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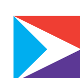

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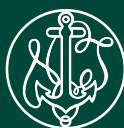

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This report was researched and written by Philip Moore, special reports writer for HedgeFund Intelligence

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Introduction

Regulatory changes and the institutionalisation of the hedge fund investor base are bringing about a significant rise in the levels of transparency that hedge fund managers are prepared to give their investors these days – and more importantly, which investors now expect to receive from their managers. But what types of transparency are useful for investors? What kinds of demands are unreasonable, or counter-productive? What are the costs and the benefits – and to whom? And what will be the longer-term impact of the new standards of investor transparency in terms of the evolving relationships between managers, investors and service providers? ***Philip Moore reports***

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Investors set the bar for new standards of transparency

"If you're a hedge fund manager, your dream scenario is that you get $10 billion locked up for 10 years and never report to anyone," says Christopher Fawcett, senior investment officer (SIO) at Permal Investment Management, which has about $22 billion invested in hedge funds across a range of strategies.

No manager could disagree and keep a straight face. The simple fact of the matter is that maintaining pellucid records and providing them to investors, regulators and others on a timely and consistent basis is expensive and time-consuming.

The good governance gospel tells you that transparency ultimately supports performance. But try telling that to a famously uncommunicative manager like Moore Capital, which few market participants would be in any hurry to make change its spots.

Others believe, however, that even managers like Moore may be unable to resist the industry's inexorable drift towards more rigorous reporting and open communication.

"Companies like Moore have been able to live off the calling card of their performance for many years, but I believe if Moore were starting out today it would not be able to raise new funds without becoming more transparent," says one former Moore manager. "Four or five years from now, I think we will see a very different Moore."

In broad terms, pressure for change has come from two sources at more or less the same time: regulators and investors. In Europe, the regulatory pressure has come chiefly from the Alternative Investment Fund Managers Directive (AIFMD) and, more recently, the European Market Infrastructure Regulation (EMIR),

both of which are explicit about requirements for enhanced transparency.

One of AIFMD's stated aims is to "improve investor protection by imposing new depositary standards and enhanced transparency through new investor disclosure rules and mandatory reporting to competent authorities".

In the US, meanwhile, regulatory pressure has also intensified since the financial crisis and the Madoff fraud. The most significant regulatory change in the US is the Dodd-Frank Act, described in a 'cheat-sheet' published by the law firm, Morrison & Foerster, as "the most comprehensive financial regulatory reform measure taken since the Great Depression".

This requires advisors to hedge funds managing $100 million or more to register with the SEC. Dodd-Frank also directs the SEC to collect information from private fund advisors regarding the risk profile of their funds.

Another key component of US regulatory change to have had an impact on transparency in the hedge fund industry is the JOBS (Jumpstart our Business Startups) Act, which lifted the decades-old ban on general solicitation that applied to funds offering private securities under Rule 506 of Regulation D.

For the SEC itself, Dodd-Frank in particular turned out to be quite an eye-opener about how little the regulators knew about the sprawling US hedge fund industry.

Mary Jo White, chairwoman of the SEC, acknowledged as much in a keynote address to the Managed Funds Association (MFA) in October 2013. As recently as 2010, she explained, regulators' view of the hedge fund market was limited to advisors who had voluntarily registered with the SEC, or were required to do so because they also managed a mutual fund.

"We knew that there was a gap in our knowledge," White explained. "But we did not know how many hedge fund managers existed and we did not know who they were – we could not tell how big this slice of the market really was."

Dodd-Frank changed all that, with hedge funds and other private fund advisors required to show their hands for the first time. Prior to

>> As of September 23, 2013, hedge fund managers feel they have a new freedom to communicate with the public, to advertise, to talk to reporters, to speak at conferences and, most importantly, communicate with investors openly and frankly >>
Mary Jo White, chairwoman of the SEC

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Dodd-Frank, according to White's numbers, the SEC had information on some 2,500 hedge funds. Soon after it, 1,500 new funds stepped forward, bringing the total to just over 4,000.

"Until then," said White, "we did not know that we had not accounted for one-third of the industry. Today, as we now know, approximately 40% of the investment advisers, who are registered with the SEC, manage one or more hedge funds or other private funds."

