the challenge. They are building fund governance and firm infrastructure that match up to the most exacting international institutional requirements.*

Our research shows that some Asian hedge fund managers are rising to the challenge. They are building fund governance and firm infrastructure that match up to the most exacting international institutional requirements. They and their service providers are backing this with the transparency that allows investors to verify performance, asset information and operational controls. As a result, the region's hedge fund sector is polarising, and a small number of managers command a disproportionate amount of assets.<sup>2</sup>

Yet Asia is different from other parts of the world. Precisely because the market is relatively young, and investment prospects relatively attractive, some investors are likely to accept higher levels of operational risk than they would elsewhere in the world. Asian high-net-worth investors are growing in number and are willing to accept operational risk; equally some institutions recognise that smaller managers have

to control costs. Even so, in the past few years the new managers that have built sophisticated infrastructure have tended to reach US\$1 billion in size more quickly than others.

### *Background to research*

Perceiving a gap between the expectations of the world's large institutional investors and the reality in Asia's young hedge fund sector, we set out in late 2011 to interview organisations from across the region's value chain,<sup>3</sup> to discover to what degree these factors are influencing the fortunes of managers. We then polled delegates at our PwC Asia Pacific Alternative Investments Conference in Hong Kong and Singapore in November 2011. What we found was a wide divergence in 'trust and transparency' standards between different hedge fund managers.

<sup>2</sup> Asia's 10 largest hedge funds manage about 30% of US\$144.65bn hedge fund assets at end June 2011, AsiaHedge

<sup>3</sup> PwC interviewed approximately 20 organisations, including Asian hedge fund managers, investors (fund of funds, pension funds and endowments), administrators, prime brokers, consultants, industry associations and regulators

A small group of managers has successfully combined strong performance with institutionalised infrastructures, governance and transparency. These managers have realised the importance of meeting the governance and transparency demands of the pension funds, endowments, sovereign wealth funds and others that increasingly are the sector's dominant investors.

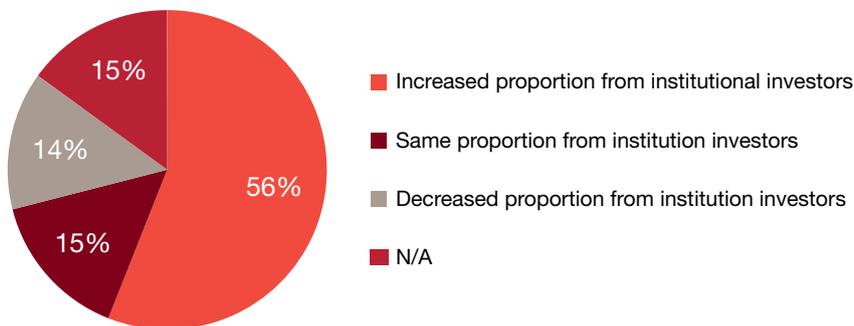
One respondent observed that the fund of funds investor base is shrinking, and as a result they are trying to target long-term money. It is the larger managers in Asia who now seem to be attracting the bulk of the money that US and European institutional investors are allocating to Asia, with institutional money seeking managers with proper infrastructure and the appropriate resources to support their business.

Not everyone thinks that institutions' preference for hedge fund managers with strong governance infrastructure will be rewarded by good investment performance. Ed Rogers, Founder of Tokyo-based Rogers Investment Advisors, an Asia-focused fund of funds advisor, for example, is sceptical about whether all institutional investors use the extra information they have received wisely. Rogers believes that smaller hedge funds are most likely to perform well as they are more nimble and don't have the distraction of producing such reports. Even so, he recognises that if Asian managers want to grow beyond a certain size they have to court the larger international institutional investors. Says Rogers, "If you want to be a US\$20 billion manager you have to raise money from US investors."

## Changing investor base

Asian hedge funds are increasingly reliant on institutional investment, just as hedge funds in other regions are. According to Deutsche Bank's Alternative Investment Survey 2012, institutions account for well over half of investors in Asian alternatives funds by number. What's more, the 2011 Preqin Global Investor Report: Hedge Funds confirms that institutional investors have been increasing their allocations to hedge funds globally in the past five years.

