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With regulations such as Fatca and Dodd-Frank shaking up the US financial services industry, hedge fund managers on the East Coast of America are under more scrutiny and pressure than ever before. Fund managers are shouldering the burden of new government oversights and an exhausting increase in reporting requirements as new waves of legislation wash ashore.

However, the US market is not entirely a case of increasing pressures and challenges. In the midst of a slowly recovering economy, opportunity is afoot, as initiatives such as the SEC’s proposed JOBS Act and developments such as those in the ’40 Act space open the door to new investors. Additionally, as the benefits of using emerging managers are once again slowly being recognised, new players are gaining prominence on the scene. The country long known as the land of opportunity is starting to see increasing promise once more.

The East Coast community represents a large slice of the US, and indeed global, hedge fund industry, with over $1trn in AuM in Connecticut, Massachusetts and New York, and remains home to some of the biggest names in the business. Taking the importance of this region in the global market into consideration, HFMWeek has gathered together some of the best in the business for this, the HFM US East Coast Report, to provide some insight on the issues and opportunities that are shaping the industry from, what remains, the industry’s heartland.

Alexis Burris
REPORT EDITOR
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Aaron Steinberg of Pershing Prime Services speaks to HFMWeek about the main drivers behind the growth of alternative ‘40 Act funds as well as the advantages and challenges of these structures
Concept Capital Markets, LLC offers a comprehensive suite of brokerage and related services that provide traditional and alternative investment managers with solutions that are customizable and scalable. The firm was built by former investment managers to serve hedge fund managers, managed account platforms, institutional investors, family offices, and registered investment advisors with turn-key solutions designed to free its clients to focus on their core competencies. Our offering features world-class custody and clearing options, multi asset class capabilities, leading execution and order management systems, a seasoned execution desk, a range of financing options, a highly professional operations and customer support team, comprehensive portfolio reporting capabilities, and capital introduction.
As an industry leader in fund services, U.S. Bancorp is focused on investing in their clients’ future, including advising them in a changing regulatory environment. With the implementation of Fatca looming for the US and many managers putting the preparations on the back burner, U.S. Bancorp Fund Services is providing its clients with advice on what they can do to prepare as the effective date draws near. We catch up with Beth Mueller on the issues behind the new requirements as well as how U.S. Bancorp Fund Services is assisting their clients with the implementation and providing new technology efficiencies such as their new investor service solution, Finomial.

HFMWeek (HFM): The IRS opened the Fatca portal for FFI registrants on 19 August. Have many hedge fund clients signed on yet?
Beth Mueller (BM): Although the site is open, the registration submissions won’t be accepted by the IRS until 1 January 2014. At U.S. Bancorp Fund Services, our staff are being trained on the features of the registration portal and we’ll be reaching out to clients in the fourth quarter to offer assistance with the registration process.

We have been communicating with clients regarding Fatca since its initial announcement, keeping them informed of its development. Now that the regulations are finalised and registration is pending, we’ve offered a number of educational opportunities to clients, such as newsletters and webinars, and we’ll continue to provide educational opportunities in the future.

HFM: Hedge fund managers seem to be putting preparations on the back burner due to delays. What would you tell them about preparations?
BM: I agree that many managers had put Fatca preparations on the back burner initially; however, we are definitely seeing an uptick in interest as the initial registration date draws closer. Even managers who had delayed in the past are now reaching the point where they are ready to begin preparing for the implementation on 1 July 2014. At U.S. Bancorp, we recommend that managers begin preparing now by familiarising themselves with the regulations so that they understand the requirements. They also need to determine who at their firm is going to be responsible for Fatca compliance and what their plan of action will be, including whether this initiative will be accomplished internally or on an outsourced basis. In addition, they should begin a review of their investor base or identify a service provider to assist them with that process. Finally, non-US hedge fund entities will be considered Foreign Financial Institutions for Fatca purposes, and they will need to register as such come 1 January 2014 at the earliest.

Fatca requires a keen focus on a hedge fund’s investor on-boarding process. Until now, hedge funds have applied anti-money laundering regulations to fulfil their obligation to know who their investors are. Fatca adds a layer of procedures on top of the standard AML/KYC process by requiring that the information being collected be electronically searchable, is cross-referenced to identify discrepancies, and is regularly reported upon.

HFM: There has been a lot of criticism of the costs of these regulations. What are the benefits?
BM: The cost is definitely significant; Fatca compliance requires a considerable amount of time and resources. I believe that as the world moves increasingly towards a global economy, there’s a greater need for governments to share information. Having some type of globalised reporting system is going to become a necessity and I think Fatca is the first step in that direction.