The other regulatory jab to the ribs of the US investment management industry, JOBS, has impacted hedge funds in a very different way, by encouraging a level of openness that would have been regarded as heresy by many managers a decade or so ago.

"As of September 23, 2013," explained White, "hedge fund managers feel they have a new freedom to communicate with the public, to advertise, to talk to reporters, to speak at conferences and, most importantly, communicate with investors openly and frankly. And you can do these things without the fear of securities regulators knocking on your door, or your outside counsel screaming at you."

That will be welcome news to every journalist, every research analyst and every student that has googled scores of leading hedge fund managers only to encounter startlingly uninformative websites, password-protected against external scrutiny by anyone other than deep-pocketed clients.

Nobody contests the view that regulation has played a decisive role in pushing hedge funds towards enhanced transparency. A number of industry participants say, however, that initiatives ranging from AIFMD to Dodd-Frank have probably acted as catalysts for change, rather than as the sole drivers of a Road to Damascus-style rethink among hedge funds.

A more important driver, say many, has been the increasing participation in the hedge fund industry of institutional investors, which has gathered momentum since the financial crisis. The trend towards the increased institutionalisation of the hedge fund industry is confirmed by industry surveys on the size and structure of the market. According to the latest snapshot of the industry taken by Deutsche Bank's Global Prime Finance business, nearly half of institutional investors upped their hedge fund allocations in 2013, and 57% plan to increase their allocations in 2014.

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INVESTORS ARE THE KEY DRIVERS

Clearly, then, it is institutions rather than high-net-worth individuals or family offices that will be the driving force of the industry's continued growth, with Deutsche reckoning that total assets under management will reach a record $3 trillion by the end of 2014, compared with $2.6 trillion at year-end 2013. "Institutional investors now account for two thirds of industry assets, compared to approximately one third pre-crisis."

Peter Sanchez, chief executive officer at Northern Trust Hedge Fund Services in Chicago, puts the institutionalisation of the market above regulatory pressure as the main catalyst of change within the industry.

Peter Sanchez, CEO at Northern Trust Hedge Fund Services

>> Institutional investors demand a high level of transparency in terms of exposure, performance and compliance, and they want these commitments in the offering memoranda >>

"Institutional investors demand a high level of transparency in terms of exposure, performance and compliance, and they want these commitments in the offering memoranda," he says. "All the pressure for transparency that they brought to the traditional world, they have also brought to the hedge fund world."

Permal's Fawcett puts this evolution into its historical context. "Until 2008, the balance of power lay very clearly with the hedge fund managers," he says. "There was more demand than supply, a lot of funds were closed to new investors and managers could more or less dictate their own terms."

"2008 changed that dynamic in several ways," says Fawcett. "Although hedge funds performed better than long-only managers, as a group they still suffered losses. At the same time, investors discovered that a lot of the funds had considerably more exposure to illiquid investments than they thought."

In some of the most extreme cases, exposure to illiquid positions meant that portfolios were radically different from what investors had been led to

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believe. Jeff Holland, managing director and co-founder of the London-based Liongate Capital Management, points to the case of the German hedge fund manager, Florian Homm, as one of the more colourful examples of an individual whose management strategy turned out to bear very little resemblance to what his investors had expected.

Homm, founder and one-time chief investment officer of Absolute Capital Management Holdings, is alleged to have channelled his client's funds into dubious penny stocks rather than liquid listed equities. That, along with a number of other allegations, led the SEC to charge Homm and others with "violations of several broker-dealer record-keeping provisions".

Jeff Holland, managing director and co-founder of Liongate Capital Management

>> By and large, managers don't have sinister reasons for not being transparent >>

Fortunately, says Holland, cases of discovered or alleged fraud *à la* Madoff or Absolute Capital have been few and far between. "What is much more common," he says, "is an element of window-dressing, where a long/short equity manager claiming to deal only in liquid equities is in reality over-exposed to smaller, less liquid names. Over the last few years, investors have become much more attuned to this sort of risk."

Holland says that in fairness to managers, many who continue to resist calls for more transparency have perfectly understandable reasons for doing so. "By and large, managers don't have sinister reasons for not being transparent," he says. "Many say that their ideas are proprietary and they want to protect their process."

The horrifying recognition that investors may have had very little idea of what was in their portfolios, let alone have the tools they needed to analyse those portfolios, had a notable impact on the relationship between hedge fund managers and their investors.

