KPMG

Speed. Control. Growth.

Alternative investments keep their luster

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Introduction: Alternative investments keep their luster

After a decade-long run, marked by a 10 percent compound annual growth rate,[1] one might expect the steady ascent in alternative investments (AI) assets under management (AUM) to slow down in 2016. We believe, however, that a number of factors suggest the run still has legs. Hedge funds inflows globally in the first half of 2015, for example, increased 31 percent compared to the same period in 2014, with much of the increase occurring in the second quarter.[2] And, at $7 trillion AUM and counting, up from $3 trillion of AUM in 2005,[3] today's popularity and the future attraction of alternatives overall is rooted in several factors:

- Many investors see AI as an attractive option in their overall investment portfolio
- A sizeable sector of institutions and retail investors view alternatives as a means to provide a low correlation with traditional investment assets
- Alternative assets offer diversification benefits
- Alternatives are not necessarily seen as investments reserved only for high net worth or highly sophisticated investors
- AI assets are providing much-needed liquidity for the world's finance system, benefiting the capital markets and helping to redistribute risk.

In this report on the opportunities that can be realized by managing trends and challenges facing the industry, we tapped the knowledge of a group of our noted subject matter professionals to identify ways that investors can capture those opportunities. These KPMG LLP (KPMG) professionals, with extensive industry experience and daily interaction with the industry's high-profile and sophisticated institutions and individuals, identified five focus areas for managing challenges to enable growth. To be sure, the industry faces other significant issues. But, for purposes of this paper, we focus on five that we see as significant in the months ahead:

- Technology and operational transformation
- Valuation and fee allocation
- Merger and acquisitions (M&A) opportunities
- Prime brokers' return on assets (ROA) and balance sheet utilization
- Risk management and cybersecurity issues.

In the pages that follow, we examine the drivers of these focus areas, and we suggest approaches to help manage the challenges and risks they present. We invite your feedback on our points of view and suggestions for action steps. Our intention is to open a dialogue with industry participants about the opportunities for constructive change and sustained growth through deliberate strategies that fit a dynamic and rapidly changing environment.

Jim Suglia and Jeff Kollin

Jim Suglia

Jim is the National Practice Leader for the Alternative Investments practice and is also a member of the firm's Global Investment Management Executive Leadership team. With more than 20 years of industry experience, Jim has served an extensive roster of both Mutual Fund and Alternative Investment clients.

Jeffrey J. Kollin

Jeffrey is the Lead Advisory Principal for the Alternative Investments practice. Jeff focuses the Firm's resources in the hedge fund and alternative investments market, including all activities for business and practice development, professional development, technical support, and market activity.

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[1] "*Preqin Investor Outlook: Alternative Assets H1 2015*," Preqin.com; "*Alternative Investments 2020: An Introduction to Alternative Investments*," July 2015, World Economic Forum

[2] "*Hedge Fund Industry Sees $76bn Net Inflow in H1 2015*," Preqin.com, August 26, 2015

[3] "*Preqin Investor Outlook: Alternative Assets H1 2015*," Preqin.com

Contents

Technology and operations transformation

As it is in virtually every other established and regulated financial services business, the AI industry's rapid growth and expansion has led to generally inefficient legacy technology infrastructure, which presents complex process, product, and people challenges.

But beyond the nuts-and-bolts aspect of the infrastructure, the ways of working today in the alternatives space are still more manual. Use of spreadsheets remains common—perhaps even preferred, creating the possibility for mistakes—not to mention a slow pace in a high-speed world.

That contradiction of what seems like old-line behavior stands in curious counterpoint in our current digital universe. At KPMG, we find it even more striking that there seems to be a general acceptance in the industry that adoption of the waves of lightning-quick technologies is essential—yet adoption of new ways of working in alternatives is lagging.

A seat at the table

When executives and technology specialists in AI ponder how to architect the next generation of information technology (IT) systems, they will need to focus on creating integrated platforms, even as they recognize the disparate nature of alternative asset products.

> "When we are working with firms, we find that the need for integration is amplified by the complexity and enormity of their data environment. The success or failure of platform integration hinges on a firm's ability to change inflexible, ingrained organizational behaviors. It's the inflexibility that keeps systems fragmented and information in silos at so many of today's hedge funds, PE firms, and other alternatives businesses."
>
> **David Messier**
> KPMG Managing Director, Financial Services Advisory

When we take a deep dive and examine a firm's technology processes and organizational structures, we find that, at the core, much of the challenge lies with the fact that so many of the individuals who make strategic decisions have much more experience in finance than in technology-driven operations.

And, while there must always be a major role for the "numbers" people in this industry, there is no denying that it is a business increasingly characterized by a reliance on ever-more complex technology. However, the people that possess both strong technology and finance skills are all too often not occupying a seat at the table when holistic, strategic decisions are being made.

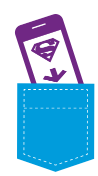
In an environment where creative products are sought by investors, and where investors and regulators demand clear and quick information on valuation and data, AI firms must improve their technological capabilities.

> "Technology and operational change doesn't start with the idea that all you need is new servers, software, and platforms. The foundation of transformation is the acceptance that change is more than a 'desired state.' Acceptance of change is essential to meaningful transformation."
>
> **Jeffrey Kollin**
> KPMG Principal, Alternative Investments

These forces are not molding the *future* of finance: It has already happened!

The world is smaller; information creation is moving at exponential speed

Mobile devices mean anyone can reach anyone, anything, anytime, anywhere



Cloud puts a supercomputer in anyone's pocket

Fundamental focus points

At the all-important intersection of people, process, and technology, the results of years of patchwork activities in alternatives businesses have created four fundamental operations and strategy challenges in the industry.

- The middle office—through which much of an alternative organization's critical data flows—appears to be "disconnected" in many firms. The middle office frequently is not integrated operationally with front-office and back-office functions.
- Too many firms lack consistent control mechanisms necessary to capture, store, and retrieve data across portfolio holdings.
- Organizations must improve their performance measurement and reporting capabilities by leveraging data they already have in silos.
- Integrated technology platforms are scarce in the industry, exacerbating challenges related to data and operations.

Actions for success: Technological and operational transformation in practice

Turning technological and operational challenges into opportunities requires tenacity and creativity, as well as a focus on the fundamentals. To that end, we offer four ideas to make meaningful progress:

Expand what is now a limited middle-office role

With so much of operational activities being document-based, there must be action taken that addresses data-gathering and reporting deficiencies by building out automated processes in the middle office.

The nature of alternative asset classes requires active hands-on work by front-office personnel to close deals, and there is nearly an equal amount of hands-on activity in the back office, where fund and portfolio accounting and investor services take place. But, for many years now, middle-office operations sometimes have been overlooked. Installing better middle-office automation and controls often has been postponed, even though automated processes are desperately needed to manage the rivers of data about the trades, reconciliation, and cash settlement flowing through that part of the business.

