

# The Evolution of the Hedge Fund Industry

One of the defining characteristics of the early hedge fund industry was a complete focus on investment activities, escaping the bureaucracy and overhead of the large investment banks and investment management houses. Unsurprisingly, this appealed very directly to its early clients, ultra high net worth private investors who were equally tired of benchmark-driven closet indexing, and relationship managers more concerned about reducing risks to their own businesses than preserving client capital and generating raw performance.

The industry has reached adolescence and is attracting significant sums from fund of funds and institutional investors. Concomitantly, as assets under management have mushroomed to near \$2 trillion, hedge funds have attracted attention from a variety of often unwelcome sources; from regulatory authorities concerned with the potential for market abuse; from law makers and central bankers concerned about systematic risk; from exchanges because of the role of hedge funds in determining market prices; from the boardroom where directors are uncomfortable about their new and more demanding shareholders; from the brokerage community as the most lucrative and active prime brokerage clients; from investment bankers, as funds become pivotal in the outcome of deals; and

from the media, ever ready to sensationalise the now fabled wealth of some participants.

All of these factors, in varying and sometimes vicious combinations, are putting pressure on the industry to evolve.

As the world's leading provider of audit and tax services to the hedge fund industry, with a dominant position in London, our clients are stimulating – indeed requiring – the broadening and deepening of our capabilities. Efficient tax structuring and traditional audits remain important, but the questions clients now pose derive from their efforts to make their businesses more durable, their interest in monetising their investment and the increasing glare of institutional investors, regulators and tax authorities.

Like yin and yang, the industry spawned from the rejection of institutional bureaucracy is itself institutionalising, while many traditional managers are adopting so-called 'multi-boutique' platforms to permit greater freedom and more accountable financial rewards.

Start ups continue, but they are less frequent as the infrastructure now required by investors prevents most managers from starting on their own with less than a few hundred million dollars under management. Our clients are increasingly turning their attention to converting their entrepreneurial activity into an enduring business: developing strong operating models with a range of managers and investment styles without losing the entrepreneurship which sparked the business in the first place.

## The questions our clients are now asking...



### How do we control operational risk?

The pressure to make operating models more robust and transparent is fuelled by an interest in achieving scalability given the growth in size and complexity of assets under management and, in many cases, the location of operations in a number of countries dealing with many different products. This is reinforced by the demands of an increasingly institutional

client base and the desire to restrain regulatory interference. Our clients seek assistance, not only on how effectively to manage the risks in their processes and systems in a holistic way, but also how best to demonstrate to their key stakeholders – investors, shareholders and regulators – that they are operating in a sound business control environment.

We are commonly asked by clients to review their models for finance, front office, middle office and back office operations, to advise them on system selection and their outsourcing arrangements, to project manage the design and implementation of their operating model, to audit their investment performance, to report on our reviews to their stakeholders (for instance via a

SAS70 report) and to help them deal with external regulators. Initially this was in the context of start ups, but increasingly our clients are seeking assistance in the transformation of their operating models to cater for a rapid growth and diversification of their business. Whether to have an internal audit function is now a more common question than how to outsource compliance.

## Should we sell an interest in our firm?

Deals to date have included outright acquisitions by banks, fund managers and other institutions, initial public offerings and sales of minority interests in equity or revenue streams. Motivations on the part of the sellers have included a desire to monetise their investment while demand is strong, facilitating a generational shift of financial interest and strengthening the operational base of the firm. The main flow has involved the purchase of hedge fund and fund of hedge fund managers. The industry is increasingly running long-only strategies, and we expect to see some hedge fund managers capitalise on

the relative pricing differential between alternative and long-only managers by purchasing a long-only firm with a view to diversifying business risk. Convergence is a strong part of and influence on the process: a convergence between long-only managers running 30/130 products and UCITS III products on the one hand, and hedge fund managers running concentrated long-only funds on the other. Similarly, but for different reasons, there is a well-rehearsed convergence between private equity and hedge funds. These trends are the subject of a separate paper, but clearly influence the thinking and destiny of hedge fund managers.

We not only have conducted financial, operating, tax, regulatory and commercial due diligence, advised on tax structuring and acted as reporting accountants, but have also acted as financial advisor sourcing the deal and implementing post merger integration programmes. We run programmes for non-executive directors and a bi-annual IPO Retreat, an intensive two-day programme with specialist advisers sharing their ideas and knowledge on what it takes to deliver a successful IPO.

