




SEI Knowledge Partnership

Insights for Investment Managers

Annual CFO Forum for Alternative Managers

The SEI Knowledge Partnership hosted the 3rd Annual CFO Forum for senior executives of SEI's Investment Manager Services' alternative investment client firms and industry partners. The half-day session brought together prominent speakers from successful firms to share their insights regarding optimizing operations, fulfilling escalating institutional investor demands, establishing efficient processes to deal with increased regulatory requirements and other important issues critical to CFOs and COOs in running an alternative investment management firm. Results of a participant survey conducted during the sessions are also presented herein.



During the CFO Forum, many discussions touched on the institutionalization of alternative managers as an important and continuing industry trend. Continued institutionalization is viewed as mandatory in order for managers to remain viable and address investors' increasing information needs.

Delivering returns remains paramount, but as the industry matures, operational and portfolio management process improvements help to address the requirements of institutional investors.

Dynamic Changes . . . Evolving Strategy

Moderator - Jim Cass, SEI

Michael Lee, Ernst & Young

Q & A session on the current state of the hedge fund industry

The first session began its exploration into institutionalization by discussing the increased amount and level of client demands. This trend was seen as consistent with the evolution in the type of investors money management firms are serving. Institutions are more demanding, and are accustomed to more traditional organizations with built-out infrastructures, with the result being that their requirements have raised the bar for managers. As the industry matures, it is necessary for a firm to prepare, not just for and via registration, but through the establishment of efficient processes to maintain information and secure capabilities. For example, as firms mature and key man risk becomes increasingly important to investors, firms are approaching the succession bellwether and recognizing the need to have a cohesive plan in place. Firms are also seeing increased convergence, with long-only managers moving into the hedge space and vice-versa.

During a discussion of corporate governance, it was put forth that, except for a brief period in the

immediate wake of the financial crisis, there has not been a significant change in the way independent Boards operate. It was observed that the most effective Boards conduct meetings in person and with greater frequency. While relatively rare in the industry, the benefit of face-to-face meetings, enabling *hearing* vs. reading about key topics, is meaningful. These "better" Boards tend not to allow the typical document review to preclude discussion. The most effective Boards were also characterized as maintaining a focus on risk and taking a keen interest in understanding how tasks were undertaken, processes followed, and generally how things were getting done.

Participants noted an increased focus on the investor relations function, which has developed substantially over the years. Increasingly, as institutions become the largest and most influential investors in the marketplace, they see firms hiring financial writers with business and English backgrounds into investor relations groups to help create credible, well-written responses to specific inquiries. Firms are also transitioning staff from marketing communications to investor relations roles. It was also noted that a number of firms have hired PR professionals with crisis management skills who can assist CFOs in addressing multiple issues and leverage their writing skills to effectively communicate or mute problem issues, while ensuring consistent messaging.



Another nascent trend brought up was that annual meetings are no longer focused exclusively on portfolio management. This was seen to reflect the emergence of activities traditionally seen in public companies in the hedge fund space.

Firm Level: Running the Business

Moderator - Ross Ellis, SEI

Richard Abraham, Global Endowment Management

Pritpal Aujla, EIG Global Energy Partners

Robert Bastone, Spruce Private Investors

A panel of senior industry experts discussed key issues facing CFOs running investment management enterprises.

To a large degree, CFOs focus their time on two major buckets of issues: those affecting the management of the firm as an ongoing investment management business enterprise, and those affecting the management of the products they are promoting. This panel discussed the former, with the subsequent panel discussing the latter.

When asked about the need to separate responsibilities in firms where CFOs wear multiple hats, panelists suggested that firms need to engage in self-assessment regarding how they are most effective. While there may be an obvious cost benefit, consideration must be given to how it would look to potential investors if one individual were to oversee too many functions. Depending on the type of client a firm caters to, it may be problematic for the CFO to also be the COO, CCO, head of due diligence and investor relations. If the same person at a manager's firm walks into all the meetings, consider how that will be perceived.

The most effective due diligence responses were judged to be those that are well-balanced and fully integrated with the rest of the marketing materials presented to investors. Consistent with the comments in the opening

session regarding hiring more professional IR staff, the best responses share the same style and messaging and are assembled into a cohesive, professional-looking marketing-style package.

Although responsibility for valuation, especially with Level 3 assets, most often lies with the fund itself, it was generally agreed that in the institutional space it is beneficial to outsource accounting and administration. With strategies becoming increasingly more complex, panelists expressed having more comfort with a third-party administrator, especially because it offers a system of checks and balances, and is typically demanded as mandatory by institutional investors. Benefits of outsourcing include segregation of duties, especially for process-heavy functions, which may not be inherently a strength of investment management firms. Employing an in-house shadow accounting function to monitor activity in order to mitigate risk of error and ensure increased reconciliation was viewed as often necessary and consistent with using an outsourced partner.

Discussion turned next toward the sophistication of investors as it related to the level of communication necessary. Sophisticated investors generally take a much closer look at risk. Panelists mentioned that sovereign wealth clients want to know *exactly* what firms are doing and cautioned that underestimating their skill and knowledge is at your own peril. Along with significant assets, these clients bring a set of increasingly complex issues, especially tax and domicile issues, which can put a strain on a firm's resources and require experienced high-caliber people to sort through.

In a brief discussion on attracting and retaining staff, both to create alpha and to sell it, the importance of cultural fit was seen as paramount. Making sure that candidates can work with existing staff is the key to successful talent acquisition. In terms of retention, managers must use various elements of base salary and incentive-driven compensation, yet be aware that uneven distribution of portfolio/firm gains may lead to disgruntlement and be a continued problem firm-wide.