HFM: Fatca has been said to have spurred the onset of global information exchanges. How do you see this global issue progressing?
BM: This process has already begun. British offshore domiciles, such as Guernsey and the Isle of Man, have already been pushed into new tax transparency where they...
need to report back to the UK government. This evolution has been dubbed by some as the ‘Son of Fatca’, and the number of new information exchanges will only continue to grow as the need for transparency continues to increase. In the future, we should expect to see information reporting between countries worldwide, not just back to the US or between countries that have inter-governmental agreements with the US.

**HFM:** Which types of strategies will likely encounter the greater number of challenges and how can these be overcome?

**BM:** Compliance with Fatca is relevant to any strategy with US-sourced income. However, the challenge of Fatca compliance is less a function of a fund’s strategy, and more a function of the size of its investor base. The larger the fund’s investor base, the greater the challenge of collecting and managing all of the data and documentation on its investors that are necessary to comply with the Fatca regulations.

**HFM:** In what ways will your new investor services solution, Finomial, assist hedge fund managers in effectively complying with Fatca?

**BM:** Finomial is an innovative investor processing solution and we are very excited about our recent partnership with them. Finomial incorporates fully-automated Fatca compliance within the investor on boarding process saving considerable time under the new regulations. With Finomial, all of the data that investors provide in their subscription documents will be stored in an electronically searchable database, including their tax form data. Finomial enables investors to submit all of the required subscription information electronically through its secure investor portal. Therefore, the subscription documents and the tax forms are all recorded electronically by the Finomial platform. This system enables all parties, including the hedge fund manager and the investor, to have a fully transparent on-boarding process and also have clear access to the data that is being stored on file. Due to the fact that all of this data is stored electronically, it can easily be cross-referenced and analysed enabling the hedge fund managers to see the end result of this mass data analysis. Fund managers will always know the compliance status of their fund, in real-time, without having to do the heavy lifting to arrive at this critical information.

“THE CHALLENGE OF FATCA COMPLIANCE IS LESS A FUNCTION OF A FUND’S STRATEGY, AND MORE A FUNCTION OF THE SIZE OF ITS INVESTOR BASE”
Security breaches, and the fallout that comes with them, are a grave issue affecting hedge fund managers, and understanding the danger is paramount to maintaining a healthy business environment. Internal attacks are arguably more likely to occur than external attacks, leaving a firm's intellectual property exposed. Earlier this year, IT services provider Agio acquired security firm Secure Enterprise Computing, effectively building a single, integrated IT and security platform to address these rising industry concerns.

HFMWeek (HFM): What are the main security risks that hedge fund managers need to be aware of?

Bart R. McDonough (BM): Arguably, the highest risk comes from the actions of an employee. Due to the nature of the industry, hedge funds are unlikely to have a large external internet footprint, and as such are less likely to be targeted from a perimeter perspective. However, the well-intending user is capable of gaining access to valuable, and potentially sensitive information, and can inadvertently leak this information to unauthorised parties. This leakage comes in many forms – whether through the introduction of malware via email or social media, or through the installation of unauthorised software that is then leveraged by an attacker.

Christopher Harper (CH): The unfortunate truth is that many firms have little control over the applications in their environment. The introduction of unauthorised applications makes it difficult, if not impossible, to keep these applications up-to-date, and to have any sort of control over the vulnerabilities they introduce. As Bart mentioned, these vulnerable applications can be leveraged by attackers to introduce malware into the environment, gain control of servers or other systems, or exfiltrate sensitive data.

HFM: How does Agio manage these types of security risks?

BM: Currently, Agio provides a number of security assessment services, including vulnerability assessments, penetration testing, and enterprise risk assessments. We also offer our clients user awareness training, robust policy consulting, and assist with applying appropriate controls around how information is accessed and tracked using the principle of least privilege and assigning access on a need-to-know basis.

CH: To dig a little deeper, our customised monitoring solution – Agio Monitoring Service (AMS) – has the capability to discover all systems and software in the environment, which provides us with a unique view into the systems and components in each of our client’s networks. This information enables us to then report on potential risks associated with unauthorised applications, and to what extent these applications pose a risk to our client’s firm. We also have the ability to detect suspicious activity on the network, and quickly take action to prevent further harm.

BM: Finally, we’re in the process of building a comprehensive suite of managed security services that includes next generation Security Information and Event Management (SIEM), Continuous Vulnerability Management, Configuration Management, Unified Threat Management (UTM), and Endpoint Security solutions. These managed security solutions will integrate directly with our existing managed services for networks, storage, databases, servers, and applications.

HFM: Now that we understand a bit more about your security solutions, tell us about the original drive behind bringing security in-house and how it helps to deal with the industry’s increasing regulatory and investor demands.