In our meetings in the marketplace, we make clear our belief that a focus on enhancing the middle office can no longer be postponed, given the potential for significant downside regulatory and operational impacts. What is more, such enhancement in the middle office offers benefits that portfolio managers will realize as they actively manage their investments in alternatives. Those benefits include potentially better accuracy in forecasting returns and identification of risks based on the strategies and terms of the deals in their portfolios. Further, managers would be able to utilize information on planned or "in-flight" activities of their assets that may not have settled in order to make strategic investment decisions.

These new ways of working, which are powered by integrated technology platforms, need to be embedded and accepted, giving the middle office and the entire operation the enviable ability to pivot and adapt in this rapidly changing industry.

Build consistent access to data across portfolio holdings

Our work in the field suggests many institutions do not possess the kind of technologies that offer a clear view of data. Those views are vital in providing a capacity for making strategic business decisions for the business. Creating that view requires firms to reduce manual processes and create "maps" or dashboards by tapping into multiple data sources.

While not a simple task, it is an essential one, given the expansion of asset classes in alternatives, where there is a multitude of private equity (PE) funds moving into hedge funds and real estate, of hedge funds investing in credit products, traditional asset managers boosting their investments in alternatives, and much more. Accordingly, the demand to increase investments in technology must be applied to issues as diverse as strategic growth, risk management, and transparency.

We believe that, with the need for more transparency, there will be significant challenges for technology solution providers (whether internal teams or third parties). These providers will need to create mechanisms that can capture and synthesize the appropriate depth and scope of data that funds must provide investors, regulators, and a host of stakeholders.

> "At KPMG, we believe we deliver real value with data and analytics by helping organizations create actionable opportunities to meet ongoing business challenges. Our entire purpose in creating tangible solutions is to deliver solutions and improvements that actually can be measured across the dimensions of costs, growth, and risks."
>
> **David Messier**
> KPMG Managing Director, Financial Services Advisory

Generate timely statements

In this era where individuals and institutions want data now and want it without errors, there is a pressing need for alternatives firms to provide the information that is critical to assess the risk and value. Investors and regulators demand consistent and timelier statements on underlying holdings.

With the rapid growth in use of mobile devices (there are roughly 7.1 billion mobile subscriptions in the world as of mid-2015[4]), coupled with the expectations of customers for immediate information and the explosion in the amount of digital data, alternatives firms will need to create affordable solutions, such as cloud-based applications for storage of data and tools to analyze and report on the data they are creating.

Though desperately needed, the alternatives industry is still playing catch-up in a number of technological advances that will benefit their businesses and the clients.

KPMG has been working to understand the tools and forces that are generating change and transformation. (**See sidebar at right about KPMG's Innovation Lab.**) Advancements by the industry can not come soon enough, with pressure building for an array of stakeholders.

Therefore, immediacy and clarity of information will be vital for alternatives managers that expect to stand out in this competitive industry. A prime example of this need can be seen in investors and asset managers needing to use cash flows to date for a closer real-time evaluation, which may include transactions that have occurred since the last statement was published, as they await final statements to be recorded on their books and records by accounting. Without that capacity, there could be discrepancies in performance reported by the front office versus accounting's books and records.

Standardized processes, commoditized applications, and unique instruments

Asset managers, who by their nature have an entrepreneurial culture, are facing a dilemma as they seek technology solutions to help manage their highly customized investment instruments. The challenge they face is in choosing whether to try to build their own customized software solution or trying to use today's commoditized software, which often does not work well with all of their requirements.

Therefore, a task that seeks to create a technological solution that standardizes information about investment instruments that are anything but standard creates a challenge. After all, many alternative products are vastly different in their nature and goals, and a standardized platform might mean that output of the data is inaccurate or inconsistent.

That is why it is imperative that, in attempting to create a solution to the tech conundrum, managers must recognize that they are dealing with sometimes fundamentally opposing circumstances.

Managers would be well served to seek flexible and open-source technology solutions that could accommodate what may seem like an endless string of possible scenarios of alternative investments. Without a flexible and open-source solution, details in reporting and output could be lost as products change in the ever-changing regulatory environment.

KPMG's lab for innovation

At KPMG, we have made a substantial investment to being at the forefront of innovative technologies. In 2014, KPMG launched its "**Innovation Lab,**" which seeks to provide insights into a range of social and technological forces that are changing our clients' customers and competitors, and driving innovation and transformation in their industries.

"New opportunities will emerge over the next five years that are detectable now, through signals like changing demographics, technology innovation and start-up activity," says Steve Hill, vice chair for strategic investments and innovation.

Located in New York City's SoHo neighborhood, the Innovation Lab explores trends analysis, customer demographics and behaviors, customer experience and motivational design, technology innovation, the start-up/venture capital landscape and more. Our team is there to help clients make sense of the signals of change emerging in their markets and industries.

[4] "Ericsson Mobility Report," June 2015

Valuation and expense/fee reporting methods under the microscope

Midway through 2014, the Securities and Exchange Commission (SEC) revealed that, after examining documents from 112 PE firms, 50 percent allocated expense and collected fees inappropriately, and in some cases, illegally. The SEC alleged that there were violations of law and material weaknesses in controls, which negatively affected fund investors. The findings led to citations and harmed the industry's reputation.

The SEC's Office of Compliance Inspections and Examinations (OCIE) director called the results a "remarkable statistic,'' and that, "for private-equity firms to be cited for deficiencies involving their treatment of fees and expense more than half the time we look at the area is significant."[5]

PE is not alone. In 2015, the SEC said a number of hedge funds had improperly valued investments for the purposes of collecting unearned fees. Some of the SEC actions have led to multimillion-dollar settlements and fines.

Regulators—along with investors—continue to press for more-complete disclosure about how funds value assets and charge fees. Since being granted increased oversight of money managers under the 2010 Dodd-Frank Act, the pace of government enforcement actions in the PE and hedge industries has increased steadily, and we expect no slowing of that pace in 2016.

In our view, executives in these businesses would be well-served in the months ahead to step up efforts on examining their valuation and fee-allocation processes.

[5] "SEC Finds High Rate of Fee, Expense Violations at Private-Equity Firms,'' *Wall Street Journal*, May 6, 2014

Keys to better valuation and disclosure efforts

PE and hedge fund executives can stay on top of valuation and disclosure demands by improving documentation and reporting procedures.

Interestingly, hedge fund investors surveyed in 2015 by Northern Trust Co. reported a disconnect between hedge fund managers and their investors: While 55 percent of investors the bank surveyed said they wanted more information and transparency from their managers, 98 percent of hedge fund managers in the survey said they believed that all or nearly all of their investors are satisfied with the level of transparency they receive.[6] Clearly, work needs to be done to understand how transparency and disclosure matters can improve.