Fund Level: Running the Fund

Moderator - Mike Leahy, SEI

Jeff Baisley, Graham Capital Management, L.P.

Philip Barreca, Goldman Sachs & Co.

Spencer Raymond, Garrison Investment Group

A discussion of issues facing the CFO in terms of running the funds or managing the products, including handling regulatory, compliance and tax demands.

A benefit credited to a service organization control (SOC) report such as a SAS 70 is that it has made firms look in the mirror, at the strength of their control structures, and try to create best-in-class solutions. It has also made administrators enhance their capabilities because of the pressure/desire to better assist clients to meet regulatory requirements.

In the startup phase, with limited infrastructure in place, some firms may lack institutional-quality documentation. As they mature and attract more sophisticated and demanding investors, however, it is important to revisit compliance and procedures manuals to make sure all processes still work as initially intended or have accommodated ongoing changes.

Tax and jurisdictional issues are important and firms must devote time to business rationalizations related to jurisdictions and investment activities. It is important to determine in which jurisdictions firms can trade most effectively, and they should be careful with issues such as cross-border transactions that may trigger unanticipated regulatory filings. It is a good practice to focus the efforts of tax specialists on understanding all requirements prior to investment.

Panel members expressed differing views regarding valuation, but noted there has been a significant uptick in time spent with investors on the issue.

When asked about mechanisms to control liquidity and requests for transparency, the panelists were in agreement that a firm's liquidity management depends on the product set. For example, redemptions in hedge

products are typically permitted quarterly with 30-60 days' notice depending on the underlying product whereas the liquidity structure is simpler with a closed-end fund structure.

Panelists agreed that the institutional investor *asks* for transparency whereas while other investors would love to see it, they don't specifically ask. That being said, it is important to consider the relative costs and difficulties of requests to look deeply inside the portfolios, with the understanding that many requests are not just "one and done" but part of a continuing list of demands.

Regulatory Landscape

Steve Nadel, Seward & Kissel, LLP

U.S. Regulatory Developments

Mr. Nadel touched on the SEC's recent passage of the rules relating to registration requiring that most hedge fund advisors will have to be registered with the SEC by 3/30/2012. He cautioned attendees to beware of the new SEC term "Regulatory Assets Under Management", relevant for advisors in determining certain eligibility under Form ADV and Form PF. He explained that an advisor's regulatory assets under management must: (i) be calculated on a gross basis, and (ii) include family and proprietary assets, assets managed without receipt of compensation and the amount of any uncalled capital commitments. He explained that while some firms may qualify for exemptions such as the "Private Fund Investor Exemption" for firms with less than \$150 million in Regulatory AUM solely in private fund assets, the term Regulatory AUM is given a very broad definition and firms with managed accounts may not be able to count on that exemption.

The speaker then discussed SEC Form PF, which was introduced about a year ago and has just been finalized. He mentioned that the preliminary feedback on Form PF is that it will be a big undertaking, especially for managers who have multiple funds,

complex investment structures or are “large hedge fund advisors” (i.e. over \$1.5B in Regulatory AUM). Some managers have indicated that between 10-20 internal personnel at their firms, in addition to outside service providers such as administrators and prime brokers, will be involved with some aspect of completing the Form. The cost and time requirements for completing this Form, both at the firm and administrator level, will be significant and may result in the genesis of a new C-suite executive, the “CPFO”, who will be responsible for its coordination. The speaker noted that it may take upwards of 140 hours per quarter to complete this form for a large hedge fund advisor.

Also worthy of note, according to Mr. Nadel, is that the city of New York has been looking at disallowing the full deduction of a manager’s overhead expenses against the management fee, saying that a part of it should be attributable to the carry instead. Because the carry is not subject to the NYC UBT tax, while the management fee is, this could result in a higher UBT hit on the management fee (because the pre-tax gross management fee will be higher).

Mr. Nadel added that, similar to the post-Lehman environment where managers scrambled to review their counterparty and custody arrangements, we are seeing a similar response in the aftermath of MF Global. He noted that managers are looking at approaches including diversifying risks by having multiple FCM’s negotiating the lowest level of margin above the exchange minimums, asking to look at the FCMs, records on segregation (which is probably not realistic) and maintaining no excess cash.

Stephen Carty, Maples and Calder

EU regulatory initiatives, including AIFMD and MiFID II.

The goal of AIFMD is to directly regulate and supervise the activities of alternative investment fund managers within the EU. As to the question of whether AIFMD will create a new alternative funds brand and replicate

the success of UCITS, Mr. Carty pointed to the Irish qualifying investor fund (QIF) as the closest fit to an EU AIFMD-ready fund structure for a variety of reasons, including: MiFID professional investor criteria, €100,000 minimum subscription amount, a single depository and annual audited accounts.

Mr. Carty then touched on the impact of the MiFID II proposal for non-EU investment firms operating in the EU. The objectives of that proposal are to make financial markets more efficient, resilient and transparent and to strengthen the protection of investors. The new framework will also increase the supervisory powers of regulators and provide clear operating rules for all trading activities.

