



cutting through complexity



Alternative Investment
Management Association



MANAGED FUNDS
ASSOCIATION

The cost of compliance

2013 KPMG/AIMA/MFA
Global Hedge Fund Survey

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Foreword

As the hedge fund sector becomes increasingly institutionalized, it seems clear that managers have started to come under ever-greater scrutiny, particularly from regulators. As a result, regulations promulgated in the immediate aftermath of the credit crisis have now started to come into effect, creating a complex environment of regulatory change for those operating in the hedge fund sector.

We believe that – for the sector to achieve growth through this era of fundamental change – fund managers will need clear insight into the challenges posed and solutions being offered in the market today. That is why KPMG, the Alternative Investment Management Association (AIMA) and the Managed Funds Association (MFA) partnered together to undertake a comprehensive survey, both online and in person, of hedge fund managers.

What we found was a sector that is taking its compliance obligations seriously, with significant investments of time, effort and capital already being made by many of those operating in the sector. But there is also a strong recognition that as costs continue to climb as managers grapple with new

compliance requirements, barriers to the industry are also being raised.

This report explores these challenges and opportunities in more detail and shines a light on some of the solutions being undertaken in the market. Throughout, we have incorporated quotes and insights gathered from our one-on-one interviews with some of the industry's most successful fund managers, as well as analysis from our own hedge fund specialists.

We hope that this report provides managers and regulators with valuable data to help inform and drive their decision making processes and adds to the existing body of knowledge on the cost of regulatory compliance for the hedge fund sector.

Robert Mirsky
Global Head of
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KPMG in the UK

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Contents

About the research	3
Executive summary	4
The industry commits to compliance	6
Exploring the cost of compliance	10
Looking to the future: Increased investment and activity planned	16
Preparing for new regulations	20
The impact on operating models	22
The impact on product development	24
What you should take from this survey	27



About the research

To learn more about the impact that regulation is having on the hedge fund sector, KPMG partnered with the Alternative Investment Management Association (AIMA) and the Managed Funds Association (MFA) to conduct a comprehensive, global survey of hedge fund managers around the world.

What we hoped to discover was how greater regulatory scrutiny was impacting managers. We also wanted to compare the cost of compliance across different regions and uncover some of the solutions that managers had implemented in response.

This report incorporates the views of 200 hedge fund managers representing approximately USD910 billion of assets under management (AUM). Survey respondents included hedge funds of all sizes, with approximately a quarter of respondents managing less than USD100 million, 34 percent managing between USD100 million and USD999 million, 32 percent managing between USD1

billion and USD9.9 billion, and 9 percent managing greater than USD10 billion.

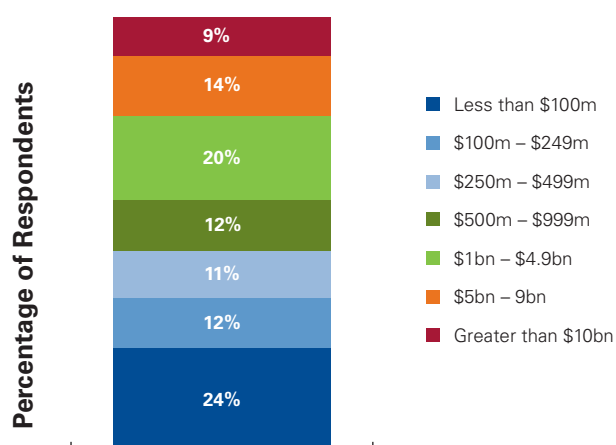
And while the greatest proportion of respondents (39 percent) named North America as the primary location of their headquarters, the geographic dispersion of respondents roughly reflects the overall market with around a third (32 percent) naming the UK as their headquarters, 16 percent naming Asia Pacific and 12 percent identifying themselves as headquartered in (non-UK) Europe.

This report also benefited from a series of structured one-on-one interviews with leading hedge fund managers in major centers around the world who provided

deeper insight into the complexities and opportunities currently facing the sector. Surveys were conducted online between May 2013 and June 2013, while the structured interviews were conducted between May 2013 and August 2013.

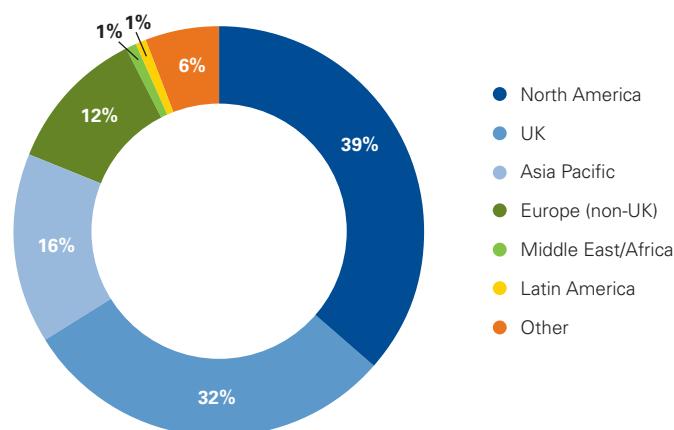
On behalf of KPMG, AIMA and MFA, we would like to thank all of those that participated in the survey. In particular, we would like to thank the managers that gave their time to share their views through our structured interviews. The insights and views of all of our participants – online or in person – have been invaluable in helping form this unique and valuable report.

Breakdown of respondents by AUM size



Source: The cost of compliance, KPMG International, 2013

Where are your headquarters?



Source: The cost of compliance, KPMG International, 2013

Executive summary

The hedge fund industry continues to grapple with an environment of change and uncertainty. The trend towards increased institutionalization of the sector continues, bringing even greater focus onto the due diligence, risk management and transparency management processes of funds and their managers. At the same time, the regulatory environment has continued to shift which has created not only uncertainty and complexity, but also significant costs.

As this report clearly demonstrates, the hedge fund industry is taking its compliance obligations seriously. Not only have most firms already put significant time, effort and capital into meeting regulatory requirements, the majority have also elected to allocate these costs to the fund manager rather than the funds themselves.

Those costs continue to mount; according to our data, total industry costs are more than USD3 billion. For established funds and managers, the rising cost of compliance is squeezing margins, and for some is influencing product and operating model decisions and adding to the already high level of complexity. Smaller funds, in particular,

are paying the price; our survey demonstrates that smaller funds spend more (as a proportion of AUM) than their larger peers. For new funds launching in the market, the story may be of greater concern with the cost of compliance quickly becoming a significant barrier to entry.

This report also finds that the vast majority of managers expect their compliance costs to increase over the next five years. Many say that the ongoing cost of complying with new regulation will continue to require precious resources and time, making the industry less competitive and less appealing to investors. Managers also suggest that the more complex the regulation, the more

they believe they will spend. AIFMD and FATCA, in particular, are creating concern for managers, as is the SEC's Form PF.

Our survey and in-person interviews uncovered a number of important findings that hedge fund managers, investors and regulators should note. Some of the highlights include:

- The industry is investing heavily in compliance on average spending more than 7 percent of their total operating costs on compliance technology, headcount or strategy. Based on extrapolations from our data, we believe that compliance is costing the industry more than USD3 billion with smaller fund





managers spending USD700,000 on compliance on average, medium fund managers spending approximately USD6 million, and large fund managers spending more than USD14 million.

