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Asset management industry update

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Executive summary

The turbulent global economic and regulatory environment of the past three years has asset managers considering their current position and formulating growth strategies for 2012 and beyond. Expectations regarding investor expectations, monetary returns and overall growth are being recalibrated to reflect the reality of a slow economic recovery and an uncertain financial and regulatory environment following the 2008 market correction.

Despite the harsh environment, the prospects for the asset management industry — encompassing hedge funds, private equity funds, and registered investment companies — are upbeat because of performance and operational efficiencies achieved during 2011. While heightened regulatory scrutiny has its drawbacks, the greater transparency and stronger risk management practices resulting from this scrutiny are helping the industry restore investor confidence and innovate in the new economy. However, the overall sentiment, particularly given the fact that 2012 is an election year, is one of cautious optimism.

Survival of the largest and specialization of the smallest

The dichotomy of Dodd-Frank regulations and evolving investor expectations has created a barbell effect within the asset management industry. On one end of the survival spectrum are large institutions with ample human resources, technology and assets under management (AUM) to more easily comply with costly regulations and accommodate more robust investor requests to perform due diligence on their operations and service providers. Pre-Dodd-Frank, many of these behemoth organizations already had fairly sturdy governance as well as operational and risk management infrastructure. So far, these well-equipped organizations have been reaping the greatest benefit of investor uncertainty – when in doubt go for the large, sophisticated, well-managed manager.

In response to financial turmoil and market uncertainty, investors are redefining and expanding their definition of risk. Consequently, investors have attained a new level of sophistication in their demands that primarily the larger asset managers have been able to respond to. As part of their expanded perspective of risk, investors are performing more robust due diligence procedures on asset managers and their service providers. In addition, with the general slump in returns, experienced investors have become savvier about management and incentive fees and are more apt to negotiate for tiered fee structures or other provisions that lower management and incentive fees. The larger asset managers have more wiggle room to accommodate lower incentive and management fees.

Stakeholder demands for greater fund transparency are also putting pressure on asset managers to improve the reporting accuracy of and governance controls over the funds they manage. Larger fund managers are increasingly relying on technology and outsourcing to support the institutional-level reporting and compliance processes that are mandated by today's stricter regulations and demanded by investors. These technologies and outsourced consultants represent additional costs that the smaller and mid-size managers cannot afford.

On the other end of the survival spectrum are small and mid-size asset managers who have creatively carved out a strategic niche that even large institutional investors are finding attractive, despite the fact that they represent a greater element of business risk to investors. These smaller asset managers are able to strike the risk-reward balance for investors because they are able to demonstrate that they bring unique experience to the table; they can create value; they can articulate their risk-management process; and, despite not having bulge bracket infrastructure, they still embrace a culture of compliance and have controls that are appropriate for their size. Managers with Byzantine investment strategies where the risk profile is opaque will struggle.

Overall, even more change is expected over the next few years as the asset management industry continues to grow and adapt following the financial crisis. "Industry observers sense that there will be winners and losers. The Darwinian process will undoubtedly ensure the long-term vitality of the industry through an evolutionary cycle of innovative products, increasingly transparent operations and effective stewardship. Advisers who are patient, think globally and focus on diversification will be best-positioned to succeed in the new economy. The creative manager will win. The greedy will lose," says Winston Wilson, Grant Thornton LLP National Asset Management industry leader.

Hunt for growth

Product innovation continues unabated as asset managers strive to meet the shifting needs and investment preferences of everyone from baby boomers to institutional investors. Some asset managers are scouring through various industries and exploring new strategies to eke out desirable growth. These managers are exploring investments in real estate, infrastructure, struggling banks and the global marketplace. On the strategy front, some managers are focusing on strategies that can deliver absolute return, which has become the focus of some investors. This desire underpins the formation of new asset classes. In addition, as growth in some mainstreamed products becomes stagnant because of investors' desire for lower-cost, higher-return investments, some asset managers are exploring newer products. Contemporary investment vehicles such as transferable securities – better-known as Undertaking for Collective Investment in Transferable Securities (UCITS) – and exchange-traded funds (ETFs) are also coming of age as viable alternatives to traditional funds.

Regulatory environment remains uncertain

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act, the Act or Dodd-Frank) imposes a sweeping new regulatory framework on the financial services industry.[1] Provisions related to investor protection, systemic risk and corporate governance touch the operations and strategies of a broad range of industry service providers, including asset managers. For the first time, private investment advisers and funds fall under the watchful eye of the SEC. The asset management industry is moving to anticipate, assess and implement these changes as they unfold.

Congressional budget cuts have delayed the implementation of a number of reform measures, creating a sense of uncertainty among fund advisers. Early estimates of the cost of complying with regulatory changes are forcing many fund advisers to rethink their growth strategies, particularly advisers of smaller funds that may be unable to bear additional compliance costs under their current business model. These economic and regulatory pressures may accelerate fund consolidation in years to come as small firms band together for economies of scale or sell out to larger funds.

[1] The Dodd-Frank Wall Street Reform and Consumer Protection Act was passed July 21, 2010. See www.cftc.gov/LawRegulation/DoddFrankAct/hr4173_enrolledbill.