Mr. Carty also briefly discussed various third-country measures as they relate to MiFID II. For example, the measures require non-EU firms servicing retail clients to establish a branch in the EU and obtain authorization from the competent authority of the relevant member state where the branch is located. Cooperation agreements must be in place between the EU member state regulator and the home regulator of the investment firm. A non-EU investment firm proposing to establish a branch in the EU must be subject to authorization and supervision in its home country – “equivalence assessment” – offering a comparable level of protection to EU investors. Each branch is subject to adequate capital requirements. Non-EU firms intending to provide investment services to eligible counterparties are not required to establish a branch but will be subject to ESMA registration.

The speaker noted that AIFMD and MiFID II are somewhat interconnected, as both measures regulate the same core activity of investment management.

Regarding the impact of UCITS IV, which became effective July 1, 2011, the speaker explained that its aim was to increase cross-border efficiencies and enhance investor protection. He suggested that it contained no “game changers” and its focus was on a range of specific aspects and not a radical reshaping.

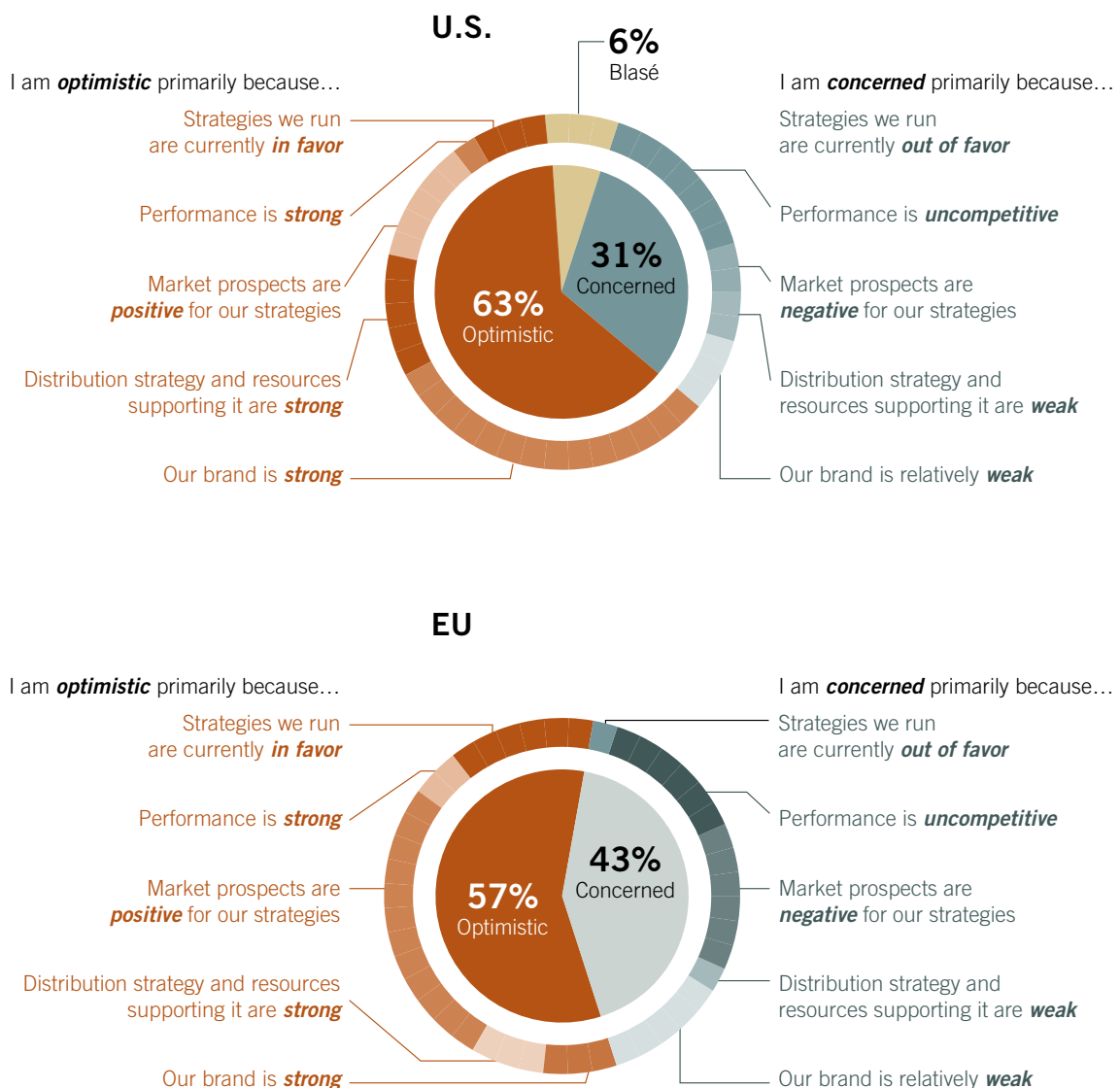
Quick Poll Results

A poll was conducted at the Forum and was completed by the CFOs, COOs, and senior executives in attendance. The following are highlights of the findings of the U.S. poll, along with some interesting comparisons to a similar poll conducted in London in October 2011 at the annual Forum for EU managers.

Alternative Managers Remain Largely Optimistic Despite Uncertainty

Uncertain Economic and Regulatory Environment Will Drive Increased Spending on Areas Including Compliance, Operations & Technology and Marketing & Distribution

The results showed that a majority of U.S. investment managers (63%) remain optimistic about their firms' prospects over the next 3 years. That number was down significantly from last year's poll in which 88% of participants indicated optimism, but was slightly more upbeat than the results from the EU CFO Forum in London where 57% of participants expressed optimism and a greater percentage showed concern (43% vs. 31%).