[6] "Hedge Fund Industry 'Blind Spots' Persist," Northern Trust Co., media release, March 19, 2015

Action steps:
- Assess the organization's valuation and disclosure policies and procedures.
- Benchmark the leading policies and procedures in the industry by using an independent organization that has access to a range of the industry participants' policies and practices.
- Adjust your organization's valuation and disclosure methods from a procedural, technical, and quality-control standpoint.

Hedge fund valuation challenges:

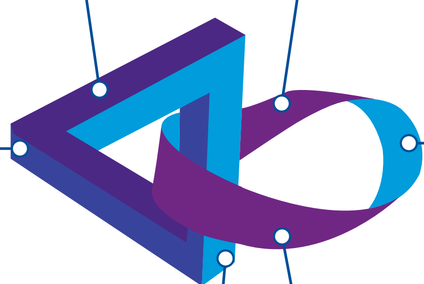
External demand for transparency

External demand triangle

Investors
- Investors are demanding additional assurance on valuations and specific disclosure topics.
- Investors value transparency on valuation in their due diligence process.

Regulators
- Dodd-Frank Act requires defined procedures and policies concerning securities' valuation.
- AIFM Directive Level 2 demands additional checks and controls on valuations (e.g., comparison with third-party valuations).
- Regulators are focused on whether organizations use well-documented and consistent processes relating to fee and valuation policies.

AI firm leadership (including directors)
- Seek external input in the valuation process.
- Maintain vigilance of the rising possibility of litigation relating to fee and valuation.



Internal awareness for quality and consistency

Internal requirement circle

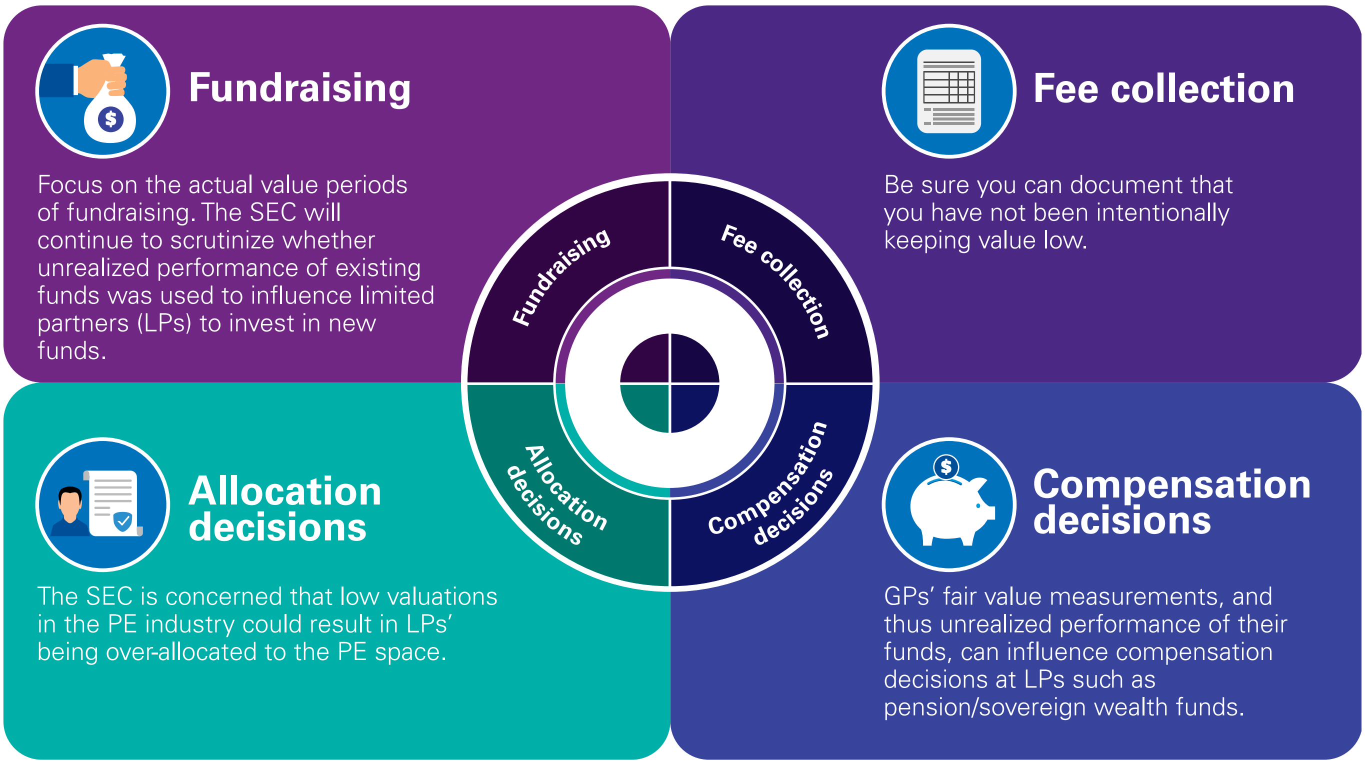
Consistency across funds
- Different administrators may derive different valuations for identical assets.
- Asset managers seek to derive consistent valuations and disclosures among their funds.

Administrator
- Many fund companies invest significant resources in shadowing asset valuation.
- Reconciling valuation differences is often difficult and time consuming.

Industry benchmarking
- Peer group benchmarking is seen to be highly valuable for hard to price investments.
- Changing market standards lead to new challenges for valuations and related disclosures.

Source: KPMG document: "Valuation Assurance for Alternative Investments – The KPMG iRADAR."

SEC's focus areas in examining interim PE valuations and fee-allocation methods



SEC's key areas of concerns regarding PE valuation

The SEC has signaled an emphasis on the integrity of PE valuations and will focus on examining whether fund managers have "inflated" valuations during periods of fundraising. The SEC recognizes that "unrealized performance" of existing funds can influence LPs to invest in new funds, primarily because the track record of a current portfolio may be viewed by potential investors as indicative of future performance.

On the other hand, regulators are cognizant that some funds may intentionally keep values low in order to justify longer holding periods and thus create longer periods for management fee collection.

Interim valuations, therefore, increasingly are under close scrutiny, sparking some debate inside and outside about how to value certain illiquid assets on an interim basis. The need for independent assistance in making these interim valuations may never be greater than it is now.