## Changes in source of hedge fund capital over five years



Source: 2011 Preqin Global Investor Report: Hedge Funds

While Asian institutional investors – such as superannuation funds and sovereign wealth funds – are growing in size, European and US investors still account for over half of total allocations to hedge funds in Hong Kong, the largest Asian hedge fund centre. According to the Hong Kong Securities and Futures Commission's (SFC) March 2011 hedge fund survey,<sup>4</sup> US investors made up 36.1% of allocations and European investors represented 24.3%.

The West's pension funds are upping their allocations to Asian alternative investments, and there is no sign of this abating. They are diversifying from their home markets, where return expectations are lower, and seeking investments that offer exposure to the prospect of Asia's superior economic growth.

<sup>4</sup> Report of the Survey on Hedge Fund Activities of SFC-licensed Managers/Advisors, March 2012

## ***Looking to the future***

Going forward, this means Asian hedge fund managers need to identify and target specific investor bases. If they wish to raise institutional money, they will need to make the necessary investments in infrastructure and controls, while also providing sound fund governance. They will need to demonstrate the measures they have put in place through greater transparency.

Data from our PwC Asia Pacific Alternative Investments Conference in November 2011 showed that smaller managers without the scale to build ‘institutional’ type infrastructure realise this and are seeking capital from Asia’s new wealthy. Some 44% of delegates viewed high-net-worth individuals and family offices as their most important investor bases. A further 38% saw institutional investors (including sovereign wealth funds) as their primary investors, and 18% were looking to fund of funds.

As Asia’s fast-developing economies create a burgeoning class of potential high-net-worth investors, so regional managers might choose to avoid building ‘institutional’-type infrastructure. But managers that don’t have institutionalised infrastructure are subjecting themselves to various operational and compliance risks.

“Asia’s hedge fund industry is the youngest regionally but also potentially the one that holds the greatest growth opportunity for managers,” asserts Mike Greenstein, Global Alternative Investments Leader at PwC. “Seizing that opportunity requires understanding and meeting the requirements of regulators and the demands of leading international institutional investors for transparency and strong infrastructure.”

# *The fund*

*Institutional investors are seeking confidence that Asian funds will be run in their best interests, without unwelcome surprises such as unplanned 'gating'. Asian managers targeting these institutions for fund raising are finding ways to reassure them, implementing effective, practical solutions that give investors greater certainty.*

## Fund boards

Hedge fund governance is a hot topic not only in Asia but also across the world. Following the collapse of Weaving Capital and the Cayman Grand Court's verdict that its independent directors aided fraud, investors have questioned the effectiveness of many boards of directors. The HFSB, whose members include some of the largest managers and investors, has attempted to define best practice, stating that a fund governing body should comprise a majority of independent directors, who possess suitable experience and qualifications to hold the manager to account for its performance and conduct.

In common with hedge funds elsewhere in the world, Asian funds are enhancing governance, although significant variations remain. Our interviews showed that some of Asia's largest hedge funds have developed highly effective boards, populated by experienced directors who make valuable contributions to the fund's management and administration, especially in areas of potential conflict of interest. These boards have regular meetings where independent directors, who have the experience and time to diligently fulfil their roles, debate investors' interests.

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The survey of delegates at the PwC Asia Pacific Alternative Investments Conference confirmed this trend. Some 13% of respondents surveyed had increased the number of independent board directors, and 27% had upgraded the board agenda, for example by holding more meetings.

Yet while the funds that successfully raise assets from pension funds and other institutions often have boards that represent best practice, in other cases boards meet irregularly and are dominated by the fund manager. If managers want to be taken seriously by institutional investors their funds need to have strong, independent boards, with regular and relevant meetings, and engaged competent directors.

Senrigan Capital, a Hong Kong-based event-driven manager, has grown its asset base quickly through a focus on strong governance. They have concentrated on crafting an independent board with strong oversight of the fund, and recently increased the number of directors from three to five, in line with investors' wishes. All but one of the directors are independent and board meetings have a definite form. There is a clear agenda, all minutes from previous meetings are confirmed and a letter from the fund's administrator confirms that the manager is doing everything required under the administration agreement. Investors are able to see these minutes on request while on site in Senrigan's office.