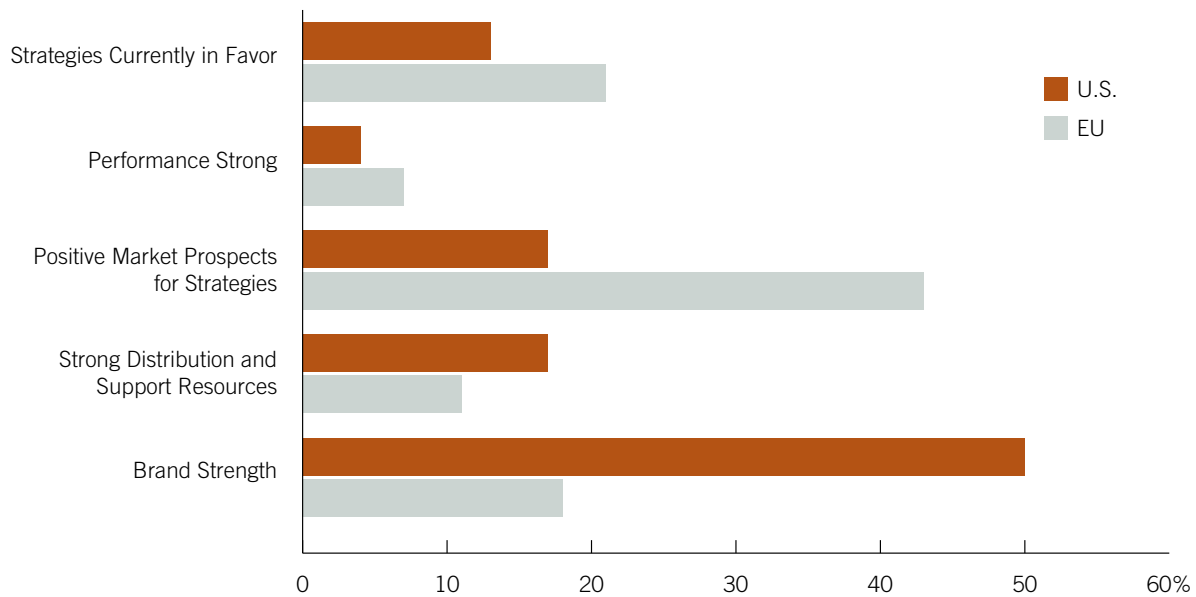


Reasons for Optimism

The reasons cited for optimism among U.S. managers included:

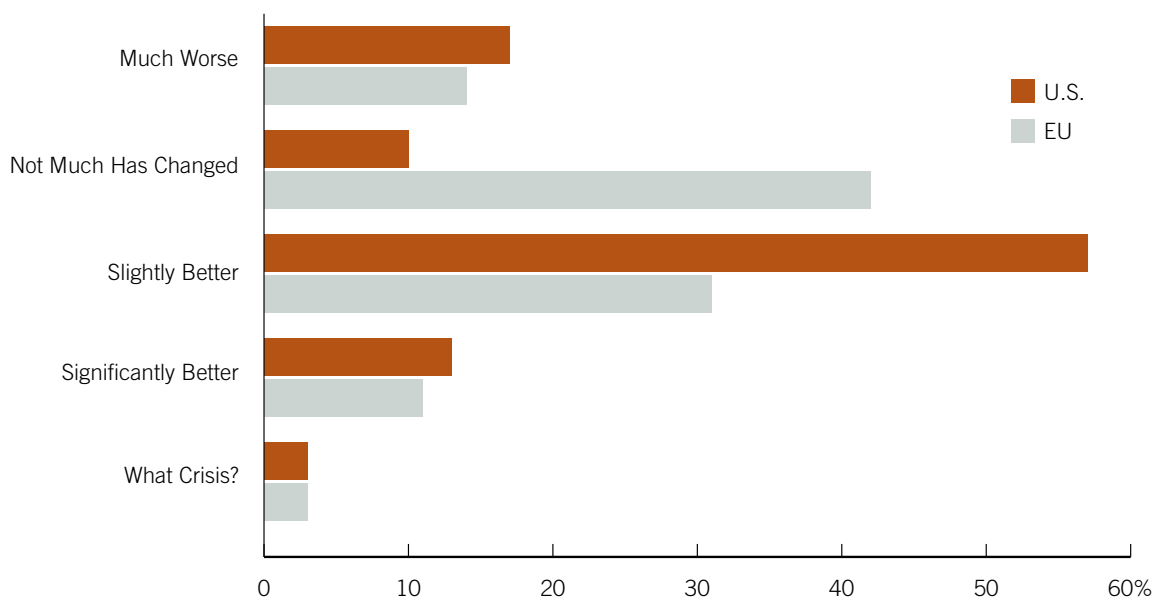
- brand strength (50%),
- positive market prospects for the firm's investment strategies (17%), and
- strength of distribution strategies and resources (17%).

Respondents in the EU survey were decidedly less reliant on brand strength as key to success (18%), but more upbeat regarding their investment strategies being in favor (21%) and the market prospects for those strategies (43%).