State of the asset management industry

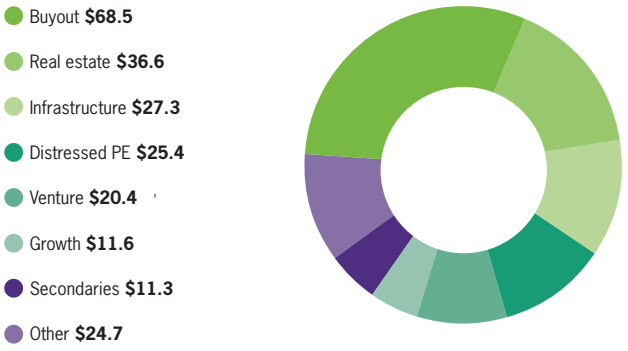
Private equity growth and opportunities

Private equity is a cyclical business that moves to the rhythm of the global markets. When the recession took hold in 2008, the private equity industry saw quality deals, new funding commitments, and multiples drop alongside prices in the stock market.

Following a three-year slump, the private equity industry is on the mend. Deal activity slowly increased in 2010 as firms sought to deploy an estimated $450 billion in uncommitted capital, according to Preqin.[2] This trend continued in 2011. Although inflated asset price expectations prevented many transactions from reaching a conclusion, those that did benefited from a rise in performance from returns that started the slow creep back to pre-crisis levels.

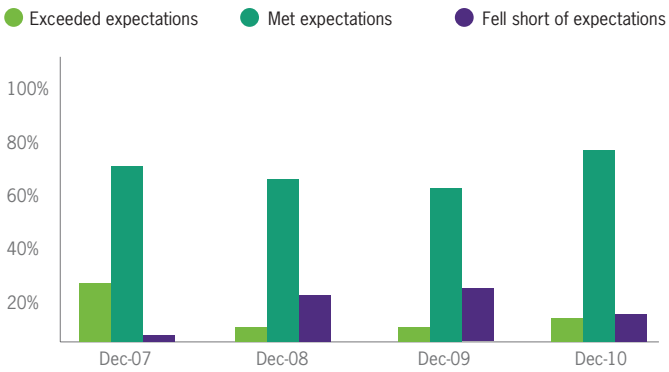
Global demand, which had been hampered by a shortage of quality deal flow at reasonable prices, is also on the upswing. In more developed private equity markets, competition to deploy pent-up capital is intense among domestic firms. In some emerging markets, such as China and India, the development of the industry is still at an early stage where demonstrable returns are necessary to overcome a lingering skepticism about private equity practices and a desire to protect a culture of family-owned businesses. Overcoming this cultural divide is among the greatest challenges to increasing cross-border transactions.

Which type of funds are raising the most cash?
Global private equity fundraising by fund type 2010 (US $ billions)



Source: Preqin

Most private equity investors satisfied with returns 2007-2010
Investor satisfaction with private equity portfolio returns



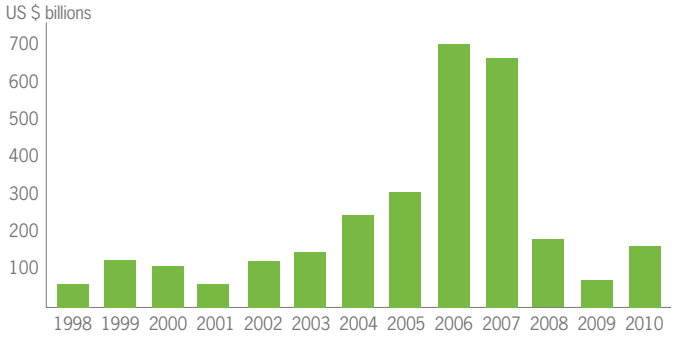
Source: Preqin

[2] *2011 Preqin Global Private Equity Report*

Not all private equity firms weathered the financial downturn equally. Among the hardest-hit by the recession were middle-market private equity funds that had neither niche nor scale to fall back on and firms with less-than-robust funds and business practices. At the same time, small specialist funds are having a degree of success in getting off the ground, and large investment houses are attracting investors largely on the strength of their brand and an element of reliability. This dynamic is driving a wedge in the market between large funds and small, with fewer funds for investors to choose from in between.

Private equity funds are turning their attention to enduring strategies and opportunities to drive growth in 2012.

Healthy recovery in global buyout deal activity
Global buyout deal value



Source: Dealogic

Secondaries on the rise. Tough economies tend to increase liquidity concerns and create a larger market for secondary transactions. As a result, secondary investments, or investments made in existing private equity assets, are on the rise. Barry Carroll, CEO and president of Augentius, a leading global private equity fund administrator, says investors expect more markdowns to be taken in private equity portfolios before the market reaches a sustainable stride, which should keep secondary buyout activity high for some time.

Syndication more appealing. Syndication represents a further avenue of growth as private equity funds and hedge funds pool investments and share risk. Although the culture, mindset and expertise of these two industries differ, Carroll says syndication offers asset management firms that typically compete for the same investments an opportunity to diversify into emerging markets, products and sectors.

Performance improvements unlock value. During the worst of the financial slump, the number of salable businesses shrank because of fewer reasonable exit opportunities in the lethargic market. This dynamic pushed fund advisers to improve valuations through portfolio performance improvements — a trend that continues today.

In the United States, many private equity firms have added strategic and operational value to portfolio companies in an effort to unlock greater returns. Private equity firms support incremental growth and improvement through operational improvements, origination, deal-making, or overall portfolio management. A similar value-added approach to portfolio management may be the best way to demonstrate value and prepare companies for eventual sale.

