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Financial Services

Global Asset Management Industry Outlook

Issues on the horizon 2007

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Dear Colleague

For almost a decade the member firms of Deloitte Touche Tohmatsu have released an annual *Global Asset Management Industry Outlook* report, outlining the key challenges facing the asset management sector for the coming year.

The aim of the report is to draw on the thoughts and experiences of the many partners and practitioners around the world who serve in the sector, in order to provide clients with a broad view of what challenges and opportunities to expect in the coming year.

The past year has seen a continuation of the fundamental changes that have been transforming the asset management sector. Demographic trends, such as the burgeoning population nearing retirement and the influx of a new generation into the workforce; changes to the competitive landscape, such as the continued growth and popularity of alternative investments; and the unique challenges posed by the need to safeguard customer information in an increasingly accessible world, are some of the issues examined in this year's report.

We continue to focus our energy and resources on the financial services industry to help clients meet challenges and capitalize on opportunities. Ten years of producing the *Global Asset Management Industry Outlook* reports is a testament to that commitment, and I hope that you find this year's report useful and thought-provoking.

Yours sincerely

Garry L. Moody

Global Asset Management Leader
Deloitte Touche Tohmatsu

Executive summary

The asset management industry continues to face fundamental changes that have been transforming the competitive landscape over the last several years.

The **Global Asset Management Industry Outlook 2007** examines the impact of these trends both on “traditional” asset management firms – whether subsidiaries of banks, securities firms, or insurance companies, or stand-alone entities – and on “alternative” investment firms – such as hedge funds and private equity. These vehicles are growing rapidly as both institutional and individual investors are allocating an increasing percentage of their portfolios to them in their search for higher returns and strategy diversification.

Meanwhile, serving the corporate pension market is changing as companies continue the transition from offering defined benefit to defined contribution plans. The race to create new products to serve this market is underway, with lifecycle funds one popular choice. The search for products that would appeal to the growing pools of individual investors led the **Financial Times** and ABN Amro to design a competition for readers to dream up “the financial product or service of the future.”¹

The demographic shifts in developed economies that are driving these changes are having important impacts on asset managers. The baby-boom generation, which is just beginning to retire, will be drawing down their pension plans. And in both North America and Western Europe, the departure of baby boomers from the workforce is igniting a battle among asset management firms to attract and train talented professionals from the new – and stylistically different – generation now entering the work force.

In the midst of all these developments, some financial services institutions have re-examined the role of asset management in their strategies. In 2006, Merrill Lynch sold Merrill Lynch Investment Managers to BlackRock, with Merrill taking a 49.8% stake in the company.² In 2005, Citigroup exchanged its asset management unit, Citigroup Asset Management, with Legg Mason in exchange for its retail brokerage unit.³ At the end of 2005, UBS AG sold investment manager GAM to the banking firm Julius Baer.⁴ It is possible that other diversified firms may follow suit.

But at the same time, in 2006 some major banks increased their commitment to asset management. In December 2006, Bank of New York and Mellon merged in a \$16.5 billion deal that created one of the top ten asset management firms globally.⁵

Traditional firms have also added to their alternative investment capabilities. For example, in July 2006, State Street Global Advisors, one of the world’s largest institutional money managers, undertook a major expansion of its alternative strategies lineup by launching additional hedge funds beyond its traditional long/short funds.⁶

The member firms of Deloitte Touche Tohmatsu believe asset managers should pay special attention in 2007 to the following five key issues.

1. The challenge posed by the shift to corporate defined contribution plans. The continuing shift of retirement assets from corporate defined benefit to defined contribution plans is creating a new competitive landscape. To be successful, traditional asset management firms will need to respond to the needs of individual plan participants for financial information and advice, while working to create innovative products appropriate for less knowledgeable investors.

2. Alternative investments undergo growing pains. Assets continue to flood into hedge funds and private equity funds, and increasingly these come from institutional investors, which demand much greater transparency. In addition, some hedge funds will need to respond to investor concerns that their risk management processes may not be strong enough to handle the risks they have assumed.

3. Ensuring data security and privacy. Traditional asset management firms are gathering more confidential customer information than ever before. They face the significant challenge of safeguarding the privacy and confidentiality of their growing databases of sensitive information.

4. Coming transformation of risk management. In the past, traditional investment management firms focused on market and credit risk, but now they are equally concerned with managing operational and compliance risks. Firms face the challenge of consolidating all the various risk-related issues and initiatives across their organizations to manage their risks more effectively and efficiently.

5. Recruiting the joystick generation. The aging of the workforce in most developed economies, coupled with increasing skill requirements in many industries, has created fierce competition for talented professionals. To successfully recruit the members of the new generation of workers now entering the labor force, asset management firms will need to understand and respond to their distinctive profile and requirements.

The challenge posed by the shift to defined contribution plans

The continuing shift of retirement assets from corporate defined benefit to defined contribution plans has given the institutional retirement market a decidedly retail character. To be successful in serving this market, traditional asset managers will need to respond to the needs of individual participants in their approach to product development, financial advice, and distribution.

While many asset management firms have been managing defined contribution (DC) plans for years, institutional money managers that have specialized in defined benefit (DB) pension plans may find it difficult to make the transition. In addition, asset management firms are increasingly competing with other financial services providers, both to manage assets in DC plans and to capture these assets when participants retire or change jobs.

