

# The Impact of Registration


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By Terri Messina

In November 2005 Ernst & Young sponsored a survey of alternative investment managers in an effort to understand the extent to which such managers are prepared for SEC registration, the impact registration is having on the hedge fund industry, and emerging compliance practices. The results provide a basis against which to evaluate future changes and maturation of the market. We hope they may also assist new market entrants and/or registrants by providing insight into leading compliance practices.

The survey was positively received. One hundred and nine firms responded, of which 31 were fund of funds managers. Chief Compliance Officers (63%) were the majority of the respondents, although Chief Financial Officers, General Counsels, and Chief Operating Officers were represented. Seventy-three of the firms represented (67%) managed more than \$500 million of assets. The position of Chief Compliance Officer (CCO) is a full-time position in 42% of the firms and an existing employee assumed the role in 52% of the firms. Just 2% of the firms do not plan to appoint a CCO. Note that none of the respondents has outsourced the CCO function.

## The Changing Industry

Some will argue that registration is changing the industry. Others will argue that

industry changes are causing firms to register. We wanted to know what industry participants think. While it is impossible to tell if registration is a barrier to entry, it is evident that hedge fund firms are expanding in size and complexity. More than half (52%) of the firms responding to our survey state that they are expanding the investment strategies they offer. Of these respondents, 72% are handling such expansion through existing employees. Another 49% are hiring additional portfolio managers and 11% are planning mergers or acquisitions. Obviously, some respondents are employing multiple methods to expand their product lines.

Sixty-three percent of survey respondents state that registration is having no impact on hedge fund distribution. However, 25% note increased competition for institutional assets and 13% note the disintermediation in the market (i.e., large intermediaries seeking unaffiliated product for their client base). Sources of capital also continue to diversify. Just 41% of firms currently distribute through friends and family and 12% rely on word of mouth – primary distribution channels in the recent past.

Registration has also had little impact on investors to date. Fifty-eight percent of responding firms state that client demands have not changed in the past 12 months. While the response rate was lower, client demand was noted to be increasing in the following areas: increased transparency (27%); more timely delivery of client state-

ments (16%); more frequent presentation of performance estimates (14%); and demanding/expecting manager registration (12%). Perhaps these responses provide insight into the look of things to come.

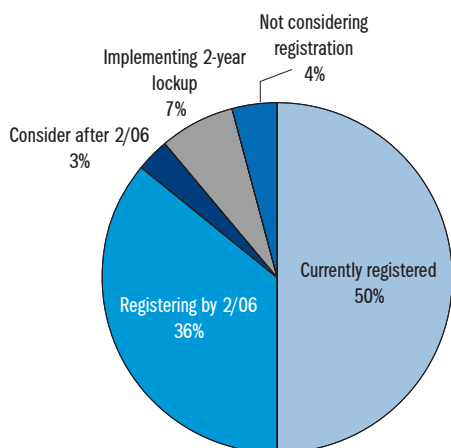
How does your firm distribute product?	Check all that apply
Through friends and family	41%
Intermediary agreements with institutions	34%
Capital introduction programs	33%
Solicitation agreements	33%
Pension consultants	25%
Business associates/word of mouth	12%
In-house marketing/sales efforts	9%
Financial advisory firms	4%
Other or non-applicable	5%

## Registration Status

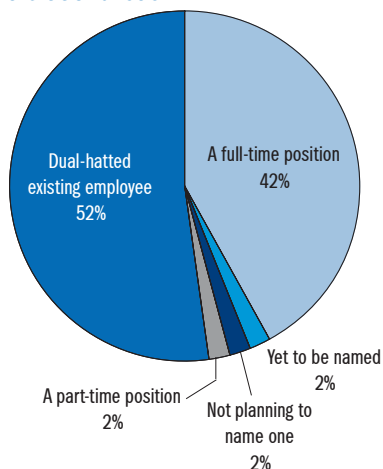
The survey confirmed speculation that the number of adviser registrations would swell in the November/December 2005 time frame. While 50% of the responding firms were already registered with the SEC, 36% plan to register by February 2006. Just 7% will opt for exemption by implementing a 2-year lockup and 4% have no plan to register. The 11% total (of those implementing a lockup or choosing not to register) provides an interesting contrast to the fact that 98% of the responding firms have appointed or plan to appoint a CCO. Although forgoing registration, most of these firms still appear to be implementing a

compliance program and function, a fact that evidences the industry's commitment to ethical behavior.