Summary findings on valuation deficiencies

The following are often cited by regulators and others as examples of valuation deficiencies:

- There is insufficient documentation regarding valuation policies and procedures, as well as the support of methodologies and assumption for individual valuations.
- There is inconsistency in the valuation process. Such inconsistency, we find, is often the result of not having fully detailed policies and procedures, or not enough education within the organization about existing policies and procedures.
- The actual valuation process is not aligned with promises made to investors by an adviser.
- The valuation methodologies are lacking, and the documentation that should support it is either flawed or even nonexistent.

Examples of key valuation deficiencies
Some notable deficiencies have surfaced in the past few years:

- Cherry-picking "comparables" to arrive at the desired result
- Adding back inappropriate items to earnings before interest, tax, depreciation, and amortization (EBITDA); the most common item is recurring costs
- Changing the valuation methodology from period to period without a logical purpose; an example of this kind of deficiency is changing from using trailing comparables to using forward comparables to inflate values for certain struggling investments
- Inappropriately holding investments at cost or keeping key inputs and assumptions stagnant for extended periods of time.

The bottom-line message regarding valuation issues is that key valuation inputs and assumptions must be supportable ***and*** documented—particularly if such inputs and assumptions changed period over period. Moreover, the valuation must be consistent with the overall valuation methodology and disclosed to investors.

The SEC: Looking ahead

We expect that in 2016, the SEC will continue to employ a risk-based approach when selecting which PE and hedge funds to examine, and the SEC's emphasis will be driven by situations or behaviors that it believes could pose significant risk to investors.

We expect particular emphasis among alternatives will be on PE, especially on real estate and infrastructure deals, as well as credit advisers.

Further, we would not be surprised if valuation exams are lengthier and more in-depth than they were during the "Presence Exam" initiative, which focuses on valuation, fees, and expense allocation. We further expect that there will be more thorough examinations of valuation issues in connection with fund restructurings, such as stapled secondary transactions.

Actions for success: an approach to transparency

There is scant guidance on how AI fund executive teams can build and maintain top-level valuation and fee-allocation policies and procedures.

"The issue we find frequently when there is a valuation examination by the SEC of a fund is a focus on whether the organization has strong governance around the process that is used, particularly for assets classified as Level III. Are the valuation inputs and assumptions supportable? Is the valuation methodology consistently applied? Are there adequate control procedures in place to promote accuracy and independence? Is the process adequately disclosed to investors?

Our message is that the SEC oversight process is very thorough, and fund officials need to be prepared for an in-depth examination of the organization's valuation policy and procedures. If it's not a priority at a fund, then we'd suggest it become one."

Brian Bouchard
KPMG Managing Director, Economic & Valuation Services

We advocate a strong valuation policy that promotes accuracy, independence, consistency in approach, and transparency.

Key areas that should be addressed in a valuation policy and procedures document include:

- Governance
- Fair value standards and guidance
- Valuation sources and inputs
- Valuation process, procedures, and methodology
- Quality control procedures
- Reporting and documentation.

Governance:
Sound governance ensures no bias (or appearance of it) in valuation. The SEC finds deficiencies when individuals exert too much control over valuation.

Action steps: Create a valuation committee that:
- Consists of firm's leaders in finance, operations, compliance, and portfolio management who can be voting or nonvoting members
- Establishes guidelines/makes recommendations to the board about the valuation of investments
- Creates clearly defined roles and responsibilities regarding the valuation process
- Gives the chief financial officer the duty to sign off on all valuations.

Fair value standards and guidance:
The standards and guidance on determining fair value, required in the valuation policy, must be understood by those who determine value as well as the organization's management and board. The SEC has expressed concern about funds being purposely conservative in valuation estimates.

Action steps:
- Follow "Fair Value Measurements and Disclosures" accounting standards, which defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
- Leadership must understand the three "levels" of fair value as defined in ASC Topic 820, where "Level I'' assets have quoted market prices for the identical asset in active markets, Level II assets have observable market inputs other than a Level I quoted price, and Level III assets have significant unobservable inputs that cannot be corroborated by observable market data.

Valuation sources and inputs:
Valuation sources and inputs should be disclosed; use more than one pricing source when possible to value a position.

Action steps: Increase accuracy in valuation by using:
- Market data and vendor pricing sources
- Broker quotes
- Third-party valuation specialists
- Internal and external pricing models that have been approved by your valuation committee.

Valuation process, procedures, and methodology by asset class:
Investors (and regulators) are seeking details from the general partner about valuation.

Action steps: Disclose process, procedure, and methodology by asset class across the portfolio. Include:
- The general description of the fund's approach to valuation
- How adjustments are made
- The methods employed to determine fair value.

Quality control:
Use safeguards to promote accuracy in the valuation process.

Action steps:
- Take steps to ensure there are no "stale'' prices.
- Perform "back-testing" to determine the effectiveness of pricing sources and valuation methodologies.
- Work with specialists to validate the financial models used in the process.

Reporting and documentation:
One of the most important elements in your valuation process is the ability to provide tangible evidence that the general partner's valuation process in being followed consistently. The SEC advises funds to disclose the process and controls used so that investors may evaluate a fund manager's operations.

Action steps:
- Document valuation support at the investment level, including the methodologies, the significant inputs, and the resulting fair value estimates for each Level III investment.
- Provide minutes of valuation committee meetings; include dissenting opinions on value conclusions and the rationale for any period-over-period changes to the fair value of illiquid investments.

M&A still appealing

The lines that traditionally formed clear boundaries separating the various types of AI firms are continuing to blur. We expect deal activity across a wide range of transaction types, from minority stake sales to large-scale acquisitions. This consolidation will allow firms to offer a more diverse range of products and strategies to investors, provide access to new distribution channels, and facilitate succession planning and the ability to retain top talent.

But, as the appeal of M&A grows, it is important for buyers to keep top-of-mind both the unique and sometimes fickle nature of the business they are acquiring as well as the management team they are investing in.

Conducting a comprehensive due diligence review of both the manager and its funds under management, and structuring deal terms that take these factors into consideration, can greatly limit the risk of the deal and preserve the value a buyer expects from the transaction. Consequently, KPMG's AI professionals are finding that fund managers increasingly are seeking help to identify and prioritize strategic solutions.

Diverse deals

Driven by steady inflows from institutional and retail investors seeking risk-adjusted and uncorrelated returns, alternatives managers are showing a keen interest in expanding into adjacent asset classes. As one of the fastest-growing, yet highly fragmented segments of the asset management industry, we see M&A in alternatives maintaining its pace of recent years. Looking ahead, we expect deals in:

- Platform acquisitions by managers seeking to offer an expanded product line-up and strategies
- Minority stake sales to PE and long-term institutional investors
- Acquisition of AI funds by traditional asset managers who see opportunity in marketing AI strategies to retail investors
- Regulatory-driven bank divestitures of AI units and sales of "stranded" stakes acquired precrisis.