BM: The real premise of the acquisition was rooted in the belief that, as a managed service provider of technology, we could no longer outsource security. Whereas most technology providers currently maintain an outsourced
relationship with a security specialist, Agio believes the critical nature of security mandates a more strategic and integrated approach. Understanding security is core knowledge that we need to possess to remain at the forefront of the industry for our clients.

**HFM:** What are the main benefits for managers in switching to a single, integrated IT and security platform?

**CH:** Not surprisingly, security is as much, if not more, about what you don’t know than it is about what you do know. Like a car’s blind spot, it’s what you don’t see within your environment, or understand when it comes to industry policies, that can be dangerous.

With that in mind, many IT services firms are focused on up-time, reliability, and providing services to the end user. Doing this well requires a strong understanding of the environment, including the applications, the networking and the supporting systems. On the flip side, managed security service firms tend to focus on the perimeter, and lack the insight into their clients’ internal systems. Combining the security expertise and background with the internal network intelligence brings an end result that is much more valuable than the sum of the two.

When security is as much about what you don’t know, a security partner unfamiliar with the ins and outs of your infrastructure is limited in the quality of security they can provide – because they too, don’t know what they don’t know about your environment, where the vulnerabilities might be, and how to intelligently build processes to prevent security issues.

**HFM:** Finally, what aspects of a firm’s risk management structure are most important when integrating a new security solution?

**BM:** Hedge funds possess an enormous amount of intellectual property, and they need to make sure that intellectual property stays within their virtual four walls. Whenever you’re evaluating a security provider, you should make sure the provider understands the uniqueness of your environment and how important intellectual property is to a manager.

Your provider should also be able to perform enterprise risk assessments, whereby they evaluate your use of resources and controls, and then recommend changes to the environment that improve security. These recommendations should also include education of users and helping them to understand how you manipulate the data, the pathway it follows and where the data ultimately resides, which is critical for any hedge fund.

Christopher Harper is managing director, Security Services at Agio. With 20 years’ experience and a certified PCI QSA, Chris is team leader of the security practice and is responsible for building Agio’s managed security service. A frequent speaker at IT security-related events, Chris is widely respected as an authority in the field of network and data security.
Introducing Custom House Gateway, a pathway to success for your fund management business. Whether you are an emerging manager looking to lower start-up costs while utilizing sophisticated, institutional level infrastructure, or a global manager requiring a scalable solution that grows with your reporting and regulatory needs, Gateway is a solution designed for the entire investment management community.

Your clear path to success
As the summer comes to a close, we can look back at some stalled 2013 tax proposals that just might be a sign of things to come. Earlier this year, Senator Carl Levin introduced legislation entitled as the Cut Unjustified Tax Loopholes Act (S. 268, introduced on 11 February 2013; also known as the CUT Loopholes Act). This ominous sounding legislation includes many provisions designed to make investment managers and their investors less wealthy or perhaps poorer depending on your view of the glass as either half full or half empty.

One key provision of the CUT Loopholes Act is the revival of the attack on carried interests. Title VI of the Act is entitled “Ending the Carried Interest Loophole”, but the very first provision of Title VI states that it may be cited as the Carried Interest Fairness Act of 2012. Hmm – is that glass half empty or half full? In either case, this title does exactly what it was intended to do. Investment managers would lose the benefits of the lower tax rates applicable to long-term capital gains and qualified dividends as all taxable income attributable to the carried interest would be re-characterised as ordinary income and subject to self-employment tax. The carried interest is referred to in the proposed statute as the ‘investment services partnership interest’. Private equity fund managers and real estate operators would, as in previous versions of the proposed legislation, become less wealthy faster than hedge fund managers who traditionally realise less long-term capital gains. As might be expected, the statutory language has advanced over the years and now effectively eliminates virtually all loophole strategies to avoid the ordinary income result in favour of the more beneficial long-term capital gain treatment. However, investment managers will still receive the benefits of the lower tax rates applicable to long-term capital gains and qualified dividends attributable to their own capital contributions. The portion of the investment manager’s interest that is attributable to capital contributions is referred to as the ‘capital interest’. What is not so clear is how an investment manager moves realised ordinary income from an investment services partnership interest to a qualified capital interest. As silly as it might seem, a partnership might have to distribute cash representing...
the realised taxable income from the investment partnership services interest to the investment manager and the investment manager may have to re-contribute the cash to the qualified capital interest to avoid any additional ordinary income that is not attributable to the carried interest itself. Congress appears to be hopelessly bogged down with petty party line disputes and a split in control over both houses. Nonetheless, the proposed legislation to end the benefits of the carried interest keeps reappearing year after year since it was first introduced in 2007. Will the current carried interest treatment prevail? Is your glass half full or is it half empty?

