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The evolution of an industry

2012 KPMG/AIMA Global Hedge Fund Survey

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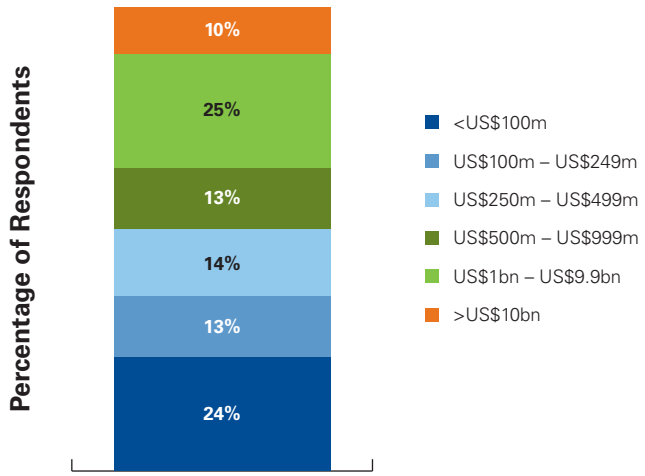
About this Research

KPMG and the Alternative Investment Management Association (AIMA) have prepared this report based on surveys and structured interviews conducted between October 2011 and February 2012 with hedge fund managers from around the globe. Our research has benefitted from the participation of 150 respondents representing approximately US$550 billion of assets under management. The respondents to the survey include hedge funds of all sizes, with 24 percent of respondents managing less than US$100 million, 40 percent managing between US$100 million and US$999 million, 24 percent managing between US$1 billion and US$9.9 billion, and 10 percent managing more than US$10 billion in assets under administration.

The objective of this study was to obtain insights and opinions from hedge fund managers with respect to a wide range of timely, industry-related topics, including the continuing institutionalization of the business, the changing face of hedge fund operations, the growing emphasis on transparency and due diligence, the ongoing regulatory challenges and the future of the industry. We also set out to provide additional perspective to the findings we reported in 'The value of the hedge fund industry to investors, markets and the broader economy', another joint initiative between KPMG and AIMA, which was published on April 24, 2012.

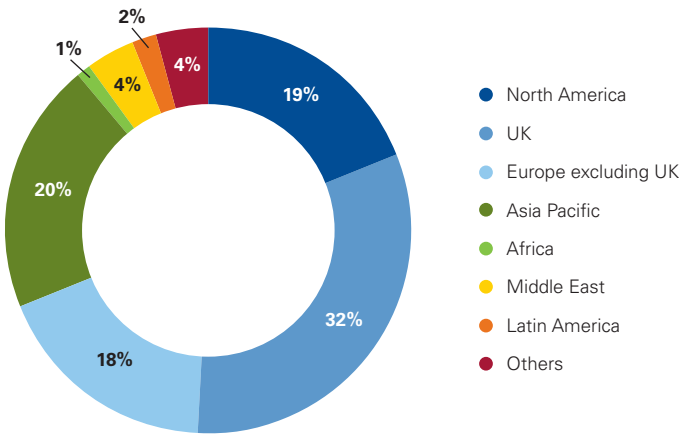
Our foremost thanks go to the individuals who participated in this research. We would also like to offer our special thanks to the hedge fund executives who participated in our structured interviews. The insights, opinions and expertise of all the survey participants were invaluable in helping to paint as complete and accurate a portrait as possible of the global hedge fund industry of today, as well as the opportunities and challenges that are facing it in the years to come.

Breakdown of respondents by AUM size



Source: KPMG International, 2012.

Where do you have offices?



Source: KPMG International, 2012.

Robert Mirsky
Partner, Investment Management
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Anthony Cowell
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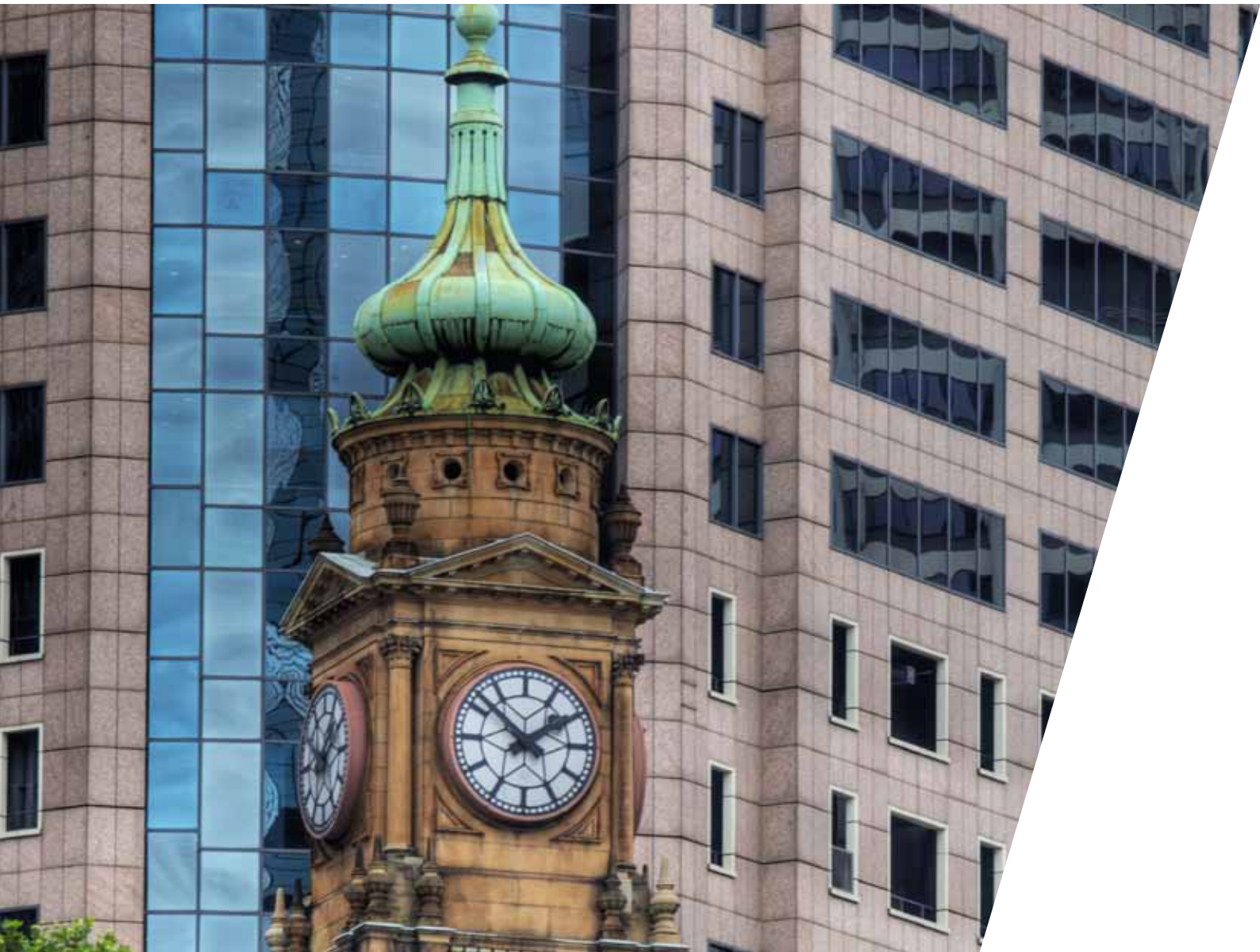
KPMG in the Cayman Islands

Andrew Baker
CEO, AIMA

Executive Summary

In the years before the global financial crisis, the global hedge fund industry experienced dynamic growth, reaching US$2 trillion in assets under management (AUM) in 2008. That period of growth was marked by increased institutional investment as pension funds and university endowments were attracted by uncorrelated returns and low volatility. However, high net worth individuals, traditionally the main investors in hedge funds, were still the leading investors in the industry.



The global financial crisis resulted in significant redemptions from hedge funds. Meanwhile, since the crisis, new capital coming into the industry has been largely from institutional investors, who had stuck by the industry during the crisis. This has resulted in significant changes. Pre-crisis, the majority source of capital came from non-institutional investors such as high net worth individuals and family offices, post-crisis it is now institutional investors who are the leading allocators to hedge funds. Because institutional investors are extremely demanding in terms of due diligence, they require robust operational infrastructure in the managers they allocate to, so managers have responded by strengthening their own infrastructure. And because these institutional investors seek increased transparency, managers have increased their capacity to provide that too.