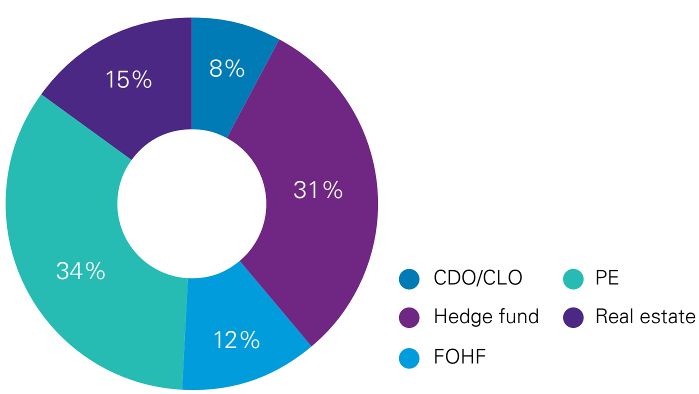
"When we boil it all down, the main issue we see is fit. Do the people and cultures fit? Do the strategies meet the needs of my investors? Am I adding complementary distribution channels? Does the combined platform deliver scale? Those are elements that really matter."

Brian Seidler
Managing Director, KPMG Deal Advisory

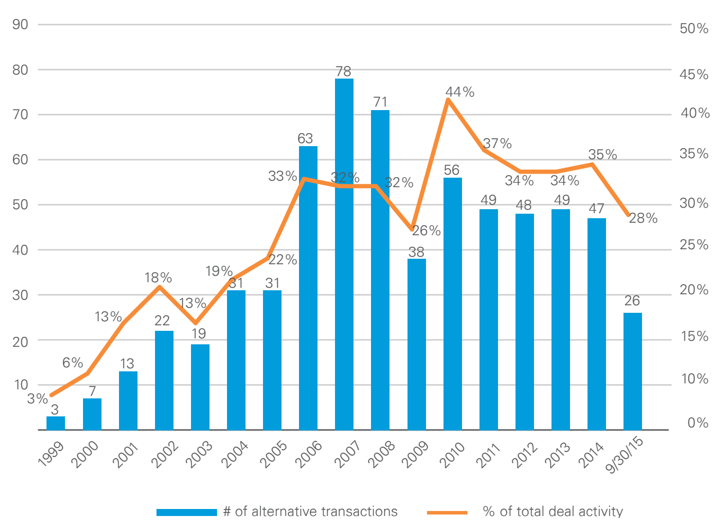
M&A activity in AI has been steady since 2011, as seen on the bar chart. In the four-year period ended December 31, 2014, there were 193 alternative asset manager deals, according to Sandler O'Neill + Partners data issued in 2015. By comparison, in a four-year period about a decade ago (2000 through 2003), there were only 61 deals. Complete data for 2015 is not yet available, but anecdotal information suggests the 2015 total could be near or slightly lower than the totals of 2013 and 2014. In the pie chart we see PE deals are most popular, and we believe that the drivers are PE firms targeting minority stakes in hedge funds, and traditional assets managers—in pursuit of diversification—are taking stakes in PE funds. Following these charts are factors KPMG expects will have a material impact on M&A activity in 2016.

Data source: Sandler O'Neill + Partners (used with permission)

Alternative asset manager deals by target type (9/30/15)



Aggregate alternative asset manager deals (as of 9/30/15)



Key factors KPMG expects will affect M&A in 2016

Search for size, scale, distribution	In the desire to diversify, AI firms will seek to increase scale, offering an array of products. We see PE firms expand into adjacent asset classes such as real estate, infrastructure, and hedge funds. We expect AI firms will broaden their search for strategic partners that can provide distribution and support asset-gathering efforts, particularly overseas as they look to expand their global footprint.
Succession planning	Rather than wind down their funds after a successful investing career, we are seeing managers seeking to build a firm with a lasting legacy. A sale transaction (including minority stake sales) can help enable generational transition and broaden the ownership structure. Concurrently, such action can provide a mechanism to attract and retain the "next generation" of fund managers.
Convergence with traditional asset classes	In the coming years, we expect that assets managed that have traditionally focused on the "long-only" segment of the market will turn to M&A as a tool to acquire alpha generation skills and to capitalize on growing "retailization" of alternative strategies—the increasing availability of these products to retail investors through registered investment (mutual) funds and retirement accounts.
Regulatory reform	The costly, complex, and uncertain regulatory requirements remains a significant driver. In the years since passage of the Dodd-Frank Act, many banks reacted to stringent capital and liquidity rules, and demands to reduce certain risk-taking activities by divesting their AI units. Spin-offs of that type could continue in 2016 as banks decide to focus on activities that are more core to traditional banking.

Motivation

Whether they were blockbuster or midsize deals in 2015, managers who made the decisions to align with new partners share a commonality in motivations that we see carrying on into 2016.

Seller motivations

- Succession planning
- Access to new distribution channels
- Growth capital
- Regulatory reform and cost burden
- Competitive pressures

Buyer motivations

- Expansion into new products and strategies
- Talent acquisition
- Economies of scale
- Broaden geographic footprint
- Grow wallet share

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Actions for success: AI deals require enhanced due diligence

Though there is never a "sure thing" in doing any deal, and no checklist is ever complete, our experience in assisting AI firms in M&A deals leads us to offer a few ideas to consider in an attempt to limit risk and preserve value:

- At its core, asset management is a "people" business and HR issues pose significant postdeal execution risks.
  - Acquirers should pay particular attention to assessing the quality and depth of the target's management team—including investment and noninvestment personnel.
  - While sometimes difficult to ascertain, close attention should be paid to whether a merger will work culturally. Though sometimes described as a "soft" aspect of a deal, cultural compatibility can often make or break a union.
  - Buyers also will need to understand employee incentives and the manager's ability to retain top talent after the deal closes. While key personnel risk is inherent in many AI companies, it can become magnified in small firms where there may be heavy reliance on a "star" fund manager and limited bench strength.
- Due diligence must include a comprehensive quantitative and qualitative assessment of the manager's investment strategy and track record, including an analysis of where and how returns are generated.
- AI managers tend to carry greater headline and reputational risk, especially in this time when the regulatory spotlight is bright, and regulatory prosecutions seem commonplace. Acquirers should ensure that any investment firm being considered for an acquisition has a robust operations platform and risk and control environment.
- Buyers also need to understand the "stickiness" of investor relationships, the overall level and mix of AUM, and the composition and sustainability of earnings.
- In structuring the deal, pay close attention to details involving employment agreements with individuals deemed critical to the ongoing business and their postclosing compensation arrangements. Here are some considerations:
  - The acquisitions of AI managers are fundamentally about acquiring people, investment know-how, and client relationships. Therefore, employment agreements with individuals deemed to be critical to the ongoing business and their postclosing compensation arrangements need to be addressed prior to the signing of any definitive contracts. Long-term retention and incentives can take the form of an earn-out, management equity stakes, or other incentive plans to align buyer and seller objectives. Earn-out mechanisms, which result in future payouts if certain performance thresholds are achieved (e.g., EBITDA or revenue targets), have become a common feature of transactions involving AI firms and are typically used to mitigate valuation uncertainties and motivate key executives after the deal closes.
  - Acquirers should also, if possible, seek contractual protections relating to the retention of client relationships and assets. It is common for transaction agreements to consider and incorporate a closing condition relating to the client consent process, enumerating a minimum amount of required AUM or run-rate revenues (RRR) as of the closing date, and/or a purchase price adjustment mechanism based on changes in the amount or type of AUM or RRR (in some cases excluding the impact of market movements) at closing as compared to a specified preclosing date.