*A part of the board's role is assessing the valuation policy – a key tool to help safeguard against conflicts of interest, particularly in funds with hard-to-value assets.*

Another interviewee that focuses on the strength of the board is Kaiser Trading Group, the Australian commodity trading advisor. Kaiser has created a five-man board with a number of independent directors bringing together relevant investing and corporate governance skills. None of the directors have more than 20 directorships, and several of them are independent. The board discusses a wide variety of matters, ranging from investment performance to regulatory developments.

A part of the board's role is assessing the valuation policy – a key tool to help safeguard against conflicts of interest, particularly in funds with hard-to-value assets. In the case of Senrigan, the fund's directors sign off the valuation policy, which the administrator then implements. As valuation of hard-to-value assets is a sensitive area, and open to interpretation, independent directors have an important part to play in settling differences of opinion between the manager and the administrator.

“While the managers we interviewed for this report had differing opinions about the usefulness of fund boards, we believe that boards have an important role to play in overseeing fund governance,” explains Carlyon Knight-Evans, Financial Services Asset Management Partner at PwC Hong Kong. “In our view, a large fund that can afford the expense of a strong board should have frequent meetings throughout the year and well-qualified directors. The majority of them should be independent of the fund's management company, and they should take an active role in the governance of the fund and have sufficient time to devote to their roles.”

## *Portfolio transparency*

Since the financial crisis, institutional investors have requested and been granted more transparency. Interviewees agreed that both transparency of portfolios and the timeliness of reporting had increased significantly in the period since the credit crisis. Some 79% of respondents at the PwC Asia Pacific Alternative Investments Conference said they had enhanced transparency in the past three years, and a further 5% said they planned to do so in future.

While the trend towards greater transparency is welcome, we believe that supplying the right information to allow investors to carry out pricing verification and portfolio analysis is more valuable than merely providing large quantities of data. Many of our respondents questioned the usefulness of full position-level transparency. Additionally, a number of them commented that it is far harder to get proper insight into the valuations of hard-to-value assets, and yet this matters far more.

“Our feeling is that the long-short strategies will not keep you awake at night,” explains Richard Johnston, Head of Albourne Asia. “Full transparency into long-short is less useful than basic information into credit strategies. If we can just have simple data – the level 3 assets – this is more helpful than full position disclosure.”

For some investors the desire for greater fund transparency extends to supporting documentation. Japanese investors are well known for their exacting transparency standards. MCP Asset Management, a Hong Kong-based fund of hedge funds manager with Japanese institutional clients, has recently started to give extensive access to the underlying funds’ key documentation. Tetsuya Tanaka, CFO of MCP Asset Management, says: “We used to share weekly performance data of underlying funds with clients. Now we try to share the underlying funds’ key documentation as well, including audited financial

statements, offering memorandum and monthly statements from our managers.” MCP has built a web-based interface allowing investors to view this information online.

We welcome the trend towards greater transparency, but believe the type of transparency should be tailored to specific strategies and situations, rather than applied in a ‘one-size-fits-all’ manner. Supplying the information that is most useful for verifying a fund’s performance, objectives and assets is far more useful than huge volumes of data that might fulfil no practical purpose.

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*Generally speaking, there is now a far closer link between a fund's redemption terms, the underlying strategy's liquidity and the investment holding period.*

### *Liquidity*

Just as is the case elsewhere in the world, in the period since the credit crisis, institutional investors in Asian hedge funds have tended to focus on whether funds offer appropriate redemption terms.

Investors in Asian hedge funds have tended to encourage managers to match the fund's redemption terms more precisely to the liquidity of underlying investments. "If a manager offers quarterly redemption yet they can liquidate in a day, we negotiate with them to shorten the redemption terms. If they do not do so and cannot give us an explanation it is very unlikely that we would invest," says MCP Asset Management's Tetsuya Tanaka.

Our respondents had mixed views about the trend towards employing managed accounts and UCITS funds to improve fund liquidity. Some said that managed accounts are not as in vogue as they had been immediately after the credit crisis, and others remarked that UCITS funds extra liquidity came at the price of performance.

"If you look at the performance of UCITS III hedge funds versus offshore funds, there can be a big difference," explains Gunther Jost, Head of Sales and Marketing at SAIL Advisors Limited, one of Asia's largest fund of hedge funds. "Our goal is to find the best hedge funds around the world. For most strategies, we do not find these hedge funds in the UCITS space as there is a trade-off between attractive performance and operating within the UCITS III framework."