Another provision in the CUT Loopholes Act changes the tax treatment of Section 1256 Contracts. A Section 1256 contract is a regulated futures contract (e.g. the classic commodity such as orange juice made famous in the movies) and other specifically defined contracts. Under Section 1256, gain or loss is marked to market at the end of the year and all net gain or loss from all Section 1256 contracts (contracts sold during the taxable year and contracts marked to market at the end of the taxable year) is treated as 60% long-term capital gain or loss and 40% short-term capital gain or loss for federal income tax purposes. Under the CUT Loopholes Act, all net gain or loss from a Section 1256 contract would be treated as short-term capital gain or loss. Some proponents of the proposed legislation would argue that the 60%-40% treatment was originally enacted without much merit as part of a Congressional deal. While this may be true, the original income tax was also part of a deal and some might say that the recent tax increases are part of a deal that has little merit too! It is hard to predict where this proposal is headed.

The CUT Loopholes Act would also source swap contract payments to the location of the payer. Thus, swap payments made by a US person to a foreign person that represent fixed or determinable, annual or periodic income would be subject to income tax withholding. This provision makes sense to anyone familiar with the attempts to shield substitute dividend payments from income tax withholding.

Following a pattern consistent with previous legislation introduced by Senator Levin, the CUT Loopholes Act would attempt to strengthen Fatca in a variety of ways under Title I entitled “Ending Offshore Tax Abuses”. Several of the Fatca proposals will increase the burdens of compliance and may strengthen enforcement. However, one provision stands out as particularly adverse to offshore funds that presently enjoy the protection afforded by the trading in securities or commodities exclusion from trade or business income under Section 864(b) of the Internal Revenue Code. Under Title I, Section 103 of the CUT Loopholes Act, a foreign corporation that is managed and controlled in the US would be treated as a domestic corporation if the assets of the corporation exceed US$50m, the assets are being managed on behalf of investors and the decisions on how to invest the assets are made in the US. New proposed Section 7701(p) of the Internal Revenue Code would apparently trump the aforementioned exclusion from trade or business income and cause offshore funds organised as corporations to be subject to US income tax. Furthermore, tax-exempt entities would indirectly pay income tax on their share of profits from an offshore fund organised as a foreign corporation in a tax haven jurisdiction. This provision could have a very adverse impact on the US markets and would also reduce tax revenue by forcing offshore funds to find investment managers offshore. In 1997, when Section 864(b) of the Internal Revenue Code was revised to expand the exclusion to offshore funds with some nexus to the US, Congress predicted that tax revenues would be enhanced by the expansion. To undo the benefits of increased revenue now makes little sense. This proposed legislation is substantially similar to Senator Levin’s ill-fated proposal in 2009 which would have caused tax-exempt entities to indirectly pay income tax on their share of profits from an offshore corporation or face the unhappy alternative of investing directly through a domestic partnership that could result in the imposition of the unrelated business income tax. In today’s economic environment, the glass is already half empty for tax-exempt pension plans.

Two other bills introduced earlier this year would change the due dates and extended due dates of partnership and corporation returns. S. 420 and H.R. 901 introduced on 28 February 2013 would accelerate the original due dates for calendar partnership and S corporation returns to 31 March from 15 April. The original due date for calendar year C corporation returns would be deferred from 15 March to 15 April. The final extended due dates for calendar year partnerships and S corporations would be 30 September. The final extended due date for calendar year C corporation returns would be 15 October. Under both bills, the due date for the Report of Foreign Bank and Financial Accounts would be accelerated to 15 April from 30 June, but a six-month extension would be permitted.

While the new accelerated dates make sense, it is hard to imagine that investment managers, fund administrators and accountants will be able to meet the accelerated deadlines without some serious self-reflection. Is your glass half full or half empty?
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THE IMPORTANCE OF MANAGED SECURITY SERVICES

WARREN FINDEL, OF ACE IT SOLUTIONS, TALKS TO HFMWEEK ABOUT THE DANGERS OF CYBER RISK AND WHY EMPLOYING SECURITY SERVICES IS PARAMOUNT

Today’s rapidly evolving threat landscape and compliance requirements demand smarter and more responsive security services. According to IBM’s Security Threat Report, the top two industries targeted in nearly 50% of all security incidents are manufacturing and finance; industries that offer attackers significant potential payoff.

An ever-increasing number of devices and growing volumes of data can make it difficult for hedge funds to develop and deploy effective cyber security measures. While information security continues to evolve in sophistication, attacking networks and stealing information has arguably become easier due to popular new technologies that introduce loopholes in enterprise security.