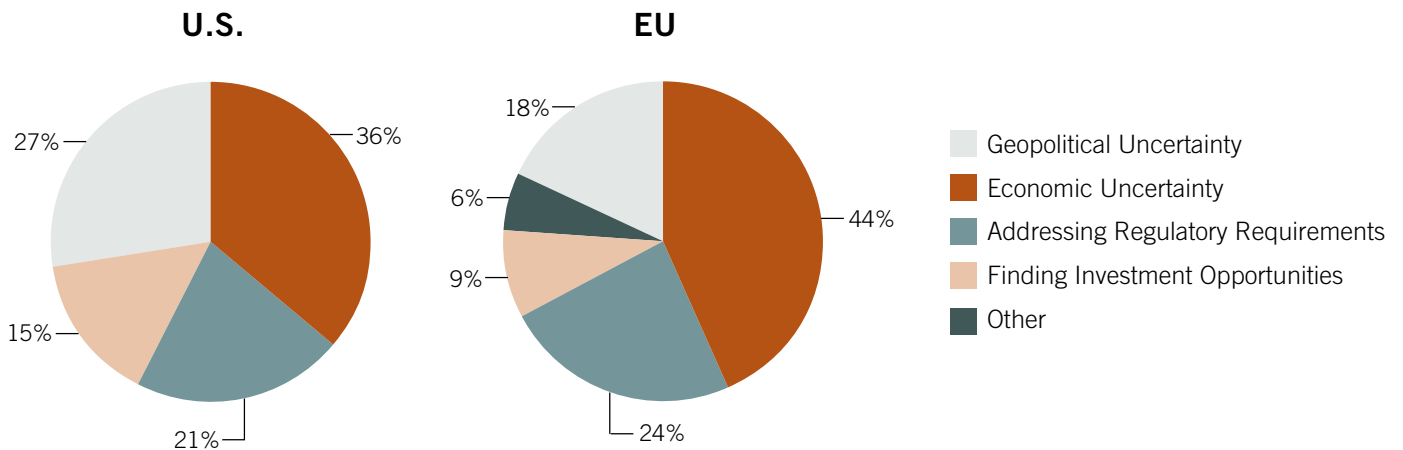
Investor Confidence Seen as Stronger in U.S.

Respondents at the EU CFO Forum differed markedly with their U.S. counterparts on several issues. Notably, when asked whether investor confidence is better or worse today than in the aftermath of the financial crisis in 2008, 57% of U.S. managers indicated confidence is slightly better, while 56% of EU managers said things were worse or not much has changed.



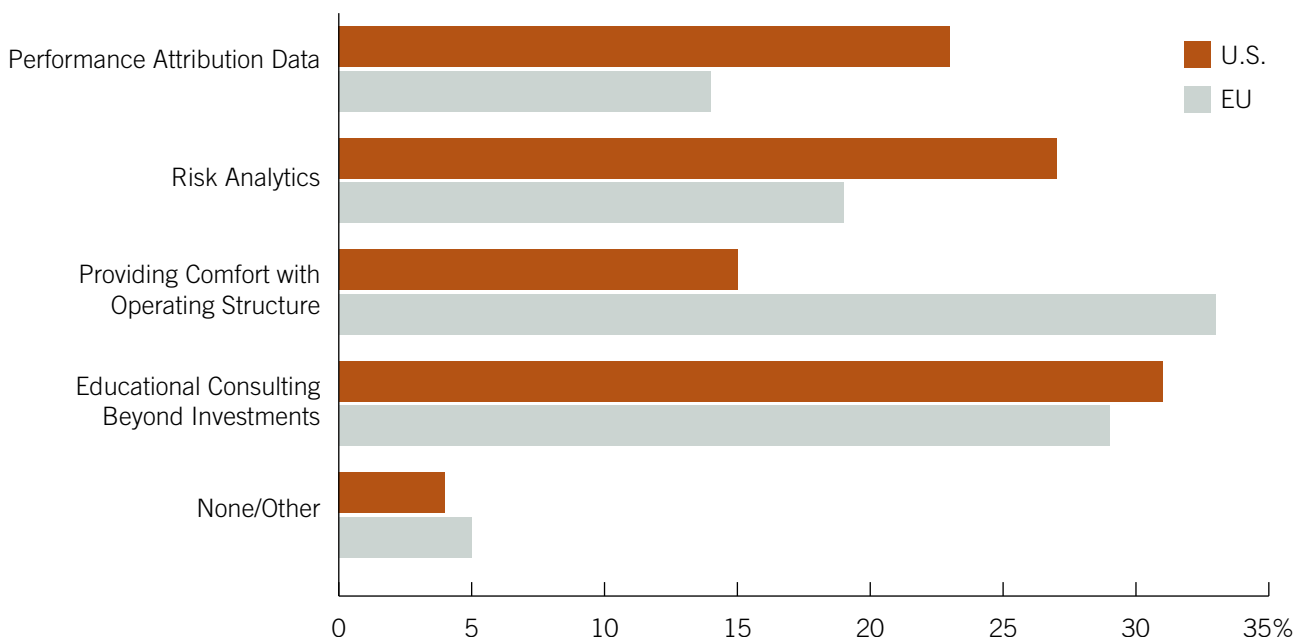
Firms Face External, Economic and Geopolitical Challenges

A majority of respondents indicated that the most significant challenges facing the industry in the next 12-18 months are economic uncertainty (36%) and geopolitical uncertainty (27%). Addressing and handling changing regulatory requirements was also seen as a challenge by 21% of U.S. poll participants. U.S. and EU managers were fairly consistent in their perceptions regarding challenges, although economic uncertainty weighed heavier on the minds of EU participants (44%).