All this has been happening in the context of a major wave of new post-crisis regulation impacting the industry. That, too, has had an impact on operational structures, as managers have had to increase their own in-house compliance capacity to respond to the new regulatory requirements.

The industry is therefore becoming more 'institutionalized' not only in terms of assets under management but also in terms of its own operational infrastructure. But this has created issues for emerging managers. The increased costs to implement more robust operational infrastructure in order to attract institutional capital is becoming a real challenge to their growth.

These changes, as well as the hedge fund industry's responses, attitudes and opinions toward them, were the catalyst for this joint research initiative between AIMA and KPMG. This paper features analysis of a recent survey of global hedge fund managers and considers the impacts of a changing investor base on the industry, including the manner in which the institutionalization of the hedge fund industry is resulting in an increased focus on operational infrastructure by managers and how global regulation is impacting day-to-day operations.

The following are some of the many compelling findings from the survey:

- Institutional investors now represent a clear majority of all assets under management by the global hedge fund industry, with 57 percent of the industry's AUM residing in this category. The proportion of hedge fund industry assets originating from institutional investors has grown significantly since the financial crisis.
- Investor size and manager size are strongly correlated in terms of allocations made by investors to managers. Large institutional investors are more likely to allocate to large hedge fund managers, while smaller family offices are more likely to allocate to smaller hedge fund managers.
- For fund of funds, the opposite is true, as allocations are twice as likely to go to managers with less than US$500 million in assets than those with assets in excess of US$1 billion. Fund of funds are increasingly focusing on emerging managers.
- New money injected into the industry since 2008 has come primarily from North America, Asia-Pacific and the Middle East, while allocations from the European Union have held steady and those from Switzerland have declined.
- The amount of time managers say they have spent handling due diligence inquiries from investors has doubled since 2008.
- Seven of every 10 respondents reported a decrease in fund of funds allocations since 2008. This decrease has been largely offset by the new influx of capital from institutional investors.
- Managers have become much more institutionalized in terms of their operational infrastructure as a result of increased investor demands. In fact, 82 percent of respondents reported an increase in demand for transparency from investors, while 88 percent said investors are demanding greater due diligence.
- Managers have significantly increased headcount to respond to both increased regulatory compliance requirements, and increased investor demand for transparency and due diligence. Respondents almost unanimously (98 percent) reported an increase of at least one employee in the area of regulatory compliance, while 26 percent said they had hired two or more people in this area.
- Respondents, both large and small, are confident there will be strong inflows into the industry over the next several years, but expect there will be fewer managers in operation at both ends of the scale.
- Boutique players continue to demonstrate an ability to evolve and, indeed, thrive in this changing business landscape. One example is the emergence of 'co-opetition', where managers with different strategies, who would otherwise be competitors, come together to form mutually-beneficial working relationships.

These will prove to be pivotal days in the evolution of the global hedge fund industry. The strategies, decisions and reactions of today will shape the form and function of the industry for years to come. What better time, then, to examine the inner workings and decision-making processes taking place within the boardrooms of the world's hedge funds?

The Institutionalization of the **Global Hedge Fund Industry**

The single most compelling and persistent theme emerging from the survey results relates to the continued force and momentum with which the global hedge fund industry is becoming institutionalized.

As the survey data demonstrates, this term 'institutionalization' refers not only to the continuing influx of new institutional capital into hedge funds (which we examine in this section), but also the continued evolution and advancement of hedge funds' infrastructure and operational processes with respect to transparency, compliance and due diligence (which we explore in more detail in subsequent sections).

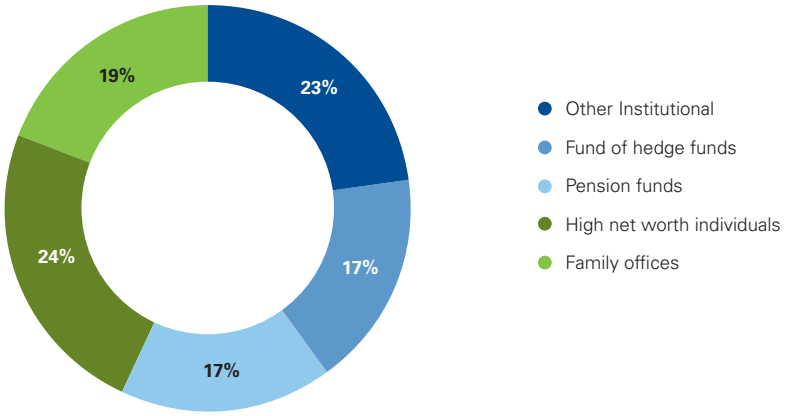
The days when hedge funds catered almost exclusively to high net worth individuals and family offices are long gone. As the survey data bears out, we are witnessing a significant shift in the types of investors who invest in hedge funds. Today, investors in hedge funds are much more likely to be institutions, such as charitable foundations, public and private sector pension funds, insurance companies, university endowments and the like. As one manager described this shift, "We're starting to see a major upturn in capital-raising largely through institutional asset flows. We've doubled our assets under management in the last few years and we are now close to pre-2008 levels." Another characterized this shift by saying, "We're seeing an evolution in the investor base. Pension funds will continue to be a huge source of capital."

And while the industry has been witnessing this shift in hedge fund investor demographics over the past decade or so, the survey data shows that the proportion of institutional assets being allocated to the global hedge fund industry has grown significantly in the years following the financial crisis. This is a trend that has had, and is continuing to have, profound implications for an industry that is adapting rapidly to its newest – and now largest – investor demographic, as well as the more complex and rigorous demands that accompany these institutional investors.

Institutions now represent a clear majority of assets under management

The survey results suggest that institutional investors now represent a clear majority (57 percent) of all assets under management by global hedge funds, a trend that is creating profound implications for the industry.

Global hedge fund AUM by investor type



Source: KPMG International, 2012.

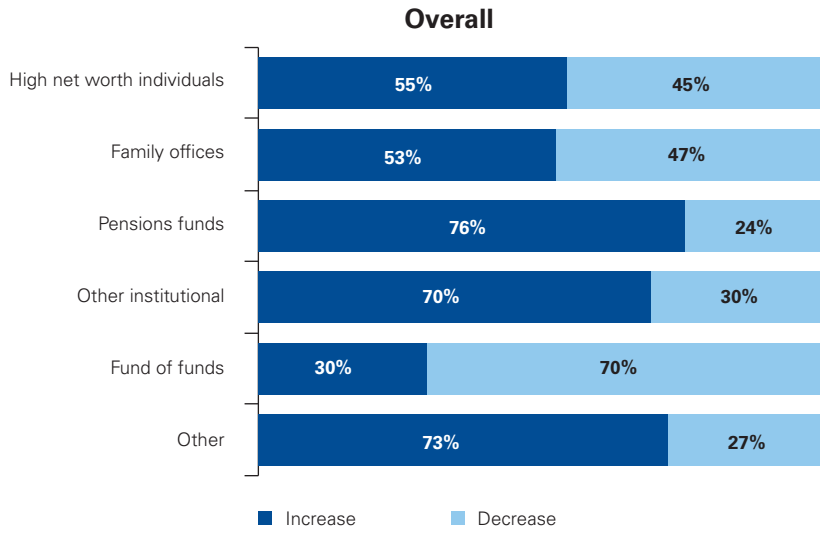
The days when hedge funds catered almost exclusively to high net worth individuals and family offices are long gone.

A significant increase in institutional assets across the board

The survey results show that the proportion of institutional assets in the global hedge fund industry is growing. As the accompanying illustration highlights, 76 percent of all survey respondents indicated they had seen an increase in pension fund assets since 2008. At the same time, 70 percent of respondents said 'other institutional' assets had increased since the credit crunch.

These findings reinforce the hypothesis that there is a strong and sustained influx of new institutional capital into the global hedge fund industry as a whole.

Q. Please indicate if these categories have increased or decreased since 2008?



Source: KPMG International, 2012.