Two types of incidents dominate the cyber security landscape; malicious code and sustained probes/scans used to search for potential targets account for over 60% of the security incidents.

Outsiders are the primary culprits of security threats, with 46.3% of attacks perpetrated entirely by outsiders and another 52.7% perpetrated by a combination of outsiders and insiders.

While most attacks originate outside a company’s network, the role played by inadvertent actors cannot be dismissed. Case in point is the recent hacking attack of The New York Times website, which fell victim to a DNS attack.

As an IT firm that consults with businesses about network security, this story really caught our attention. If a business with the technical resources and expertise of The New York Times can get hacked, how can a smaller organisation possibly protect itself?

THE SOLUTION IS THREOFOLD
1. Don’t go it alone; work with a trusted and experienced IT partner who has the expertise to deal specifically with security issues. Don’t rely on your in-house IT team to fully secure your network, the complexity involved in making sound security decisions in today’s environment means you’d probably benefit from talking to a security expert from outside your company.
2. Regular penetration and vulnerability testing of your network helps identify security gaps. Continuous vulnerability assessment of an organisation’s IT assets, including web applications and databases, is essential to effectively securing the infrastructure. However, as ACE IT Solutions’ security expert, John Dodge, advises clients, “penetration testing is a moment-in-time assessment of your firm’s network security posture. As this can change dramatically with little notice until something bad happens, proactive scans and reviews of your network infrastructure will detect gaps and vulnerabilities accelerating response and remediation. This is particularly important for hedge funds and other financial services firms where information integrity is paramount,” which brings us to point number three:
3. Managed security services can help reduce the cost and complexity of securing your technology infrastructure and meeting compliance mandates with a collection of security services that protect your network in real time.

MANAGED SECURITY SERVICES
As organisations face tighter requirements around privacy and compliance, they also face a mounting challenge in countering advanced threats. The accuracy of identifying threats becomes essential as security teams migrate from legacy approaches to a security intelligence model.

To address these cyber security challenges, hedge funds must fundamentally change how they think about security.

Upgrading technology and following best practices are not enough to ensure a secure technology infrastructure; combating attacks requires a more
pragmatic approach that informs every decision and procedure. Continuous management of a hedge fund’s IT assets, including web applications and databases, is essential to effectively securing your infrastructure and avoiding policy violations. By addressing these preventable factors and educating end users, organisations may be able to significantly reduce the number of attacks.

Unless security technologies are consumed as a suite or portfolio of complementary and interconnected products, companies are left with best of breed technologies that are not designed to work in unison—they cannot share valuable information or coordinate actions across vendor platforms.

Security technologies and services such as penetration testing, firewall, intrusion detection and vulnerability scanners are all proficient at solving specific security problems; however, they are often standalone and are not designed to work together. As a result, perpetrators of advanced threats have become adept at learning the idiosyncrasies in and around security technologies, capitalising on the gaps between technologies or their intrinsic weaknesses or vulnerabilities.

Robust, cloud-based, fully managed security solutions can help hedge funds address data security issues, reduce capital and operational costs, better manage regulatory compliance and improve employee productivity. Managed security services deliver a simple, cost-effective way to limit potential threats, improve a hedge fund’s security posture and help reduce the cost and complexity of regulatory compliance efforts by leveraging industry-leading tools, technology and expertise to secure information assets 24/7.

ACE IT Solutions’ Managed Security Services, offered in partnership with IBM, provide a simple and cost-effective way to limit potential threats. Through our partnership, ACE IT Solutions leverages one of the world’s largest collections of security information to combine advanced analytic capabilities into cloud-based security services that can be mixed and matched according to specific needs.

Services include: penetration testing, managed security and event management, firewall management, intrusion detection and prevention system management, managed protection services, unified threat management, hosted security event and log management, and hosted vulnerability management.

FACT
The financial industry accounts for 20.9% of security incidents across all monitored industries* — with an average of more than 111 million security events annually.

PREVENTION
Proactive scans and reviews of your network infrastructure will detect gaps and vulnerabilities allowing for remediation to prevent attacks.

SOLUTION
ACE IT Managed Security Services, offered in partnership with IBM, provide a simple and cost-effective way to limit potential threats.

*Information is based on cyber security event data collected by IBM between 1 April 2012 and 31 March 2013 in the course of monitoring client security devices, as well as data derived from responding to, and performing forensics on, cyber security incidents.
A successful alternative investment firm needs to grow its business not its list of to-dos.