- Smaller hedge funds seem to be spending more, both as a percentage of AUM and relative to operating costs, than their larger counterparts suggesting that some of the smaller funds may struggle in the face of increased regulatory scrutiny.
- Overwhelmingly, managers are absorbing the cost of compliance rather than passing it on to their funds. The vast majority of respondents said that their managers were absorbing

between 76 and 100 percent of the costs.

- Managers around the world are struggling with an increased cost of compliance including capital investments, time spent on compliance and outsourcing requirements which, in turn, is creating significant barriers to entry for new players and growth for existing players.
- Managers rank AIFMD and FATCA highest in terms of cost, time and need for external support, likely due to their complexity and global reach.
- Nine out of ten managers expect their spend on regulatory compliance-focused technology and external

consultants to increase over the next five years, indicating an expectation of rising compliance costs.

- Larger managers are more likely to be subject to the European Short Selling Regulation than smaller managers and two thirds of the larger managers said that short-selling bans would negatively impact their involvement in the markets of that jurisdiction.
- The majority of managers say that they have not considered moving their fund domicile, management company or center of main economic activity in response to regulatory change: Fifty-five percent said they had not considered this action while 40 percent said that they had.

The industry commits to compliance

Our survey clearly demonstrates that fund managers are committed to meeting their compliance requirements. But that's not all: they are also absorbing the additional costs rather than passing them on to their clients.

Hedge fund managers are certainly not waiting for the regulatory winds to pass. Indeed, responses to our survey seem to demonstrate that most hedge fund managers have already made significant investments into building their compliance capability and processes. Clearly, the industry has committed itself to meeting its compliance requirements.

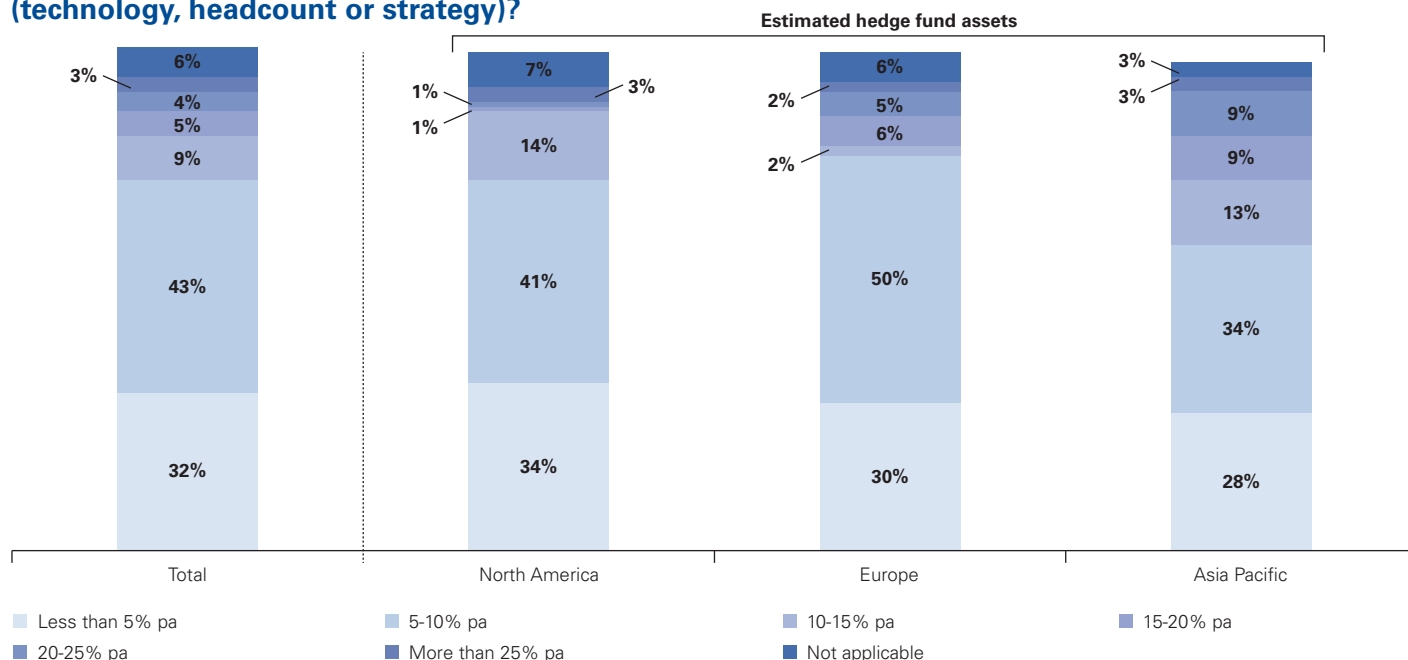
Almost two thirds (64 percent) of respondents reported that they were spending upwards of 5 percent of their total operating costs on meeting their compliance requirements while more than a fifth (21 percent) said they were spending more than 10 percent of their operating costs. Funds headquartered in Asia Pacific seemed to allocate a disproportionately high level of operating costs to compliance; and more than a third (34 percent) of Asia Pacific respondents said they are spending in excess of 10 percent of operating costs on compliance, versus just 15 percent of Europeans and 19 percent of North Americans. However, when we looked at the total spend reported by our respondents as a percentage of their total assets under management we

found that North American managers are spending more than those in Asia Pacific and Europe. This likely reflects that Asian operating costs tend to be relatively lower which results in a higher percentage of costs allocated to regulatory compliance.

Significantly, smaller hedge funds seem to be spending more on regulatory compliance costs on a relative basis than their larger counterparts. More than a third (35 percent) of hedge funds with less than USD250 million in AUM said compliance requirements represented more than 10 percent or more of their total operating costs. No funds with AUM of more than USD5 billion and only 14 percent of those with AUM of between USD1 billion and USD5 billion said the same.