### Is your firm a registered investment adviser?



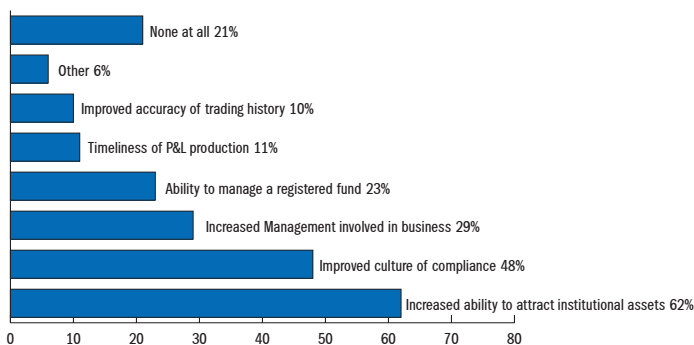
### Describe the CCO function



The cynical reader could infer that a compliance program is becoming requisite to raise assets as 62% of respondents note "Increased ability to raise institutional assets" as a benefit of registration.

Institutional investors are known for applying formalized due diligence programs, which often require registration, to the adviser selection and oversight process. The counterpoint to this result is the

### What benefits do you expect from registration? (Select all that apply)



fact that 21% of respondents see no value at all to registration.

### Compliance Infrastructure and Cost

As noted earlier, a majority of firms (52%) have appointed an existing employee as the CCO. This answer is consistent with other responses, including the fact that 55% of the respondents have just one associate dedicated to the compliance function and that 54% did not hire any compliance associates in the past 12 months.

Compliance costs are the biggest surprise of the survey. Cost estimates from industry experts ranged from \$25,000 to over \$1,000,000. However, 37% of survey respondents estimate the incremental cost of compliance to be less than \$100,000. In total, 85% estimate the annual cost to be \$500,000 or less. Of course, the largest cost forecasted by the industry is the hiring of a CCO. Given the number of firms appointing an existing employee as CCO, these survey results make sense. In a similar fashion, the majority of respondents have no plan to install new software to support monitoring and regulatory compliance. The majority implementing new technology are installing a new e-mail platform. Sixty-seven percent of the respondents have installed or plan to install a new e-mail system in the near future. Forty-six percent have installed or plan to install a new order management system. This result confirms the belief that many firms lack the technology and procedures to comply with the basic rules of compliance, such as document retention relating to trading history.

Which of the following solutions has your firm installed, or do you plan to install to address compliance requirements?

Technology	Already Installed	Plan to Install	No Plan to Install
New e-mail system	46%	21%	33%
Risk Management software	42%	8%	50%
New trading/order management system	29%	17%	53%
Front-end compliance system	22%	16%	62%
Back-end compliance system	18%	16%	66%
Software to monitor employee trading	17%	11%	72%

### Leading Practices

One of the main survey goals was to provide insight into leading practices for compliance in the industry. Hence, many of our inquiries were related to compliance policies of hedge fund managers. We offer the following for your review.

### Security Valuation

The SEC has previously stated that portfolio valuation in the hedge fund industry was an impetus for manager registration. Since that

#### How does your firm control security valuation? Please check all that apply.

The fund's administrator values the portfolio independent of adviser influence	64%
Formal comparison of security valuations to those provided by the prime broker, at each break period, for reasonableness	38%
Individual portfolio managers cannot override a third-party price	34%
An internal valuation group independently prices securities	25%
Formalized valuation models are used to price illiquid and/or restricted securities	23%
A cross-functional fair valuation committee reviews and approves all security valuations for which an automated price is not available	22%
OTC derivative contracts are priced by someone other than the counterparty	17%
Administrator(s) with manager input	3%
Independent entity reviews/determines	2%
Other	4%
Not applicable/fund-of-funds	5%

time, many in the industry have changed their approach to valuation. We have even begun to see administrators develop valuation models as a second check on client-supplied prices. Our survey results showed consideration of controls over the valuation process. In addition to compliance controls, 48% of respondents have formed a valuation committee to govern and oversee the pricing process.