At Equinoxe, we understand the walk along the efficient frontier taken by alternative investment managers like yourself. So when we administer your account, you have seasoned professionals dedicated to your fund and its investors. This experience, coupled with our bespoke operating model and flexible reporting, lifts the weight of every administrative detail from your shoulders and places it squarely on ours.

www.equinoxeais.com
Stephen Castree, scastree@equinoxeais.com, GLOBAL
Helen Parfit, hparfit@equinoxeais.com, USA
Rod White, rwhite@equinoxeais.com, BERMUDA
Alan McKenna, amckenna@equinoxeais.com, MALTA
Irfaan Hossany, ihossany@equinoxeais.com, MAURITIUS
Stuart Drake, sdrake@equinoxeais.com, IRELAND
Liam McHugh, lmchugh@equinoxeais.com, SINGAPORE
Since our whitepaper was published in May we have continued to see incredible growth in '40 Act alternative mutual funds – now commonly being referred to as 'liquid alternatives'. Net asset increases for the first six months of 2013 were $83bn, driving total alternative mutual fund AUM up by 54% from $152bn to nearly $235bn.

Chart 1 (below) illustrates this impressive growth in 2013 and shows the key strategy buckets we track: $42bn AUM in equity long/short strategies; $31bn in multi-manager alternative products or "multi-alts"; $26bn in equity market neutral strategies; $105bn in non-traditional bond strategies, and the remainder in currency and managed futures.

‘40 ACT ALTERNATIVE FLOWS EXCEED PRIVATE HEDGE FUND GROWTH

Inflows of $43bn into liquid alternative mutual funds during the first six months of 2013, compares with net investor inflows of just $23bn into similar hedge fund strategies. Equity hedge and event driven hedge fund strategies saw net investor inflows of +$8.7bn year-to-date and investors added +$14.5bn into relative value strategies according to Hedge Fund Research.

While non-traditional bond alternative mutual funds and relative value hedge funds have been the fastest growing categories in terms of investor flows, more and more investors are starting to see cash come off the sidelines and move into the equity focused strategies. This trend is seen as investors preparing themselves for a turn in the credit cycle. Chart 2 (on the following page) shows that flows into equity-focused liquid alternatives have been positive in each of the review periods, even during 2012 when equity hedge and event driven hedge fund strategies experienced net outflows of $17bn.

THUS FAR, LIQUID ALTERNATIVES ARE UNDERPERFORMING HEDGE FUNDS

In terms of performance we have seen a greater correlation to market beta in the equity long/short focused strategies with Morningstar pegging average YTD equity long/short mutual fund performance through August at +9.46% compared with S&P 500 performance of +15.4% and absolute return US equity long/short index returns of +6.74%.

Equity market neutral mutual funds returned +1.09% compared to the HFRI equity market neutral index at +3.49%. Multi-manager mutual fund products returned an average of +1.99% through August as compared to the HFRI fund of funds composite index that was up +3.58%.

Looking across the entire universe of alternative mutual funds (including non-traditional bond funds, commodities, managed futures), year-to-date performance through August as reported by Morningstar stood at +1.63% excluding bear market funds. This compares to the HFRI fund weighted index at +3.91%. This supports the idea that private vehicles are worth higher management and performance fees as we have seen on average
a 228 basis point performance difference between public and private funds. This is against a backdrop of strong equity markets, however. This environment is hardly a test case for products designed to provide downside protection. Many observers are withholding judgement about the sustainability of the alternative mutual fund trend and waiting to see if these strategies can deliver the protection and risk-adjusted returns that investors are seeking in a period of market volatility or downturn.

**NEW AUDIENCE SEEKING LIQUID ALTERNATIVE EXPOSURE COMES INTO FOCUS**

The demand story for liquid alternatives is gaining more clarity and acceptance. There has been a lot of dialogue at industry conferences and coverage in the media about how wealth advisors are looking to use liquid alternative products to create stability in their client portfolios given the change in their compensation model that now ties more of the wealth advisor’s revenue to fees on client AUM as opposed to commissions.

Wealth advisors are beginning to move away from traditional ‘style box’ fund selection to a more sophisticated allocation. They are beginning to pursue investment solutions that offer an ability to ‘dampen volatility’, offer ‘inflation protection’ and provide ‘downside protection’ as opposed to selecting investments solely for their ability to drive investment objectives like ‘growth’ and ‘value’. In this way, the emerging wealth advisor audience is similar to the pension audience in the years post the technology bubble when those institutions also began to reconsider their portfolio allocations to include more alternative strategies.