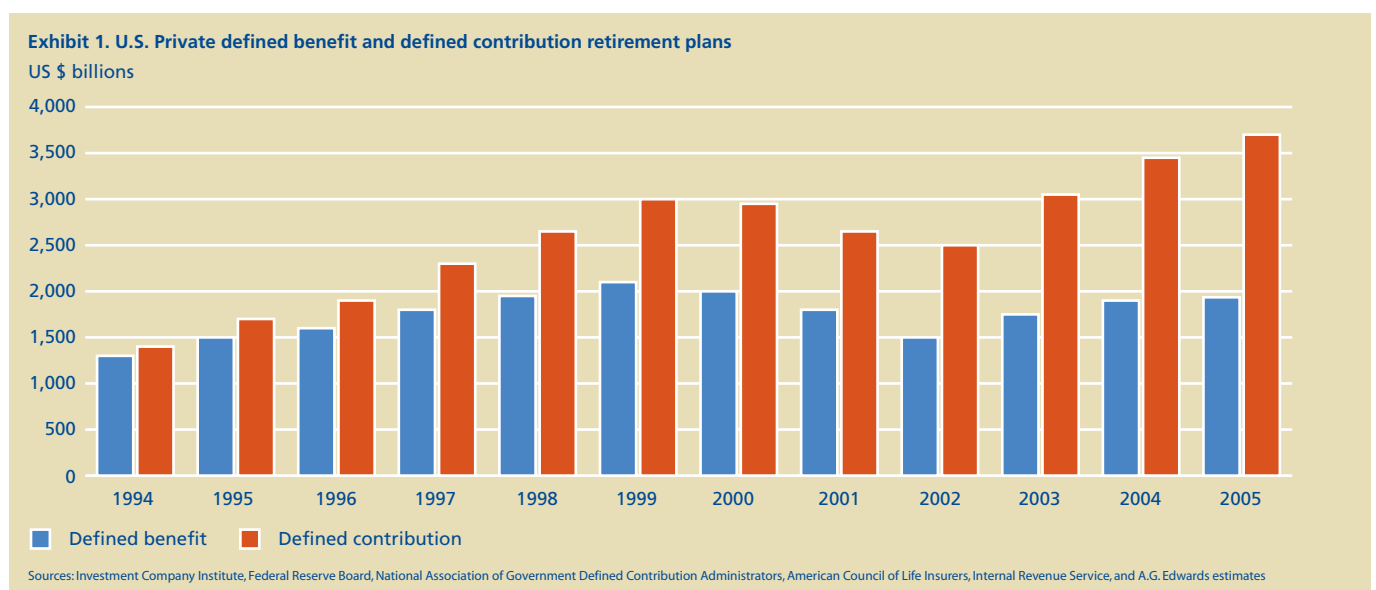
The rise of defined contribution plans

Longer life spans have put enormous pressure on corporate DB plans, driving many of them into insolvency. In December 2006, the *Financial Times* reported that U.S. corporate DB plans were underfunded by an estimated \$450 billion⁷ and the plans of U.K. FTSE 100 companies by roughly £40 billion (\$78.4 billion).⁸ Among the 1,000 largest U.S. companies with DB plans, 18% had frozen at least one of their plans by the end of 2005, according to Watson Wyatt Worldwide.⁹ When U.S. companies file for bankruptcy protection, they typically ask the courts to release them from their pension liabilities. Participants of corporate DB plans are understandably wondering whether their promised benefits will be there when they retire.

The financial problems facing company DB plans have driven a flight to DC plans, in which the individual makes the investment decisions and bears both the risks and rewards. Approximately 30% of the \$14 trillion in total global retirement assets are estimated to be in

DC plans. In the United States, the total assets under management in DC plans rose 164% from 1995 to 2005 to reach \$3.7 trillion – as a result of new investments and appreciation – while the assets in DB plans grew only 40% in the same period to \$1.95 trillion. (See Exhibit 1.) As a result, DC plans now account for roughly two-thirds of the assets in U.S. corporate retirement plans, up from approximately half just ten years ago. In the United States, the Pension Protection Act of 2006 is expected to encourage the further growth of DC plans by creating stricter rules that companies must follow on funding their DB plans and encouraging employers to automatically enroll new employees in DC plans, unless the employees opt out of the plan.

DC plans are becoming more popular in other countries as well. Three-quarters of FTSE 100 companies in the United Kingdom have now closed their DB plans to new members. It is estimated that there were £400 billion (\$784 billion) in DC assets in the United Kingdom in 2005. This figure was roughly half the £800 billion (\$1.568 trillion) in company DB plan assets, but the assets in DC plans are expected to grow. In September 2006, a U.K. government white paper recommended that corporate DC plans be substantially expanded through the creation of personal accounts into which employees would automatically be enrolled, but with the right to opt out. The shape of the program is a topic of active debate.



In Japan, by October 2007, more than ¥200 trillion (\$1.7 trillion) is expected to be removed from the Japanese postal system's government-sponsored and government-guaranteed savings programs and placed in quasi-private accounts. Japanese savers are expected to direct an increasing percentage of their monies to asset classes other than Japanese government bonds, which could create substantial opportunities for asset management firms. Goldman Sachs projected that by year-end 2010, total mutual-fund balances held through the postal system could total over \$60 billion.¹⁰

In December 2005, Korea introduced corporate retirement programs that included a DC component. After one year in operation, these plans had gathered almost \$540 million in assets, although this lagged the original expectations of many analysts. Sweden, the Netherlands, and India are other countries that are considering or introducing retirement plans with a DC component.

The right mix of products

The shift from DB to DC retirement plans has fundamental implications for asset management firms. The continuing shift of assets into DC plans should serve to favor firms that are already active in managing these plans, offering mutual funds or other products targeted to individual investors. The challenge is greater, however, for asset management firms that have specialized in serving the DB market. With more DB plans being frozen, they must decide how to react and whether they can compete for DC assets. Although developing mutual funds is one option, these firms may be dissuaded by the regulatory burdens these products entail. In addition, while collective investment funds, which are less regulated, are gaining popularity, they are still not offered in a significant number of DC plans. Thus, DB specialists need to consider how they can create institutional products that fit into DC plans.

Offering separately-managed accounts is one approach. Popular in DB plans, U.S. 401(k) assets in separately-managed accounts grew 9.5% to \$444.2 billion over 2005, according to Hewitt Associates LLC.¹¹ For DC plans that have enough assets to justify establishing them, these vehicles can slash expenses by avoiding many of the regulatory burdens and fees associated with mutual funds.

But even asset management firms that are already active in managing DC plans are reconsidering the best products to offer to capture these assets. Many firms have focused on providing products that automatically adjust to the financial needs of the individual, rather than depending on individuals to invest wisely. Lifecycle funds, which automatically shift the portfolio allocation as an individual grows older, attempt to do just that. Assets in U.S. lifestyle and lifecycle funds totaled \$167 billion at the end of 2005 and continue to grow. In the United Kingdom, lifestyle funds are the default option in 85% of DC plans, according to **Pensions Week**.¹² Lifecycle funds were also introduced in the Korean market at the end of 2006 by HSBC and Woori Investment & Securities.¹³

A study by ING Investment Management found that 401(k) plan participants who invested in balanced or asset allocation funds were more consistent in outperforming benchmarks since the funds were professionally managed and asset allocations were rebalanced, which most investors don't do.¹⁴ Other variants are a choice of multiple lifestyle strategies, asset-allocation funds that take into account additional factors beyond age, such as the participants' risk tolerance, and funds that provide a predictable annual income stream from its accumulated balance.

In the past, lifestyle and lifecycle funds mainly invested in stocks, bonds, and cash. In a search for higher returns and more diversification, now nearly half of the companies that offer these funds are bringing more asset classes into the mix including real estate investment trusts (REITs), commodities, and emerging-market debt.

"Companies, and their pension consultants, will need to make sure their defined contribution plans offer a wide, diversified range of investment options," says John Hailer, President and CEO of IXIS Asset Management Group, a holding company for investment management firms that in September 2006 managed \$581 billion in assets around the world. "And just as important, plan participants will need sound advice to help them create a portfolio that meets their needs and avoid making bad investment decisions by chasing the latest hot performers."

Becoming a trusted adviser

Many employees enrolled in DC plans are seeking assistance in making investment decisions, and asset management firms realize that they can forge lasting customer relationships by being seen as a source of sound financial advice. In a Forrester survey, U.S. consumers were more likely to consider a financial services firm for their next product purchase if they perceived the firm to be a "customer advocate," that is, doing what's best for its customers and not just for the firm's bottom line.¹⁵ Asset management firms that are seen as customer advocates will likely gather more DC assets as participants choose among the many investment options offered.