"The Lehman crisis and the Madoff scandal really acted as a wake-up call for

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Pete Cherecwich, head of the global fund services business unit at Northern Trust

>> As fees became more of a focus, investors demanded more for their money. Above all, they wanted more detail about where their performance was coming from >>

investors," says Pete Cherecwich, head of the global fund services business unit at Northern Trust in Chicago. "Investors started to ask whether they really knew what their exposures, concentrations and correlations were, and to focus much more on the liquidity of their investments."

Institutional investors differed from hedge funds' client base in two other important ways, both of which also had implications for the thoroughness of reporting standards. One of these is that they tended to adopt a more critical approach to the fees they were paying, and on the quality of the all-round service they were coughing up their 2+20 for. "As fees became more of a focus, investors demanded more for their money," says Cherecwich. "Above all, they wanted more detail about where their performance was coming from."

In some instances, another new element that institutions brought to the manager-client relationship, says Permal's Fawcett, was a fiduciary requirement to know exactly what they are investing in. "For example, insurance companies' capital adequacy risk weightings on their hedge fund investments rise if they don't have transparency," he explains. "So managers recognise that they have to be transparent if they want to access certain pools of capital."

In the vast majority of cases, managers had no choice but to respond constructively to the requirements of their increasingly demanding, sophisticated and fee-conscious investors. "If I'm an individual who wants to put $50,000 into a hedge fund, my bargaining power with the manager is limited," says Cherecwich at Northern Trust. "If I'm Calpers and have a $200 million allocation to make, the balance of power is very different."

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WHAT KIND OF TRANSPARENCY?

Even prior to the crisis, however, the transparency bandwagon had been gathering momentum. Pacific Alternative Asset Management Company (PAAMCO), which was set up in 2000 in Irvine, California, is an example of a fund of funds which was insisting on full position-level transparency long before the crisis exposed serious fault-lines across the hedge fund industry.

"PAAMCO launched in 2000 and ever since then, we have demanded position-level transparency from all our managers on at least a monthly basis," says Joshua Barlow, vice president, who joined PAAMCO in 2006 to perform the firm's operational due diligence. "In 2005, we created a managed accounts platform to strengthen the oversight of our investments and enable us to customise our exposure. Today, all our new investments are either on our managed accounts platform or through a fund of one."

Joshua Barlow, vice president of PAAMCO

>> In 2005, we created a managed accounts platform to strengthen the oversight of our investments and enable us to customise our exposure >>

Whether or not investors are prepared to pay for enhanced transparency is a moot point, although as one manager points out, the success of the UCITS movement in Europe suggests that some might be.

"We have seen clear examples of investors who are very happy with managers' Cayman-based strategies moving money into the onshore versions of the same funds," he says. "They know full well that they will be paying a management fee of 1.75% rather than 1.5%, but they appear to be willing to pay the extra 25bp to cover the extra costs incurred by the UCITS wrapper for the added transparency it offers."

Certainly, one of the reasons often cited for the popularity of UCITS is the robust standards of oversight they are required to maintain. As Credit Suisse advises in a recent report: "Arguably one of the most effective measures taken by the UCITS directive to provide investor protection is the requirement for UCITS funds

to hire independent service providers such as trustees, auditors, administrators and custodians. As for fraudulent activities, it can be said that while it is impossible to guarantee total protection from fraud risk, the independent custody of assets should significantly improve the protection of investors' assets."

Kevin Hrad, senior consultant, hedge fund research, at investment consultant Hewitt Ennisknupp in Chicago, says that transparency is a vague term that can mean different things to different investors.

Kevin Hrad, senior consultant, hedge fund research, at investment consultant Hewitt Ennisknupp

>> Some investors just want the comfort that assets are there. Others want a much better understanding of how a portfolio is managed for not being transparent >>

"Some investors just want the comfort that assets are there," he says. "Others want a much better understanding of how a portfolio is managed and an insight into the thought process and philosophy behind its asset allocation, which means testing how well the team knows its 25th largest position rather than just its top two."

"Others want to aggregate positions across a portfolio for a more holistic view of their investments and the risk factors they are exposed to, not just with one manager but across a range of managers who may represent things very differently," he says.