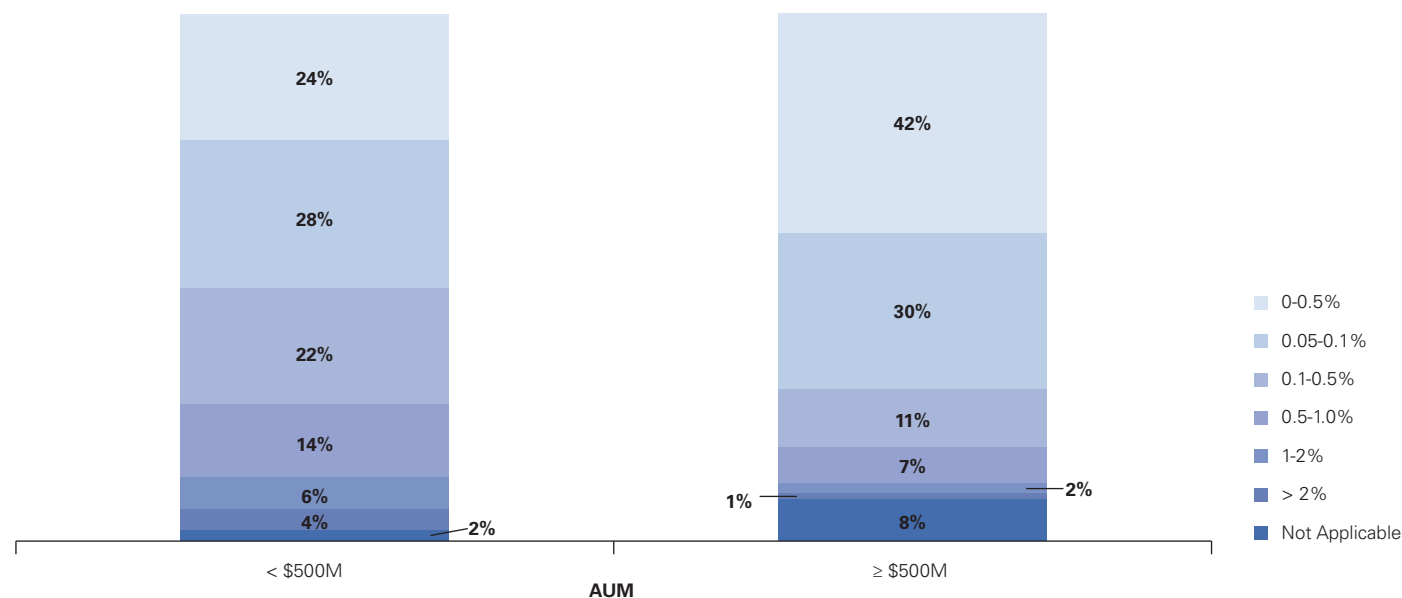
Managers also are focused on creating a culture of compliance. As one UK manager told us, "We want to be robust in our compliance and so we need to always strive to ensure we have an ethical culture that emphasizes the importance of doing things the right way. That's how you deliver long-term value." Others agree: "It's all about having the right internal controls and the right ethos that prevents fraud."

To date, what percentage of your firm's total operating costs is allocated to regulatory compliance (technology, headcount or strategy)?



Source: The cost of compliance, KPMG International, 2013
(Percentages may not add up to 100 due to rounding off)

To date, what is the cost of regulatory compliance on your firm expressed as a percentage of aggregated global AUM?



Source: The cost of compliance, KPMG International, 2013

What is particularly noteworthy is that – on the whole – managers seem to be bearing the increased cost of compliance rather than passing costs on to their funds and, ultimately, their investors.

Indeed, more than seven in ten respondents said that regulatory compliance costs were borne by the management company.

When asked what percentage of costs were being passed on to the manager versus the fund, the vast majority of respondents said that their managers were taking between 76 and 100 percent of the costs. Our data shows that this is not a peculiarity of size or geography; statistically similar results were provided by funds small and large and regardless of the location of their headquarters.

“We haven’t changed our rate card or our service fees and no additional costs have been passed on to investors,” noted one European fund manager.

Understanding costs is one thing, but predicting future changes to business models is more difficult. However, some managers believe that the pace of change is still too slow. “One of the problems is that the consultation papers that are coming out are very broad and most fund managers don’t really understand the direct impact that the change will have on their business,” noted an Asian manager. “I’d like to see more discussion amongst service providers and peers about the direct impact that the consultation papers will have on the industry.”

Others suggest that the regulatory process itself may be slowing progress and inhibiting growth. “In Europe, the implementation doesn’t seem to have been well thought out,” noted a European manager. “It’s making Europe seem like a less attractive place to invest, particularly when you look at the US where there is a very coordinated approach.”

FATCA and the cost of compliance

At its most basic, FATCA is essentially designed to prevent US citizens and residents from using offshore accounts and investment vehicles to disguise their identity and thus avoid paying US taxes. But while the focus of the regulation may be on US citizens, its impact on both US and non-US hedge funds will likely be significant. Enacted in March 2010, FATCA introduces a new, compulsory reporting regime that requires investment funds and other non-US financial institutions around the world to:

- Register and enter into a binding disclosure agreement with the IRS (or comply with local country rules adopting the terms of the disclosure agreement), under which they will have to implement FATCA “Know-your-customer” policies to identify any investors that are US persons or who hold foreign accounts or financial instruments on a direct or indirect basis.
- Annually report information concerning certain US persons – such as their transactions and account balances – to the IRS (or local tax authority), to assist the IRS in developing an audit trail.
- Demonstrate tax withholding capabilities to ensure compliance with FATCA.

Implementing operational policies and procedures to ensure compliance with FATCA poses some of the greatest challenges for hedge fund managers and often requires them to:

- Review their organizational structures to classify their entities for FATCA under the appropriate rule sets (final regulations vs IGA) and register entities with the IRS as required.
- Implement procedures to monitor (on a go-forward basis) changes to their organizational structures to ensure FATCA registration statements are maintained. This would include

determining the FATCA impact arising from new entity formations, acquisitions, dispositions, liquidations and shifts in ownerships.

- Implement the capabilities to collect and validate US tax forms which are substantially more complex.
- Develop a well-coordinated process to ensure information gathered on investors and account holders by various functions within an organization and, likely, outside the organization (e.g., administrators) is aggregated so that FATCA’s tax due diligence requirements are satisfied and information can be monitored on a real-time basis going forward.
- Capture new information for effective FATCA reporting purposes.

Those that have relied heavily on third-party service providers such as administrators to handle tax documentation requirements in the past will need to decide how – and to what extent – they will use outsourced service providers to achieve their FATCA compliance.

Fund managers that currently have a high number of investors or account holders may also struggle to remediate the tax documentation which will likely prove to be an expensive chore requiring resources to complete in a timely and wholesome manner. Most funds are now also developing plans to communicate whether they will be FATCA compliant and what impact this may have on investors/account holders.

So while certain FATCA guidance is still pending from the IRS and Treasury, fund managers will need to continuously monitor FATCA developments and remain nimble enough to adapt to those changes and clarifications within the prescribed effective dates.

Exploring the cost of compliance

The industry has spent significant time talking about compliance around the world. Yet there is scant data to properly compare and correlate the true cost – in resources, time and money – of the different regulatory requirements. This report aims to fill that gap and delivers a unique view into how much funds and managers are investing based on which regulations they must comply with.

While our survey did not include every hedge fund manager around the world, the data suggests that, as an industry, hedge funds are spending at least USD3 billion on regulatory compliance, including technology, headcount and third-party vendors.