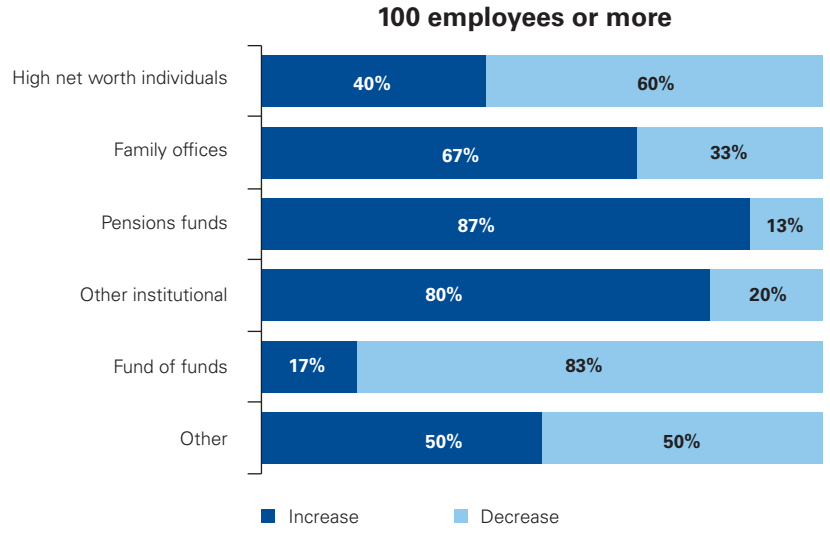
The information reflected in the graphs and charts of this report was obtained by KPMG during both the survey stage as well as the structured interview stage. The anonymous interview quotes throughout this document were obtained during the interview stage of the research project. Please note that with the graphs illustrated, not all answers add up to 100 percent because of rounding or because respondents were able to provide multiple answers to some questions.

This trend is even more pronounced among the industry's largest hedge funds (as measured by number of employees).

As the accompanying illustration shows, in hedge fund firms with 100 employees or more, 87 percent of respondents with 100 employees or more indicated an increase in pension fund assets as a proportion of their overall assets under management since 2008. Eight in 10 respondents said 'other institutional' assets had increased as a percentage of their assets under management since that time.

87 percent of respondents with 100 employees or more indicated an increase in pension fund assets as a proportion of their overall assets under management since 2008.

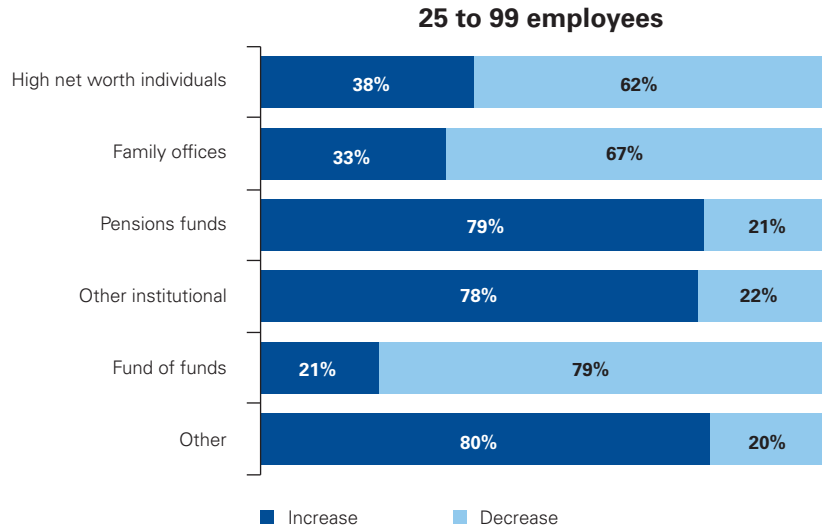
Q. Please indicate if these categories have increased or decreased since 2008?



Source: KPMG International, 2012.

This increased influx of institutional capital was also readily apparent among mid-sized hedge funds (25 to 99 employees), with 79 percent of these respondents reporting an increase in pension fund assets since 2008 and 78 percent indicating 'other institutional' assets had increased during the same period.

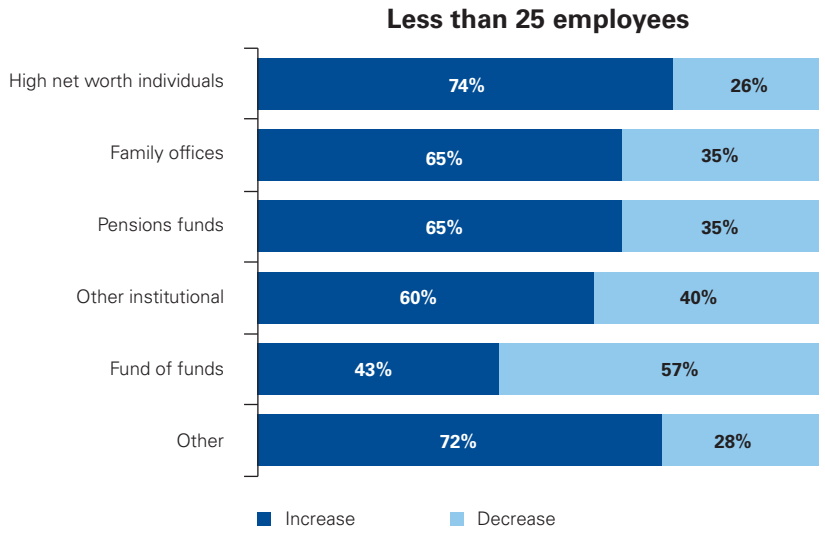
Q. Please indicate if these categories have increased or decreased since 2008?



Source: KPMG International, 2012.

And while the trend was also evident in the industry's smaller firms, it was far less pronounced than with the larger ones. For this smaller group of hedge fund managers (having 25 employees or less), 65 percent of respondents indicated an increase in pension fund assets as a proportion of their overall assets under management since 2008, while 60 percent said 'other institutional' assets had increased in the same regard.

Q. Please indicate if these categories have increased or decreased since 2008?



Source: KPMG International, 2012.

The continued bifurcation of the industry

These results underscore a growing tendency for larger institutional investors to gravitate toward larger managers with more institutionalized operations and brands that held a higher level of recognition within the industry.

A phenomenon that is perhaps inversely related is evident with respect to high net worth individuals and family offices, which appear more likely to allocate assets with the industry's smaller managers. Three quarters (74 percent) of hedge funds with 25 employees or less reported an increase in assets from high net worth individuals, while 65 percent reported an increase in assets from family offices.

These statistics support the notion of an expanding gulf between the boutique hedge fund firms and the industry's larger players. As one manager observed, "Robust infrastructure is the only way to attract institutional investors." Another echoed this sentiment, stating, "The big will get bigger going forward because of the barriers to entry."

This bifurcation of the industry has been taking place for a number of years now, but is becoming even more pronounced in the years following the financial crisis. As one manager of a large hedge fund stated, "We've become increasingly institutional over the years. We used to deal with high net worth investors. Today, it's predominantly institutional."

While this appears to be a growing trend, it does not mean that institutional investors are completely ignoring the smaller players. "Institutions will still invest in the smaller funds," said one hedge fund manager. "The right strategy can still attract those

The big will get bigger going forward because of the barriers to entry.

– Hedge fund manager

institutional investors." At the boutique end of the market, there is also a new breed of collaboration referred to as 'co-opetition', in which managers using different strategies and who would otherwise be competitors, are coming together to form a mutually-beneficial, collaborative working relationship. The emergence of this trend is just one of the many examples of how the smaller players are successfully adapting to the ongoing changes in the marketplace in order to survive and thrive in a rapidly-changing environment.

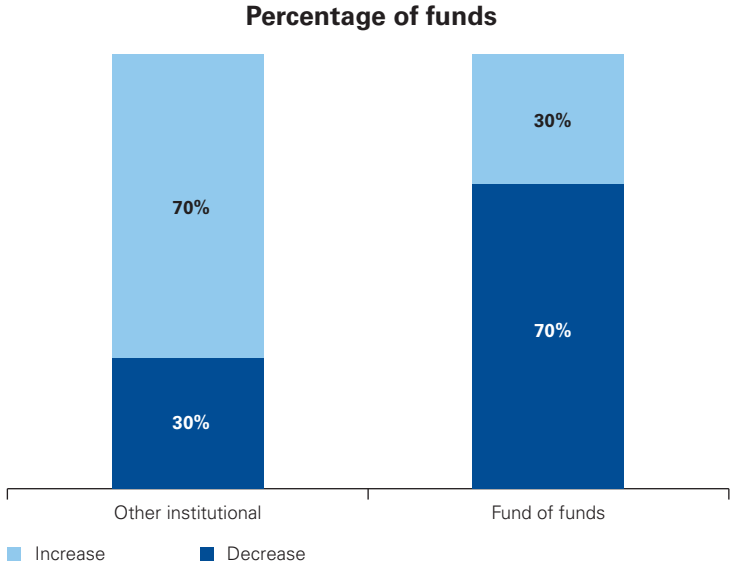
In the middle of the spectrum are the mid-sized players, some of which are caught in a delicate balancing act, large enough to attract institutional money, but perhaps lacking adequate scale to create the type of robust, in-house operational infrastructure many institutional investors want. Without the same capacity to add to their headcount that the larger players enjoy, many of these mid-sized managers have to work extremely hard in order to satisfy the compliance and transparency requirements of these new institutional investors.