These firms will also be more likely to retain assets that are withdrawn due to retirement or job changes. For every dollar invested in DC plans in the United States in 2006, Cerulli Associates expected \$0.83 to be withdrawn due to retirement or job changes. Retaining these rollover assets will be a formidable challenge. A 2004 analysis found that 77% of assets rolled over into IRAs in the United States were invested with a different company than the one that managed their 401(k) plan.¹⁶ For investment management firms to improve those odds will depend in large part on their success in becoming trusted financial advisers and establishing relationships with the individual plan participants, in addition to the DC plan sponsor.

Although there had been restrictions on providing advice, the Pension Protection Act of 2006 explicitly permits firms managing 401(k) plans to directly offer investment advice to participants. However, it is unclear how much impact this change will have since many managers of 401(k) plans already offer advice through branded programs run by independent firms, such as GuidedChoice Inc. and Financial Engines Inc. These programs are often offered online to reduce cost, and the new law requires computerized advisory programs offered directly by 401(k) managers to be validated by a third party. Yet, a number of firms believe they can benefit from directly providing advice and are rolling out advisory services for 401(k) plan participants.

One area of potential conflict is company stock in a 401(k) plan. Investment management firms need to ensure they are providing disinterested financial advice and not encourage participants to invest too heavily in company stock. Advice providers handle this issue in a number of ways, such as reallocating around company stock shares, tilting recommendations, or allowing workers to keep a maximum of between 15% and 20% in company stock, if it matches their risk tolerance.

New competitors at the gate

While an asset management firm managing a DB plan faced no competition for the plan's assets when additional contributions were made to the plan, DC plans typically offer participants a range of investment options, usually from several firms (i.e., unbundled). Thus, for a provider of a DC plan's investment option, there is an ongoing competition for existing assets within the plan, as well as for new contributions.

In an effort to save money, some employers in the United States are turning to low-cost investment vehicles known as "collective investment funds," which are typically offered by banks, trust companies, and other financial-services firms. These funds aren't regulated and are available only to qualified retirement plans, like 401(k)s. (Collective investment funds in the United States retirement market are distinct from Collective Investments in Transferable Securities (UCITS), which are European mutual funds.)

A primary rationale of employers for moving to collective funds is cost. Collective funds do not need to pay for retail distribution, and their investors generally buy and hold for the long term, driving down transaction expenses. And unlike retail mutual funds, collective funds offer a sliding fee scale, with larger plans receiving lower fees. It is estimated that DC plans can reduce their costs by 30% to 50% by switching to collective funds.¹⁷

Traditional asset management firms are also increasingly competing with insurance companies, both to manage DC plan assets and to capture these assets when they are rolled over. Insurance companies see opportunities to penetrate the retirement market by offering variable annuities, which provide a guaranteed income stream, appealing to investors with a lower risk appetite. An international survey in 2006 by Hartford Financial Services Group found that a guaranteed income in retirement was considered extremely or very important by 77% of those surveyed in Japan, 58% in the United States, and 48% in the United Kingdom.¹⁸

Many insurance companies are repositioning their offerings as "retirement services" to capture investment dollars and seeking to change a perception that their products are complex and expensive. For example, both Prudential Retirement and John Hancock Life Insurance Company have introduced retirement products that combine a guaranteed income stream with the ability to choose an investment style and benefit from a rising market.¹⁹ Insurers are also developing annuities that can be offered through 401(k) plans.

The competitive environment for corporate retirement plans continues to undergo a fundamental transformation. Traditional asset management firms, especially institutional money managers that have concentrated on the DB market, will need to respond to these new realities by providing the sound financial advice and innovative products needed to build long-term relationships with DC plan participants. Asset managers serving this market will need the flexibility to adjust their approach or plan participants will move their assets to firms that better meet their needs.

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Alternative investments undergo growing pains

With assets under management in hedge funds, private equity funds, and other alternative investment vehicles exploding, they are coming under much greater scrutiny. Traditionally nimble, entrepreneurial operations, hedge funds and private equity firms are now facing some of the same operational and compliance challenges as traditional asset management companies. In particular, their success in gathering assets is leading both institutional investors and regulators to take a much closer look at their activities.

Alternative investments growing rapidly

JPMorgan research estimated the total size of the global assets in alternative investments to be \$3 trillion in September 2006, including investments in hedge funds, private equity firms, real estate, and commodity funds. (See Exhibit 2).²⁰ Investments in alternative vehicles have been growing rapidly, at an estimated average rate of 19% in recent years.

Many of these new assets have flowed into hedge funds. By September 2006, more than 9,000 hedge funds managed an estimated \$1.2 trillion. Yet, as recently as 2000, there were less than 4,000 funds with \$490 billion in assets. Hedge funds are also pursuing new strategies. More hedge funds are expanding internationally, buying distressed debt, originating loans directly, or entering private equity.

Perhaps as a result of so much money searching for investment opportunities, however, the compound annual return for Hedge Fund Research's index has dropped from 18.3% in the 1990s,

to only 7.5% since 2000.²¹ Given these lower returns, some wonder whether assets will begin to shift back to traditional investment vehicles.

The private-equity industry has also skyrocketed to become a major factor in the global economy. In the second half of 2006, there were more than 2,700 private equity firms worldwide managing an estimated \$900 billion, according to JPMorgan.²² A 2006 analysis by the British Venture Capital Association found that 19% of the U.K. private sector workforce was employed by firms that had received private equity funding.²³

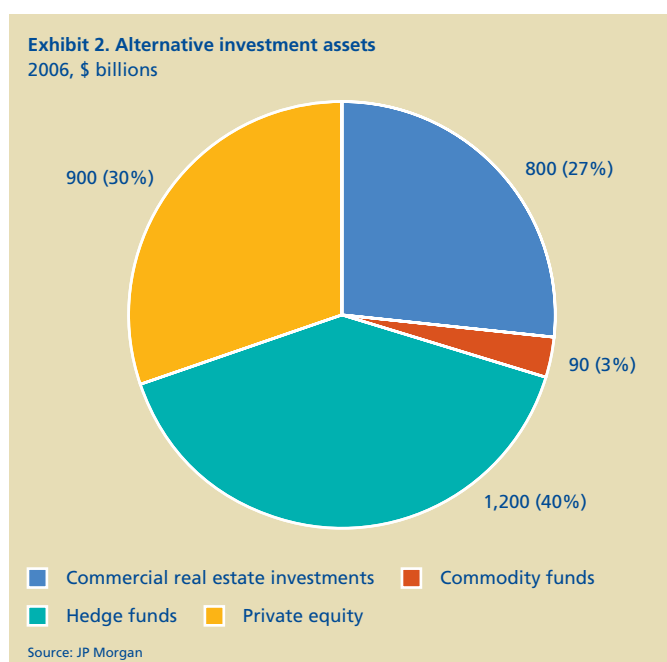
Recently, some alternative investment managers have begun to list on the public markets. In 2006, BlueBay Asset Management, Ashmore, and Charlemagne Capital all listed on the London Stock Exchange.²⁴ In the United States, Fortress became the first U.S. hedge fund to go public, floating its shares on the New York Stock Exchange.²⁵

Meanwhile, alternative asset managers are also listing individual funds, rather than the management firms themselves, on the Amsterdam's Euronext exchange. In 2006, the private equity firm Kohlberg Kravis Roberts listed a \$5.5 billion fund on Euronext, while Marshall Wace, a hedge fund manager, raised \$2 billion by listing one of its funds on the exchange.²⁶ Although listing on the public markets raises the level of regulatory scrutiny and required disclosure, more alternative asset management firms have been attracted by the possibility of raising a pool of capital that they can invest without concern about redemption.