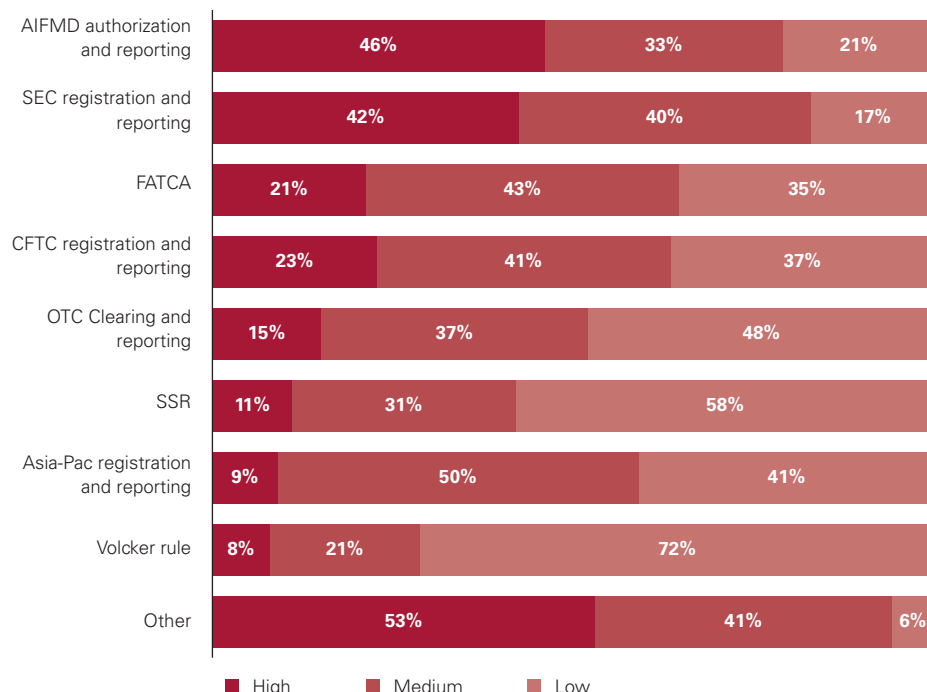
However, each fund manager is often subject to a mix of regulations, each of which will incur different costs and require different resources depending on the scope, geographic location and customers that each fund and manager serves. But when we asked our survey respondents to rank the cost of compliance of a range of different regulations, it quickly became clear that some regulations were exacting a higher toll than others.

In particular, respondents noted the high costs of AIFMD authorization and reporting. Almost half (46 percent) of all respondents impacted by AIFMD rated the cost of compliance as 'high' and a further third (33 percent) rated it as 'medium'.

SEC registration and reporting was identified as the second most costly regulatory requirement to comply with: more than four in ten (42 percent) of those who have registered or are in the process of registering with the SEC deem compliance costs to be 'high' with only slightly fewer (40 percent) characterizing their costs as 'medium'. Asia-Pacific registration and reporting, on the other hand, was only considered to have a 'high' cost by 9 percent of those impacted by the regulation.

Of course, cost is not limited to capital investment. Many regulations also carry a high resource cost in terms of time or management attention. Of those registered as an investment advisor with the SEC, for example, more than a third (36 percent) said they spent between 50 and 100 hours preparing and filing for SEC registration; a quarter spent between 100 and 500 hours; while seven percent spent more than 500 hours. That being said, a number of respondents noted that regulators were aware of the challenge. "The SEC has tried to be as helpful and productive

Please rank the specific impact of the following regulations in terms of cost of compliance



Source: The cost of compliance, KPMG International, 2013
 Percentages may not add up to 100 due to rounding.

as possible in the fulfillment of their congressional mandate.” said a US manager.

Other regulatory requirements are taking additional time. More than 20 percent of those required to complete the SEC’s Form PF said they spent more than 500 hours preparing and filing their initial submission; nine percent said they spent a similar amount of time registering with the CFTC/NFA; and seven percent of those registered with an Asia-Pacific regulator said they also spent more than 500 hours preparing and registering under their requirements.

“Form PF is hundreds of pages long. We had to outsource the heavy lifting to service providers and pay technology providers for risk and data warehousing services,” noted one US-based manager. “We spend six or seven hundred thousand bucks a year on remaining compliant.”

“We’ve had to almost double the size of our legal and compliance teams to deal with these regulatory changes,” noted a hedge fund manager. “We’ve spent more money on professional services firms and our managers are spending more time reviewing processes. It’s made it challenging to grow.” Others agree; “We must be spending about GBP1.5 million more than we were before because of regulation,” noted a UK-based manager.

On the positive side, the addition of new resources and sharpening of focus on regulatory compliance and risk management suggests that hedge fund managers around the world are committed to ensuring that they meet not only the high regulatory burden, but also the heightened demands of their institutional investors. “We’ve really enhanced our capabilities in areas such as legal and compliance, settlement, credit risk management and IT and this has led to improvements in our processes which, in turn, should result in

More than half of respondents believe that recent regulation has at least *somewhat improved* the strength, transparency and reputation of the market, and improved investor protection.

The SEC has tried to be as helpful and productive as possible in the fulfillment of their congressional mandate.

– US hedge fund manager

opportunities for enhanced performance particularly as investors start to demand even more transparency,” added another Asian manager.

Not surprisingly, our research shows a correlation between the perceived complexity of regulatory compliance and the cost. Six in ten respondents impacted by AIFMD suggested that the complexity of the regulation was ‘high’, versus only 11 percent of those registering with Asia-Pacific regulators. More than a third of respondents also rated FATCA as ‘highly’ complex and a similar number rated their SEC registration and reporting requirements as ‘high’ in complexity.

Some suggest that the complexity of AIFMD and FATCA is related to their broad global reach.

The survey findings are further reinforced by data that shows that a vast majority of hedge funds have required external compliance support for many of the more complex or costly regulatory compliance requirements. More than two thirds (67 percent) said they needed outside help with AIFMD authorization and reporting; 65 percent needed help with FATCA; 63 percent with their SEC registration and reporting; and 62 percent with their CFTC registration and reporting. In comparison, less than a quarter of respondents said they needed external help with Asia Pacific registration and reporting.

Form PF

Form PF represents a new and complex regulatory reporting requirement for some SEC-registered investment advisers. Form PF requires private fund advisers to report new data points with increased granularity and to disclose comprehensive fund information to the SEC. Simply put, Form PF requires larger hedge fund managers to deliver an unprecedented breadth of information to the SEC.

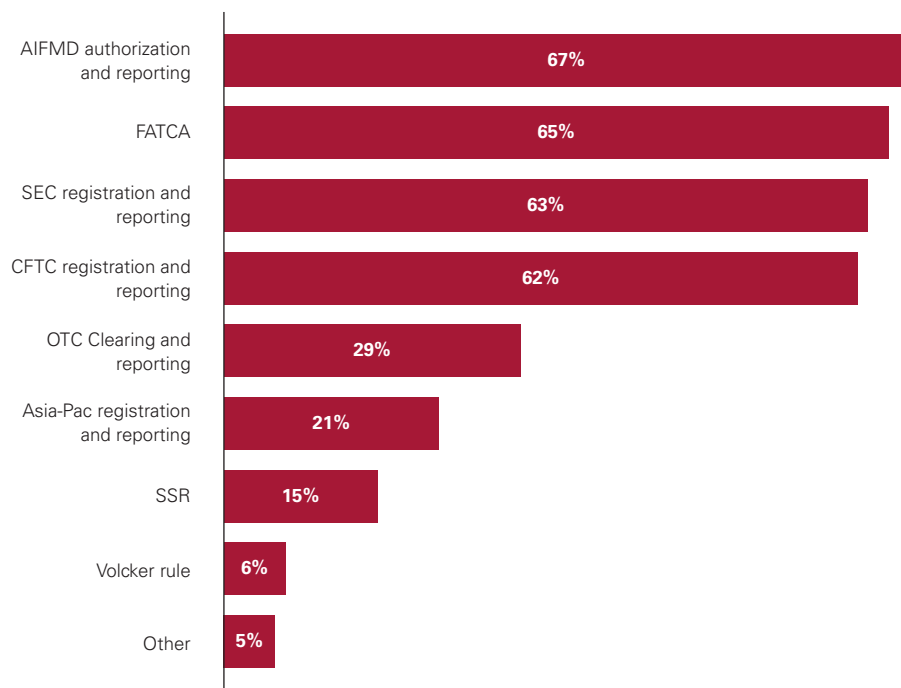
Form PF creates unique challenges for the hedge fund industry, particularly since the scope of compliance extends beyond the traditional legal and compliance functions to also include finance, operations and others. Moreover, the form requires managers to identify, collect and report information that has not previously been reported, forcing many firms to fundamentally change their internal systems and processes to ensure that they can comply with the requirements of the form.