Generally speaking, there is now a far closer link between a fund's redemption terms, the underlying strategy's liquidity and the investment holding period. We believe that managers should explain this link clearly to investors, giving insights into why particular redemption terms are appropriate for a specific investment strategy.





## *The manager*

*When evaluating hedge fund managers, institutional investors judge them not only by their investment skills, but also increasingly by the quality of their organisations. For some European and US institutional investors investing in Asia, strong hedge fund manager organisations have become a precondition to investment.*

## People

Portfolio managers' superior investment skills have always been the key selling point for hedge fund managers. Nevertheless, institutional investors are now extending their scrutiny to senior individuals in the middle and back offices as well, viewing these people as key to having effective controls.

High-quality people are a hallmark of the Asian hedge fund managers that are successfully raising assets from institutional investors. In particular, the roles of Chief Operating Officer and Chief Financial Officer are important. One of the Chief Operating Officers that we spoke to observed that for anyone launching today, the CFO/COO role has become an absolute necessity, whereas this was not necessarily the case five or six years ago.

Many of those Asian managers specifically targeting institutional investors have hired senior executives with strong credentials over the past few years. These managers rightly see the quality of their people as a way of differentiating themselves in investors' eyes. The calibre of COOs, CFOs and risk managers in particular has improved, with a number of them moving to the hedge fund industry from investment banks following the 2008 credit crisis.

Some large investors are now conducting background checks on not only the senior portfolio managers, but also the operations staff. "A big change for us is that we used to just do background checks on the investment guys – now we do the operational guys as well," says one investor in Asian hedge funds.

Institutional investors also want to see segregation of roles, regarding this as helping to make sure that specialists carry out essential tasks, and that managers have proper controls in place. "Our operational due diligence (ODD) team has come across managers, especially those which are newly established, and noted that certain individuals often wear too many hats which inhibits a clear segregation of duties especially between the front and back office," explains Yan-Yan Li, Chief Operating Officer of SAIL Advisors Limited. "In some cases, the managers have addressed the concerns raised by our ODD team and made the necessary changes such that SAIL feels comfortable in investing with these managers. So getting competent people on board and having the right people in place is critical."

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### *Infrastructure and controls*

Strong infrastructure is no longer just a cost but a necessity for Asian managers seeking institutional assets. A formal control environment – including valuation and risk committees – that monitor the manager’s activities, is becoming an important differentiator. Importantly, the investment and operational functions must be separate, especially in critical areas such as asset valuation and asset allocations across funds.

Asian managers are concentrating on improving the quality of processes, IT infrastructures and controls, although to varying degrees. Our PwC Asia Pacific Alternative Investments Conference survey confirmed the trend, with 72% of respondents saying that they were enhancing their infrastructure.

Fourteen-percent said this was due to investor pressure and 22% attributed this to regulatory pressure. Many of the region’s larger managers have introduced processes and IT infrastructures that are consistent with international standards. Indeed, some of the recent start-ups view this as a prerequisite to raising institutional assets from day one.

“In the last year the infrastructure has definitely improved a lot,” says Albourne’s Richard Johnston. “If you look at the big start ups that have just launched, they really do tick the boxes up to an international level for their infrastructure. It is very clear that the barrier to entry to get launched now is much higher. Part of the reason for that is that there is not so much money from the fund of funds and more from the bigger institutions.”

Obviously a firm’s infrastructure and control environment should reflect the size and complexity of the manager’s activities. Darran Goodger, Head of Finance and Client Relations at Kaiser Trading, explains: “We have grown from one person in 2000 to 38 in 2011 and decided at the beginning of this year to strengthen the firm’s core governance and risk management infrastructure by hiring a dedicated risk and compliance officer, and obtaining an independent review of trade order, execution and settlement processes. As part of this process we have looked to enhance our internal policies across the entire end-to-end process.”

“We have put in place stronger corporate governance and risk management infrastructure to support the increasing institutionalisation of our market.”

The tax function is an important part of the manager’s infrastructure. Under pressure from investors, regulators and legislators, hedge fund managers globally are integrating their tax departments into the firm’s operational risk management functions. This requires the tax department to think and act differently. In an environment where investors are doing more thorough due diligence, tax does not escape.