## Should we raise permanent capital?

The need for liquidity to meet redemptions has not been tested across the market since net new investment has been robust and is increasing. However, individual funds have been vapourised by a sudden wall of redemptions, in some cases a panic reaction intensified by the relative illiquidity of the fund. The allure of absolute returns with minimal draw-downs resonates with both high net worth individuals and institutional investors and the future for hedge funds remains bright. A number of forward looking managers have capitalised on their current appeal by raising permanent capital in the form of listed closed-end funds; some whilst closing their open-end funds. This particularly makes sense when nearing capacity constraints.

Here, in addition to audit and tax services, we have advised on listing requirements and corporate governance, conducted due diligence for the prospectus (including auditing the investment performance track records) and advised on readying the business for the increased transparency that comes from a listing, dealing

with discounts and establishing discount control mechanisms.

## How do we deal with this unexpected call from the regulator or tax man?

While both regulators and tax authorities have been largely mindful that antagonism towards hedge funds would not be in the public interest, there is a marked change in the stance of these authorities who are more willing to spend time and money investigating hedge funds perceived to be pushing the boundaries of acceptable practice.

The authorities have armed themselves with new “levers” to get on the inside of hedge funds, including increased regulatory requirements through the Markets in Financial Instruments Directive (MiFID) and the Capital Requirements Directive (CRD). In addition, both the UK Financial Services Authority (FSA) and HM Revenue and Customs (HMRC) have set aside dedicated resources to monitor

the hedge fund market, with newly set up specialised hedge fund units. Other external bodies have entered the regulatory arena, for example Moody's Operations Quality ratings for hedge funds, the EU Alternative Investment Expert Group and the Alternative Investments Task Force established by the Auditing Standards Board.

In large part, the regulators on this side of the Atlantic and, in particular, the FSA have taken a sensible, principles-based approach to the industry, not responding to some of the more hysterical outbursts of politicians or senior businessmen with vested interests. Luxembourg has recently introduced new legislation on Specialised Investment Funds (SIFs), simplifying the rules for setting up fund structures, such as hedge funds.

The industry, in turn has grown in responsibility and, wisely, is beginning to have well-thought out and properly prepared positions supported by good documentation for matters such as transfer pricing policies. There is often a trade-off between best practice and maintaining an entrepreneurial spirit and flexibility.

Some onerous rules originally designed for other activities, for example banking, are being imposed on asset managers and need to be applied with a light touch.

In-house staff are likely to benefit from our wealth of experience as advisers to some three-quarters of Europe's top 50 hedge fund managers. In addition, we are extremely supportive of the efforts of organisations such as, for example Alternative Investment Management Association (AIMA), providing the chairman and a secondee to the AIMA Tax Committee to facilitate discussions with HMRC on recent changes to the Statement of Practice governing the application of the Investment Management Exemption (IME).

We have helped our clients manage Revenue enquiries which have increasingly focused on dual contracts, transfer pricing, remuneration planning and the application of the IME, and have also supported our clients in their implementation of new regulations, including MiFID, CRD and SEC registrations, as well as detailed compliance monitoring programmes.

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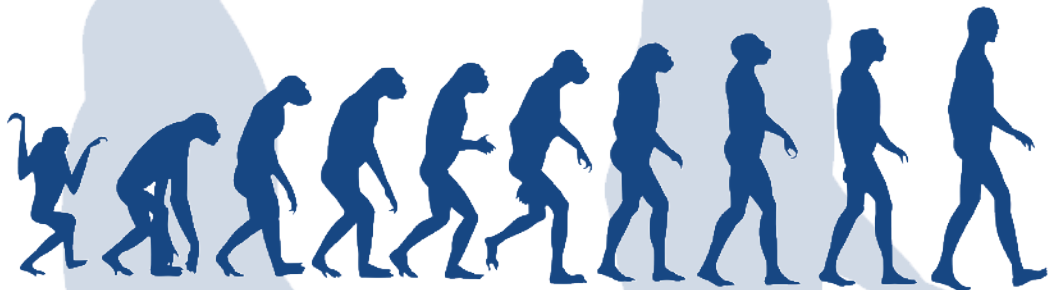
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**Best Accountancy Firm for Hedge Funds  
Hedge Fund Journal 2006**

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# Questions our clients are asking

as the hedge fund industry evolves

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