"For us, it is all of the above," says Hrad. "We make it clear that we want full-level transparency. We're not going to compromise on transparency, regardless of the reputation or track record of the manager."

"The most extreme approach is to require that all an investor's funds are managed on a completely transparent basis and conform to a framework where there is real-time independent monitoring of all positions," says Holland at Liongate. "There is an expense associated with this approach, both in terms of the cost of the mandate and in terms of the opportunity cost that can limit returns by creating very narrow risk templates that funds have to fit into."

While Holland says that Liongate insists on robust

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due diligence, it recognises that there are limits to what is practical in terms of transparency. "Our minimum required level is not 100% transparency," he says. "But we do demand that all our managers have third-party administrators and must allow us to obtain verification of the breakdown of assets from the administrator. Taking the example of a long/short equity strategy, we would want confirmation from the administrator of the liquidity of each of the positions within the portfolio."

Managers less prepared to offer position-level information will generally provide information via third-party aggregators such as the RiskMetrics HedgePlatform. Some would say that provides the best of both worlds for funds and investors alike. According to RiskMetrics, "because position-detail is not revealed, hedge funds maintain their investment edge while investors are able to perform robust due diligence, monitoring, portfolio construction and risk management".

THE LIMITATIONS ON BEING OPEN

Even among managers that are comfortable with full reporting, there are some very clear limitations to the amount of transparency that funds can offer, for a number of reasons. The most obvious of these is in cases where the fund's strategy – its *raison d'être* – depends on a degree of confidentiality.

"We would have sympathy with some funds not wanting to reveal all their positions in real time," says Fawcett at Permal. "In the case of activists, for example, managers may be building up a strategic stake in a company which is market-sensitive information. So we would understand why that would make managers reluctant to provide information."

Another potential limitation to full-level transparency is in the area of hard-to-value derivatives and other complex new instruments, although market participants say that notable progress has been made on the provision of more granular information in this area. "Technology has come a very long way over the last decade," says Northern Trust's Cherecwich. "It was very difficult to guarantee transparency 10 years ago on the derivatives side, for example, because everything was bilateral and paper-based. The level of automation we now have means that even in the complex derivatives space, we can provide transparent, real-time reporting."

Another limitation on transparency is in the case of smaller or start-up funds

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that may be very good at generating alpha in their particular strategy, but which equally may have neither the time, resources nor expertise to deliver the reporting required by today's more demanding investors.

PAAMCO's Barlow has authored a report on this subject, which advises that "as an operational due diligence team, we hold the emerging manager to the same standards as we do the more established manager, and recommend that other investors take a similar approach".

On some occasions, as Barlow's paper acknowledges, routine but important procedures of testing a manager's processes cannot be undertaken, simply because the new manager has not begun to trade. In those instances, due diligence can be more time-consuming. It also means that due diligence testing can, according to Barlow, end up becoming "more like due diligence consulting".

Christopher Fawcett, senior investment officer at Permal Investment Management

>> We have been aware of investors being given very transparent reporting who were hopelessly ill-equipped to analyse it >>

In practice, as well, being provided with the information is one thing. Being able to make effective use of what may amount to information overload is another. "We have been aware of investors being given very transparent reporting who were hopelessly ill-equipped to analyse it," says Permal's Fawcett. "If you get sent a 100-page print-out from a convertible arbitrage manager, for example, it is a detailed and complicated document. If it's not sent in the right format, and if you don't have the people who are able to understand it, it's no good to you at all."

As Fawcett says, this gives rise to the suspicion that some managers may simply be going through the motions in terms of transparency. At best, he says, this will result in reams of reports being sent to managers that are not read, let alone analysed.

At worst, Fawcett says that he knows of some funds of funds claiming to have been given full-level reporting from managers which don't provide transparency. "To be blunt, people were lying about the transparency they were getting," he says.

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THE COSTS AND THE BENEFITS

Regulators and hedge fund investors acknowledge that the more onerous demands being made of managers are inevitably burdensome. Transparency, as the SEC's Mary Jo White said in her address to the MFA in October, "means being subject to an occasional visit by a team of our professional compliance examiners – who will review your records and sit with you to evaluate whether your firm is being run in compliance with… business conduct rules and other requirements."