Within Asia, the cross-border nature of many funds, and the increasing complexity of satisfying tax laws in different jurisdictions, means that investors are paying more attention to permanent establishment and tax treaty risks, often retaining outside advisors to assist them with this analysis. Raymond Kahn, Tax Partner at PwC Japan notes that while in-house tax teams aren't yet expected, investors do like managers to have a strong CFO/COO to take charge of tax and investor reporting issues. Asian funds are not yet focussed on the reporting requirements under the US Foreign Account Tax Compliance Act (FATCA), but this may soon change as the enactment of the new FATCA rules draws nearer.

With institutional investors becoming such an important source of assets in Asia, larger managers are looking for ways to efficiently demonstrate their control environment. One increasingly common way to do this is to commission independent controls assurance reports. US pension funds often request these reports, seeing them as a helpful due diligence tool. As Asia's managers grow in size and complexity, controls assurance reports are likely to become more useful as a way of demonstrating and benchmarking the quality of their infrastructure against internationally accepted standards.

Many alternative and traditional asset managers looking for a competitive advantage are turning to increased transparency and controls reporting as a way to increase investor trust and confidence.

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## Regulation

Regulators are also pushing managers to improve their infrastructure. While this is increasing costs for Asian managers, it is also likely to enhance US and European institutional investors' confidence in Asian hedge funds generally, making them more willing to invest directly with local managers rather than in Asian funds managed by global hedge fund managers.

Some international institutional investors have resisted investing in local Asian hedge funds because they are not familiar with local regulations. "Medium-sized US institutional investors are typically unfamiliar with the Asian regulatory systems," notes Sam Gallo, a Managing Director, Alternative Investments at PwC US. "If they have a three-person hedge fund research team, they generally do not have sufficient resources to get comfortable with the regulations." But institutional investors are likely to become comfortable with local regulations if they move more towards US and UK models with which they are familiar.

In Singapore, the Monetary Authority of Singapore is introducing more stringent regulatory requirements in 2012, which will principally require all fund managers to be registered with the authority. In addition, managers will be required to employ at least two investment professionals (if

licensed), and are expected to maintain a risk management framework that is deemed relevant and adequate based on the size and complexity of their business. Finally, fund managers will be subject to an annual audit. A number of fund managers operating out of Singapore, which is home to over 400 hedge funds, might view these measures as costly and onerous, prompting suggestions that some may choose to merge with other managers.

Japan too, is toughening regulatory standards following the February 2012 disclosure by AIJ Investment Advisors that it could not account for nearly Y200 billion in assets it had been entrusted to manage. Japan's Financial Services Agency (FSA) will inspect the country's 263 asset managers in the widest probe of the sector in recent years. What's more, the FSA is looking into requiring firms to give their clients more information in order to enhance oversight of the industry.