Strategic leadership and back-office basics. In today's challenging business environment, success will be driven by exceptional leaders with a clear and compelling plan for positioning their funds for potential growth in the United States and abroad. Pragmatic businesses are preparing to build relationships and broaden back-office capabilities. Technology upgrades or outsourced expertise will help private equity firms achieve greater control over financial accounting data, build a solid foundation for growth, enhance transparency and rebuild investor confidence.

Cautious optimism for private equity. Based on the rebound in buyout deals, private equity investments in 2012 are likely to be stronger than in the previous year. Because private equity is a long-term investment, Carroll says demonstrable returns over the past two decades bolster a sense of potential in these markets.

The private equity sector has been underinvested for years, and is ripe for growth, in funds for buyouts, real estate and infrastructure. The United States is still the largest economic engine in the world, and presents some of the best opportunities for private equity growth not just to enhance performance but also to create jobs to help ameliorate the economy.

As growth picks up, private equity markets should be strong across the energy, venture capital, health care, renewable sciences, and real estate sectors. "Already new funds are launching in every sector," Carroll says. Elsewhere in the world, the growth in funds of private equity funds is boosting total returns and expanding global exposure to Europe, Asia and BRIC countries without the added investment in infrastructure to administer the funds.

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Mutual fund growth and opportunities

U.S.-registered investment companies managed $13.1 trillion at the end of 2010, according to the Investment Company Institute's *2011 Investment Company Fact Book*. This figure represents an increase of $943 billion since 2009.[3] Major domestic stock indexes climbed 13 to 17 percent during 2010, pumping up the assets of funds invested in U.S. equities; foreign stock markets behaved similarly.[4]

2010 facts at a glance	
Total worldwide assets invested in mutual funds	**$24.7 trillion**
U.S. investment company total net assets	**$13.1 trillion**
Mutual funds	$11.8 trillion
Exchange-traded funds	$992 billion
Closed-end funds	$241 billion
Unit investment trusts	$51 billion
U.S. investment companies' share of	
U.S. stocks	25%
U.S. municipal securities	33%
Commercial paper	45%
U.S. government securities	11%
U.S. household ownership of mutual funds	
Number of households owning mutual funds	51.6 million
Number of individuals owning mutual funds	90.2 million
Percentage of households owning mutual funds	44%
Median amount fund-owning households invested in mutual funds	$100,000
Median number of mutual funds owned	4
U.S. retirement market	
Total retirement market assets	$17.5 trillion
Percentage of households with tax-advantaged retirement savings	70%
IRA and DC plan assets invested in mutual funds	$4.7 trillion

The United States has the world's largest share of the mutual fund market. At the end of 2010, U.S. mutual fund managers held $11.8 trillion in assets under management (AUM), or 48 percent of global mutual fund AUM totaling $24.7 trillion.[5] These statistics are particularly impressive in a year when the industry saw net cash outflows of $297 billion in 2010; the Investment Company Institute attributes those outflows to the unfavorable interest rate environment and the slow economic recovery.[6]

In any case, investor confidence in mutual funds remains positive, and their performance outlook is healthy for 2012. Diversified holdings have helped mutual funds generate higher returns than U.S. treasuries or stock. There are opportunities for advisers to drive growth through a variety of mainstream and innovative funds.

Real estate mutual funds. Another growth area is real estate mutual funds. Real estate mutual funds are part of what is referred to as "specialized mutual funds," which includes commodity mutual funds, gold mutual funds and real estate mutual funds. Given the collapse of the real estate market and related securities in that market, such as collateralized debt obligations (CDOs) and collateralized mortgage obligations (CMOs), mutual fund advisers have an opportunity to capture growth and increase returns in the real estate sector.

Accordingly, real estate mutual funds are being established to invest in real estate investment trusts (REITs), mortgage securities, and companies serving the real estate industry. Investment advisers are also seeking global real estate investment opportunities in Asia and Europe and within the nascent South American private real estate market.

[3] Investment Company Institute, *2011 Investment Company Fact Book: A Review of Trends and Activity in the Investment Company Industry*, 2011. Available at www.ici.org/about_ici/annuals.
[4] *Ibid.*
[5] *Ibid.*
[6] *Ibid.*

Rise of trusts. The use of shared trust structures, otherwise known as multiple series trusts (MSTs), continues to gain popularity since their introduction in 2008.[7] MSTs provide a turnkey back-office solution for startups and fund advisers who want to add revenue streams or expand product lines without adding overhead. MSTs rely on fund administrators such as money center banks to bring funds managed by unrelated advisers into the trust.

The MST structure permits a single umbrella registration for a series of unrelated funds under the oversight of one board of directors, one administrator and one custodian. This streamlined back-office structure cuts costs and allows contributing fund managers to realize the benefits of economies of scale immediately. This arrangement can be particularly attractive to successful hedge fund managers who want to expand their product line from hedge funds restricted to institutional investment to funds that are open to the public.

