

A second wind

The regulation, taxation and distribution of hedge funds around the globe

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Foreword



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Firstly, a note on our new format. In prior years, this publication was in hard copy and ran to over 100 pages. As good “eco-citizens” (and to make things easier for you as reader to navigate), we have moved to a predominantly on-line version, with the country information now available in user-friendly web format. We hope you enjoy this new format and would welcome your feedback.

The last few years have been challenging ones for hedge funds, with reduced returns and assets being coupled with an unrelenting focus on the hedge fund industry as a whole by investors, regulators, tax authorities and indeed the general public. Recent fines imposed by regulators for supposed transgressions and the European drive towards pushing through the Alternative Investment Fund Managers Directive are evidence of a tougher stance, particularly by European politicians who have had hedge funds in their sights since well before the financial crisis. With the advent of the crisis, US and Asian authorities are also in the process of introducing more stringent tax and regulatory measures.

So how will hedge funds react to the planned changes? We have examined this in the pages that follow.

Despite the planned onslaught, hedge funds have proved surprisingly resilient with improved returns and assets returning close to all time highs. With increasing numbers of countries introducing bans on shorting, it is sometimes easy to forget the liquidity

that hedge funds bring to markets, something very evident after the post 9/11 slowdown. The web based information that accompanies this document will provide guidance on the frameworks in place in different territories. While not much has changed since our 2009 paper (“Changing Rules”), we expect many tax and regulatory amendments in the next 12 to 18 months. With all change comes great opportunity and for an industry that has proven itself capable of innovation, the coming year could be a successful one and may well be the second wind for hedge funds, with proper planning and always assuming that no unforeseen financial storms lurk beyond the horizon.

The contribution from our global network has been invaluable in providing this information and contacts for each territory are listed in this document and on-line. Please feel free to contact them (or your usual contact at PricewaterhouseCoopers) if you wish to discuss any aspect of the attached.

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This report, along with a comprehensive country-by-country analysis of the regulation, taxation and distribution of hedge funds around the globe is now available online.

After the crisis comes greater scrutiny

At a time when hedge fund assets are returning to growth, investors, regulators and tax authorities are making tighter controls and stronger governance the price of future success.

01



For a sign that the hedge fund industry is facing greater regulatory oversight, one needs look no further than the fact that high-quality compliance officers are in demand and their remuneration packages rising. Soon new regulations will be introduced and many managers will have to be regulated from at least two jurisdictions. In the meantime, regulators have been beefing up their enforcement teams.

As we begin to emerge from the financial crisis, investors, regulators and tax authorities are all subjecting hedge fund managers to far more scrutiny. Many hedge funds performed well compared with equity markets during the crisis, and many have made up losses; yet the market storm revealed unforeseen weaknesses in the management of investment liquidity, custody of assets and counterparty risk.

Investors are now increasing their hedge fund investments once again, but on the condition that managers have better operational, regulatory and tax controls. Acutely aware of managers' operational and counterparty risks, as well as the mounting regulatory and tax risks, investors are insisting on a far more robust and comprehensive control environment. Having strong investment performance backed by a sustainable investment strategy is no longer enough – large pension funds and others are more likely to consider investing with managers that can demonstrate adequate controls for today's environment.

The impact of the changes underway has yet to show in the details of our annual report on hedge fund regulation, taxation and distribution. Yet regulators and tax authorities are already taking a far more assertive stance, which will be followed by changing rules. In the United States, the Securities & Exchange Commission (SEC) has requested a 12% increase in its budget for 2011 partly to

add more enforcement and examination staff, as well as more trial lawyers. It is also seeking "self funding" which would give it the ability to pay for its budget with the fines levied from transgressors. If approved, this would enable it to dramatically increase its size and influence. Tax authorities around the world are also launching more audits of managers, while actively seeking the identities of investors. By the time of next year's survey, we anticipate wholesale change in regulations across the United States, Europe and Asia.

Investors, regulators and leverage providers are all pushing hedge fund managers to introduce greater controls. For their own reasons, each constituency is also seeking greater independent involvement in ensuring that many of the hedge fund problems revealed by the crisis cannot happen again – either looking for independent controls audits or independent depositaries to hold assets. As for the tax authorities, their newfound vigour, stimulated by empty governmental coffers, is effectively creating a need for hedge fund managers to hire more expertise to deal with a more rigorous environment.

For those managers that rise to these challenges, there is the potential reward of new assets under management at a time when the sector, in the main, appears to be returning to growth. Assets under management are now approaching their pre-crisis highs although the new assets are being discerning and are favouring the funds that have outperformed in rising and falling markets. According to an April

2010 survey,¹ assets may grow 25% during 2010 to reach US\$2 trillion by the year-end, slightly exceeding the pre-crisis peak of US\$ 1.9 trillion. The survey found that the strongest annual returns for a decade in 2009 had helped to reverse outflows. The investors surveyed reported they were most likely to add new assets in macro and event-driven funds.