Institutional investors call for increased transparency and improved risk management

Institutional investors now are much larger investors in alternative vehicles, and they bring much greater demands for information and disclosure. An estimated 50% to 60% of hedge fund assets now come from institutions, according to Credit Suisse/Tremont Index.²⁷ A 2006 survey by State Street Corp. found that 84% of institutional investors had invested in hedge funds.²⁸ Even more pension fund assets could flow into U.S.-domiciled hedge funds as a result of the U.S. 2006 Pension Protection Act, which will no longer require hedge funds to count public employee or foreign pension plan assets towards the threshold of 25% that requires them to be considered a fiduciary under the Employee Retirement Income Security Act (ERISA).

Exhibit 2. Alternative investment assets
2006, \$ billions



Private equity funds have also seen an influx of institutional money. Pension funds are estimated by *Forbes* to contribute 40% of the total assets in private equity funds, with a number of pension plans reported to have between 10% and 20% of their assets invested in these vehicles.²⁹

A 2006 survey by Russell Research found that European and Japanese pension funds and insurance companies plan to increase their exposure to private equity to approach U.S. levels. The survey found that U.S. institutional investors allocated an average of 7.5% of assets to private equity, compared to 4% in Europe and 2.5% in Japan.³⁰

Institutional investors are expecting greater transparency from hedge funds and private equity firms, requesting more timely, accurate information on investment positions and valuations. In the past, these alternative vehicles have provided much less information and provided it much more slowly, than traditional investments, such as stocks, bonds, and separately-managed accounts. In part, this has been due to a concern that they not publicly reveal their strategies.

Another difficulty for hedge fund managers is that a hedge fund's investments can be in complex instruments that are thinly-traded and difficult to value. Placing a value on a private equity stake in a company is even more a matter of judgment. Institutional investors are expecting alternative investment firms to provide detailed descriptions of their valuation policies and how they address these issues. A 2006 Deloitte Research survey of 60 hedge fund advisers from around the world found little uniformity in how complex or illiquid assets were valued. This lack of uniform accepted pricing methodologies underscores the need for the review of pricing methodologies by independent third parties. Yet, only 47% of the hedge fund advisers surveyed by Deloitte Research reported that they engaged a third party to provide independent pricing validation.

The demand for more information has been especially great from U.S. public pension funds, which have been criticized for allocating assets to alternative vehicles that are not subject to the transparency and liquidity requirements of registered mutual funds or public stocks and bonds. In some cases, hedge funds have reportedly declined to accept new investments and have returned previous investments from certain public pension funds due to the additional disclosure required.

In Japan, many regional banks have invested in alternative investment funds and, as a result of Basel II, they require significantly more information on these products. Hedge funds and private equity firms will need to develop new approaches that allow them to provide the timely information demanded by institutional investors, without revealing their investment strategies and losing their competitive advantage.

Many hedge funds will also need to strengthen risk management. Deloitte Research's hedge fund survey identified a series of "red flags" – risk management "best practices" that were not being followed by as many as half the hedge fund advisers surveyed. These red flags include trading limits, stress testing, liquidity analysis,

backtesting, and an understanding of leverage. When a hedge fund adviser encounters one of these red flags, they should examine their risk management procedures and determine whether they are truly appropriate given the risks they have assumed or whether, in fact, they need to be strengthened. (For more information about Deloitte Research's survey of hedge fund advisers, please see the report, **Precautions that Pay Off: Risk Management and Valuation Practices in the Global Hedge Fund Industry.**)

Regulatory scrutiny

Regulatory authorities around the world are also increasing their focus on alternative investments, especially hedge funds. In 2006, the G8 decided to place the issue of improving hedge fund transparency on its agenda for 2007.³¹

Regulatory authorities have been concerned that less affluent individuals, who may not understand their risks, are also now investing in hedge funds, usually in funds of hedge funds. In June 2006, a new U.S. Securities and Exchange Commission (SEC) regulation that would have resulted in the registration of many hedge fund advisers was overturned by the U.S. Court of Appeals for the District of Columbia Circuit in Washington. However, more than 2,400 hedge fund advisers with aggregate assets of more than \$2.4 billion have already registered with the SEC, according to a survey by the Investment Adviser Association and National Regulatory Services.³² Many are expected to keep their registration, partly because it is helpful in attracting investment from institutional clients such as pension plans.

More attention to hedge funds from the SEC may be coming. In July 2006 testimony at a U.S. Senate banking committee hearing, Christopher Cox, SEC chairman, called the agency's current regulatory regime for hedge funds "inadequate" and proposed additional measures, including an anti-fraud rule that would clearly state that hedge fund advisers have a fiduciary obligation to investors.³³

In stark contrast to the United States, all hedge funds in the United Kingdom must receive authorization to operate from the Financial Services Authority (FSA). The registration process can take up to six months, and requires the disclosure of detailed information on everything from the firm's compliance systems to its risk controls. They also are required to set aside up to 13 weeks of expenses as regulatory capital.

The FSA recently stepped up its scrutiny of the 30 largest hedge fund managers, which control roughly half the U.K. hedge fund assets under management and approximately 10% of global hedge fund assets. These larger funds are subject to more detailed supervision of their systems, their procedures for managing conflicts of interest, and their regulatory compliance.

In Ireland, hedge funds can be established as what are known as Qualifying Investor Funds (QIF). All investment and borrowing restrictions that apply to non-UCITS funds are automatically waived in the case of a QIF. To qualify, however, a QIF must meet tests relating to minimum subscriptions and the net worth of investors.

In the Cayman Islands, the largest domicile for offshore alternative investment vehicles, the Cayman Islands Monetary Authority has worked to streamline the monitoring of the over 10,000 offshore funds registered there. It has implemented an e-reporting filing requirement, which took effect in January 2007, which requires the operators of funds to submit certain quantitative and qualitative information on an annual basis. This will augment the previous annual filing requirement of submission of audited financial statements. Cayman laws also have strict minimum investment requirements, which effectively limit investors in such products to institutions and high-net-worth individuals.

The European Union's new Capital Requirements Directive, which was expected to come into effect at the start of 2007, will apply to all financial services companies including hedge fund managers. Under the provisions of Article 152(8), however, institutions have the option of continuing to use many of the provisions of the existing Directives until December 31, 2007. Under the new requirements, the ability to identify and manage operational and balance sheet risks will be directly linked to the amount of capital that firms will have to set aside. Firms' control and assessment processes will be subject to reviews by local regulators.