In addition to this checklist, of course, there are other issues specific to M&A in the AI industry that KPMG's transactions professionals manage with clients on a routine basis.

Fluid state persists with prime brokers and balance sheet consolidation

The dynamic changes in how alternative managers and prime brokers interacted in 2015 will likely continue to have an impact in 2016.

We expect business models on both sides of the equation to transform as brokers continue to pare down fund managers from their books of business, funds seek new sources of financing, and the ongoing focus on ROA and balance sheet allocation becomes even more intense.

Shifting models, new opportunities, lessons learned

As banks' prime broker units reacted by cutting ties with a sizeable portion of alternative funds in 2015, the fabric of that business has taken on a new texture.

Many alternatives are learning how to operate without the multiprime broker model that has served them over the past decade.

The result: Funds are now dealing with heightened operational issues of balance sheet allocation, order execution, leverage, lines of credit, and other prime broker services.

Despite those realities and the resulting challenges, 2015 also offered valuable lessons for brokers and funds that can be applied in 2016. The challenges are forcing penetrating examinations of portfolios and strategies by both parties with the purpose of determining the optimal balance between products and services.

Where matters stand when 2016 comes to a close will be interesting when we look back and review decisions and their impacts. We expect that the review could show that 2016 was a year where there were as many opportunities as there were points of peril for both prime brokers and alternative asset managers. For those and other related reasons, we advocate fund managers proactively manage their counterparty credit relationships, maintain vigilance on impacts to their business in order to immediately recognize trends, and move when appropriate to seize opportunities in nontraditional counterparties that can improve and stabilize their liquidity.

"When people talk about banking, we often hear: 'Too big to fail.' But, when the topic is the relationship among prime brokers and alternative asset funds, it's more like: 'Too small to survive.' I'd argue that 2016 could see new developments and some creative ideas that help stabilize the situation."

Carl Versella
KPMG Advisory Managing Director

Expectations about banks' prime broker interactions with alternative funds in 2016

Funds will need to be prepared for higher expectations on a number of fronts from their bank's prime brokers in 2016. In return for financing, securities lending, access to balance sheet, and other services, prime brokers will demand a better (and sustained) level of after-cost return[7] from the funds in their portfolio.

"The way these parties interact in 2016 will look nothing like it did just two years ago,'' says KPMG's Versella. While the fundamental nature of their relationship will likely be much the same in terms of providing services, we are in the midst of a "sea change across Wall Street in the prime brokerage business.''[8]

Large banks are contacting certain customers with the message that they do not want their cash deposits. The action is the result of banks having large amounts of cash on deposit and having a difficult time investing its cash profitably and because of the complications imposed on banks by the liquidity coverage ratio (LCR) regulation.[9] The cash quandary is hitting hedge funds particularly hard. One hedge fund insider was recently quoted about the cash issue: "At some point you wonder whether there will be a shortage of financial institutions willing to take on these balances.''[10] Where to hold cash is a major topic of conversation among funds.[11]

[7] "Building an Effective Hedge Fund Prime Broker Relationship,'' Wells Fargo Prime Services, August 6, 2015

[8] "J.P. Morgan Shuffles Ranks of Prime Brokerage Business,'' Wall Street Journal, June 19, 2015

[9] "Big Banks to America's Firms: We Don't Want Your Cash,'' Wall Street Journal, October 18, 2015

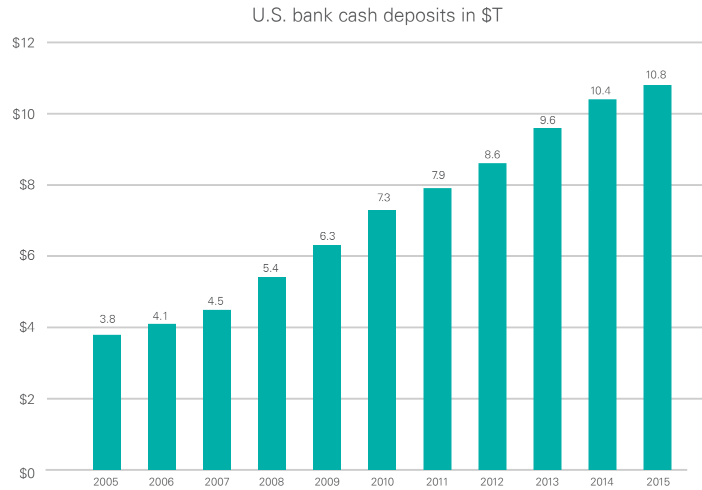
[10] Ibid.

[11] Ibid.

Because of that situation and others, fund managers must gain a thorough understanding of how prime brokers are recasting their own business models due to regulatory and investor pressures.

Since relationships are the foundation of the alternative fund/prime broker dynamic, and since prime brokers face massive pressure on the capital and leverage fronts, alternative asset managers will need a deep understanding of how their own trading strategy is having an impact on the prime brokers' business model.

We expect prime brokers will be diligent in seeking to optimize their business in 2016, and thus will challenge the status quo of many fund relationships. Without understanding prime brokers' specific profitability model changes, funds may inadvertently jeopardize their credit lines and thus their access to financing options that are critical to grow their own business in a rapidly shifting marketplace.



Source: FDIC 2015

Basel III – Driving the need for collaborative solutions

The ongoing transformation we are witnessing in how prime brokers and funds interact, being driven by The Basel Committee on Banking Supervision's Basel III Accord, has created intense focus on banks' capitalization level and how banks calculate and monitor LCR, net stable funding ratio (NSFR), and others. These requirements regarding ratios have become catalysts for change in the relationship with alternatives funds.

With this new market reality as a backdrop, and as fund managers accelerate changes to their fund's business model, a major possible issue going forward could be that alternative funds are left to rely on too few brokers. The scenario would increase concentration risk, making the need to explore new sources of funding an imperative for 2016.