Healthy expansion of ETFs. The largest growth area for registered fund products relates to international and domestic exchange-traded funds (ETFs). An ETF is an investment company with shares that trade intraday on stock exchanges at market-determined prices.[8]

Investment company total net assets by type
Billions of dollars, year-end, 1995-2010

	Mutual funds[1]	Closed-end funds	ETFs [2]	UITs	Total[3]
1995	$2,811	$143	$1	$73	$3,028
1996	3,526	147	2	72	3,747
1997	4,468	152	7	85	4,712
1998	5,525	156	16	94	5,791
1999	6,846	147	34	92	7,119
2000	6,965	143	66	74	7,248
2001	6,975	141	83	49	7,248
2002	6,383	159	102	36	6,680
2003	7,402	214	151	35	7,803
2004	8,095	254	228	37	8,614
2005	8,891	277	301	41	9,510
2006	10,398	298	423	59	11,168
2007	12,002	313	608	53	12,977
2008	9,604	186	531	29	10,349
2009	11,120	225	777	38	12,161
2010	11,821	241	992	51	13,104

[1] Mutual fund data include only mutual funds that report statistical information to the Investment Company Institute. The data do not include mutual funds that invest primarily in other mutual funds.
[2] ETF data prior to 2001 were provided by Strategic Insight Simfund. ETF data include investment companies not registered under the Investment Company Act of 1940 and exclude ETFs that invest primarily in other ETFs.
[3] Total assets include mutual funds, closed-end funds and ETFs.

Note: Components may not add to the total because of rounding.
Sources: Investment Company Institute and Strategic Insight Simfund

[7] Kern, Bob. "Mutual Fund Shared Trusts Experience Record Growth," *In Focus*, April 2008.
[8] Investment Company Institute. "Frequently Asked Questions About Exchange-Traded Funds (ETFs)." Available at http://www.ici.org/faqs/faqs_etfs#similar.

Investors around the world are attracted to unmanaged ETFs because of their diversification advantages and the low expense ratios. Asset managers are drawn to ETFs because they are fairly easy to add to their product lines. Although management fees are lower than those of actively managed mutual funds, the average size of assets in an ETF is generally much larger than in mutual funds.

Over the past decade, demand for ETFs has risen as both institutional and retail investors have increased their asset allocation in ETFs. The Investment Company Institute reports that "[by] the end of 2010, the total number of index-based and actively managed ETFs had grown to 923, and total net assets were $992 billion."[9] Moreover, "[assets] in ETFs accounted for 8 percent of total net assets managed by investment companies at year-end 2010. Net issuance of ETF shares in 2010 amounted to $118 billion, [rising at nearly] the same pace as in 2009."[10] While the ETF market is only a fraction of the mutual funds market, ETFs can be a nice investment alternative.

The increased demand among institutional and retail investors — which hold ETF assets in roughly equal proportions — has prompted sponsors to develop "new asset classes, indexes and uses for ETFs in building portfolios"[11] based on a particular market sector, industry or commodity. For example, ETFs can track the movement on the S&P 500 index or in a basket of sector-related oil and gas stocks. A "limited use ETF," however, might have a greater risk profile as it sheds some of its diversification by focusing on a smaller piece of an index.

ETF sponsors are also launching actively managed ETFs and ETFs that are structured as funds of funds.[12] An actively managed ETF is essentially a mutual fund packaged into an ETF instrument that trades like stock. Advisers of an actively managed ETF try to outperform the index or sector on which the ETF is based. The growth in these ETF alternatives demonstrates that investors are willing to experiment with more complex and innovative products.

Funds of mutual funds lag. Funds of mutual funds, or mutual funds that select other mutual funds for their portfolios, have been around for some time, but they continue to lag in the market, largely because of the extra layer of management costs added to the fee structure of actively managed funds.

"Assets of funds of [mutual] funds have grown rapidly over the past decade. By the end of 2010, the number of funds of [mutual] funds had risen to 964, and total net assets were $928 billion."[9] But further growth may be hampered by the cost structure, pushing fund advisers to explore new funds of fund prospects with alternative investments, such as hedge funds and private equity funds.

[9] Investment Company Institute. *2011 Investment Company Fact Book: A Review of Trends and Activity in the Investment Company Industry*. Available at www.ici.org/about_ici/annuals.
[10] *Ibid.*
[11] Ausick, Paul. "Major Growth Trends Continue…Doubling ETF Assets by 2015," 24/7 Wall St., July 15, 2011. Available at http://247wallst.com/2011/07/15/major-growth-trends-continue-doubling-etf-assets-by-2015-bk-bx-stt-sil-gdxj-voo-amlp-eld-remx/.
[12] Bank of New York Mellon Corp. and Strategic Insight. *ETFs 2.0: The Next Wave of Growth and Opportunity in the U.S. ETF Market*, July 2011.

Hedge fund growth and opportunities

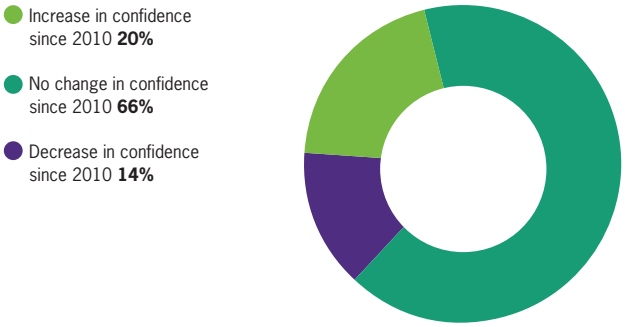
Hedge funds represent a small but growing segment of the asset management industry. According to *The Wall Street Journal*, total hedge fund AUM in April 2011 was approximately $2 trillion, or one-sixth the size of the mutual fund industry.[13]