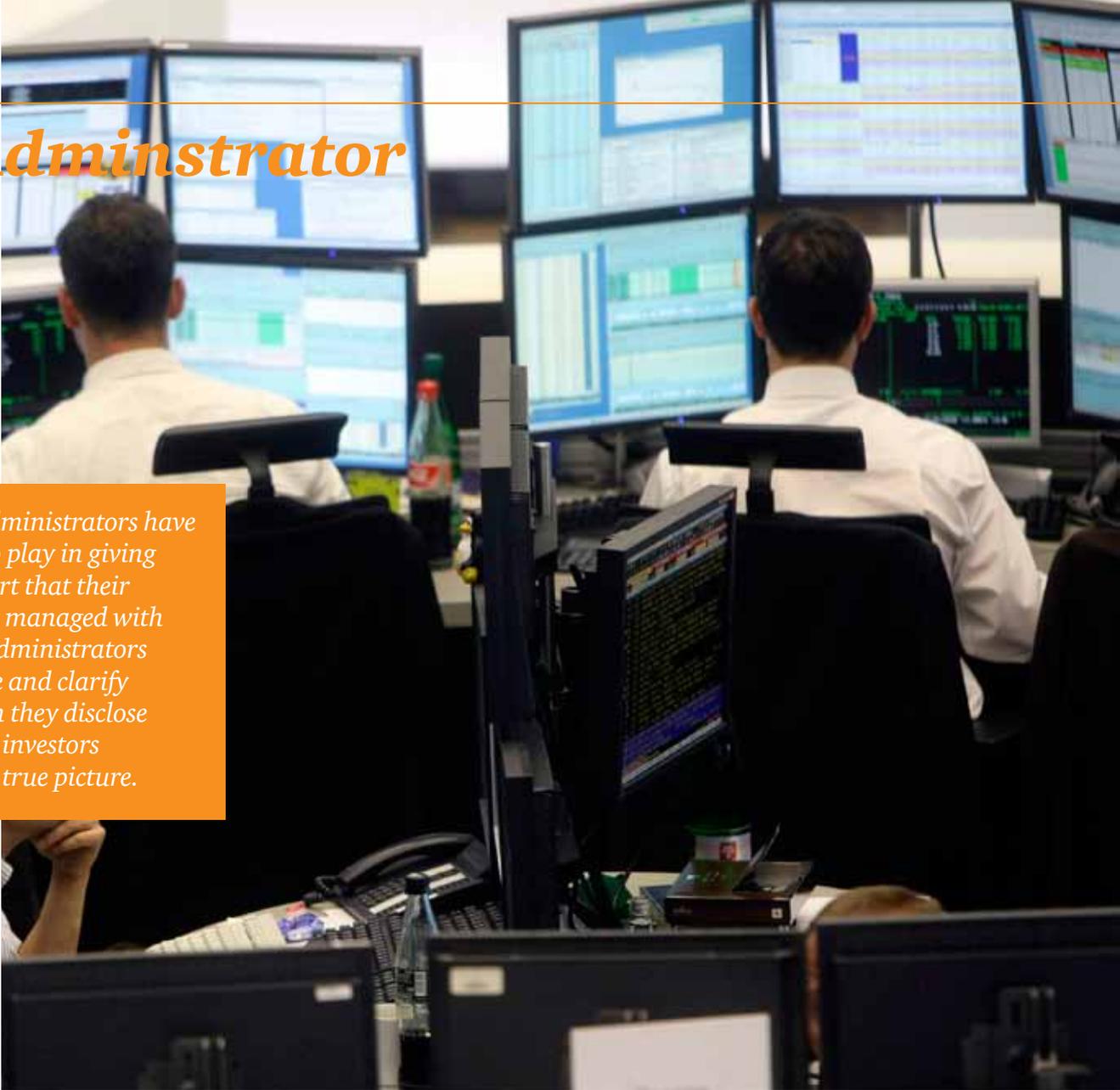
The growing coordination between different countries' regulators is also likely to increase international investor confidence in Asian hedge funds. In a written response to our questions about its approach to regulating the hedge fund sector, Hong Kong's SFC explained its involvement in the IOSCO surveys designed to assess the systemic risk posed by hedge funds, as well as the new international OTC derivatives regulations.

Some managers clearly regard the badge of respectability provided by strong regulation as an advantage. While the terms of the Dodd-Frank Wall Street Reform and Consumer Protection Act require some to register with the US Securities and Exchange Commission (SEC) in 2012, others have chosen to do so voluntarily. Explains the CFO of a hedge fund manager in Singapore, "We registered with the SEC in 2006 when this appeared to be necessary for regulatory reasons. Although this ultimately proved not to be needed, with the benefit of hindsight it was a great decision. It helped to market the fund."

For Asian managers seeking to raise money from institutional investors, the move towards tougher regulation is likely to raise the bar in terms of costs, but it will also increase investors' confidence in Asian hedge funds generally.

"Many of our clients are seeking assistance in assessing their control environment, monitoring compliance with applicable rules and regulations and strengthening their overall control environment – much of which, I believe, is in response to investors' increasing desire for transparency," says Anthony Evangelista, Financial Services Asset Management Partner at PwC Hong Kong, focusing on regulatory and compliance matters.

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## *The Administrator*

*Independent administrators have a critical role to play in giving investors comfort that their assets are being managed with integrity. But administrators can standardise and clarify the information they disclose in order to help investors understand the true picture.*

## Investor scrutiny

Administrators play an increasingly important part in the hedge fund value chain, as providers of an independently calculated net asset value. Survey respondents agree that international institutional investors place a great deal of faith in the quality and brand names of administrators. US and European institutional investors take comfort in knowing an Asian fund that has an administrator that they are familiar with, particularly if the administrator is part of a regulated entity.