Hedge fund managers also must recognize that, while there is an initial interpretation of what data the form requires, further refinements are anticipated which means that managers may need to re-tool their systems on an ongoing basis to reflect any changes to the form that may be mandated.

Not surprisingly, many investment advisors are seeking independent advice and assistance in the preparation of their Form PF filings. However, those using external support will want to ensure that there is tight coordination between their firm and their chosen service providers which, in turn, may require new processes and validation procedures to be created, implemented and evaluated.



Which regulations have required external compliance support?



Source: The cost of compliance, KPMG International, 2013

“As the reporting requirements have increased, we’ve had to put more into outsourcing, particularly on short-selling reporting,” noted one US manager. This has driven up costs and complexity and eroded margins and focus.

Once again, however, this increased reliance on external compliance support suggests that funds and their managers have – overall – committed to finding solutions that will both achieve their compliance requirements and allow managers to focus on their core business. Indeed, many of our interviewees suggested that, by engaging expert external support, they have cut the amount of time spent on compliance and reduced their risk of non-compliance.

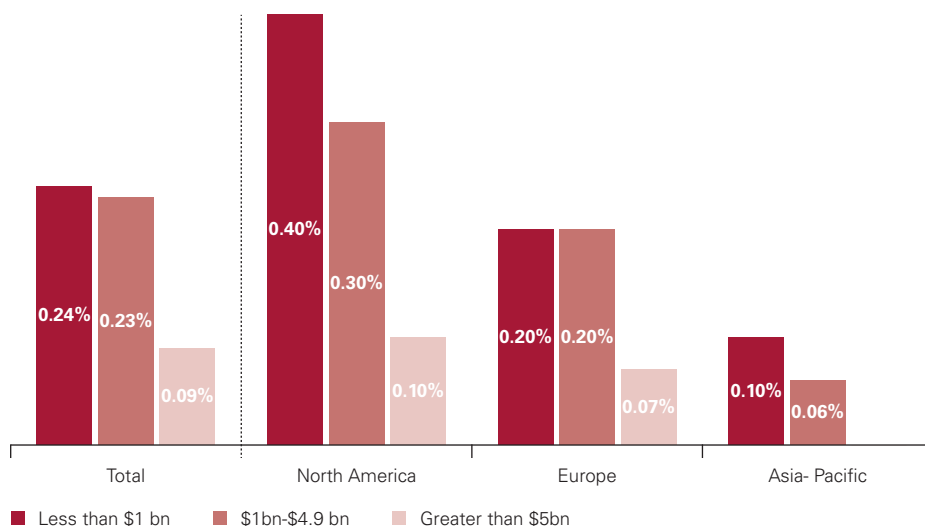
However, according to many leading hedge fund managers, the constant focus on regulatory compliance is having significant negative impacts on the industry overall. One Asian fund manager astutely noted that “the entire nature of the alternative investment industry – particularly the hedge fund industry – is one of innovation and finding new ways to achieve alpha. There’s no doubt that regulation is constricting this and making it harder for new players to enter the market.

The sentiment was echoed by a large fund manager who said, “new, complex regulation favors the very big firms, because it’s all about big economies of scale.”

FATCA is still an area of significant uncertainty for us.

–Asian hedge fund manager

Estimated cost of compliance expressed as a percentage of aggregated AUM



Source: The cost of compliance, KPMG International, 2013

To gain a deeper understanding of the relative cost of compliance, we looked at the total spend reported by our respondents as a percentage of their total assets under management. What we found further reinforced the fact that smaller firms are spending more than their larger peers and – interestingly – that North American managers are spending more than those in Asia Pacific and Europe.

Indeed, while our data suggests that the industry as a whole is spending more than USD3 billion on compliance each year, these results also suggest that the costs are not borne equally across the board with smaller fund managers spending USD700,000 on compliance on average, medium fund managers spending approximately USD6 million, and large fund managers spending more than USD14 million.

What the data also demonstrates are that compliance costs absorb a higher

amount of the funds' assets for smaller firms (those with less than USD1 billion in assets under management) than their larger (USD5 billion plus) peers. In North America, for example, smaller firms report spending four times more of the assets under management on compliance than their large peers on a relative basis. The trend remains largely consistent across all regions.

What is perhaps surprising is that North American firms report spending more as a percentage of their AUM than those in other regions. In part, this likely reflects the already in process compliance requirements in the US which include Form PF reporting and SEC registration, versus the expected compliance requirements of the soon-to-be implemented AIFMD. The fact that many of the largest funds participating in our survey are based in North America may also raise the total cost as a percentage of AUM.

¹ <http://www.kpmg.com/KY/en/Documents/the-value-of-the-hedge-fund-industry-part-1.pdf>

Looking to the future: Increased investment and activity planned

While all evidence points to the fact that the industry has already invested significant capital, time and resources towards achieving regulatory compliance around the world, it is also clear that more will be required before funds and their managers can be confident of their compliance processes and solutions.

According to our survey, hedge fund managers are convinced that the costs and resources associated with regulatory compliance are only set to increase over the next five years. Almost nine out of ten respondents (89 percent) said that they expected their regulatory compliance-focused technology spend to increase, while only 10 percent suggested that it would stay the same. Only one optimistic respondent (out of 200) thought that this area of spend might decrease over the same period.

Interestingly, these results were consistent regardless of the size of the fund in question or the location of the management company.