Hedge fund performance has dipped in recent years with the weakening global economy. In 2012, industry performance is expected to turn around as hedge funds retool and refresh their strategies for performance growth, and they march closer to becoming mainstreamed within investor portfolios, and hedge fund advisers improve their approach and frequency of reporting to promote transparency. According to a recent Preqin survey of fund consultants, hedge fund advisers can expect a large influx of capital into hedge funds from institutional sources over the next 12 months, enabling hedge fund assets to potentially reach or exceed the pre-crisis tally of $2.6 trillion.[14]

Many hedge fund advisers are focused on driving growth with specialized hedge fund products in the more established markets of North America and Europe.[15] With the rise of hedge fund-managed accounts, fund-of-one, and hedge fund-style ETFs, investors are beginning to explore alternative ways of investing in hedge funds. In general, investors are also looking for greater transparency, commitment to a culture of compliance, and customization or specialization within the hedge fund industry. Hedge fund managers who are able to meet these investor expectations and demands will experience growth in their AUM. Traditional hedge fund of funds vehicles remain a viable option for growth, particularly with respect to global- and asset-class exposure for which the hedge fund manager does not have expertise. Larger funds are also exploring the public market as a way to grow and gain permanent equity.

Investor due diligence and competition are weighing heavily on hedge funds. Hedge funds without the size and institutional capabilities to monitor and manage accounts may continue to see net outflows if investor confidence wanes. In the past year, in what is being dubbed as "survival of the largest," the majority of all inflows to hedge funds went to a handful of the largest hedge funds with the institutional scale to manage investor due diligence at a high level. Nevertheless, smaller and mid-size asset managers (sub-$750 million in AUM) who have a niche focus have tended to outperform some large asset managers and have delivered very attractive returns to investors. As such, many large institutional investors have not defaulted to investing in the larger hedge fund managers. Rather their investment objectives strike a balance between the business risks that smaller and mid-size asset managers present and the returns these asset managers are able to deliver. As such, the counter-trend is the "specialization of the smallest." This trend provides opportunities for fund managers to focus on specialization as a way of achieving growth.

Change in institutional investor confidence in hedge funds since 2010



Source: Preqin

[13] Strasburg, Jenny, and Eder, Steve. "Hedge Funds Bounce Back," *The Wall Street Journal*, April 18, 2011. Available at online.wsj.com/article/SB10001424052748704204604576269114056530484.html.
[14] Preqin. *Preqin Special Report: Institutional Investor Outlook for Hedge Funds in 2012*, November 2011. Available at www.preqin.com/listResearch.aspx.
[15] Preqin. *Preqin Investment Consultant Outlook: Alternative Assets – H2 2011*. Available at http://www.preqin.com/docs/press/Preqin_Alternative_Investment_Consultant_Outlook.pdf

Up-and-coming managed accounts, UCITS and hedge fund style ETFs. Investors are looking for greater liquidity and transparency in their portfolios than they did prior to the financial crisis. These preferences have driven growth in the development of specialized hedge fund products, such as fee-based managed accounts and UCITS.

Managed account platforms provide an alternative structure for accessing hedge funds. This structure permits investors to make direct investments in managed hedge fund portfolios of individual securities. Despite the higher costs of a managed account and limited availability, institutional investors looking to outsource operational due diligence are particularly drawn to this type of managed alternative investment structure.

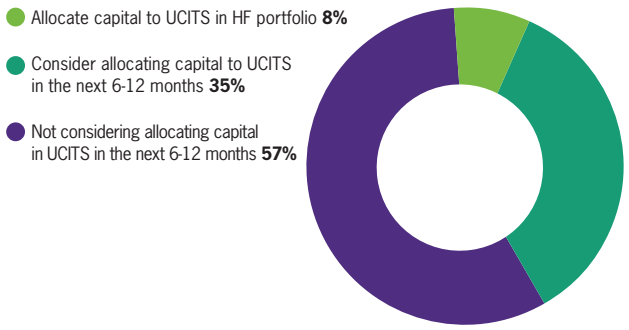
Similarly, UCITS are emerging as leading global transferrable funds that combine robust investor protection with access to alternative investments such as financial derivatives. According to HFMWeek research, hedge fund assets at the industry's10 biggest UCITS have more than doubled to an estimated $8.5 billion for the year ended Oct. 31, 2011, and sales in Europe, Latin America and Asia are booming.[16]

UCITS are primarily accessed through the use of financial derivatives and carry a higher degree of investor protection, regulation and disclosure than other hedge fund assets. UCITS can be resold in the secondary market, giving investors greater control over the liquidity of their portfolio, and are suitable for both institutional and retail investors. U.S. fund advisers are stepping up their interest in UCITS, particularly for funds of hedge funds as the domestic market matures.

Growth in these structures remains relatively niche-driven, with more overseas hedge funds launching UCITS structures in response to investor demand for more liquid and transparent portfolio investments. While diversification and operational requirements and mandates impose additional costs on UCITS funds, advisers and investors are more willing to bear these costs given recent market experiences.