A decrease in fund of funds allocations

The survey findings also reveal that hedge funds of all sizes have witnessed a drop in fund of funds allocations since 2008. While more than half of all other investment categories saw increases in allocations since that time, 70 percent of respondents reported that fund of funds allocations decreased over the same period. This decrease was most noticeable among the largest hedge funds (100 or more employees), 83 percent of which saw fund of funds allocations drop. At the same time, 79 percent of mid-sized hedge funds (25 to 99 employees) saw fund of funds allocations decrease, while 57 percent of the smallest firms in the survey (25 employees or fewer) saw these allocations drop.

However, as the accompanying illustration shows, the reduction in fund of funds allocations across the hedge fund industry over the past three to four years has been largely offset by the new institutional money that continues to pour into the sector.

Source of funds: Increased or decreased (since 2008)?



Source: KPMG International, 2012.

Geographical **Implications**

So where is this new hedge fund capital coming from? The results of the survey reveal a number of intriguing patterns with respect to the geographic allocation of capital to the hedge fund industry in the post-financial crisis era.

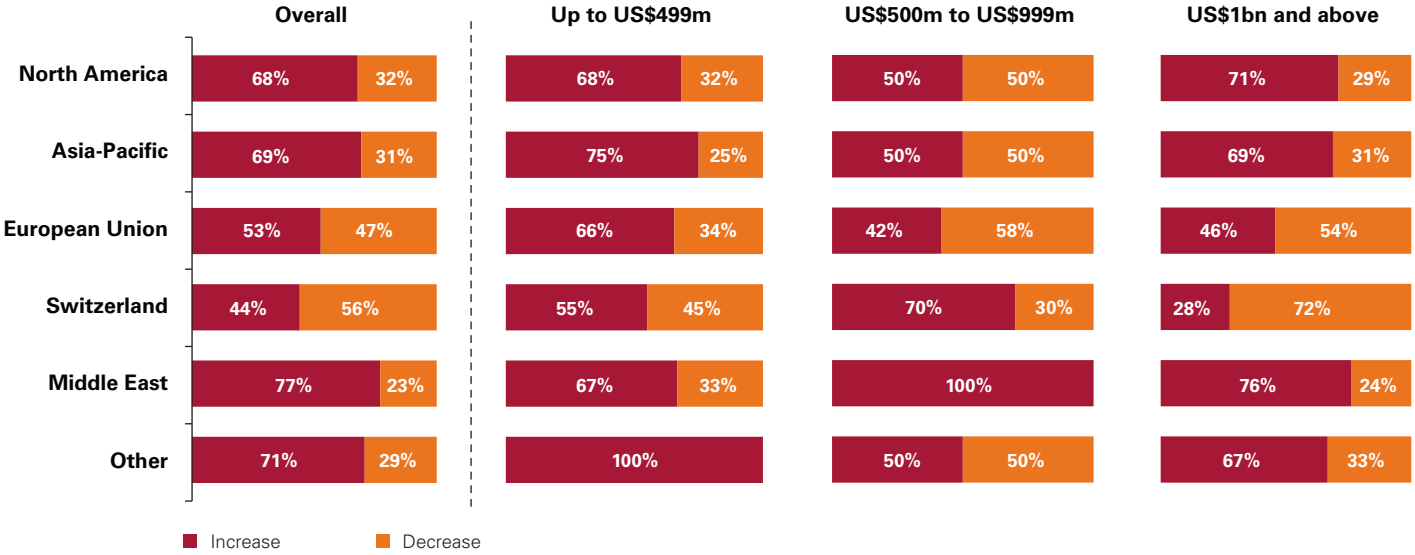
As the accompanying chart illustrates, there have been increased allocations to hedge funds from almost every region of the world since 2008. Of all the managers surveyed, 68% said there had been increased allocations from North America, 69% reported increases from Asia-Pacific, 53% reported increases from the European Union and 77% reported increases from the Middle East. The only area where more managers reported decreases in allocations than increases is Switzerland (where only 44% of managers reported increases).

These figures are more pronounced for the larger hedge funds managing more than US$1 billion in assets, with 72 percent of respondents reporting a decrease in Swiss investment and 54 percent in European Union investment. Meanwhile, the percentage of US$1 billion plus managers reporting an increase in investment from North America was 71 percent.

The survey data also revealed other interesting trends with respect to the geographic allocation of capital to the global hedge fund industry. For example, the results indicate that investors from the Asia-Pacific region tend to gravitate toward smaller hedge funds (up to US$499 million) since 2008, while investors from the Middle East tend to focus on mid-sized (US$500 million to US$999 million) and large (US$1 billion and above) hedge funds.

Q. Please indicate if these categories have increased or decreased since 2008?

Change in Categories



Source: KPMG International, 2012.

Investors Serve as Catalysts for **Operational Change**

A Trend toward Increased Transparency

Our data shows that 82 percent of all survey respondents believe that investors have become more demanding with respect to transparency since the financial crisis. As one manager put it, "Portfolio transparency demands have increased in terms of demands for more detail around individual positions, composition of portfolio assets, verification of custody arrangements and direct confirmation from the custodians. Operational transparency demands have also increased with respect to the understanding of computer systems, compliance procedures and trading arrangements."

And, as the accompanying illustration demonstrates, the larger the hedge fund, the more universal and pronounced the demand for increased transparency. Among the largest hedge funds surveyed (US$1 billion or more in AUM), a full 100 percent reported increased demand for transparency by investors. This figure was lower for mid-sized hedge funds (US$500 million to US$999 million), 78 percent of which reported similar views. And the percentage of smaller hedge fund managers (up to US$499 million) reporting increased demands for transparency was 69 percent. At least part of the reason for this increase in demand for transparency among the largest hedge funds can be traced back to its largest new investor demographic – large institutional investors such as pension funds – which have highly comprehensive reporting and due diligence requirements.

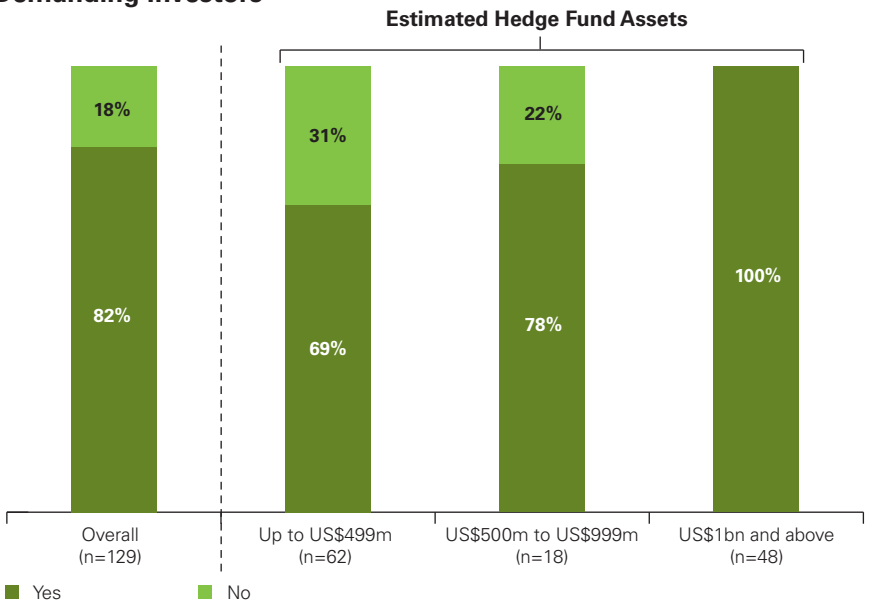
The survey data also indicates that as investors have demanded more transparency, hedge funds, particularly the industry's larger ones, have begun adapting their philosophies, policies and staff headcounts in order to deliver it to them. "We hired a chief marketing officer post-Madoff to deal with institutional investors on a day-to-day basis," said one hedge fund manager.

In fact, 84 percent of all respondents indicated they had increased transparency to investors since 2008. As the accompanying illustration shows, this trend was most noticeable among the largest hedge funds (US$1 billion or more in AUM), 94 percent of which said they had increased the transparency of their fund management since 2008. With respect to the smaller (up to US$499 million) and mid-sized funds (US$500 million to US$999 million), 79 percent and 78 percent respectively said they had increased the transparency of their fund management to investors since 2008.