Sounds comfy. But a visit from the securities industry's cop on the corner is unlikely to be like a cosy fireside chat. "This may not be the most welcome aspect of the new age of transparency for hedge fund advisers," White conceded.

Visits from funds of funds' operational due diligence teams can be equally rigorous. "If we want to meet people, we expect to be able to meet them," says Barlow at PAAMCO. "If we want them to walk us through certain processes we expect them to show us the processes and documents. That is an absolute requirement."

Administrators, too, are being subjected to a level of unprecedented oversight. "Today, we have more organisations coming in to do due diligence on us than ever before," says Cherecwich at Northern Trust. "More and more, investors are demanding demos to see our controls in action. They also want to meet the individuals who service their accounts."

But regulators and investors insist that the long-term *quid pro quo* of these rigorous governance standards will be increased operational efficiencies and even improved performance, which in turn should support rising levels of assets under management. Quantifying the performance benefits of better due diligence and enhanced transparency is inevitably more of an art than a science.

Barlow, however, insists that PAAMCO's exacting transparency standards contribute to performance. "Structure and position-level transparency don't hinder performance," he says. "These are some of the things that help make us successful investors. That may sound counter-intuitive because not all managers are prepared to conform to our standards. But our manager selection has helped us to outperform, and we seek to outperform our managers' co-mingled funds by having lower fees and customising our funds."

At Northern Trust, Sanchez says that the cost savings associated with transparency should not just be measured by the relative performance of a fund. "There is a correlation between firm-wide transparency around controls and

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data management – which aid faster and better investment decision-making – on the one hand, and enhanced alpha above and beyond the strategy-specific alpha generation in the portfolio," he says.

For example, says Sanchez, the general consensus is that Dodd-Frank and EMIR guidelines will lead to a requirement for market participants to hold higher levels of eligible collateral and access to more secure short-term liquidity.

"This is leading to a greater emphasis on collateral, liquidity and funding optimisation, more timely rebalancing based on exposure, and FX cash overlay transparency on a firm-wide basis," says Sanchez. "These are all examples of areas where enhanced transparency and controls can add alpha-generating performance to the bottom line."

Beyond investors themselves, there are a number of clear winners to have emerged as a result of the broader move towards transparency. One of these is managed accounts platforms, which are generally seen as having revolutionised transparency standards in the hedge fund universe. "The best way to address the issue of transparency is undoubtedly through managed accounts," says Fawcett at Permal. "I don't think there's any evidence that because you have a managed account, information leaks out to the market and your positions are compromised."

The other major winner from the industry's increasingly strident calls for pellucid reporting practices is administrators in general, and the larger, more global hedge fund servicers in particular. The fastest-growing of these, says Sanchez, is Northern Trust, which has enjoyed something of a turbocharged expansion since its acquisition in 2011 of Omnium, a hedge fund administrator which at the time had some $30 billion of hedge fund assets under administration as well as the $40 billion Lehman Brothers Estate.

In the three-year period since then, says Sanchez, Northern Trust has worked with Lehman to wind down the estate, while at the same time its client base has grown three-fold and its hedge fund assets under administration have more than tripled. By year-end, Sanchez reports, the total increase in administration assets will be more than eight-fold, once several key conversions are completed. "Our growth has been global, because we have significant operations in Europe and Hong Kong, but the predominant growth has been in the US," he says.

Growth, says Sanchez, has been qualitative as well as quantitative. "Our capabilities in technology, which are well-known for being among the best, and combined with

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our ability to aggregate data have put us in a phenomenal position in terms of offering transparency on performance, risk and exposure on a real-time basis," he says.

The growth that Northern Trust has seen in its franchise across the world mirrors a global trend that is playing to the strengths of larger administrators, potentially squeezing smaller, niche players and probably acting as a catalyst for more consolidation in the industry.

"For a while, every big fund has recognised the need to outsource its administration to a reputable third-party administrator," says Northern Trust's Cherecwich. "But regulatory developments such as AIFMD are also meaning that funds' external administrators also need to offer trustee and depositary services. This in turn means that bank-affiliated firms such as Northern Trust, which are supported by big balance sheets, will increasingly enjoy a competitive advantage."