### Trading Practices

Most respondents are very comfortable with their current trading practices. The majority of survey respondents (54%) have not changed their trading practices in the past year. Those that have implemented change have done so to meet basic regulatory expectations such as document retention, client disclosure, and the formalization of compliance policies. This is consistent with expected results, particularly in Year One of this survey.

Which of the following changes to trading practices has your firm implemented in the past 12 months? Please check all that apply.	
Increased disclosure regarding the resolution of trade errors	22%
Tracking of trade errors	22%
Retention of trade history	19%
Reduction of soft dollar use	11%
Capturing/input of cancels and corrects	10%
Automatic allocation of blocked trades for consistency	6%
Formalization of parameters to measure style drift	6%
Individual portfolio managers no longer value securities	2%
No changes made	54%

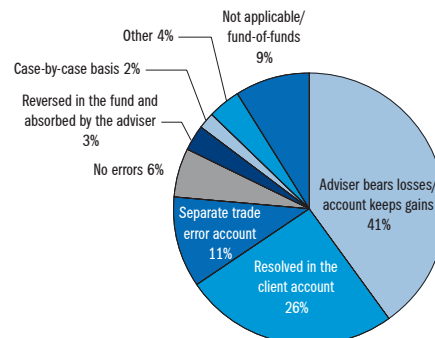
The subjective nature of broker selection and the definition of best execution has been recognized by the hedge fund industry. The majority of respondents (53%) have formed a best execution committee to govern and guide the best execution process. Qualitative and quantitative factors were well represented as criteria for best execution measurement. The list is led by “Broker responsiveness” (68%) with “Commission rates” (67%) a close second. “Quality of execution,” “Responsiveness,” and “Quality of research” trail the list with 3% each. The

continued need for investment ideas and available inventory is highly evident.

Which of the following factors are formally considered in your evaluation of best execution?	
Broker responsiveness	68%
Commission rate	67%
The extent to which a broker provides investment ideas	45%
Value weighted average price	42%
Broker inventory	33%
Soft-dollar commitments	22%
Willingness to provide quotes on portfolio holdings	14%
Capital introductions provided by the broker	10%
Quality of execution	3%
Responsiveness	3%
Quality of research	3%
Other	7%
Not applicable/fund-of-funds	16%

Trade errors have been a point of contention for the hedge fund industry since the announcement of the registration requirement. Many believe that alternative strategies don’t allow the time nor provide the restrictions to define, identify, and track trade errors. Firms often balk at the standard for handling trade errors, as expected by the SEC and embraced by traditional asset managers. The industry is standing firm. Seventy-five percent of respondents believe their trade error process to be adequate and 26% resolve trade errors in the client account.

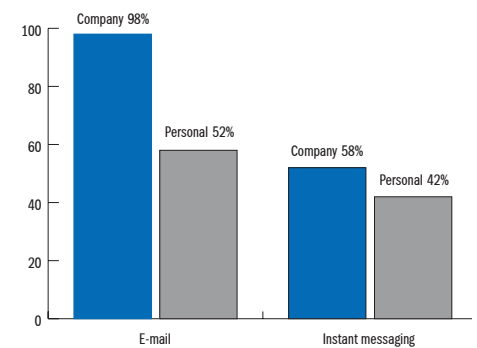
### How does your firm handle trade errors?



### E-mail and Instant Messaging

E-mail and instant messaging pose significant challenges for investment managers. These methods are commonly used to affect trades, communicate with investors, and internally share investment ideas and market observations. Retaining these communications poses significant challenges, particularly if the use of personal e-mail and instant messaging is permitted. Firms are increasing limiting the use of personal tools.