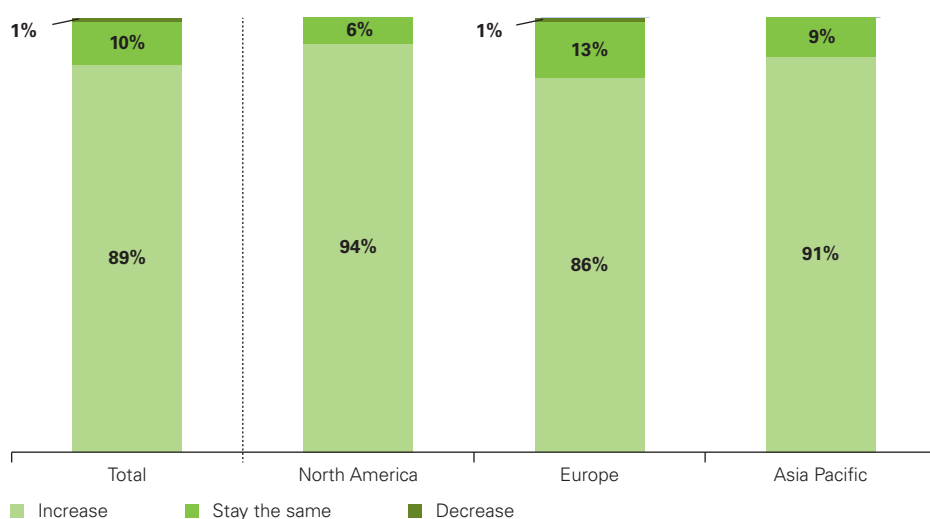
As one European manager put it, "Most of this legislation is still new and everyone is struggling to understand and get prepared for it. I don't think there is any question that – in an absolute sense and as a relative percentage – costs are going to rise."



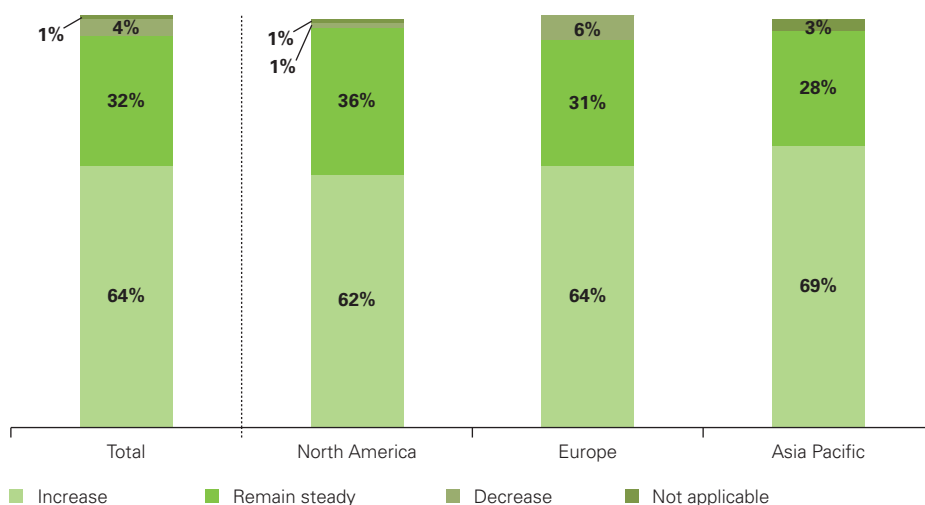
At the same time, respondents were almost unanimous in stating that their use of outsourced or third party advisors and consultants to support their compliance strategies would either increase (64 percent) or stay the same (32 percent) over the next five years. Not surprisingly, the

smallest firms (those with AUMs of below USD250 million) were almost 10 percent more likely to suggest that they anticipate increasing their use of external advisors over the next five years, while mid-sized firms are most likely to suggest that their use of consultants will remain steady.

Looking ahead from now to 2018, do you expect your regulatory compliance-focused technology spend to increase, decrease or stay the same?



Looking ahead from now to 2018, what is your anticipated change in use of outsourced/third party regulatory advisors, consultants an/or other service providers?



In particular, respondents indicated that they would be most likely to increase their use of legal advisors (cited by 84 percent of those who indicated that their use of service providers would increase overall) and regulatory advisors (cited by 80 percent of the same

group). More than half (52 percent) also suggested that they would increase their use of tax advisors, demonstrating that managers have started to be more aware of the tax implications of regulatory and operational changes and are actively seeking solutions in response.

Alternative Investment Fund Managers Directive (AIFMD)

The EU's Alternative Investment Fund Managers Directive (AIFMD) creates new complexities, costs and considerations for those operating in this sector. The challenge is not limited to only EU-domiciled fund managers. Any alternative fund manager, in any country that markets their funds to EU investors will need to comply with AIFMD. This creates a host of new organizational requirements for managers to grapple with and new business complexities for organizations to overcome.

The road to AIFMD compliance must start with organizations taking stock of their entire fund strategy; to find ways to reduce complexity by, for example, rationalizing strategies, merging funds, centralizing management company activities, or even merging into one AIFM with multiple branches. Those that take this opportunity to 'clean house' will not only reduce their compliance burden, they will also streamline their operations and fine-tune their strategies.

AIFMD will also have a significant impact on service providers, who may find it increasingly difficult to sustain their business model in a post-AIFMD world.

The European Market Infrastructure Regulation (EMIR)

One of the more recent regulatory changes to come from Europe is the EMIR. Regulatory Technical Standards for EMIR came into force on 15 March 2013, with requirements being phased in starting with risk mitigation for non-cleared OTC derivatives. In its current form, EMIR may create some new complexities for hedge fund managers both inside and outside of Europe.

For example, EMIR requires many investment managers to have indirect clearing arrangements in place to clear OTC derivatives. In our experience, few have fully appreciated the significant addenda and repapering of agreements that will be required to ensure that such agreements are put into place and that client assets are held in segregated or omnibus accounts at Clearing Members according to their client's best interests and wishes.

And while there has been some consolidation among service providers in the industry, this activity has also made some member state regulators wonder whether this could potentially increase counterparty and concentration risk.

EMIR will have a number of other impacts on investment managers. In particular, market participants will be required to report transactions in exchange-traded and OTC derivatives to Trade Repositories (TRs); the obligation for which will be phased in during 2013–2014. Firms will need to consider their contractual relationships with TRs, and also whether their existing data repository and infrastructure is capable of meeting the requirements.

Non-cleared OTC derivatives will be subject to additional risk mitigation techniques. In particular, most transactions will need to be collateralized, confirmations will need to be sent in a timely manner and contracts will need to be marked-to-market/model on a daily basis. The collateralization of transactions will also carry a number of opportunity costs and the impact to profitability on existing products and services will also need to be modeled.

Preparing for new regulations

While short-selling bans and Financial Transaction Taxes (FTTs) are not a new concept, we have witnessed numerous implementations of short-selling bans (some temporary, others permanent) and much talk of FTTs over the past five years. Indeed, both the US and the EU currently have FTT legislation in development and – while the mooted G20 FTT concept may be dormant for now – the potential for other jurisdictions to follow suit is certainly real.

Our data shows that – of the almost half (49 percent) of all respondents reporting their trading activity as being subject to the requirements of the European Short Selling Regulation (SSR) – respondents were unanimous in saying that short selling bans (or even the likelihood of such bans) would have a negative effect on their involvement in the markets of that jurisdiction.

And while many of those impacted by short selling bans suggest that achieving

compliance with the regulation was not overly time consuming in comparison to other regulatory requirements, others have found the short-selling filing requirements to be onerous. “We have one person dedicated to short-selling reporting and have spent between USD8 million and USD9 million a year in technology as well as two years of consultant technology and personnel fees,” noted one UK manager.