Operational and Regulatory Challenges also Weigh on Managers' Minds

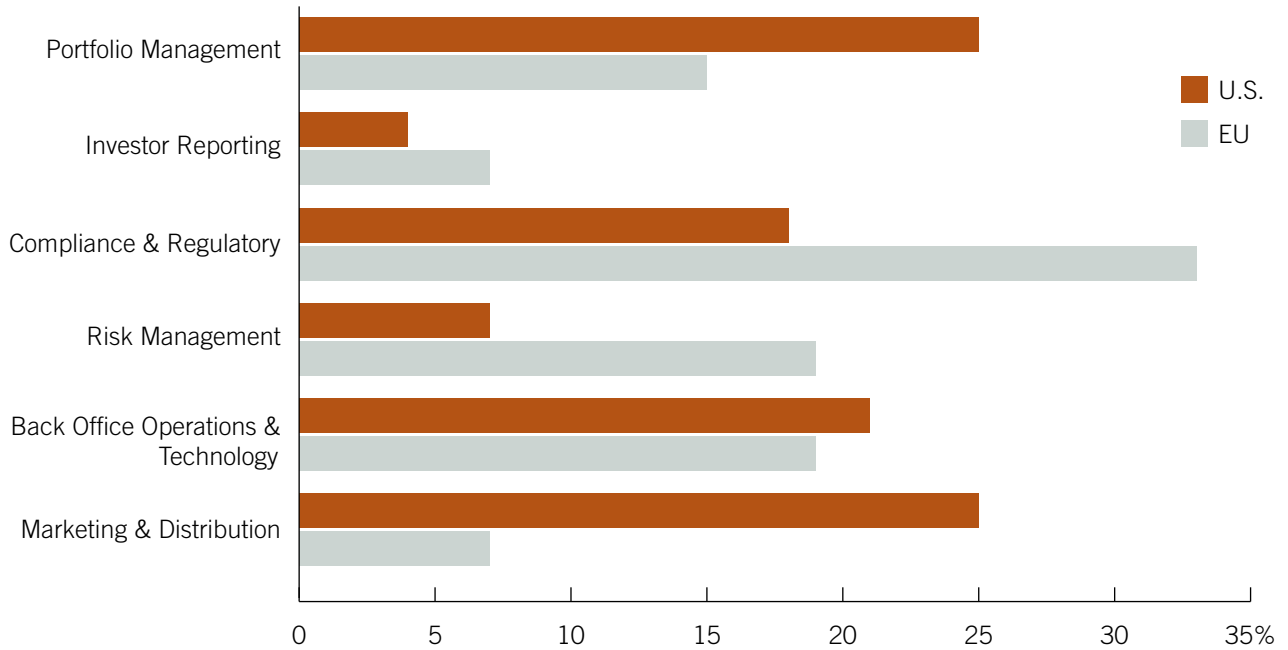
For U.S. firms, the greatest challenges in satisfying investors in addition to performance are providing: educational consulting beyond what they receive when making an investment (31%); satisfactory risk analytics (27%); and satisfactory performance attribution data (23%). By contrast, EU managers said getting investors comfortable with their firm's operating infrastructure was the greatest challenge (33%) followed by educational consulting beyond investments (29%).



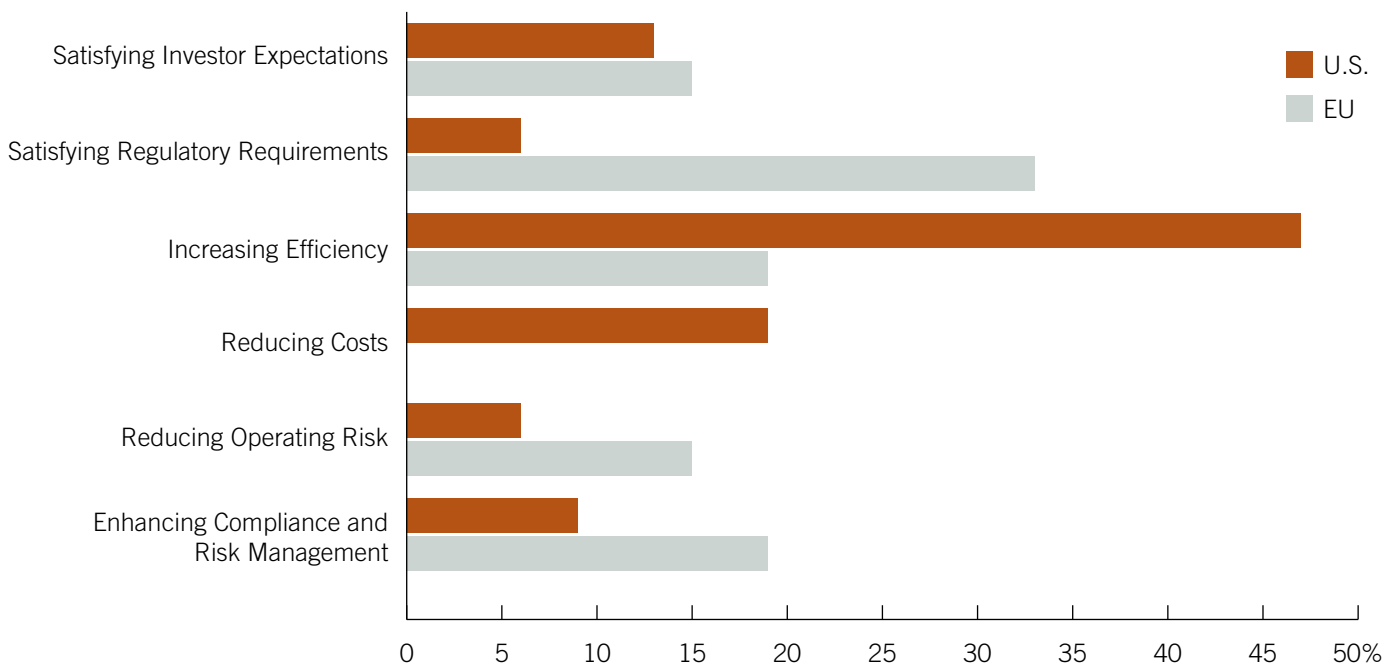
Spending to Address Challenges

U.S. participants identified portfolio management and marketing & distribution as the top areas for investment over the next 12-18 months, yet selected increasing efficiency as their greatest operational challenge. In the EU, managers found that compliance & regulatory was the most challenging and backed that up by pointing to satisfying regulatory requirements as the leading area for investment.