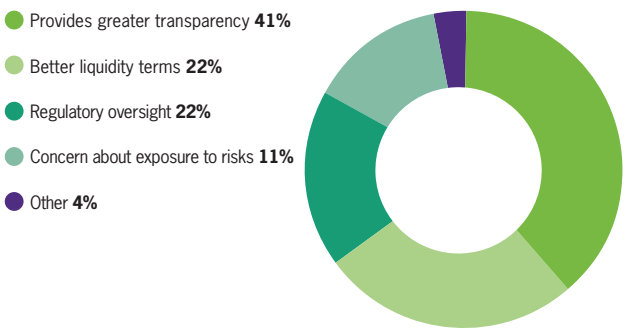
Relatively new to the asset class are hedge fund-like ETFs, which are emerging as a way for many of the largest hedge fund firms to bet on the direction of the overall market or a basket of stocks in an individual industry or market. As more hedge fund-based ETFs hit the market, growth in this asset class will be dependent upon the asset class demonstrating a proven track record of returns.

Investor attitudes towards UCITS



Source: Preqin

Investors' main reasons for investing in UCITS



Source: Preqin

[16] Griffiths, Tony. "Top 10 UCITS," *HFMWeek.com*, Nov. 17–23, 2011. Available at www.hfmweek.com/features/1700847/top-10-ucits-platforms.thtml.

Funds of hedge funds. Growth prospects in the asset management industry might also come from funds of hedge funds, despite the fact that hedge fund of funds have become less prevalent over the past four years. Global hedge fund of funds peaked in 2007 when their assets represented about 45 percent of the industry. Currently, hedge funds of funds represent only about 33 percent of the global hedge fund assets. Nevertheless, hedge fund of funds have their place since investors can gain broader exposure and growth potential than they would in a single hedge fund investment. Moreover, funds that seek to gain global exposure might be able to do so through investing in a global fund rather than attempt to scale the cost, resource and language barriers to entry into the individual countries.

Growth within the hedge fund of funds sector will most likely occur where asset managers provide investors with enhanced transparency into the underlying investments and customization which allows them to reduce management and incentive fees. As investors become more comfortable with these asset classes, growth will occur and investors will be able to take advantage of the higher returns the underlying hedge fund assets are capable of generating.

Hedge funds going public. While it is not a major trend for smaller funds, there has been a rise over the past five years in IPOs among larger asset managers. While there are significant costs associated with being a public company, the benefits include having access to permanent equity, raising the brand profile of the fund, and providing a viable exit strategy for the pre-IPO investors.

Public hedge funds sell shares in a hedge fund that can be bought and sold on an exchange. Unless the hedge fund goes out of business, the equity is permanent. Going public affords these funds a more stable capital base to experiment with new products and evolve to more sophisticated business models.

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Legislative and regulatory change

The global asset management industry is experiencing unprecedented legislative and regulatory change. The sheer breadth of the Dodd-Frank Act has regulators pressing ahead to implement more than 400 mandates of the financial overhaul legislation, thereby amplifying regulatory scrutiny of the asset management industry through full implementation of the Dodd-Frank Act.

As was the case with the last sweeping regulatory framework, Sarbanes-Oxley, there will undoubtedly be unintended consequences, implementation challenges and cost constraint issues. To avoid some of the implementation hiccups that occurred with Sarbanes-Oxley, industry associations like the MFA, along with various large asset managers, have penned several comment letters to the regulators to repeal, reassess or reduce the scope and applicability of certain pending regulations.

The global asset management industry is experiencing unprecedented legislative and regulatory change.

Federal budget woes increase regulatory uncertainty

With the failure of the deficit-cutting supercommittee to reach a bipartisan deal, the threat of a double-dip recession continues to loom into 2012. The immediate economic impact for asset management firms comes down to investors, whose confidence has already been struck a severe blow by high profile infractions in the industry as well as the nation's slow economic recovery. Consequently, investors will make decisions regarding which asset managers to invest in based on the extent to which these managers comply with evolving regulations, some of which require implementing costly technology, compliance and operations infrastructure. This dynamic creates a continued sense of uncertainty for managers who are shuffling to manage investors' variegated expectations. The regulatory compliance burden weighs more heavily on the small to mid-sized managers who are now seeking resourceful ways to comply with regulations and manage investor expectations.

Regulators face their own challenges. For example, Congress has specifically pared down operating budgets for various regulators. In particular, the SEC and the Commodity Futures Trading Commission (CFTC), two regulators with significantly increased regulatory responsibilities under the Dodd-Frank Act, have been forced to make ends meet with budgets well below their funding requests to Congress. Because of limited staffing and resources during the previous fiscal year, both the CFTC and SEC missed the July 2011 rulemaking deadlines set by the Dodd-Frank Act. The SEC and CFTC have both repeatedly warned Congress that a lack of budget resources will hamper their agencies' ability to further implement and enforce regulations stemming from the Dodd-Frank Act.

For the first two months of fiscal year 2012, the SEC continued to operate on its fiscal 2011 budget of $1.18 billion while its $1.4 billion budget request for 2012 was stalled in Congress. Through the Consolidated Appropriations Act, Congress agreed to fund the SEC at $1.3 billion in fiscal 2012, a 12 percent increase. Of the approved funds, nearly $6.8 million is designated for the Office of the Inspector General. In addition, Congress rescinded $25 million from the SEC Reserve Fund, established by Dodd-Frank, with the use of such funds at the discretion of the SEC.

Congress agreed to give the CFTC $205 million for fiscal 2012, roughly $100 million less than President Obama's budget request. In addition, Congress mandated that the CFTC spend $55 million of its budget on IT investments, leaving just $150 million to pay staff and engage in regulatory activities. As a result of such spending requirements, the CFTC is facing a $15 million budget shortfall and is considering staff reductions, despite a dramatically increased workload regulating the derivatives, futures and swaps markets.