### Which of the following are your firm's employees permitted to use at your company?



Reviewing e-mail has also been a favored examination method of the SEC. Many advisers (50%) are following suit as the CCO performs reviews on a regular basis. Key word searches (87%) and random reviews (74%) are preferred methods for performing such reviews.

### Personal Trading

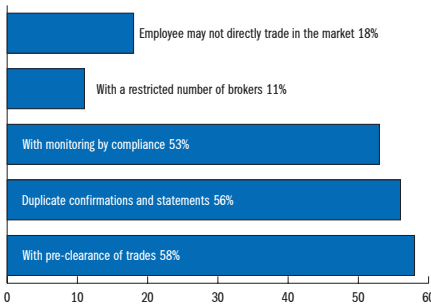
Personal trading inquiries provided unexpected results. The majority of respondents (54%) state that registration has had no impact on the identification of access persons. Just 22% of respondents treat all employees as access persons. This result was below expected levels, given the common practice of allowing all employees a minimum of inquiry access to the trading system. Eight percent of respondents are still unfamiliar with the term “access persons.”

A second surprise was the extent to which employee trading was restricted. Just 11% of respondents restrict the brokerage firms with which an employee may trade. Yet 18% do not permit direct trading in the market.

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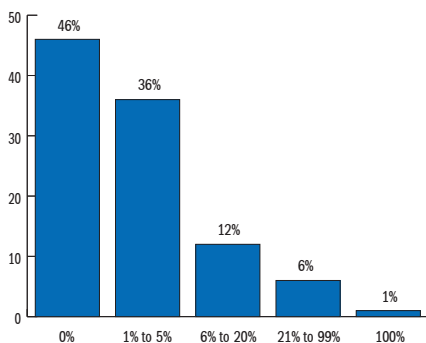
**Under what circumstances does your firm allow personal trading? Please check all that apply.**



**Side Letters**

The SEC undertook a mini-sweep in 2005 that inquired about the use of side letters to provide transparency to select investors. This practice was evident in survey responses.

**To what percentage of investors have you provided side letters?**



Although the most common use of side letters is to relax liquidity constraints, a common demand by institutional investors, and to provide fee concessions. Interestingly enough, registration has had minimal impact on the portfolio disclosure policies of hedge fund managers. Seventy-four percent report no change from the prior year.

Which do side letters provide your investors? Please check all that apply.	
Relaxation of liquidity constraints for institutional clients	48%
Fee concessions	40%
A certain level of transparency	29%
Most favored pricing	19%
Capacity rights	8%
Mid-month fee estimates	6%
Term confirmation/clarifications/changes	5%
ERISA and BHCA plan representation	3%
Subscription/term matching	3%
Other	5%

**Compliance Governance**

We regularly suggest the formation of a cross-functional compliance committee with senior management membership. Such committee provides a collaborative forum to develop, adopt, and monitor compliance policies. It serves as a point of escalation for potential violations and provides the means

to communicate the “tone at the top” in a natural, professional fashion. Perhaps the preaching has paid off. Sixty-five percent of respondents have an established compliance committee.

**Summary**

The survey results confirmed our expectations regarding the status of registration and evidenced that, to date, SEC registration has had little impact on the hedge fund industry. Few managers have changed their way of doing business. Whether this is due to the fact that current policies and procedures are sufficiently strong, managers are naïve, or simply stubborn, remains to be seen. The most unexpected result of the survey was the estimated cost of compliance, which was generally below market projections. The most pleasant surprise was the industry’s general commitment to the implementation of compliance programs and infrastructures. We hope that insight has been provided into developing compliance practices in the industry and look forward to using these survey results as a point of comparison for future years.

*Terri Messina is a partner with Ernst & Young and has over 23 years of experience in the Asset Management industry. Terri currently leads the firm’s Asset Management practice, providing advisory services.*