The rating agencies have also taken steps to assess the risks facing hedge funds. In September 2006, Moody's Investors Service published its first public ratings on the operational risk of individual hedge funds – assessing how well the funds manage a variety of risks including fraud, security breaches, and information systems breakdowns.³⁴ (Managing operational and compliance risk is also an important issue for traditional asset managers, as discussed in the "Coming Transformation of Risk Management" section in this report.)

New focus on operations

As alternative investment vehicles have grown into major financial institutions, they are now addressing many traditional operational issues. Spurred in part by lower returns, one goal is to become more efficient. Smaller hedge funds have traditionally outsourced back-office operations to a third party that is familiar with their complex strategies, usually to either a single prime broker or a hedge fund administrator.

But now some larger hedge funds are bringing more operations back in house. One reason is that larger hedge funds are increasingly using several prime brokers as a way to negotiate lower fees. To gain an integrated view of portfolio accounting, allocation, profit and loss, and return, some of these larger hedge funds are now consolidating this information in their own portfolio accounting systems. Bringing this information in house is also important for risk management, e.g., to assess the exposure to a single company or country. Some larger hedge funds are also handling fund administration internally to gain more timely access to information. While third-party fund administrators provide information that is a day or two after the fact, by handling these functions themselves, hedge funds can gain immediate access.



With more demanding institutional investors, increased scrutiny from regulatory authorities, and a new focus on operational issues and succession planning, hedge funds and private equity firms may become far different organizations over the next few years. The challenge will be to manage growth and meet new requirements for transparency while retaining the flexibility that made them so successful.

Ensuring data security and privacy

Asset management firms need to safeguard confidential customer data at a time when identity theft and other forms of cyber-crime are prevalent. Making the challenge more difficult, firms now gather more personal information from their customers than before, both to comply with more stringent anti-money laundering regulations and to gain deeper insight into their customers. But as they collect and integrate ever more customer information of a confidential nature, asset management firms need to ensure their data security programs keep pace.

Increasing threats

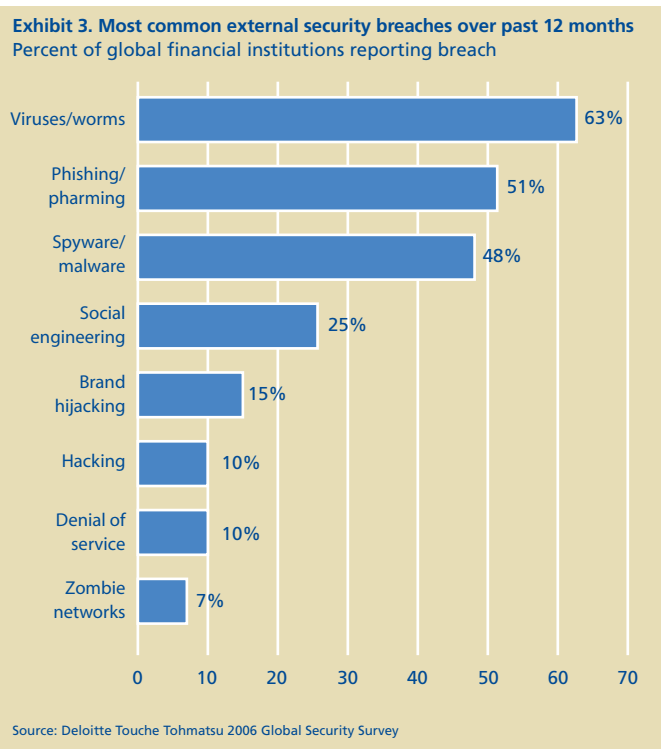
The rise of computer crime has spurred an increased focus on data security. Recent breaches suggest that financially motivated attacks are increasing, and the criminal profile is shifting from amateur hackers to well-funded organized crime rings. In particular, identity theft is on the rise because of groups that use stolen personal information to open fake credit-card accounts and commit other forms of financial fraud.

In its 2006 global security survey, Deloitte Touche Tohmatsu found that 82% of leading financial services institutions surveyed had experienced a breach in the preceding 12 months. Many breaches were purposeful, targeted acts such as “phishing” or “pharming,” in which individuals are tricked into disclosing credit card numbers, passwords, or other confidential information. (See Exhibit 3.) When asked to name their top security priorities, 58% of the institutions surveyed cited combating identity theft and account fraud.³⁵

The dramatic increase in the use of laptops and of handheld devices, such as the Blackberry and the Treo, puts enterprises at significant risk if the equipment is lost or stolen. Several high-profile data leaks involving financial services institutions have taken place over the last few years when laptops containing personal information – names, addresses, account numbers, and in some cases social security numbers – were stolen. When computer equipment was stolen from the home of a U.S. Department of Veterans Affairs analyst, 26 million people were affected. In another case, several of the largest banks in the United States had to reissue thousands of bank cards after confidential information, including personal identification numbers, were stolen from a retail chain.

Laptops are a particularly weak link in the storage of personal information at companies. Privacy Rights Clearinghouse, a consumer group, counted at least 46 instances of laptops containing sensitive information having been reported stolen or missing over a 16-month period.³⁶

Missing laptops illustrate the conflicts between the demands of a mobile society – travel to clients, frequent off-site meetings, working from home – and the need to protect personal information. These incidents also highlight a paradox in corporate IT security, where elaborate measures are taken to protect networks from penetration, but a data-laden laptop can just walk out the door.



The anti-money laundering conundrum

Concerns about crime and terrorism have led to stricter anti-money laundering (AML) and counter-terrorism financing (CTF) regulations in many countries. The proliferation of AML/CTF legislation and regulation across the globe in recent years presents significant operational and regulatory challenges to the global asset management industry. Notwithstanding the data security and privacy consideration discussed above, the breadth and multi-jurisdictional nature of the AML/CTF reforms require stringent attention to manage risk. The global nature of asset management means that a firm based in Australia may book a trade in Singapore for a client in Japan. This means an asset management firm may be subject to several distinct AML/CTF regulations for a single transaction.

Global firms also face the challenge posed by the proliferation of terrorist name checking obligations. Individual jurisdictions may use the lists as a tool of foreign policy and great care is needed to ensure that the processes and technology meet all these requirements.

The USA PATRIOT Act of 2001 calls for mutual funds to develop and maintain AML programs that are operational and effective. Mutual funds conduct shareholder transaction operations through separate entities, which may or may not be affiliated, and some elements of the AML compliance program will best be performed by personnel of these separate entities. Regulations allow a mutual fund to contractually delegate the implementation and operation of its AML program to a service provider, such as a transfer agent. However, the compliance responsibility remains with the mutual fund and careful oversight of these affiliates is essential. Mutual funds should adopt a risk-based approach when developing their AML program to counter money laundering and terrorist financing.

The USA PATRIOT Act requires mutual funds in the United States to file Suspicious Activity Reports (SARs) to flag suspect transactions in accounts with an aggregate amount of \$5,000 or more within 30 calendar days. The content of SARs is also becoming more complex as U.S. regulators demand more information.