“I believe that the large and sophisticated institutional investors have an informal ‘black’ list, ‘grey’ list and ‘white’ list of service providers who they work with,” says Sukru Kesebi, Head of Hedge Fund Consulting Asia Pacific, at Deutsche Bank Global Prime Finance. “If the fund manager’s appointed service provider is on either a grey or black list it may come under scrutiny by the investor.”

Reflecting the importance assigned to the administrator’s role, institutional investors started performing more due diligence on administrators in the wake of the 2008 credit crisis, and have steadily requested more information ever since. They are asking more detailed and sophisticated due diligence questions. Not long ago investors would send a few questions and administrators would respond by email. But in the last year, investors have asked for more information – including SSAE 16/SAS 70 independent controls assurance reports and business continuity planning summaries.

Some also visit administrators’ offices to talk to the staff handling tasks such as fund accounting, subscriptions and redemptions to make sure that what they are doing is consistent with answers to due diligence questions. “They want to walk around the office and talk to our staff,” explains Lillian Wong, Head of Fund Services in Asia Pacific for HSBC Securities Services. “This is taking time and effort on the part of administrators and increasing the cost of doing business.”

*Reflecting the importance assigned to the administrator’s role, institutional investors started performing more due diligence on administrators in the wake of the 2008 credit crisis, and have steadily requested more information ever since.*

While taking the time to answer investors’ questions is proving expensive, giving comfort in this way has become a valuable part of the administrator’s role.

Administrators may need to standardise their responses to institutional investors as much as possible, in order to answer due diligence enquiries as efficiently as possible. “For example, administrators could hold due diligence days for investors to familiarise them with administration processes. For their part, investors could help administrators by conducting due diligence on several funds serviced by the administrator at the same time.

## Transparency

Administrators are giving investors greater transparency into their hedge fund investments through investor letters and online transparency platforms. They are providing both independent risk reporting, and disclosing the percentages of funds’ assets and prices that they verify independently.

There is an opportunity for administrators to differentiate themselves by clearly describing what they mean when they say they have verified the prices and existence of assets. Administrators in the survey told us that in 2011, they fielded a growing number of requests from investors asking for independent verification of funds’ assets and prices. Nevertheless, we believe this is a grey area, where practices vary from one administrator to another. “There is confusion about exactly what administrators mean when they say they have verified prices. Some would say that they independently price the assets while others would say that they only verify within a certain

tolerance limit. In practice, managers are sometimes best placed to determine prices, especially for those instruments where market prices are not so readily available.” says Marie-Anne Kong, Financial Services Asset Management Leader at PwC Hong Kong.

While the predominance of long-short equity style funds in Asia means that portfolios tend to be relatively liquid, respondents did report that a number of funds had illiquid investments in assets such as corporate loans, private equity and real estate before the credit crisis. But, according to respondents such as BNY Mellon, in its capacity as administrator and custodian, the occurrence of illiquid assets within the more liquid strategies has declined in recent years and, what’s more, it is an area that investors are focusing on as part of their initial and ongoing due diligence.

## Controls reports

As part of the due diligence process, investors are asking administrators more frequently for access to their independent controls assurance reports. “All the large administrators have these reports,” says Wout Kalis, Regional Head of Alternative Investment Services at Citi. “If you have one and the investor asks about it, then there are not so many questions.”

But with managers outsourcing more of their middle office and other functions to administrators, there is an opportunity for administrators to differentiate themselves by expanding the areas covered by reports, for example, transfer agency, collateral management and greater detail about valuation of complex or illiquid investments.

# *The Prime Broker*

*Investors and managers are demanding as much transparency as possible into asset security and rehypothecation of assets. Managers are seeking to limit the level of their assets that can be rehypothecated, and often diversifying custody of unencumbered assets.*

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*Asia's hedge fund managers are also insisting that prime brokers limit rehypothecation arrangements, with larger managers negotiating out of them altogether and medium-sized managers agreeing ceilings ranging from 100%-200% of cash assets.*

### *Counterparty risk*

Prompted by the renewed stress in financial markets in the second half of 2011, institutional investors and managers renewed their focus on limiting the risks in prime broker and custody arrangements. Just as in the immediate aftermath of the Lehman Brothers insolvency, prime brokers owned by banks with large balance sheets won market share, so managers are once again taking steps to limit counterparty risk.