At the same time, asset managers should not simply give up and accept a notification from existing prime brokerage that their relationship has changed. Fund managers will need to immediately engage in meaningful conversations with existing prime brokers to understand those changes and where there are potential avenues that offer benefits to the funds as well as the prime brokers.

The work will require creative thinking and follow-through, a significant amount of effort and time, and—most of all—persistence. With the stake so high, though, the effort will be worth it in the short term and the longer term.

Actions for success: Better collaboration with your prime broker

Knowing that Basel III, and possibly other regulations, will continue to affect access to financing, we offer ideas that fund managers might consider going forward:

– Hold direct conversations with senior bank officials and leaders of prime broker units in order for both sides to fully understand the value each brings to the other. There may be instances where decisions about a change in a relationship have been made because the dialogue among the organizations has been either sporadic or not as transparent as it should be.

– Fund managers should be able to understand based on data and fact, the value/revenue the relationship provides the bank and prime brokers.

– Articulating the value proposition will depend heavily on the ability of both sides to present quality data. It will be vital, therefore, for both the fund manager and the credit counterparties to enhance their transparency and data quality capabilities for 2016.

– In the course of a conversation with the bank, it will be essential for fund managers to perform their due diligence and understand the metrics utilized to form a basis for the relationship (e.g., gross revenue, return on equity, ROA, return on leveraged assets, other). What are the credit counterparty's key revenue measurements? With that information in hand, the fund manager can prepare for the all-important dialogue about continuing the financing relationship.[12]

– Fund managers should gain a clear assessment of the non-balance-sheet revenue in order to determine if that revenue is in line with the bank's revenue targets.

– Understand what other metrics come into play when banks value your fund (i.e., trade executions, leverage provided, value of assets held, hard to borrow portfolio).[13]

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[12] "Leveraging the Leverage Ratio," J.P. Morgan Chase Bank, 2014

[13] "Basel III: How Hedge Fund Managers Must Leverage Prime Brokers," FinOps.com, September 1, 2015

Myriad of risks to manage in alternative investments

It certainly would be understandable that, after a review of the litany of risks confronting the AI industry, fund managers could be worried that they could be overwhelmed by the scope and interconnectivity of risks.

Be they compliance/governance related, investment, expense allocation, data quality and analysis, talent, cyber threats, valuation, or operational, managing this array of risks starts with prioritizing those that need immediate attention and those that must be embedded in a longer-term plan.

The stark reality is managers of alternative funds need superior risk-management capabilities if they expect to excel in a complex and increasingly competitive environment where demands are pressing from all sides.

At KPMG, we are working with clients to identify, prioritize, and solve near-term risks, and to develop strategic solutions.

Starting at the beginning

Managing risk and improving governance across an organization requires exemplary risk-identification skills coupled with the commitment to build a program that incorporates a holistic, strategic approach to turn those challenges into valuable opportunities for compliance, growth, and competitive advantage.

Risk management is an organization-wide imperative and it begins by identifying where gaps exist. It requires a shared commitment to create and deploy a comprehensive risk management strategy that involves internal audit teams, C-suite executives, and other cross-functional individuals across the organization.

Further, two more key imperatives are:

- First, the recognition that superior risk management, compliance, and governance programs must be modified as marketplace conditions change. In other words, while there is a starting point, there is no end point. Modification will be contingent on formal education programs about shifting compliance, internal audit, and/or regulatory issues.
- Second, a decision must be made at the top of the organization to receive assurance reports from an independent internal audit unit about the effectiveness of any controls created—including any outsourcing/offshoring programs—that could affect compliance with domestic and international regulatory mandates.

Recommended areas of focus

What follows are some of the areas of concentration. It is important to note that many of these areas have the issue of regulation running through them. Here, we examine just three areas, **operational**, **cyber**, and **vendor**, that we believe will be critical in 2016. It is vital, though, that managers recognize that there are many others that cannot drift off of their radar screens.

Actions for success: Mitigating risk

When assisting fund managers with making a decision on whether they need to redesign their operating model, we begin by asking whether the strategy of the business is well known and understood across the organization.

A shared understanding of the firm's strategic priorities requires that the people in the organization have a clear vision of the firm's plan to grow the business. They also need to be aware of the drivers of value, the needs of investors, the demands of regulators, where costs must be contained, and that they are clear on accountability standards.

The array of existing and emerging issues and challenges facing AI fund managers has put more focus on achieving an optimal operational model to meet overall goals.

A strong operating model can bring about operational integrity and efficiency while optimally supporting the generation of investment performance and delivering the required transparency to investors and regulators. These transparency needs mean that many organizations will have to enhance reporting capabilities and provide greater access to information delivered across multiple channels.

Our experience shows that a sizeable portion of fund managers in the industry will need to strengthen the knowledge base among their workforce through education and training about such diverse topics as reputational risk, budget constraints, and operational complexity.

Further, even though most fund personnel are acutely aware of heightened regulation requirements, they may not fully appreciate elevated operating costs that come from duplicative efforts across units that is evident in many organizations. The value of collaboration and clear communication has never been greater as costs rise and competition increases in the marketplace.

Optimal operational models that drive profits in this market also place emphasis on product rationalization, tax optimization, shared services, and prudent outsourcing.

Improve internal awareness and take measures to combat cyber risks

After assuring them that he would not lead them away in handcuffs, John P. Carlin, the U.S. Justice Department's top national security official, strongly suggested at a recent meeting with hedge-fund managers that they "come in and talk to the F.B.I. and prosecutors,''[14] about the spreading cyber threat in the industry. Carlin's motivation at the meeting, hosted by a KPMG cybersecurity specialist, was to encourage industry and government dialogue as a means to blunt the damage to the economy, investors, and the industry. Cyber thieves, he said, "are stealing your negotiating strategies, and they are stealing your algorithms.''[15]

Mitigating cyber risk in the alternative investment industry begins with understanding why the risk has risen.

In our work, we see that the rise in cyber crime parallels the industry's ever-growing reliance on emerging technologies, such as cloud computing, and because of the proliferation of information sharing between customers, clients, employees, and third-party vendors due to the growth of outsourcing, mobile technology, online banking, and social media.

Ever-more advanced and organized groups of cyber criminals are continually finding new ways to turn these advances into their advantage, engineering costly security breaches and seizing intellectual property, financial assets, and confidential employee, investor, and/or client data.

What is at stake?

- Loss of valuable intellectual property
- Loss of sensitive fund information
- Loss of confidential client information
- Loss of employee personal information
- Loss of major financial assets
- Negative regulatory attention

Adding urgency is the rise of regulatory requirements that demand information assurance from investment management firms. Funds must comply with industry-specific data privacy laws like the Gramm-Leach-Bliley Act. And, as the SEC focuses more and more attention on cybersecurity in its exams, even the smallest breach can create a very bad day for a fund manager.