In addition to U.S. legislation, there is growing concern about AML in Europe and the Asia-Pacific region. Both traditional and alternative asset management firms will have to comply with the EU's Third Anti-Money Laundering Directive, which also requires institutions to follow a risk-sensitive approach. The EU Directive requires that "customer due diligence" is undertaken when a "business relationship" is formed with a customer rather than when a single transaction or series of transactions breaches a specific amount. The Directive also introduces a requirement for ongoing due diligence in relation to customers including scrutiny of transactions undertaken throughout the course of the business relationship. In particular, large, complex, and unusual transactions or unusual patterns of transactions must be monitored closely.

Although the identity and business profile of all customers should be established, the Directive requires all firms to exercise enhanced customer due diligence in circumstances that pose a higher risk of money laundering. This is particularly true of business relationships with individuals holding, or having held, important public positions, particularly those from countries where corruption is widespread, or where the customer is not present when the business relationship is established. Institutions and persons covered by the Directive must establish adequate and appropriate policies and procedures designed to prevent operations related to money laundering or terrorist financing. In addition, they are required to institute ongoing training programs to help employees recognize money laundering.

Expenditures on AML systems to comply with these regulations are substantial. Global spending on AML software across all types of financial institutions was estimated at \$335 million in 2006, and expected to grow at almost 6% a year through 2009, according to Celent.³⁷

Asset management firms will need to ensure they gather and analyze all the information needed to comply with applicable AML regulations in the jurisdictions where they operate, while at the same time satisfying diverse and sometimes conflicting privacy requirements. One concern is the potential that a firm could violate more stringent privacy requirements in Europe and Japan if they provide the U.S. government with requested financial records. For example, Japan's Financial Services Authority requires asset management firms to obtain the consent of an investor before their information is transferred from their Japanese subsidiary to their offices in other countries. The difference in privacy standards was underscored at the end of 2006 when an EU panel ruled that the bank consortium, SWIFT (the Society for Worldwide Interbank Financial Telecommunications), had violated data protection rules when it provided the U.S. government with records of private financial transactions as part of U.S. anti-terrorism efforts.³⁸

Safeguarding customer data

One of the first steps to improve security is to implement "best practices" around password and identity management, with technology as a key enabler. Electronic messages, such as e-mail, can be encrypted, so they can be read only with a special pass-code or key. If a laptop merely has a password, an intruder can harvest personal data directly from the computer's hard drive with relative ease. In the case of the recent laptop thefts, most of the information was not encrypted.

While surveys show that more than 60% of large companies use some form of encryption software on laptops, it is typically installed only on computers used by employees at the highest levels, like the chief executive officer and chief financial officer. Many companies appear to be focusing their security efforts on systems and networks, but failing to adequately address the problems posed by mobility of today's executives.

According to an analysis by IDC, in 2005 U.S. corporations spent \$12 billion on information security, including anti-virus and anti-spyware software and systems to authenticate users. But they spent less than \$100 million on encryption software for laptops and desktops.³⁹ Encrypting data is especially important since many states require companies to alert their customers in the event of a data security breach, an embarrassment that any asset management firm would like to avoid.

But data security is more about people and business processes than it is about technology. While tools like encryption can serve as a "first line of defense," asset management firms need strong computer usage policies and a code of ethics that is enforced and continually updated to respond to evolving computer threats. Firms will be hard pressed to anticipate the next security breach amid the ever-changing nature of today's threats. But those threats can be mitigated by building a control environment that actively educates and engages all employees.

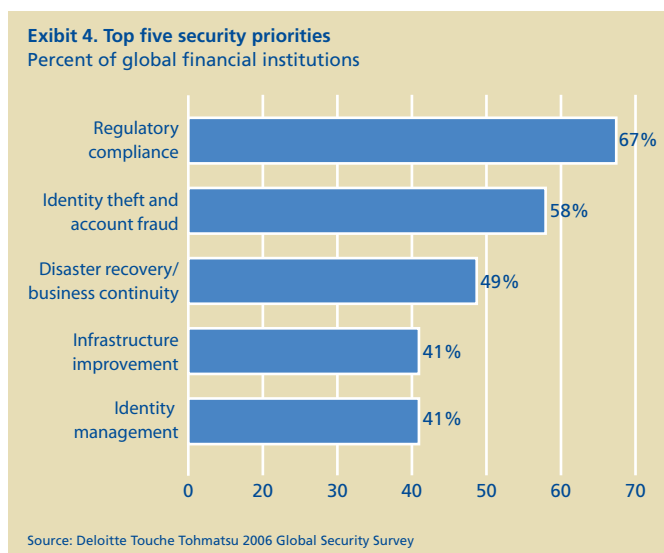
Coming transformation of risk management

While they have long been focused on risks, such as market, liquidity, portfolio, counterparty, and credit risk, traditional asset management firms are now equally concerned with managing operational and compliance risk. In the past, operational risk had been a somewhat vague concept, which was always "someone else's problem." But after a series of high-profile events – including allegations of market timing and late trading – and the responses by regulators, operational and compliance risks have become a primary focus for the industry.

Asset management firms that are subsidiaries of banks, securities firms, or insurance companies are typically farther along in taking the steps necessary to manage operational risk due to regulatory developments affecting these industries. (The additional risk management challenges facing hedge funds are discussed in the section of this report, "Alternative Investments Undergo Growing Pains.") Now operational risk is equally a concern of traditional stand-alone asset management firms. Firms that improve their management of operational risk – and achieve an integrated view of all the risks they face – will be better positioned to thrive in an increasingly uncertain global business environment.

Tighter regulatory risk requirements

In addition to the direct financial impact from operational and compliance risks, firms can also face significant fines from the regulators. One major securities firm was fined \$250 million in 2006 for illegally helping hedge funds and other customers trade mutual fund shares. That came just months after the Federal Reserve Board and other regulators fined a global financial services institution a total of \$80 million for violations of anti-money-laundering rules for not properly reporting suspicious transactions.⁴⁰ Regulatory compliance is one of the top concerns for financial institutions, including asset managers. (See Exhibit 4.)



Banks, securities firms, and insurance companies that have asset-management businesses have been focusing on operational risk over the last few years as a result of the attention placed on this issue by regulators. The focus on operational risk among financial institutions was spurred by the new Basel Capital Accord (Basel II), which recommended requiring banks to assess their susceptibility to risks of all kinds, including operational risks, and set aside an appropriate amount of capital. Basel II took effect in January 2007 in Europe with the implementation of the Capital Requirements Directive and applies to all credit institutions and investment firms as defined in the Markets in Financial Instruments Directive (MiFID). (However, institutions have the option of continuing to use many of the provisions of the existing Directives until the end of 2007.) Basel II becomes effective in the United States in 2009 for the largest institutions, but many U.S. banks are implementing operational risk management programs even before the rules are finalized to stay competitive with their European counterparts.

Basel II will most likely set the standard for operational risk management for other financial institutions as well. The SEC's consolidated supervised entity framework that was finalized in 2004 for major independent securities firms in the United States incorporated significant elements of Basel II. The EU Commission's Solvency II directive for insurance companies, expected to be published in draft form in 2007, will establish rules for risk-adjusted capital that were inspired by Basel II.