It is also clear that this trend of wealth advisors seeking alternative mutual fund products is driven by an economic cycle that marks the retirement of the ‘baby boomers’ who are now in their 60s and early 70s and reaching the end of their working careers. The conversion of 401k plans into Individual Retirement Accounts (IRAs) is moving significant capital away from the control of 401k plan sponsors to the supervision of wealth advisors who are being charged by their clients with the business of managing portfolios for a prosperous and secure retirement. Portfolio losses evidenced during the 2008 financial crisis imprinted a new awareness in the minds of wealth advisors and their clients about the dangers of market volatility. The investment solutions being presented by alternative mutual funds are thus resonating with these end investors.

**HIGH PROFILE LAUNCHES FROM LEADING HEDGE FUND FIRMS INCREASE AWARENESS**

On the product supply side we have seen some headline launches since our whitepaper in May including the high profile Blackstone Alternative Multi-Manager fund (BXM-MX), and similar products from MSIM (DASIX) and JP-MIM (JASAX), and the beginning of the launch of single manager products such as the Visium Asset Management Event Driven strategy (VIDVX). We have seen the pedigree of the multi-manager sub-advisors improve with the addition of firms like DE Shaw, Two Sigma, BTG Pactual and Wellington on the Blackstone product. As we see more ‘blue chip’ names get announced the market is becoming more accepting of these new vehicles.

Yet, the large number of multi-manager product launches indicates to us that we are still in Wave 1 of this product development. These products offer a safe harbour for a hedge fund manager to test their ability to create a suitable retail product that is differentiated from their core private fund offering. Yet, as managers become more confident about their ability to create distinct return streams, more single manager products are likely to emerge. These single manager products are likely to draw demand away from the multi-alternative structures.

As we saw with institutional investors first choosing exposure to hedge funds via a fund of fund structure and then moving on to direct allocations to single managers, we expect a similar shift to mark Wave 2 of the retail liquid alternative space.

Many hedge funds are in discussions on whether to break away from the multi-manager products to create single manager funds or on whether to run their own single manager products in parallel. Those leading hedge funds that do decide to follow the example set by AQR will no doubt attract headlines, a highly desirable outcome for products that benefit from public attention. As one of our recent survey participants noted, mutual funds are ‘sold’ and not ‘bought’.

**CHART 2: EQUITY-FOCUSED HEDGE FUND VERSUS ‘40 ACT MUTUAL FUND INFLOWS**

Source: Morningstar, Hedge Fund Research (HFR)
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OPERATIONAL CHALLENGES FOR INVESTMENT ADVISORS IN MULTIPLE JURISDICTIONS

NICHOLAS TSAFOS OF EISNERAMPER LLP EXPLAINS THE DIFFICULTIES INVESTMENT ADVISORS FACE IN COMPLYING WITH REGULATORS’ VARIOUS REPORTING REQUIREMENTS

The compliance requirements of the US Dodd-Frank Act and the AIFMD have put tremendous regulatory challenges and increased investor oversight on investment advisors who operate in multiple jurisdictions. In connection with the increase in regulation, investment advisors have to develop operational and compliance infrastructures, obtain technology and hire service providers and personnel – all to meet the reporting requirements of the various regulators.

The financial crises of 2008 gave rise to the Dodd-Frank Act and the registration of investment advisors to hedge funds with the Securities and Exchange Commission (SEC). Registration with the SEC requires hedge fund advisors to file Form PF if they meet certain thresholds. The reporting requirements become very onerous for investment advisors on the operations of certain investment advisors. Larger investment advisors incurred substantial costs developing or acquiring technology to meet these reporting requirements; these costs have had a significant effect on the operations of certain investment advisors. Larger investment advisors have been able to absorb these costs; smaller advisors will not be able to absorb such costs.

Hedge fund service providers must not only be knowledgeable of the various regulatory requirements of the jurisdictions that the funds operate in; they must also meet the service provider criteria set by the various regulators. For instance, hedge funds registered in Ireland that want to be compliant with the AIFMD must hire prime brokers and fund administrators that are based in Ireland. Ireland has service providers that meet the needs of hedge funds; however, other jurisdictions that have similar requirements might not. The use of service providers that cannot meet the needs of the hedge fund also has a significant effect on investor perceptions. Investors are asking and requiring hedge funds to obtain qualified service providers, since they believe that some of the recent hedge fund failures are due to subpar service providers.

Investment advisors should develop a compliance culture of adapting to the jurisdiction with the most rigorous requirements. The investment advisor’s employees must have the expertise to monitor service providers in regards to the quality of services provided and set the tone as to the level of service needed. Simply saying that a compliance function has been contracted out to an outside service provider is not enough; the investment advisor has a responsibility to its investors and regulators to monitor the service to ensure that the services provided are going to meet the scrutiny of the regulator. Key employees must constantly be aware of the changes in the regulatory environment and develop a process in which they communicate the changes to the rest of their organisation and the service providers; they must also develop processes to monitor the required changes in compliance and determine if the new compliance requirements are being met.