Based on these findings, it appears that the additional operational burden associated with satisfying these new transparency-related requirements is having the greatest impact on the smaller sized managers, who have been

Q. Have your investors become more demanding in terms of transparency since 2008?

Demanding Investors

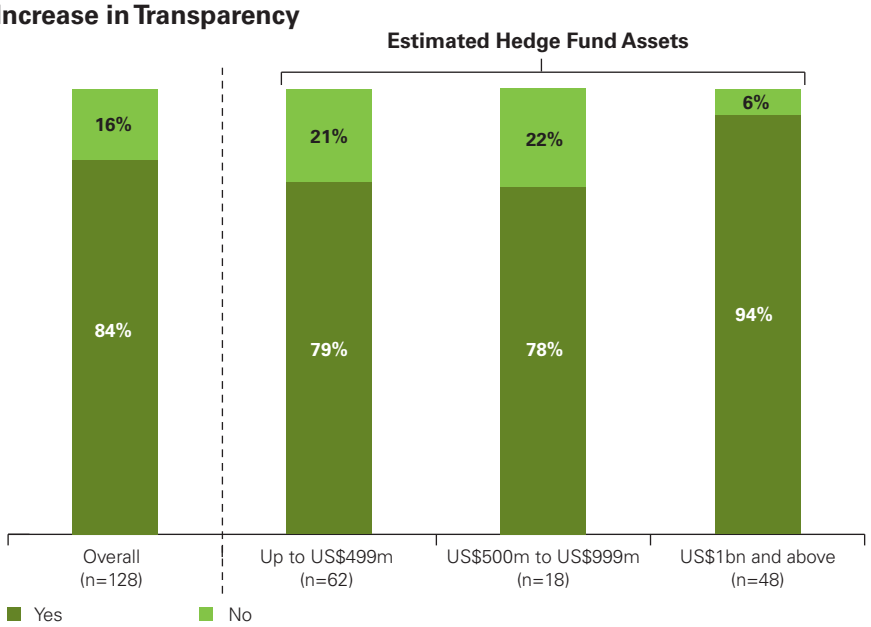


Source: KPMG International, 2012.

slower than their larger counterparts in adding employees to handle these new requirements. Only 23 percent of hedge fund managers with less than 25 employees have increased their staff to address issues related to transparency. In contrast, more than 40 percent of managers with 25 employees or more have had a headcount increase. Overall, a third of all managers surveyed reported that they increased staff headcount to accommodate this demand (nearly 60 percent of which reported that the increase did not exceed two people despite the increased demand).

Q. Have you increased, in your view, the transparency of your fund management to investors since 2008?

Increase in Transparency



Source: KPMG International, 2012.

Among the largest hedge funds surveyed…a full 100 percent reported increased demand for transparency by investors.

The operational burden associated with satisfying these new transparency-related requirements is having the greatest impact on the smaller sized managers.

Without fail, investors will all want to physically see the back office, because Madoff didn't have one. They're more 'switched on'.

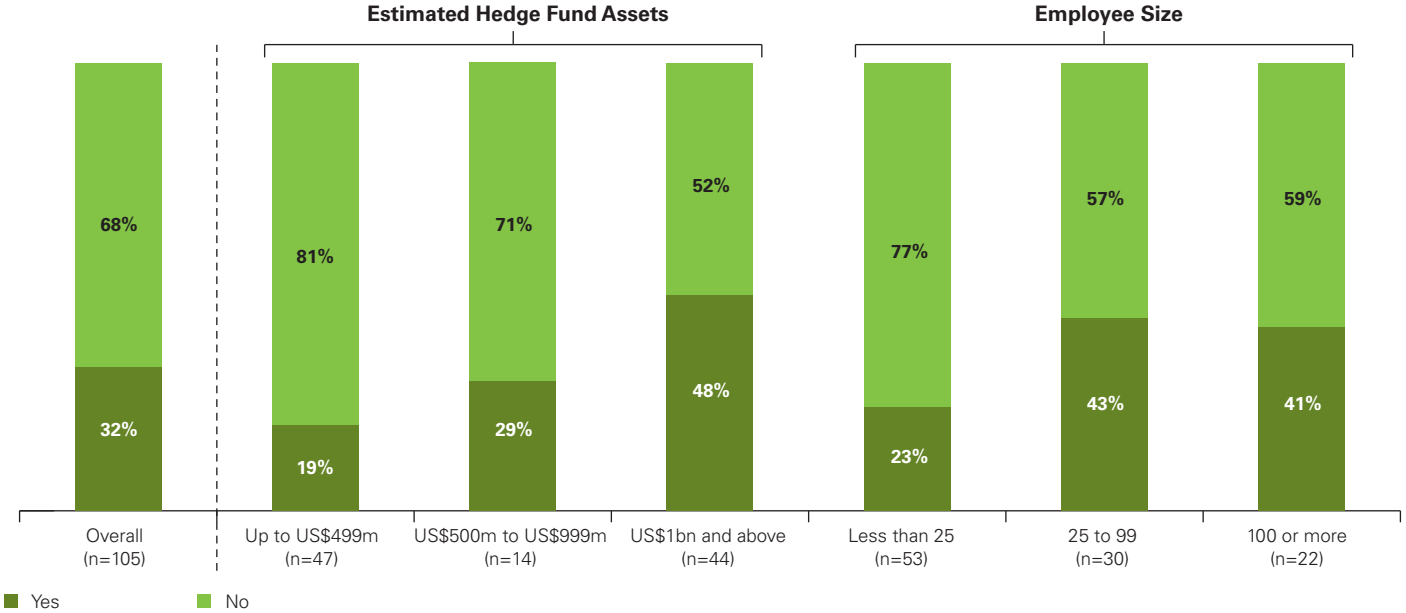
– Hedge fund manager

It is clear from the range of responses in the face-to-face interviews, however, that this trend toward increased transparency has meant different things to different managers. One hedge fund manager said, "We have always been institutional grade with our processes, controls, governance, etc. so we have not needed to change much." Another, however, expressing a sentiment shared by the majority of his industry peers, said that, "Because of these requests, we have increased our investor relations team from one to three people." With respect to the specific level of transparency being provided to investors these days, one manager characterized it by saying, "We tend to provide investors with a portfolio breakdown, but not with position-level information." And as they adjust to a more transparent environment, many managers are being required to make decisions about the timeliness of the information they will provide to their investors, given the proprietary nature of the business. As one manager put it, "We will give transparency on a lag basis. We sell intellectual output. We're not just going to give that away to anyone."

The shift toward increased transparency is one of the survey's more intriguing findings and represents one of the most striking ways in which the industry has changed since the financial crisis. This shift is also highly symbolic of the hedge fund industry's willingness to adapt not only its operational policies, but also its very culture, with some players becoming significantly more open and forthcoming with key information (including details around positions, compositions of portfolio assets, etc.) in order to appeal to institutional investors who are injecting billions of dollars worth of new capital into hedge funds around the world. And just as hedge funds are adapting to accommodate the more stringent requirements of institutional investors, those institutional investors are, at the same time, benefiting from an enhanced degree of transparency.

Q. Have you increased staff headcount in order to increase transparency management to investors since 2008?

Increase in Staff Size



Source: KPMG International, 2012.

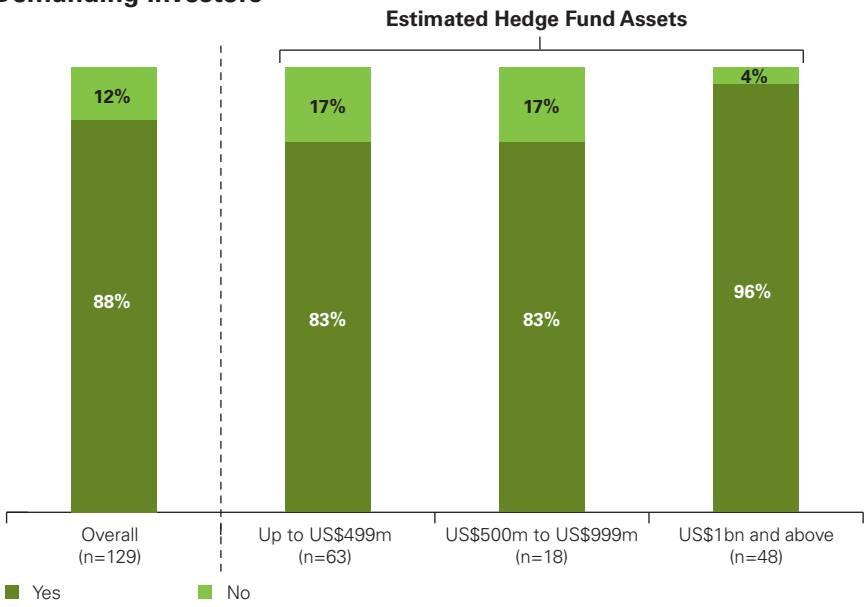
A Greater Focus on Due Diligence

Irrespective of fund size, nine out of every 10 respondents to the survey reported an increased demand in due diligence since 2008. And in keeping with the trends the survey revealed regarding transparency, the proportion was highest among the largest hedge funds, 96 percent of which said their investors had become more demanding in this area.