Peter Sanchez, CEO at Northern Trust Hedge Fund Services

>> Our growth has been global, because we have significant operations in Europe and Hong Kong, but the predominant growth has been in the US >>

THE RISE OF 'SHADOW REPORTING'

One of the more striking manifestations of rising demand for enhanced transparency standards in the hedge fund industry in the US is the growing importance of shadow accounting and administration. There is nothing especially revolutionary about shadow accounting itself. "In the early days of the hedge fund market, most funds received no more than the administrator's monthly NAV report," Sanchez explains. "As a result, investors began to expect there to be some kind of shadow function in-house to give managers a better understanding of the accounting and management of the portfolio."

"As the market matured and daily NAV reporting and middle-office services were offered by administrators, it became industry standard that if you were a billion dollar club (BDC) hedge fund you likely had not just an administrator," Sanchez adds. "You would also have an in-house middle office providing trade support functions to your portfolio managers and

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also an in-house accounting shadow function."

The next stage in the evolution of the market saw some of the largest funds re-evaluating the economics of in-house shadowing. "Demands for added transparency from institutional investors as well as regulators led to a significant increase in the investment that firms had to make in terms of people, technology and data management," says Sanchez. "And as it became a more expensive and less scalable operation, many BDCs started to question whether it made sense to keep the middle-office activities in-house."

Pete Cherecwich, head of the global fund services business unit at Northern Trust

>> As long as hedge fund managers could depend on being paid 2+20, they may have believed they could manage the middle office in-house. As soon as fees start moving down towards 1+10, they may start to see it as too much of an expense >>

Many concluded that it did not. "A trend we've seen is that many BDCs are looking to outsource middle-office services including trade management, portfolio management and P&L valuation," says Sanchez. "And as the middle-office services offered by Northern Trust comes with shadow NAV reporting, some BDCs are now seeing they can kill two birds with one stone."

Today, as Ernst & Young explains in a recent briefing on shadow accounting, "Integrity and accuracy of data are critical for trading, portfolio management, compliance, risk management and reporting to investors." Critical indeed, especially when you have $150 billion or so of assets under management, as Bridgewater Associates does. Originally set up in a two-bedroom apartment in 1975, the Westport, CT-based Bridgewater was ranked as the largest and best-performing hedge fund manager in the world in 2012 and 2013.

In 2013, Bridgewater took the process of transparency in the hedge fund world on to a new plane when it announced that it had appointed Northern Trust to shadow the fund administration work undertaken by BNY Mellon. In 2011, Bridgewater fully outsourced its middle and back-office operations to

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BNY Mellon, so the decision to appoint Northern Trust as a shadow means that the fund now effectively has two administrators.

Northern Trust is now in the process of going live on the shadow administration. "The way it works is that we take a feed from BNY Mellon every day and then compare with more than 50 datasets to our own calculations for any discrepancies," says Cherecwich.

Gilding the lily? Not at all, says Northern Trust. "The benefit to Bridgewater is that it has a full control, check and balance against every single cashflow generated within its super-large and super-complex portfolio," says Sanchez. "Second, it now has an embedded business resiliency and contingency plan."

Cherecwich says that the Bridgewater initiative probably represents the tip of the iceberg for shadow administration in the alternative asset management space. "In the traditional world, about 25% to 30% of managers have outsourced their middle office to shadow administrators," he says. "I believe the same thing will end up happening in the hedge fund world. What will drive this process will be continued pressure on fees. As long as hedge fund managers could depend on being paid 2+20, they may have believed they could manage the middle office in-house. As soon as fees start moving down towards 1+10, they may start to see it as too much of an expense."

It is true that pressure on fees appears to be heralding the demise of the traditional 2+20 structures that hedge fund managers have enjoyed for many years. According to Deutsche's recent survey, 2+20 is no longer the fee norm, with investors now paying average management and performance fees of 1.7% and 18.2% respectively.

But surely, appointing two external administrators rather than one inevitably drives up – rather than reduces – a manager's costs? After all, according to Cherecwich, Northern Trust has had to hire around 100 extra staff to work on the Bridgewater project.

Sanchez says, however, that net costs are ultimately reduced through higher efficiencies. "When you think about the costs of maintaining an in-house middle office and accounting system, they are considerable," he says. "Firms invest a great deal in their business resiliency contingency planning, but when that is all embedded into an outsourced shadow relationship the total costs are probably equivalent if not slightly lower."

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