Increasing focus on operational and compliance risk

In addition to these regulatory developments affecting asset management firms that are subsidiaries of banks, securities firms, or insurance companies, operational and compliance risk has become a top priority for traditional stand-alone asset management firms as well. There have been a variety of drivers leading to this increased focus, including the publication of the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") Enterprise Risk Management Framework, the growing trend of establishing and utilizing internal audit groups within asset management firms, Sarbanes Oxley requirements regarding the evaluation of internal controls, and the adoption of the SEC's Compliance Program Rules. One specific catalyst was the SEC's investigations of highly publicized cases of market timing, late trading, and other questionable practices in the United States. In response to the scandals, the SEC implemented a series of regulatory changes,

including the Compliance Program Rules, which require all registered advisers to have written compliance policies and procedures. These compliance policies and procedures must be regularly tested and evaluated, and the scope and depth of such testing should be based upon an asset manager's own risk assessment. In 2006, Japan's FSA also took action against a number of traditional asset management firms for alleged violations such as illegal trading and attempting to hide losses.

Beyond the response of regulators, the negative publicity generated by these practices underscored for asset management firms the potential damage to their reputation from operational and compliance risks. With the pace of globalization quickening, the increase in electronic trading, new distribution relationships, and the increasing popularity of alternative investments, asset management firms are realizing the importance of implementing state-of-the-art risk management controls. In addition, the trend to outsource more operations to offshore vendors inevitably increases the potential for operational risks from geopolitical events, natural disasters, or theft of intellectual property, among other dangers.

Asset management firms that implement state-of-the-art operational risk management tools will not only be better equipped to meet regulatory expectations, they may also have a positive impact on investor confidence and create a more secure environment both for clients and for asset managers themselves.

Managing operational risk is especially complex, because the threats are so varied, ranging from rogue traders to computer hackers. As Joseph Sabatini, managing director of corporate operational risk at JPMorgan Chase & Co., told **Securities Industry News**, operational risk "involves everything from senior business decisions down to mundane business applications. And unlike credit and market risk, there's no single cockpit of risk expertise. You don't have the ability to have all the experts in a room together."⁴¹ The challenge for asset management firms is to integrate these individual perspectives to gain a comprehensive view of risk.

Achieving risk intelligence

Too often in the past, traditional asset management firms have responded piecemeal to each new rule or risk management concern by establishing a separate committee or initiative. The lack of coordination has resulted in significant inefficiencies; for example the same controls may be tested for compliance with Sarbanes-Oxley internal control requirements and also evaluated for the report by the chief compliance officer. Even more troubling, the lack of integration leaves firms without a consolidated picture of all the risks they face. "Whilst regulators have focused the industry on frameworks, management needs a clear and concise view of the impact of their decisions in line with the risk appetite that has been communicated by the Board," says Mr. Basil Foulkes, General Manager Risk Management, of MLC (the wealth management company of National Australia Bank). "This can only be achieved through taking an integrated view across the full range of operational, financial, and strategic risks faced by the business."

Asset management firms will need to take a comprehensive approach to identifying and managing all their risks, in other words, any event that can adversely affect the achievement of their objectives. This approach should identify both risks that a negative event will occur (such as a hacker stealing customer data), but also the risk that the firm will fail to generate business value (for example by successfully integrating an acquired company).

Organizations that achieve this level of risk management can be considered **Risk Intelligent Enterprises**. (The concept of the Risk Intelligent enterprise is described in detail in the Deloitte report, **Risk Intelligence in the Age of Global Uncertainty: Prudent Preparedness for Multiple Threats**.) Each firm will face unique business challenges and bring special competencies and capabilities. But every Risk Intelligent Enterprise will share similar characteristics, including the following:

- Encompass the entire business in risk management planning, creating connections between the so-called "silos" that often arise within large organizations.
- Address the full spectrum of risks, including market, credit, compliance, competitive, environmental, security, privacy, business continuity, strategic, reporting, and operational.
- Augment the conventional emphasis on probability by placing significant weight on vulnerability.
- Take into account risk scenarios and the interaction of multiple risks, rather than focusing solely on single events.
- Infuse risk management into the corporate culture, so that strategy and decision-making evolve out of a risk-informed process, instead of having risk considerations imposed after the fact.
- Focus on risk-taking as a means to value creation, rather than only on risk avoidance.

Asset management firms that achieve risk intelligence will be far better prepared to withstand the inevitable gusts that are sure to buffet financial services firms in the years ahead, whether from operational problems, market events, or business interruptions. But even more importantly, asset management firms that can adopt this more expansive approach to risk management may be better positioned to prosper by understanding both the risks and rewards as they chart their business strategy.

Recruiting the joystick generation

The aging of the workforce in most developed economies, coupled with increasing skill requirements in many industries, has created fierce competition for the talented professionals on which asset management firms depend. A key battleground is the fight to recruit the new generation of workers now entering the labor force. To prevail, asset management firms will need to understand – and respond to – the distinctive profile and requirements of Gen Y (those born from 1982 to 1993).

Passing the baton

The aging of the workforce in most developed economies creates the specter of emerging labor shortages, especially for skilled professionals. According to the U.S. Bureau of Labor Statistics, between 2002 and 2012, growth in available workers aged 16 to 44 will lag that of workers aged 45 and older across all industries. Labor shortages will be aggravated by the impending retirement of workers in the baby-boom generation and older workers among the so-called veteran generation. Although the trend to offshore operations to emerging markets may help, it is unlikely to eliminate the problem.

The retirement of baby boomers, which has just begun, means that companies will lose large numbers of experienced workers over a short period. Given the much smaller size of the generation following them, asset management firms could face a serious loss of institutional knowledge. By 2010, two U.S. workers could be leaving the workforce for each new employee entering. In fact, RHR International, a consulting firm, estimates that America's largest companies will need to replace half their senior managers over the next five years.⁴²

The populations in other developed economies are also aging, in some cases even more rapidly. While the United Nations expects that 22% of the U.S. population will be 60 years of age or older by 2020 (under its "medium variant" scenario), that figure is expected