From lost revenue to reputational damage to business disruption, the cost of noncompliance today is truly steep. Tomorrow, it will likely only increase. As disruptive technology continues to enter the market and expose funds to new threats, it is clear that cybersecurity will be likely a major issue in the investment management industry for many years to come.

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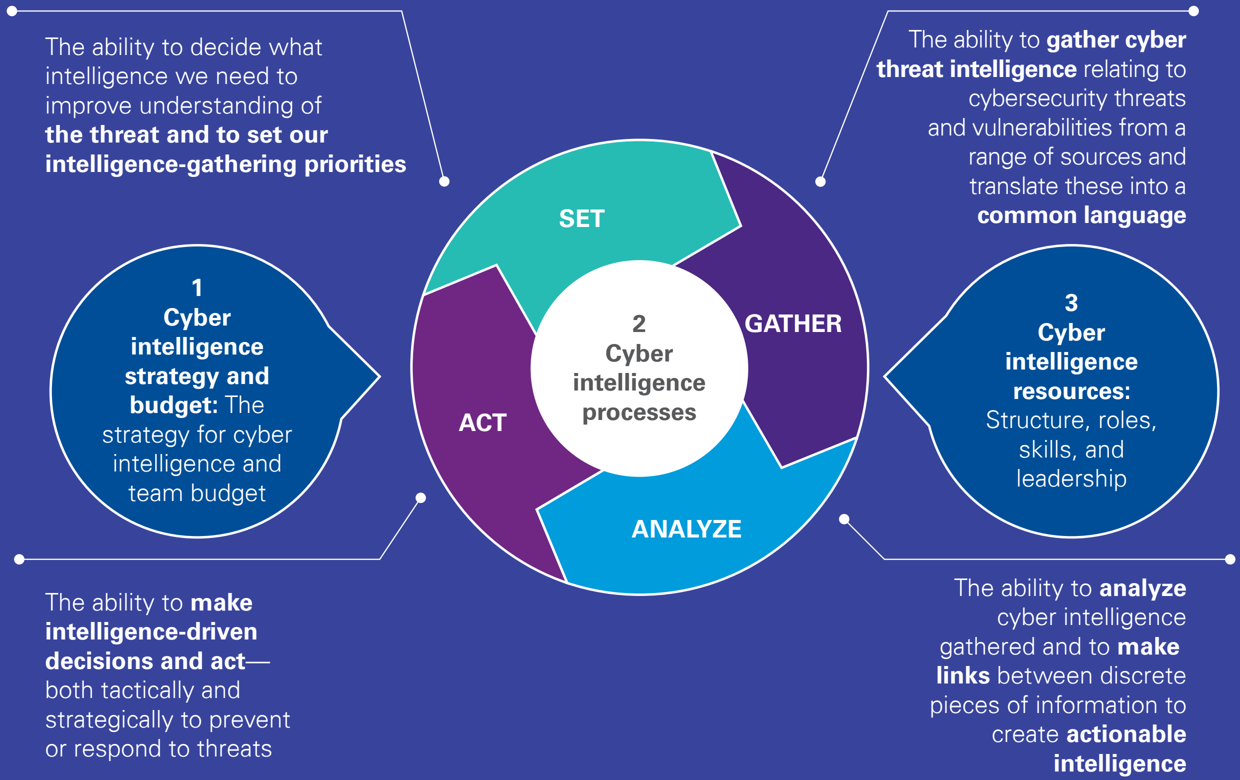
[14] "U.S. Urges Openness from Hedge Funds, an Industry Not Used to Sharing,'' *New York Times*, May 8, 2015

[15] Ibid.



We see the changing nature of vendor risk as a major area of focus,'' says Kevin Goldstein, a director in KPMG's Management Consulting practice. "You have several factors in play including regulation, mergers and acquisitions, repositioning, and the entry of new vendors into the marketplace all the time." And Goldstein adds: "Fund managers need to understand and monitor the controls that are in place at their vendors because, ultimately, regulators and investors consider it the manager's responsibility.''

Vendor risk reaches far beyond the vendors

As the use of vendors to carry out operational and financial functions (among others) that not long ago were conducted in-house continues to increase, the risk profile of the organization will be affected along several dimensions, including financial, reputation, security, and legal.

Making choices of vendors on a cost basis alone may be dangerous and, in the worst case, ruinous. Seeking help in choosing a vendor, and in benchmarking criteria to include performance and security, can help manage this risk. A thought to keep in mind when dealing with third-party vendors carrying out sensitive operations is that, even though they are outsiders, they really are insiders from a controls and compliance perspective.

Keeping track of these vendors' capabilities and their internal controls is a major concern going forward. Therefore, understanding how your firm's due diligence program is keeping up with these changing vendor risks will be critical in 2016.

Goldstein adds: "Fund managers need to understand the controls that are in place at their vendors because, ultimately, regulators and investors consider it the firm's responsibility.''

Conclusion

Leading organizations in the alternative funds industry will likely employ laser-like focus on identifying and deploying best-in-class technologies that enable the operational transformation that is so-sorely needed in a large swath of industry where manual processes are still common. We believe it will be a year marked by even more emphasis on multifaceted and global regulatory demands, putting significant emphasis on compliant valuation processes, transparency, fee-allocation, cybersecurity protocols, and vendor management—among many other areas of risk.

But, along with those possible trip wires, we also expect that 2016 will be a year of growing opportunity. We see organizations that are well positioned and vigilant being able to offer investors access to new products and markets through strategic M&A actions and tactical alliances.

In our opinion, sustained, profitable growth in this industry hinges as much on the fundamentals—such as the ability to access the right data at the right time for quick and accurate measurement of performance—as on the ability to unearth valuable opportunities in a rapidly shifting marketplace.

A message well-taken among AI managers would be to remember to stick to the basics as they seek new opportunities. There is more than success at stake; it is survival in an environment where risks are rising in step with opportunities.

How KPMG can help

Our mission at KPMG is to assist AI managers navigate in an environment where change is demanded yet transformation has been slow in coming. With the cost and complexity of running an AI organization having risen considerably, we are confident that the audit, tax, and advisory professionals at KPMG can make a difference.

Our professionals, positioned around the globe, offer real-time guidance in an environment that demands rapid responsiveness, regardless of fund structures.

KPMG's Alternative Investments practice is part of the firm's Financial Services line of business, which serves more than 20,000 clients worldwide, including more than a quarter of the FORTUNE 1000. With that depth and breadth, the Alternative Investments practice offers deep experience in the issues, challenges, trends, and risks relevant to your business.

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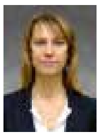

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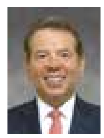

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