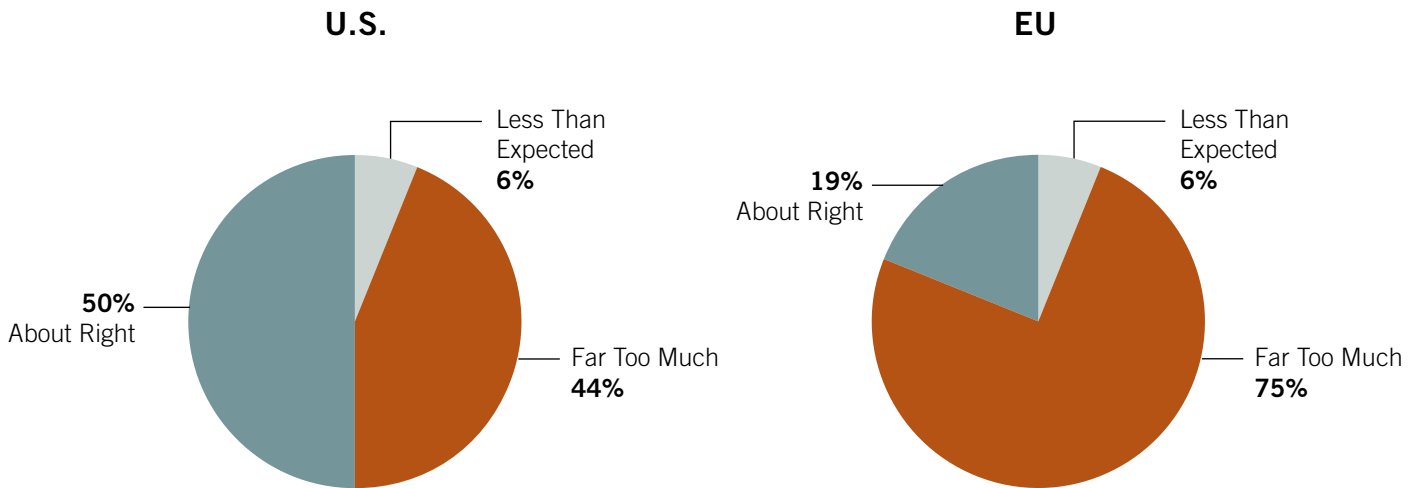
Operational Challenges



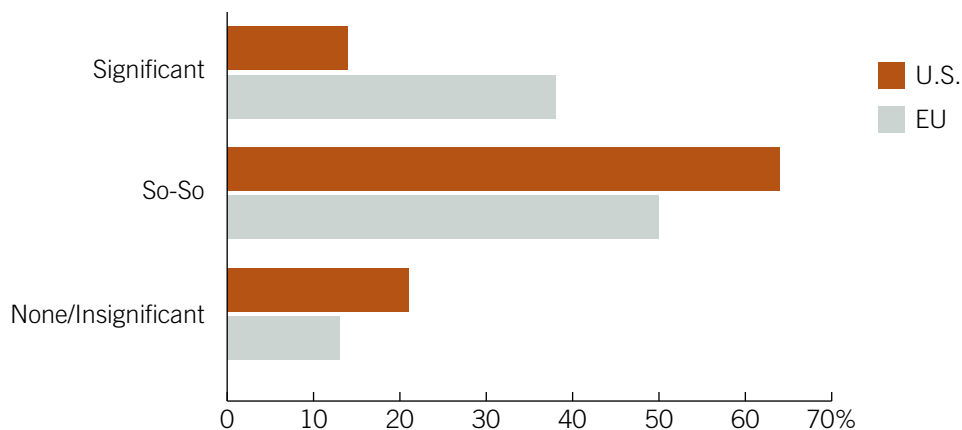
Area for Investment in Next 12 - 18 Months



Conversation at the Forums often centered on the heightened due diligence and transparency requirements that today's institutional investors now require from managers. Consistent with that, our survey revealed that U.S. managers were divided regarding the volume and appropriateness of new/proposed legislation, with half thinking it was about right versus 44% that it was far too much, while an overwhelming 75% of EU managers polled said it was far too draconian.