The increase in regulation for hedge funds operating in multiple jurisdictions has resulted in greater transparency and oversight. Crises and increased scrutiny have brought to the forefront issues that hedge fund advisors must protect against. Investors are also demanding more controls and monitoring from hedge fund managers. The increase in regulation and investor demands have brought about increased costs for hedge fund advisors. The larger hedge fund advisors and the ones which operate mutual funds and/or UCits will be better prepared to absorb such additional costs. Smaller advisors will not be able to absorb the costs as easily as larger advisors or those that have investment vehicles that are already highly regulated. The additional regulatory costs and investor demands have created a barrier to entry for small hedge fund advisors. The challenges that regulatory compliance has brought the hedge fund industry will make it stronger and more viable in the future; yet at the same time they will limit the amount of new fund advisors in the industry.
BUYER BEWARE – THIRD-PARTY VALUATION REPORTS ARE NOT CREATED EQUALLY

CRAIG TER BOSS OF EISNERAMPER LLP EXAMINES THE PROS AND CONS OF THE TYPES OF REPORTS OFFERED BY THIRD-PARTY VALUATION FIRMS

Since the financial crises of 2008, the regulatory environment and the need to comply with global accounting standards have created a demand by investors for a robust and transparent valuation process by investment advisors. In response to this demand, investment advisors, who are ultimately responsible for the valuation of their illiquid assets, have often utilised third-party valuation firms in an effort to mitigate valuation risk and facilitate a more efficient audit process. However, the services provided by the third-party valuation firms, and ultimately the deliverable product, are not created equally and the reliance on these reports by investors, regulators and auditors varies greatly.

Third-party valuation firms offer a variety of services and reports in connection with valuing illiquid assets. However, the approaches employed and the reports delivered by these firms vary significantly and typically fall into four categories: negative assurance, positive assurance, a full valuation report and a limited scope report. The following discussion will highlight the positive and negative attributes of each type of report:

NEGATIVE ASSURANCE
In a typical negative assurance engagement, the valuation firm does not perform its own valuation but reviews the investment advisor’s valuation to determine if the methodology/methodologies and calculations undertaken appear unreasonable. This type of report costs less in comparison with the other reports. The use of the negative assurance report has diminished greatly due to the lack of acceptance by audit firms, regulators and investors as it is not an independent valuation.

POSITIVE ASSURANCE
Upon the growing lack of acceptance of the negative assurance reports, the language of those reports was altered in order to strengthen their basis of valuation and calculations. In a typical positive assurance engagement, the valuation firm still does not perform its own valuation but reviews the investment advisor’s valuation and relies on data provided by the investment advisor to determine that the methodology/methodologies, assumptions and calculations undertaken appear reasonable. As this opinion is not an independent valuation either, the use of the positive assurance report has diminished in recent years due to heightened scrutiny by auditors, regulators and investors.

FULL VALUATION REPORT
In connection with the preparation of a typical full valuation report, the valuation firm performs its own valuation by selecting the methodology/methodologies, the appropriate valuation assumptions based on direct discussions with investee company management, and other procedures that they deem appropriate. The concluded value may be a point estimate or a range of values. This opinion is typically considered an independent valuation. The popularity of these reports is hampered by the cost and time-to-complete associated with them. These reports have a higher rate of acceptance by audit firms; however, if the range of values is too large, acceptance may be lessened.

LIMITED VALUATION REPORT
To decrease the time to complete and the cost associated with the preparation of full valuation reports, the limited scope valuation has evolved into a popular alternative. In a typical limited scope valuation engagement, the valuation firm performs its own valuation by selecting the methodology/methodologies and the appropriate valuation assumptions based on direct discussions with the investment advisor but typically not the investee company management. The concluded value may be a point estimate or a range of values. This opinion is typically considered an independent valuation but the reliance on an investment advisor’s analysis without further verification may draw scrutiny from auditors, regulators and investors. The use of these reports has increased due to a higher rate of acceptance and lower cost. However, similar to the full valuation reports, acceptance may be hindered if the range of values is too large or if support for the underlying assumptions is limited.

The type of report provided by a valuation firm may not mitigate valuation risk if the firm is not independent nor improve the audit process if the firm only relies on information provided by the investment advisor. To ensure a robust and transparent valuation process, there should be a clear valuation policy that is appropriately implemented by the investment advisor, utilising appropriate valuation methodologies. Regardless of the type of report prepared by a valuation firm, the responsibility of the valuation of illiquid assets lies with the investment advisor.
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