Regulatory delays and uncertainty are expected throughout implementation of the Dodd-Frank Act. Sidestepping further delay by Republicans, President Obama appointed Richard Cordray, the former attorney general of Ohio, to lead the new Consumer Financial Protection Bureau (CFPB) in a recess appointment. The appointment of a director now makes it possible for the agency to begin policing consumer financial laws and regulating nonbank financial institutions, such as private funds. As the CFPB and other federal agencies continue to roll out final rules, regulatory expectations continue to evolve. On the one hand, asset managers are assessing compliance requirements and costs against the use of various strategies to drive growth and restore investor confidence in a slow global economy. On the other hand, some asset managers, most vocally private equity firms, are surreptitiously hoping that the SEC's funding freeze and CFTC's budget woes will mean overall less scrutiny of the industry and that these agencies will reprioritize their focus on asset managers who present bona fide systemic risks.

Ongoing implementation of Dodd-Frank

The Dodd-Frank Act was enacted to address the root causes of the financial crisis. Therefore, this landmark legislation covers all aspects of the financial system. Although almost 18 months have passed since the Dodd-Frank Act was enacted on July 21, 2010, heavy lifting continues as regulators finalize rules for greater regulatory oversight and systemic risk regulations.

A number of significant Dodd-Frank Act provisions affect the asset management industry and are in various stages of implementation. New registration requirements, disclosures requirements, and over-the-counter derivatives regulations may fundamentally alter the transparency, liquidity and outlook of the asset management industry.

No more private adviser registration exemption

The Dodd-Frank Act introduces significant regulation of hedge funds and private equity funds for the first time. Specifically, the legislation eliminates the private adviser exemption under which many investment advisers were able to avoid registering with the SEC. In addition, registered advisers are subject to periodic recordkeeping and reporting requirements, and inspection by the SEC.

Most hedge fund and private equity fund advisers will need to register and operate as registered investment advisers under the Investment Advisers Act of 1940 by March 30, 2012. A number of asset managers have already registered and a significant number are currently in the process of doing so. Many advisers based outside the United States will also have to register with the SEC unless they meet the limited criteria for exemption. For example, U.S.-based advisers to venture capital funds and family offices, along with advisers holding less than $150 million in AUM and advising only private funds, need not register with the SEC.

Previously, private fund advisers were exempt from registration under the Advisers Act. The Dodd-Frank Act included registration of private funds to give regulators visibility into the trading practices and positions held by hedge funds, and the leverage held by private equity firms. This transparency is meant to assist regulators in assessing systemic risks associated with trading and investments by these private funds.

In addition, the amount of AUM in private funds has grown. With public pension funds, foundations, endowments and other institutional investors heavily invested in these instruments, lawmakers' concern over the impact that hedge funds could have on the financial system should they collectively or singularly collapse, as speculative hedge fund Long-Term Capital Management L.P. did in 2000, prompted regulatory oversight of the hedge fund industry. Less clear is why lawmakers extended registration and oversight to private equity funds.

There are two components to the new asset management industry regulations — registration of the funds and systemic risk disclosures. The SEC is requiring private fund advisers to register by the first quarter of 2012 using Form ADV if they have AUM of at least $150 million. The private fund information reported on Form ADV will be available to the public.[17] The SEC imposed registration requirements under the Investment Advisers Act of 1940. Under those requirements, individual advisers are required to register, not the funds themselves; more detailed disclosures regarding the funds are not required for SEC registration.

Once registered, advisers of hedge funds, private equity funds and liquidity funds must periodically report data on Form PF.[18] Large advisers have higher and more frequent reporting obligations than smaller advisers.[19] Large hedge fund and liquidity fund advisers file Form PF quarterly, while private equity and smaller fund advisers file once a year.

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[17] For additional information regarding Form ADV, please visit www.sec.gov/answers/formadv.htm.
[18] *Federal Register*, Volume 76, Number 221, Nov. 16, 2011. Available at www.gpo.gov/fdsys/pkg/FR-2011-11-16/html/2011-28549.htm.
[19] Securities and Exchange Commission. "SEC Approves Confidential Private Fund Risk Reporting" (press release), Oct. 26, 2011. Available at www.sec.gov/news/press/2011/2011-226.htm.

Large fund advisers Form PF filing frequency

Large fund advisers	Filing frequency
Advisers with at least $1.5 billion AUM attributable to hedge funds	File aggregate basis information on Form PF within 60 days of each fiscal quarter end. Advisers must also report information about risk profiles and exposures for hedge funds with net asset values of $500 million or more
Liquidity fund advisers with at least $1 billion in combined AUM attributable to liquidity funds and registered money market funds	File Form PF within 15 days of each fiscal quarter end and detail the types of assets in their funds' portfolios, information pertaining to the funds' risk profiles and compliance efforts with the Investment Company Act's Rule 2a-7
Advisers with at least $2 billion AUM attributable to private equity funds	File Form PF annually within 120 days of the fiscal year-end and report extent of leverage incurred by their funds' portfolio companies, use of bridge financing and investments in financial institutions

The SEC has adopted a two-stage phase-in period for initial filings, with most private fund advisers beginning filing at the end of their first fiscal year or quarter ending on or after Dec. 15, 2012. Large private fund advisers with at least $5 billion AUM must begin filing Form PF at the end of their first fiscal year or quarter ending on or after June 15, 2012. Compliance costs of updating internal systems or outsourcing additional processes to vendors for all Form PF filers will increase in the short term as firms ramp up capabilities to capture, store and report information by the filing deadlines.