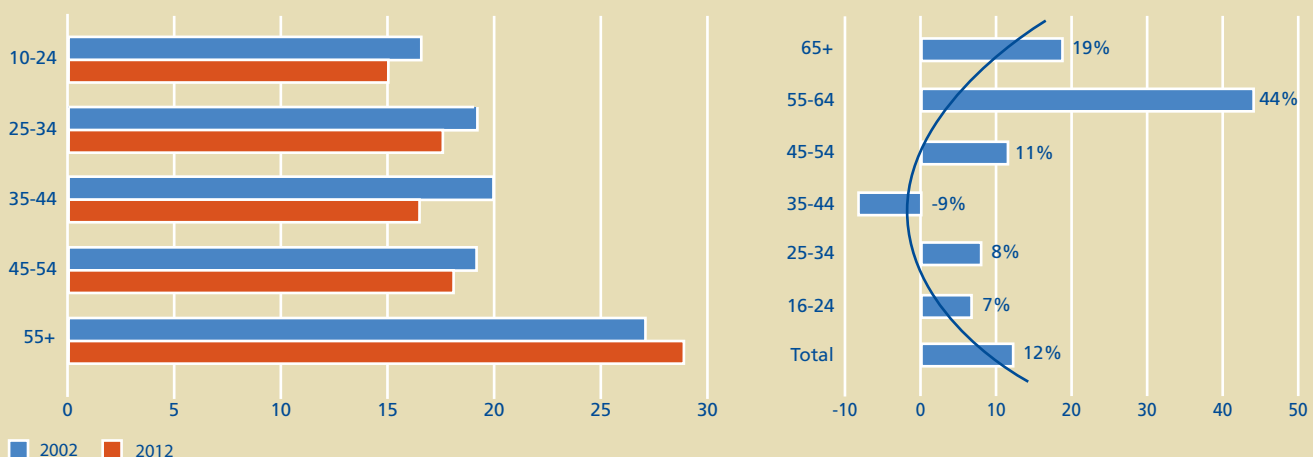
to be 29.2% in Germany and 33.9% in Japan.⁴³ Even China will see its population age rapidly, driven by its one-family, one-child policy. The percentage of China's population aged 60 and older is expected to increase by more than 56% in just 15 years to reach 17.1% by 2020, not that far behind the percentage in the United States.

Competition for talented workers in the developed economies will only increase as the population ages, and the battle for the most talented college graduates is already intense. Unemployment among U.S. college graduates has been estimated to be just 2%.⁴⁴

With business volumes expanding, asset management and other financial services firms will need to become more creative in recruiting. Some firms are deciding to hire cheaper Gen Y college graduates, rather than MBAs. Firms are also casting a broader net. Almost half the entry-level employees joining Lehman Brothers and JPMorgan Chase are now liberal arts graduates, rather than business majors.⁴⁵

Whatever the educational backgrounds of new recruits, asset management firms will need to provide more training than before to prepare recruits for dealing with ever more complex portfolios of products and to provide financial advice. In particular, firms will be seeking individuals ready to learn the intricacies of the alternative investment products that are gaining in popularity.

Exhibit 5. U.S. percentage change in workforce by age group 2002-2012
Percent of global financial institutions



Source: Bureau of Labor Statistics

The distinctive profile of Gen Y

To be successful in attracting and retaining the talented workers they need, asset management firms will need to understand the unique attitudes and needs of the new generation of workers entering the labor force. Currently, the approximately 75 million members of Gen Y constitute an estimated 10% of the U.S. labor pool, and are the largest group after the roughly 80 million baby boomers. (See Exhibit 5.) In fact, these younger workers also bring a unique perspective on how to sell to their baby boomer parents nearing retirement.

More than previous generations, Gen Y workers balance idealism with pragmatism and demand flexibility and respect. Specifically, they tend to look for long-term career development, a variety of experiences, and a sense of purpose and meaning in their work.

Having grown up online, technology is second nature. They are networked in a way that no generation has been before, from instant messaging to social networking sites, like MySpace and Facebook.

Maintaining work-life balance is a key concern. A 2006 survey by Universum of more than 37,000 U.S. undergraduates found that their top-rated career goal was to “balance personal and professional life,” while “building a sound financial base” only came in third.⁴⁶

To some extent, Gen Y is the leading edge of changes that are rippling across the entire labor force – a focus on social responsibility, an emphasis on training and professional development, more global connectedness, and a concern over integrating personal interests and

responsibilities with work. But while these issues are increasingly important to older age groups as well, with Gen Y they are considered a top priority.

New HR strategies for a new generation

Asset management firms will need to rethink and retool their work environment and expectations to attract and retain the most talented Gen Y workers. (See Exhibit 6.) To respond to their values and needs, firms will need to address such issues as the following:

- Long-term career development and multiple experiences within a single organization.
- Sense of purpose and meaning in the work.
- Availability and access to mentors and other company champions.
- Work/life flexibility.
- Tech-savvy work environment.
- Open social networks that embrace open/honest communication.

Many companies are working on initiatives to improve work-life balance. For example, Bank of America is reported to have more than 30 initiatives in this area.⁴⁷ To become more attractive as employers, several large securities firms now allow for telecommuting and other virtual work arrangements, and provide flexible health and family benefits, including health club memberships and on-site daycare.

Exhibit 6. How to attract and engage Generation Y

Gen Y workplace needs	Strategies for employers	Gen Y values
Long-term career development and multiple experiences	Enable career planning and mobility, train talent, foster mentoring, cultivate networks	
Sense of purpose/meaning in the work	Enable individual goal development and pursuit, communicate corporate vision, focus on strengths	– Flexibility
Availability and access to mentors and other company champions	Offer formal and informal mentoring approaches that are aligned with strategic aims, engage during education and early in careers	– Balance
Open social networks that embrace honest communication	Create organizational agility, enable networking/mentoring, offer channels for feedback	– Respect
Work/life flexibility	Solicit employee input, create flexible work-spaces/arrangements	– Accessibility
Tech-savvy environment	Employ online recruiting, offer flexibility around media choice, offer gaming simulations as a learning tool	

From Deloitte report “Not your father’s HR”

American Century Investments will pay adoption expenses and even the cost of home fitness equipment for its employees.⁴⁸ European firms, which traditionally have provided more vacation and time off than U.S. firms, may enjoy an advantage in attracting talented younger workers concerned about melding their private and professional lives.

Companies also need to consider their "brand" as an employer, that is, the image that they present to new recruits. This may especially be an issue for financial services firms, including asset management, due to the negative publicity surrounding regulatory violations over the last several years. In addition, traditional asset management firms may face an additional challenge of dispelling the perception that they are less innovative and exciting than alternative asset managers such as hedge funds and private equity. Among the approaches that will be important in this competition to attract the most talented younger workers are offering opportunities for recruits to quickly assume significant responsibilities, resources to develop professional skills, rotational programs, and cross-divisional/cross-generational collaboration. Firms are also employing "high-touch" recruiting, such as mentoring, scholarships, and offering internships to undergraduates to form relationships with future professionals.

Firms are also taking other creative approaches. Merrill Lynch designed a "portfolio challenge" to help it identify young talent for analyst jobs. Across a half-dozen U.S. college campuses, four-person teams of undergraduate business majors battled to generate the biggest returns – using "fantasy funds," rather than real money. Winners were awarded cash prizes and other giveaways, with the finalists garnering coveted places at the top of Merrill's callback list. Along with intensive training and rapid career development, Merrill has found that its initiatives have increased undergraduate recruiting 20% to 25% annually in three years.⁴⁹

Members of Gen Y are proving to be more demanding "consumers" of the work experience, with clear ideas about what they want and ready to jump ship if their expectations aren't met. With increasing competition for talented workers as the labor market tightens, asset management firms will need to rethink their assumptions about the workplace in order to tap the unique skills and perspectives that the new generation of employees can offer.

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