Nine out of every 10 respondents reported an increased demand in due diligence since 2008.

Q. Have your investors become more demanding in terms of due diligence since 2008?

Demanding Investors



Source: KPMG International, 2012.

As one manager put it, "The amount of time we spend dealing with due diligence has doubled."

Another characterized the change by saying, "The number of due diligence requests has increased, as has the volume of information they want us to provide." That same manager also indicated that their firm has significantly increased the number of face-to-face meetings it conducts in order to satisfy the dramatic rise in the number of requests by investors.

Yet another manager remarked on the changing times by saying, "Previously, good performance meant that investors didn't do such in-depth reviews. Now, reviews take about six hours and will involve not only boardroom presentations, but reviewing reports, speaking to staff on the floor and looking at the IT infrastructure. Investors want to know who all the counterparties and third party providers are and how they are managed. Counterparty risk wasn't discussed pre-2008."

When asked to characterize the change in their investors' focus on due diligence in the post-crisis era, one manager commented that, "The large players can fly in their own due diligence teams." Another said, "Without fail, investors will all want to physically see the back office, because Madoff didn't have one. They're more 'switched on'."

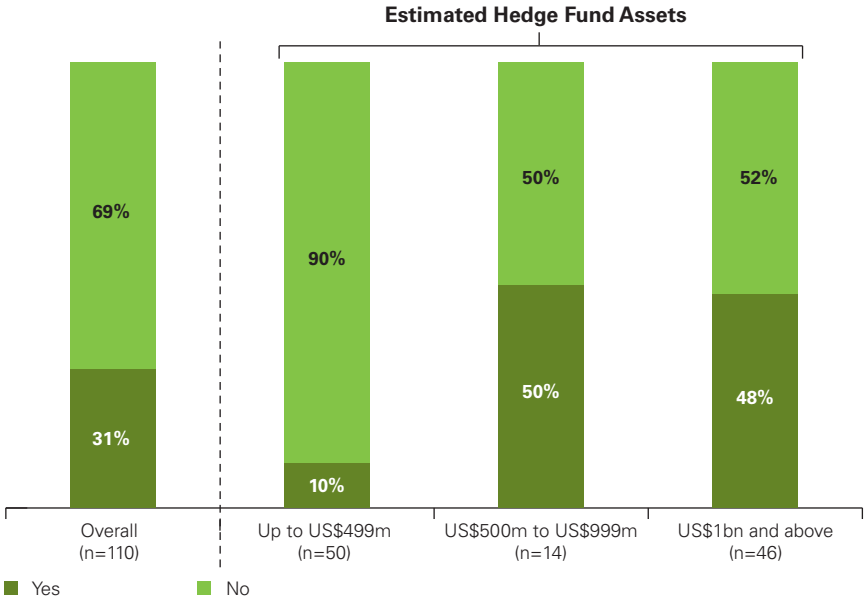
As with the issue of transparency, this additional due diligence burden appears to have weighed most heavily on the

Our overhead has increased by 35 percent over the past three years from hiring people and technology.

– Hedge fund manager

Q. Have you increased staff headcount in order to respond to investors' demand for due diligence?

Increase in Staff Size



Source: KPMG International, 2012.

smaller sized managers. As is shown in the accompanying illustration, only 10 percent of funds managing less than US$500 million have increased staff headcount (an average of one additional person has been added, or 5 percent of total headcount) in order to help meet this demand, while nearly 50 percent of the sample for funds managing more than US$500 million have increased their headcount accordingly. And while some of the smaller hedge funds appear to have delayed the hiring of additional employees to deal with this increased volume of due diligence requests, it may be just a matter of time before those growing staff counts become inevitable. As one manager of a smaller hedge fund said, "We are large enough to compete with the medium/large houses in terms of strategy, but not large enough in terms of sheer scale for the regulatory and due diligence hurdles to sometimes overcome. We are looking at increasing our headcount to deal with the additional requests."

Implications for the Hedge Fund Industry

These growing trends toward increased transparency and renewed focus on due diligence are not without associated growing pains for the hedge fund industry, including increasing headcounts and costly investments in infrastructure. And while the survey results indicate that the majority of industry players are taking decisive operational action to accommodate investors' increasing demands for access and information, not all managers are equally enthusiastic about the trend, citing the significant costs and operational headaches associated with satisfying these requirements.

As one manager said, "Costs have been driven upward by having to institutionalize the business, increase the number of people and improve operational efficiency, mainly with information technology and improved infrastructure." Another commented that, "You need to have an institutional infrastructure mindset."

The continually growing demand for information from investors has also

led to an increase in the size of the management teams of the firms themselves. The survey found that 55 percent of respondents have taken on at least two more members of staff since 2008, a significant number given the small headcount at many hedge fund firms.

As for the future, most of the hedge fund managers surveyed do not see this trend toward openness and transparency abating anytime in the near future. "We expect due diligence demands to grow," said one manager. Another, when asked about what his firm would have to do in order to cope with the increasing demands, said, "We will need to keep improving our automation of processes in order to keep up." These changes, however, are not inexpensive to implement.

"The costs are not easy to measure, but they are very real," said one manager. Another said, "Our overhead has increased by 35 percent over the past 3 years from hiring people and technology."

Some of the firms surveyed even suggested they might be using their new-found transparency as a way to perhaps differentiate themselves from some of their less transparent competitors. "We will continue to move toward increased transparency and a philosophy of disclosing early and to all clients," the manager said. "This covers things like key staff turnover, changes to service providers and fee structures."

So while boutique firms with small staff and individual investors continue to start up and even thrive in their chosen niches, many hedge fund firms today are becoming truly 'institutionalized' by way of the infrastructure they have built up and the demands of the investors they serve. As the survey results show, however, the increased scrutiny and demands from investors (not to mention the dramatic changes taking place in the regulatory environment) continue to drive significant operational changes in the world's hedge funds, particularly with respect to due diligence, transparency and governance.

These findings, which are increasingly typical of hedge fund investors in the 'post-Madoff' era, underscore the fact that operations transparency and due diligence is much more important to investors today than it was even a few short years ago.

Adapting to a Changing **Regulatory Landscape**

While the global hedge fund industry is making significant changes, both operationally and culturally, to accommodate growing investor demand for transparency and due diligence, additional changes are being forced by the industry's rapidly evolving regulatory environment.

Globally, regulators have been working toward a G20 agenda of introducing new registration and reporting rules for hedge fund managers, with the Alternative Investment Fund Managers Directive (AIFMD) in the European Union and the Dodd-Frank Wall Street Reform and Consumer Protection Act in the United States both seeking to increase the flow of information from managers to supervisors. Changes to the regulations around short-selling and over-the-counter derivatives clearing has also significantly impacted hedge fund managers and the wide-reaching Foreign Account Tax Compliance Act (FATCA) in the United States is likely to pose further problems.

In particular, hedge fund managers appear to be perplexed with the perceived overlap among financial regulators around the world, which they say is leading to confusion and duplication of efforts. "We see benefits in increased regulatory oversight, accountability and registration with regulators as a means of lifting the unnecessary veil of secrecy surrounding the industry and dispelling myths," said one hedge fund manager. "However, we would hope to see more regulatory convergence and information sharing to ensure an efficient information gathering process and also to facilitate comparative analysis."

Other managers pointed to regulators' moving deadlines and frequently changing rules as making it difficult to plan and execute their organizations' responses to the changing regulations. As another hedge fund manager put it, "The uncertainty around the rules is making life difficult. We have to anticipate how to respond." Another noted that, "Regulation is challenging as there is such a lack of clarity around what the regulations will affect."

What industry players all seem to agree on is the fact that this era of increased regulatory scrutiny is here to stay. "Increased regulation is a fact of life. We've faced up to that. And our investors expect us to do so. I don't believe it is necessarily a bad thing for the industry," said a manager with a large hedge fund based in the United States.