At our PwC Asia Pacific Alternative Investments Conference, 31% of the delegates indicated that this was still a major concern: 18% said they were in the process of arranging third-party custody away from their prime brokers; and 13% said that they were still nervous about custody and rehypothecation.

According to the Chief Operating Officer at one of Hong Kong's larger hedge fund managers, diversifying counterparties is essential. "The big shift has been to multi-prime. A lot of people had two to three primes. Now you need to be truly multi-prime. Furthermore, I think independent custody of assets is a requirement for any serious fund. You need to be sure remote bankruptcy can work in times of stress, which is not at all clear."

In response to hedge fund managers' concerns about the safety of assets, prime brokers have developed a range of operating models, all designed to improve transparency and risk management, and to protect unencumbered assets in the event of a crisis.

As Asian hedge fund managers react to recent market volatility, respondents to our survey reported a trend towards making sure assets are safe. "With five-year CDS spreads for large financial institutions widening, and people worried about the creditworthiness of financial institutions, we are seeing clients moving excess cash to cash custodians," explains one prime broker. "We are seeing a lot of clients diversifying counterparties."

Asia's hedge fund managers are also insisting that prime brokers limit rehypothecation arrangements, with larger managers negotiating out of them altogether and medium-sized managers agreeing ceilings ranging from 100%-200% of cash assets.

*SSAE 16/SAS 70 reports are becoming useful tools for prime brokers to give evidence of their controls to managers and their investors.*

### *Due diligence and controls*

As with other service providers, investors are asking many more questions of prime brokers. Due diligence questions tend to be more sophisticated, probing into areas such as controls processes, SSAE 16/SAS 70 independent controls assurance reports, commingled securities and rehypothecation.

In particular, SSAE 16/SAS 70 reports are becoming useful tools for prime brokers to give evidence of their controls to managers and their investors. Like their US and European affiliates, an increasing number of Asian prime brokers are preparing these reports to demonstrate the strength of their controls environment.

“We were the first prime broker in Asia to secure a SAS 70 certification, which is a testament to our commitment to controls and procedures. We have found that steps like these are not only good practice but good business, as our clients continue to insist on operational transparency and efficiency,” says Deutsche’s Sukru Kesebi.

Prime brokerage and custody is clearly a rising concern for both managers and investors. We believe that managers should select the best arrangement for their particular strategies. But whatever structure they select, they should offer institutional investors the transparency they need to judge its effectiveness.

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*Prime brokerage and custody is clearly a rising concern for both managers and investors.*

# Conclusion

*Investors' drive to rebuild trust in hedge funds, and the use of transparency to achieve this, is set to transform the hedge fund industry in Asia.*



We believe that managers of all sizes should focus their efforts on trying to provide the governance and controls that investors are seeking. Managers should look to move away from the the older 'black box' or opaque way of conducting their business to a new 'open book' policy to succeed in this new, more demanding world.

The growing appetite of international institutional investors for hedge funds is creating an opportunity for those managers that provide institutionalised governance, infrastructure and transparency. The small number of Asian hedge funds that possess both proven alpha-generating investment skills and sophisticated operational infrastructure are likely to grow their assets as investors seek to profit from Asia's fast economic growth.

*“Across Asia’s hedge fund industry, trust and transparency standards are rising, although to varying degrees.”*

Marie-Anne Kong, Financial Services Asset Management Leader at PwC Hong Kong

Yet only a small number of hedge fund managers are taking this route. Many others are seeking assets from local high-net-worth individuals and family offices, as our survey results show. In an industry that has always had a high rate of attrition, rising costs will doubtless force a few to close down.

Administrators will play an important part in giving institutional investors the transparency they require to verify price and asset information. At a time when managers and investors are demanding more information, administrators stand to gain competitive advantage

from standardising and clarifying the information they disclose. Prime brokers, for their part, need to make sure they give as much transparency as possible into the safety of assets.

“Across Asia’s hedge fund industry, trust and transparency standards are rising, although to varying degrees,” says PwC Hong Kong’s Marie-Anne Kong. “Those managers that decide to raise money from institutional investors need to be in the vanguard of this evolution.”

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