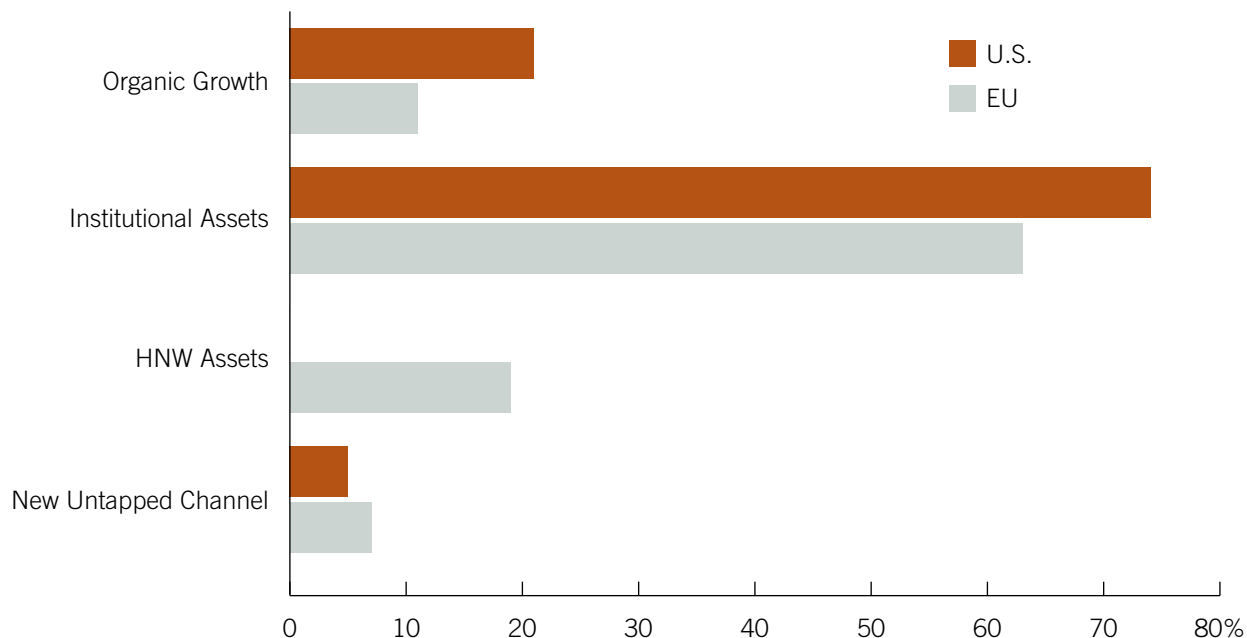
Most U.S. managers are uncertain what the effect of new regulations will be on profitability. In the EU, profit concerns are more prevalent, with over a third saying the effect would be significant.



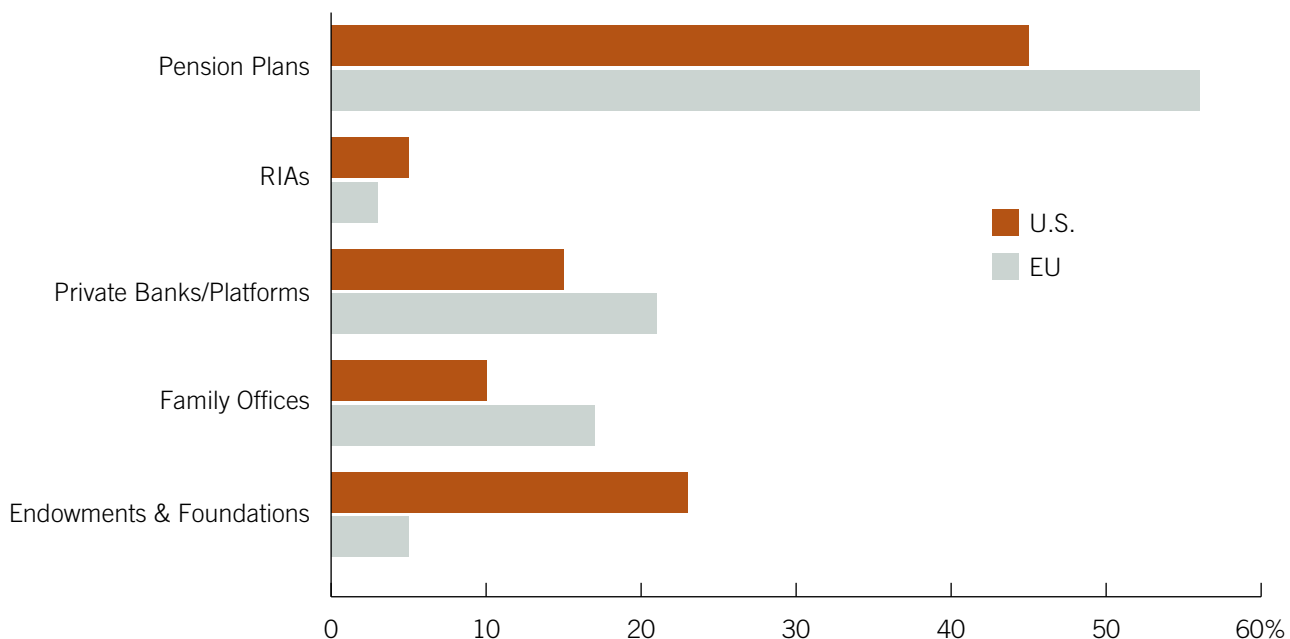


Finding Opportunities for Asset Growth in the Institutional Channel

The institutional channel was identified by an overwhelming majority of survey respondents in both the U.S. and EU as offering the greatest opportunity for asset growth in the hedge fund industry in the next 12-18 months.



Within the institutional category, pension plans were identified as the most attractive growth area by the largest percentage of those polled in both Forums.





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The SEI Knowledge Partnership is an ongoing source of action-oriented business intelligence and guidance for SEI's investment manager clients. It helps clients understand the issues that will shape future business conditions, keep abreast of changing best practices, and develop more competitive business strategies. The Partnership is an initiative of SEI's Investment Manager Services division.



About SEI

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