And then, of course, there is the matter of cost. The costs associated with regulatory compliance in this new environment can be high and include everything from investments in technology to bringing on new staff members with compliance-related skillsets. "The downside of regulation is the huge overhead cost," said one respondent. "And the effects of the US regulatory environment lends to more potential litigation, which is a big cost and a big unknown." Another manager suggested the investments required to deal with the increased regulatory requirements could be particularly trying for the industry's smaller players. "Our view is that regulation will limit the creativity of the smaller houses due to cost issues."

Another manager said, "The downsides are the extra burdens regulation places on managers through staff costs, professional advisory fees, etc. which will mean very different conditions for start-ups due to the extra costs. The biggest concern for us is the lack of coordination between the regulators."

And yet another noted that, "The increased regulation and initiatives such as FATCA are leading to increased costs of administration – therefore, funds may need to expand due to these tough market conditions."

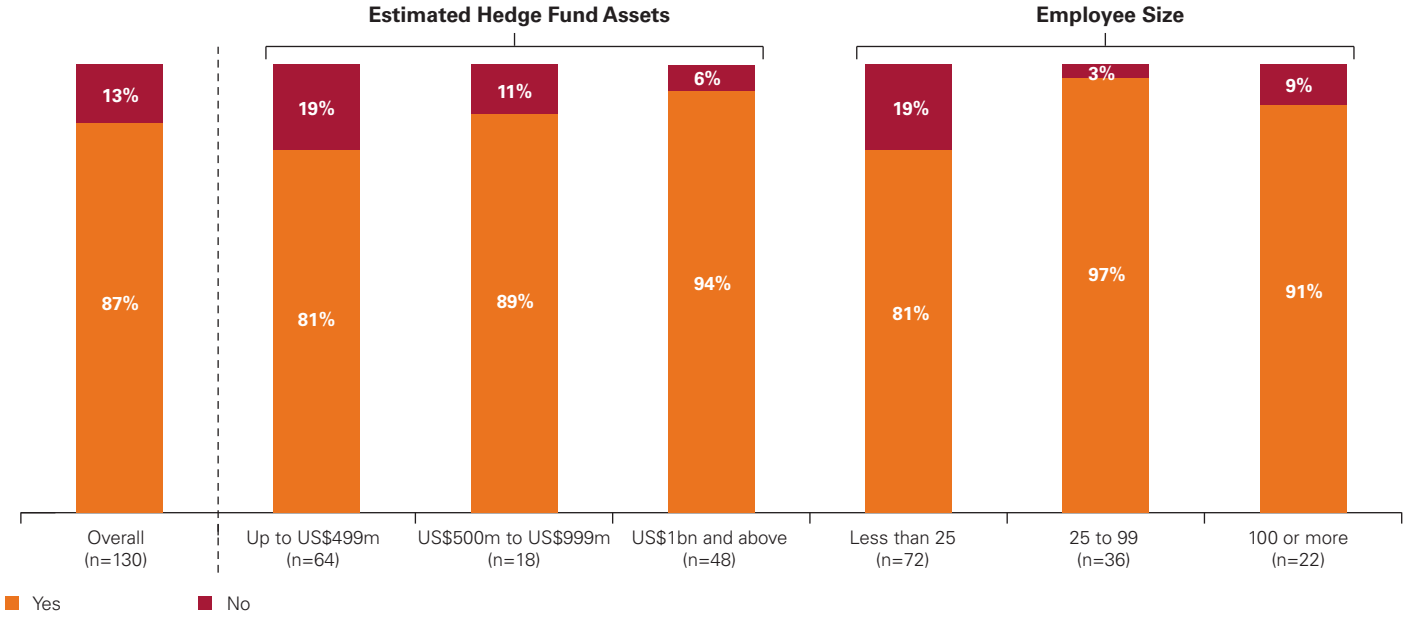
As the survey results demonstrate, regardless of fund size, nine out of 10 respondents reported an increased demand for regulatory compliance by investors. Overall, eight of each of these nine respondents reported that they had to increase employee headcount in order to accommodate this demand. In addition, seven of each of these eight respondents reported that despite the increased demand, no more than two people had to be hired to accommodate this request. Again, this additional burden appears to have weighed most heavily on the smaller sized managers, with the larger firms (in terms of AUM) reporting not only an increase in employee headcount more often than smaller firms, but the more established firms (those with 100 employees or more) had also hired double the number of people hired by the entire sample group.

The uncertainty around the rules is making life difficult.

– Hedge fund manager

Q. Have demands of regulatory compliance increased since 2008?

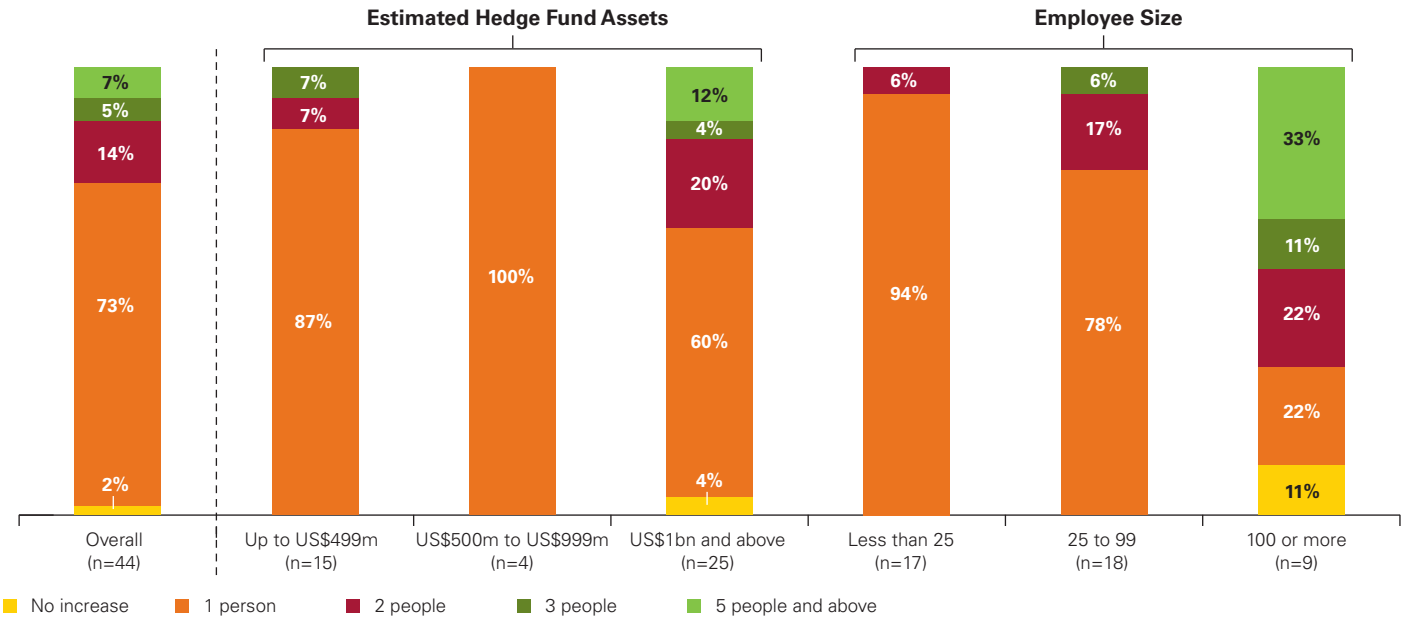
Increase in Demands of Regulatory Compliance



Source: KPMG International, 2012.

Increase in headcount in the area of regulatory compliance

Increase in Staff Headcount



Source: KPMG International, 2012.

Respondents to the survey appeared to be more likely to increase staffing levels to accommodate changes to regulatory requirements than to address the increased demands associated with transparency and due diligence. To that end, 98 percent of the respondents who increased headcount reported an increase of at least one employee in the area of regulatory compliance and 26 percent said they had hired two or more people in this area. "We've hired at least three new people on the regulatory side," observed one manager. "Regardless of the regulatory changes, because of institutionalization, we would have had to go down this path."

The survey also found that the larger hedge fund firms have the most compliance staff members. For firms with 25 to 99 staff, 11 percent work in the compliance area, compared with 13 percent for firms with 100 or more employees. The survey's finding that smaller managers have proportionately fewer compliance professionals than their larger peers also suggests that smaller managers may be finding it more challenging to meet the additional burdens associated with regulatory compliance.

Going forward, the survey found that 45 percent of hedge fund managers overall were expecting to make further increases in headcount over the next 2 years in the area of regulatory compliance. As is illustrated in the accompanying chart, this figure was relatively consistent across hedge fund sizes as measured by both assets and employee size, ranging from a low of 41 percent to a high of 50 percent. These findings indicate that managers expect the pressures associated with regulatory change to continue for the foreseeable future.