Hedge fund managers seemed equally clear that the introduction of FTTs would make them reconsider their participation in certain markets. Tellingly, respondents were unanimous in saying that FTTs would have a negative effect on their involvement in the markets of that particular jurisdiction.

From the data and our in-person interviews it seems that hedge fund

managers expect the longer-term (and possibly more lasting) result of both short-selling bans and Financial Transaction Taxes to be a reduction in selection, depressed competitiveness and limited product development; all of which negatively impacts not only the funds, but also investors and capital markets.

80%
of the *largest* managers (those with AUM of USD5 billion and above) are subject to the European Short Selling Regulation.

Central clearing

The requirement for centralized clearing of Swap transactions for certain defined products started in March 2013 for transaction between Swap Dealers. By September 2013, all transactions in these defined products were required to be centrally cleared, except where one party can avail themselves of the commercial end-user status.

As the process matures, we anticipate that additional products will be approved for clearing which, in turn, will lead to greater transparency in the marketplace. However, managers should keep in mind that changes in transparency and clearing have only just begun. As more products are subject to clearing and as exchange-type executions evolve – as well as further refinement of the regulations – further infrastructure cost will be warranted, along with the additional cost of compliance.

Regulations for Swap Execution Facilities are being finalized; and we expect exchange-like trading to commence by early 2014.

Within Hong Kong in particular, we've seen increased demand for reporting on short-selling – weekly reporting in Hong Kong, daily in Australia – which has increased our overheads.

– Asian hedge fund manager

The impact on operating models

So how are increased regulatory scrutiny and compliance costs influencing the operating models of hedge funds and managers?

According to the data, two fairly equal camps are starting to emerge – those that will use regulatory change to proactively transform their operating models and those that would prefer to react to change as it happens.

Taken on face value, the survey data would suggest that fund managers were unsure how regulatory change would impact their operating models. An equal number of respondents – 48 percent respectively – said that they had considered changing their operating models in response to regulatory change as said that they hadn't.

Interestingly, there was no real (statistically significant) variation in this split across firm size or geography. Those in North America were slightly less likely to consider changing their operating model than those in Europe or Asia Pacific, and smaller fund managers were somewhat less likely to consider a change than their larger peers.

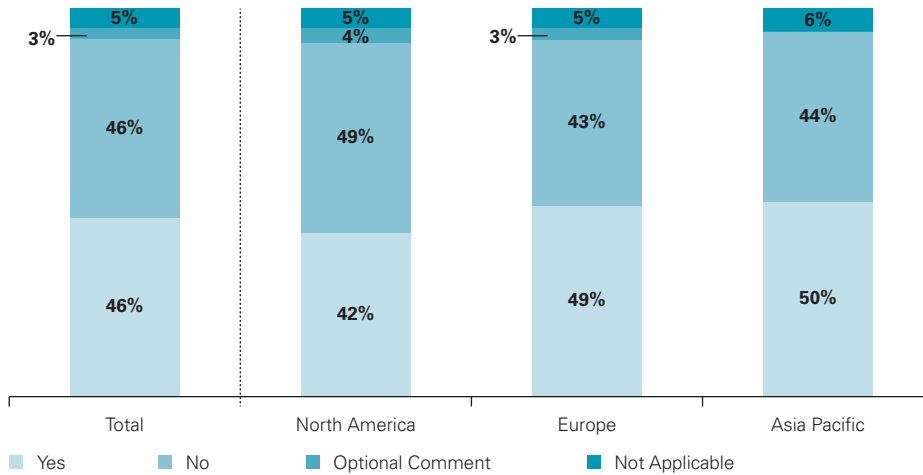
As one Asian manager pointed out, "We already had robust in-house legal and compliance capabilities so I think we're not going to see any major changes. Clearly, this could be an

advantage for us as the cost of failing to comply is very high."

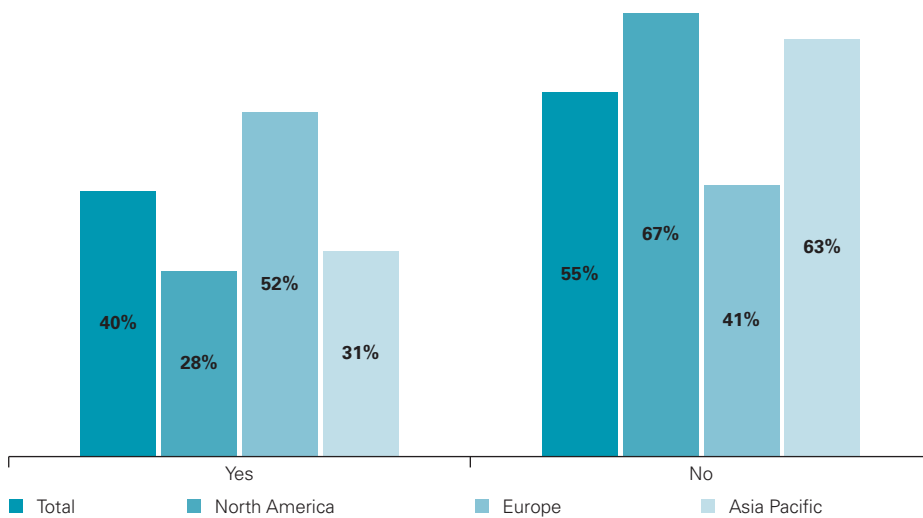
Counter to popular opinion, our research shows that the majority (56 percent) of fund managers would not consider exiting markets or lines of business due to increased regulatory pressure, nor have the majority (55 percent) considered moving their fund domicile, management company and/or center of main economic activity to an alternative jurisdiction in response to regulatory change.

Two exceptions exist, however: 52 percent of respondents from Europe said they had considered moving their fund domicile, management company and/or center of main economic activity; while 50 percent of the managers representing the largest funds (with AUM of USD5 billion and up) said they had considered exiting markets or lines of business due to increased regulatory pressure.

Has your firm considered changing operating models in response to regulatory change?



Have any regulatory changes caused your firm to consider moving its fund domicile, management company and/or center of main economic activity to an alternative jurisdiction?



If we could start over today, we would probably do it from the UK or the US.

– Continental European hedge fund manager

The impact on product development

The changing regulatory landscape has long influenced product development decisions. In this chapter, we examine the current market for US “40 Act” and UCITS funds and explore what this may tell us for the future.