Over-the-counter registration

Over-the-counter (OTC) derivatives, such as the credit default swaps that led to the collapse of insurance giant AIG,[20] were a major cause of the 2008 financial crisis. These essentially private deals between two counterparties were subject to limited regulatory oversight and rules for managing counterparty risk prior to the financial crisis.

The Dodd-Frank Act shifts derivatives trading to exchanges or designated execution facilities and requires the instruments to be cleared through central clearing houses, similar to the options trading market. By promoting transparency and imposing exchange restrictions on counterparty deals, regulators hope to avoid a systemic collapse from counterparty risk.

Rule-writing that would implement changes to the trading and regulation of derivatives by the CFTC and SEC is behind schedule. The Republican-controlled House of Representatives is pushing to delay or weaken the implementation of the Dodd-Frank Act, in part by restricting funds regulators need to carry out the rulemaking and enforcement provisions.

[20] For perspective on the historical impact of the collapse of AIG and the recession, see Grant Thornton LLP's Capital Markets Series white paper, *A wake-up call for America*. This paper is available at www.grantthornton.com/staticfiles/GTCom/Public%20companies%20and%20capital%20markets/gt_wakeup_call_.pdf.

Participants in the OTC derivatives markets, including fund advisers, are uncertain about the impact implementation of the final rule will have on executing derivatives trades. The impact of changes to OTC derivatives on hedge funds that depend heavily on trading these instruments is also unknown. A number of hedge funds that anticipated the collapse of the housing market, for example, used credit default swaps to short the market for the CDOs that had mortgage-backed securities in underlying tranches. Hedge funds may be affected by the rule change if one of the following occurs:

- Regulations force hedge funds to modify their trading strategies.
- Regulations increase costs for prime brokers in executing the trades — costs that would be passed on to the funds.
- Regulations decrease the costs of trading or investing in the derivatives markets by moving deals to an electronically based public platform.

Regulatory timeline	
July 21, 2010	Dodd-Frank Act enacted
October 2011	Form PF systemic risk reporting process approved by SEC
Oct. 24, 2011	Form SLT first filing deadline
March 30, 2012	Alternative investment fund managers of funds with more than $150M in AUM deadline to register with the SEC
July 21, 2012	Effective date of the Volcker Rule
Pending	OTC derivatives trading on regulated exchanges through clearinghouses

Global regulatory change

Global regulators are moving forward with regulatory convergence of the financial services sector. More consistent rules among global regulations may reduce the kind of regulatory shopping that results in U.S. funds moving offshore to Europe or Asia where regulatory compliance and oversight rules may be less stringent than in the United States.

Although much of the convergence work has been centered on accounting and capitalization rules, some variation in the basic framework for overseeing hedge fund and alternative investments as found in the Dodd-Frank Act might become the global standard. The SEC's Form PF is similar in many respects to the European Securities and Markets Authority's private fund reporting template and surveys of large hedge fund advisers conducted by foreign financial regulators. In addition, global regulators have already begun work on converging regulatory oversight standards for swaps rules.

In Europe, the Alternative Investment Fund Managers Directive (AIFM Directive) created a comprehensive regulatory framework for alternative investment fund managers within the European Union. The AIFM Directive was first released in draft in April 2009 and, similar to the Dodd-Frank Act, was subject to significant debate and controversy. Even though the final text was published in the *Official Journal of the European Union* on July 1, 2011, the concerns about its impact are far from over.

Resources

The Asset Management sector is a core focus of Grant Thornton LLP. We have a dedicated industry practice with 35 partners and over 300 professionals in the U.S. Worldwide, Grant Thornton International has over 55 partners and 500 professionals focused on the industry. We serve a wide array of clients (both onshore and offshore) including hedge funds, private equity funds, real estate funds and registered investment companies and advisors.

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To further support our commitment to this sector, Grant Thornton established a National Financial Services Industry Group to provide our professionals with a resource center of knowledge about accounting, tax and business advisory issues affecting the financial services industry. We know that a trusted business adviser should do more than just check the box. We stay ahead of the curve for our clients and are committed to providing you with continuous thought leadership, webcasts and events that are relevant, timely and focused on the issues critical to you and your business. The following is a sample of some of the regular thought leadership you can access from Grant Thornton

- *Financial Bulletin:* a periodic publication covering regulations and developments affecting the financial services industry.
- *Asset ManagementAdviser:* addresses hot topics affecting the asset management industry.
- *Private equity white papers:* discuss timely topics for private equity.
- *IFRS News:* quarterly summary on significant developments in International Financial Reporting Standards.
- *New Developments Summary:* technical overview of a new or emerging accounting issue.
- *On the Horizon:* weekly update covering activities of the regulators and standard setters including FASB, EITF, SEC, AICPA, GASB and PCAOB.
- *Dealmaker:* periodic publication offering mergers and acquisitions insights.
- *Tax Hot Topics:* addresses a wide range of tax issues including IRS rulings, tax-related litigation, and state, local and international tax developments.
- *Business Valuation Monitor:* addresses valuation perspectives for corporate executives and the investment community.
- *Capital Markets Series:* provides periodic reports and reviews on issues relevant to today's capital markets community.

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