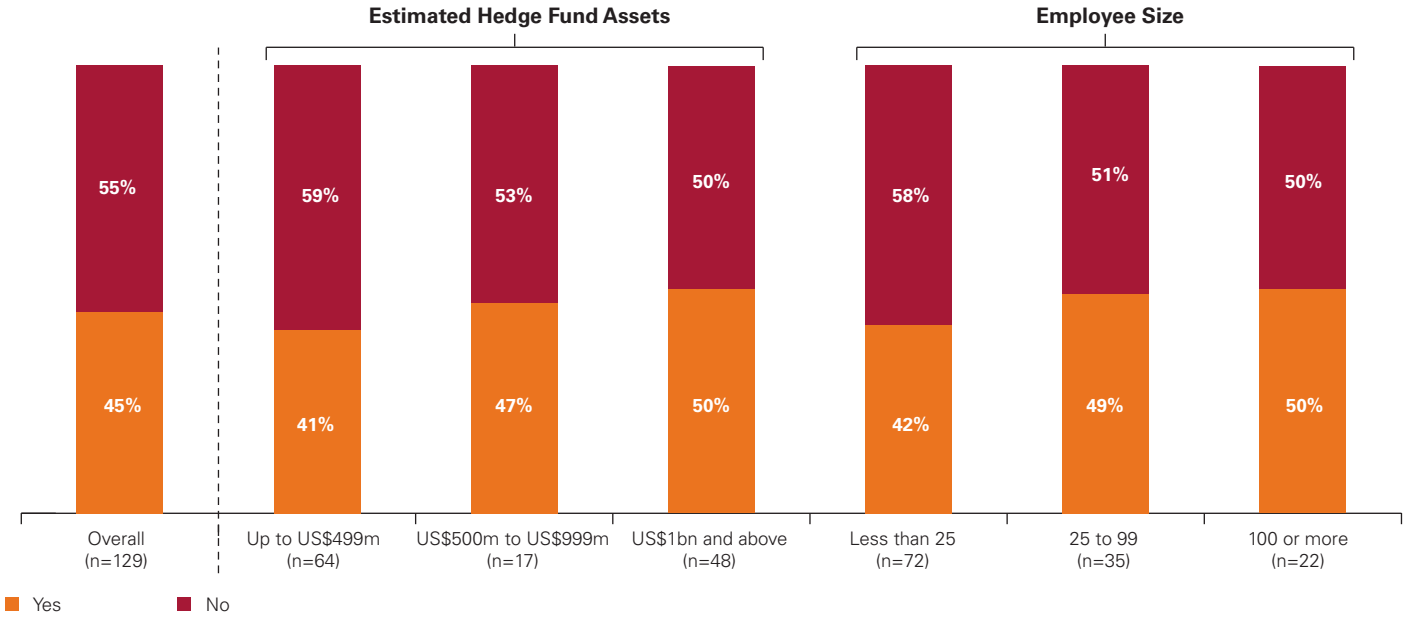
The survey results indicate the majority of survey respondents have acknowledged the fact that they have moved into an era of increased regulation. As one manager said, "When I think back to 10 years ago, the compliance person was not in the forefront with investors. But today, the compliance person is in the top three. Investors will talk to the COO, the CFO and then the compliance person." These changes are seen by some of the respondents as an unavoidable result of the recent and well-publicized troubles that have plagued the industry since 2008. As another manager observed, "Over-regulation will continue."

It's hard to disagree with the sentiment of regulation. But the way it has been done is not thoughtful.

– Hedge fund manager

Anticipated increase in headcount in the next two years in the area of regulatory compliance

Increase in Staff Size in Next 2 Years.



Source: KPMG International, 2012.

The survey responses also show that managers of all sizes are making substantial investments in terms of staffing complements and technological infrastructure in order to satisfy the wave of heightened regulatory scrutiny. "The biggest challenge around these internal processes is the automation of our procedures," said one of the hedge fund managers interviewed. "We have moved from a small business mentality to an institutional mentality."

But even as they respond to this new era of increased regulatory scrutiny, many industry players have serious concerns about the way those regulatory requirements are being implemented. "It's hard to disagree with the sentiment of regulation," said one manager. "But the way it has been done is not thoughtful. There was no cost-benefit analysis done."

Perhaps the industry's overall sentiment regarding this increased emphasis on regulatory change was best captured by the hedge fund manager who said, "We are supportive of increased regulation to reduce risk. However, we admit that it can be obstructive and time-consuming."

FATCA and the hedge fund industry

The Foreign Account Tax Compliance Act (FATCA) is aimed at preventing offshore tax abuses by US persons. The legislation requires every Foreign Financial Institution (FFI) to enter into an agreement with the Internal Revenue Service (IRS), whereby the FFI commits to identifying US accounts and reporting them annually to the IRS. Hedge funds and managers will be captured by FATCA as it impacts all domestic and foreign financial institutions that make and/or receive withholdable payments or are in the same expanded affiliated group as an entity that makes and/or receives withholdable payments. Non-compliance will result in a penal withholding regime (30 percent) on foreign entities that refuse to identify and report US persons. This would put severe commercial pressure on non-participating hedge fund managers (those not entering into agreement with the IRS) in terms of investing into the US, for either themselves or their customers/investors; thereby damaging customer relationships and reducing business opportunities.

FATCA is expected to impact hedge funds in a number of ways, including the following:

- Counterparties are likely to demand all FFIs be compliant in order to guard against the contingent risk that a hedge fund's control environment is not sufficiently robust to guarantee it will never have the slightest exposure to US assets or clients.
- Hedge funds will need to identify their US account holders and demonstrate the rest are not US taxpayers.
- Withholding rules require that the hedge fund must have the systems and process capability to identify and withhold tax on payments to entities or people who are not in good standing in the regime. This may present significant technical challenges for hedge funds.

An Industry **Looks to its Future**

It's good for the industry to grow up. Institutions need you to look like other asset managers.

– Hedge fund manager

Here is a small sampling of predictions and insights from hedge fund managers who participated in face-to-face interviews as part of the survey, touching on a variety of industry-related topics.

With respect to fees, many of the managers with whom we spoke said they expected to see continued momentum in this area over the next few years. "We anticipate further downward pressure on fees," said one manager. "Yes, there will be quite a significant downward pressure, but it won't be driven just by clients. Other managers will also be putting downward pressure on fees in an effort to compete."

A majority of respondents also said they expected to see a wave of consolidation in the industry going forward. As one participant observed, "There is likely to be some consolidation in the industry with the expectation of becoming more institutionalized." Another suggested, "There will have to be some consolidation because of increased regulation."

On the topic of the continued advancement of the hedge fund industry, one respondent zeroed in on the industry's need to address the gulf that still exists in many cases between investors and hedge funds. "We need to fix the disconnect between investors and mangers," he said. "We can do this through education and trust – and institutionalization will help."

And despite some of the challenges that lie ahead for the hedge fund industry, the majority of participants were quite enthusiastic about the future state of the industry as a whole. In some instances, these predictions focused on the continued influx of institutional funds into the industry. As one manager put it, "Pension funds need to diversify in order to meet their obligations, so there's likely to be significant flows from pension funds."

One manager said, "We're bullish on the industry. Boutiques should do great, but the regulatory burden could be challenging." Another predicted that, "The hedge fund industry should grow in the next 3 years due to the expected continued micro and macroeconomic growth in China, India and the South East Asian markets." Sharing similar feelings of optimism, observed, "There will definitely be higher industry AUM in 3 years. Money will continue to come in. Hedge funds will continue to grow." Yet another commented that, "We believe that the future is bright for us. We have continued interest and our performance is improving."

Looking Ahead

From its earliest days, the hedge fund industry has earned a reputation for its diversity, resilience and adaptability. The players within the industry have continually proven themselves adept at assessing the implications of their changing environment and then adjusting and reinventing themselves to suit their new surroundings. Indeed, since its inception, the entire industry has been powerfully incentivized to innovate, whether it be through investments in new thinking, research, strategies or ideas, in order to remain 'ahead of the curve'.

As the results of this survey demonstrate, much of the global hedge fund industry is in the midst of a metamorphosis into a fully institutionalized, mainstream player. But while smaller managers who cannot create their own institutional infrastructure face challenges attracting allocations from larger investors and coping with regulatory compliance, our findings suggest many of them are adapting and thriving through the use of new models or structures, whether these be platforms, new seeding programs or co-opetition-type relationships. Indeed, the global hedge fund industry is demonstrating once again its willingness and capacity to evolve.

We're bullish on the industry.

– Hedge fund manager

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