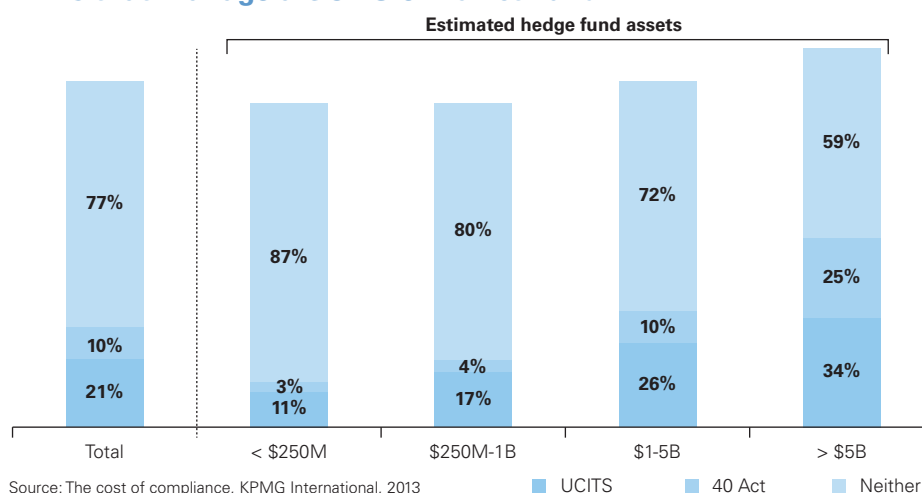
The market for regulated absolute products seems to be gaining traction with more than one in five respondents saying they have an existing UCITS fund and one in ten reporting managing a “40 Act” fund. Not surprisingly, these numbers are higher for funds based within the jurisdiction; 27 percent of European managers said they had a UCITS fund and 17 percent of US managers indicating having a “40 Act” fund.

The size of the firm’s AUM seems to have a direct correlation with the types

of funds managed: those with larger AUMs (of more than USD5 billion) are three times as likely to have a UCITS fund as their small counterparts (those with less than USD250 million). And larger firms are more than six times more likely than those with AUMs of under USD250 million to manage a “40 Act” fund.

This likely reflects the increased infrastructure required to run onshore products versus offshore products.

Firms that manage a UCITS or 40 Act Fund





In the short-term, there seems to be growing appetite amongst managers to open a directly-operated (as opposed to a third-party operated) UCITS fund or “40 Act” fund. Sixteen percent of respondents indicated that they were considering opening a directly-operated UCITS fund (as opposed to a third-party operated fund) and 13 percent said they were considering opening a directly-operated “40 Act” fund. Of those that are planning or designing a directly-operated UCITS fund, the majority plan to launch their product within the next year and most of those planning “40 Act” products expect to have products in markets within the next three years.

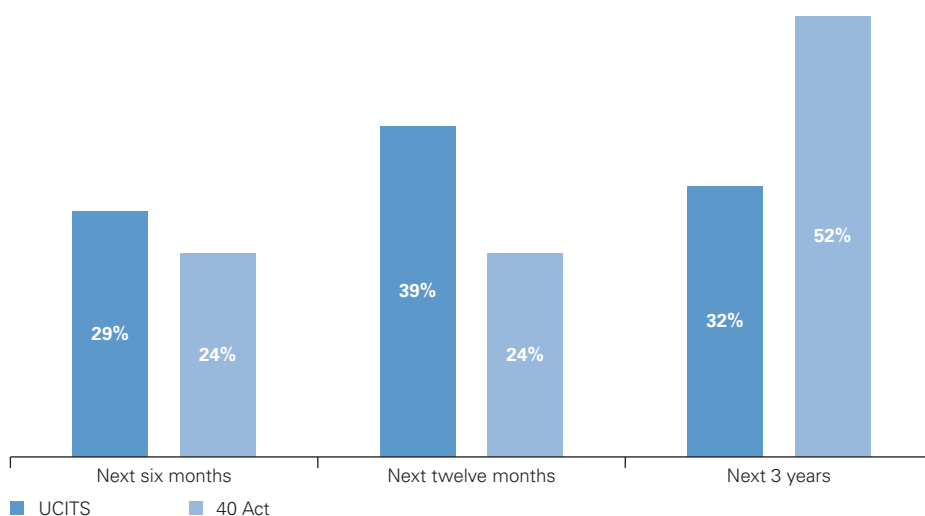
And while the short-term market seems set to be dominated by the larger managers for the time being, it appears that there may be broader interest in developing these types of regulated products in the medium-term. Many believe demand is growing for ‘absolute return’ products and – while uptake may not be overwhelming today – there is a general belief that these types of products will be fairly popular within

the next decade. “The perception of the UCITS product is quite strong in the market,” noted a European fund manager.

However, regulation and the stance of individual regulators may pose significant concern in the short-term. Many, for instance, are waiting to see how AIFMD will be applied to regulated products. As one European hedge fund manager noted, “The landscape for UCITS is still changing so there is a lot of uncertainty.”

So what lessons can we take from this? According to most of the managers that we interviewed, regulation may not be the greatest force driving product design. “Products are driven by client demand, not by regulation. Our product set is based on our current strategy not on where we think regulation may or may not be going,” said one European manager. Another European manager shared the same sentiment about “40 Act” funds. “We’ve looked at 40 Act funds but more as a business opportunity than a regulatory one,” he noted.

Timeframe of opening a directly operated fund as opposed to a third-party operated fund



Source: The cost of compliance, KPMG International, 2013

What you should take from this survey

Clearly, this report provides evidence to support some widely-held beliefs within the hedge fund sector: that the cost of regulation is rising, that regulatory complexity is growing and that the overall regulatory burden is squeezing margins and reducing selection for investors.

But what this survey also clearly demonstrates is that the industry is making great efforts to achieve compliance. Significant investments have already been made in operational infrastructure to support compliance and more is being earmarked for future investments. Managers are aware that their costs – and the complexity – are set to rise and they are preparing to meet the challenge head on.

What our interviews and supporting data also show, however, is that there is a limit to how much the industry can spend on compliance. Already, smaller fund managers are meeting significant barriers to entry as a result of the rising cost of regulation which, in turn, is limiting investor choice.

The survey also shows that managers are adapting and – in many cases – leveraging their compliance capabilities to create competitive advantage. Some are targeting greater efficiency in their compliance processes; others are taking the opportunity to create more significant operating model transformations on the back of regulatory pressure. So while profitability may be under pressure as a result of regulatory change, the survey

shows that managers are finding ways to adapt.

Key take-aways for fund managers

- The industry is investing heavily in compliance with smaller funds spending USD700,000 on compliance on average, medium funds spending approximately USD6 million, and large funds are spending more than USD14 million
- AIFMD and SEC registration were widely seen as the most onerous regimes with which to comply by survey respondents
- The rising cost of compliance has created significant barriers to entry for small or new fund managers seeking to enter the market
- Use of outsourcing and third-party vendor support will increase significantly as managers seek to focus on their core business
- Small to medium firms will increasingly struggle to achieve profitability as regulatory compliance requirements increase

Key take-aways for regulators

- Fund managers are committed to achieving compliance with regulatory requirements and are using the opportunity to rebuild trust with investors and markets
- Fund managers overwhelmingly support the aims and goals of much of the recent regulation and are dedicated to increasing transparency
- However, fund managers are also finding that increased regulatory requirements are reducing investor selection and creating significant barriers to entry for new managers
- The lack of a consistent regulatory approach across all markets is

creating uncertainty and complexity for many managers and, as a result, limiting investment

- Market participants are eager to work with regulators to reduce complexity and enhance investor protection

Key take-aways for investors

- While costs may be rising for fund managers, few are passing these costs on to their funds
- Product and fund selection may reduce somewhat as a result of regulation but – in part – this gap may be filled by firms developing regulated products



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