Yet this remains a buyer's market, with investors holding the strongest negotiating position. The battle over management fees illustrates the point. Excepting the most outstanding managers, management fees are falling from the traditional 2%, although performance fees have come under less pressure.² When added to the costs of extra compliance and both reducing operational risks, this is squeezing some managers and is likely to force fund consolidation to counter the impact of these extra costs. Many of the extra costs are also borne by the funds themselves, meaning that investors are paying a price for their added comfort.

Even so, the comfort of greater transparency, controls and regulation has evident appeal to investors. For example, Europe's Undertakings for Collective Investments in Transferable Securities (UCITS) directive has provided a regulated structure that enables many different types of investors to access hedge fund strategies. For hedge fund managers, the price is less investment freedom, more transparency, greater regulatory oversight and the extra systems needed for compliance with the UCITS directive.

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1 Credit Suisse Annual Hedge Fund Investor Survey, April 2010

2 Preqin Research Report. Hedge Funds: The Fee Debate – An End to "2 & 20"? April 2010.

Investors ask for greater comfort

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02



The Alternative Investment Management Association and Hedge Fund Standards Board had already established best practices in many of these areas. Yet the degree of change is now far greater than was previously envisaged, with investor due diligence becoming far more thorough and wide-ranging.

Third-party assurance reports are giving investors greater insight into the type and quality of controls throughout the hedge fund value chain. In particular, prime brokers are commissioning independent controls reviews following the concerns caused by the Lehman Brothers collapse. Many large prime brokers are subjecting themselves to SAS 70-type reporting, surveying their control objectives and activities. Just two years ago, this was regarded as an expensive luxury – now it is a necessity.

Investor pressure is causing prime brokers' operating models to evolve and three basic models are now emerging, all of which seek to offer some reassurance to investors that they could recover their assets quickly in the event of the prime broker passing into bankruptcy. The 'remote special purpose vehicle' model involves the prime broker setting up and capitalising a new organisation, which then holds unencumbered client assets. The 'integrated custodian' model involves unencumbered assets being passed to a third-party custodian and being held there in the client's name. Finally, the 'internal custodian' model has been adopted by prime brokers located within financial services groups thought too big to fail. Leverage providers, such as prime brokers, are also seeking assurance about the collateral and cash management controls of hedge funds and hedge fund of fund clients.

A number of hedge fund managers are also providing greater assurance to investors by commissioning SAS 70-type reports examining their own control environments, and we expect more to

follow. Managers are also under pressure to adopt Global Investment Performance Standards (GIPS), providing standardised and transparent measures of performance. Most traditional asset managers have long complied with GIPS standards, but hedge fund managers have only recently started to show interest. Adherence with GIPS can help to establish a more consistent set of procedures regarding calculation and reporting of performance, thereby enhancing investor trust. Given the complexity of hedge strategies, the GIPS standard setters are currently working on dedicated guidance for hedge fund managers, which is due for public comment in 2010.

In the United States, which often pioneers what will then follow elsewhere, investors are seeking more transparency and liquidity, and investing through managed accounts is seen as being a way to achieve this. Again, this is a trend that started before the crisis but has since accelerated and investors with substantial sums to invest are finding that they are able to dictate terms regarding transparency and fees. In the event of another market storm, managed accounts reduce investors' risk of being left with a significant percentage of illiquid, hard-to-value assets as might be the case if they were invested in a fund subject to significant redemptions. Many more investors are choosing to invest in other structures that offer greater protection, for example those that have their assets held by a third-party depository.

In Europe, smaller institutional investors' preference for regulated investments has led to a dramatic rise in the number of hedge funds marketed in compliance with the UCITS directive. According to the PricewaterhouseCoopers point of view "Future Newcits regulation?",³ hedge fund managers have now launched more than 200 UCITS funds

with hedge fund-like strategies. Managers are responding to demand from funds of hedge funds, private wealth managers and smaller pension funds. These investors are attracted by the fact that UCITS are regulated vehicles, with limits on risk factors such as leverage, and with minimum standards for liquidity and transparency. Leverage in particular is receiving considerably more focus, with recent pronouncements from CESR and the ongoing debate around the Alternative Investment Fund Managers Directive (AIFMD).

Many more investors are choosing to invest in structures that offer greater protection.

What all of this means is that the traditional fund structures for investing in hedge strategies no longer suit all investors. Globally, many larger investors may choose to invest through managed accounts, which will reduce managers' economies of scale. Within Europe, regulated Newcits vehicles may continue to gain in popularity, although investors will pay a price for the extra comfort they offer in terms of the reduced returns likely to be a consequence of investment restrictions and costs of compliance.

So, new methods of investing with better protection through either greater transparency or regulatory restrictions are the current trend. Providing further insight into these issues, PricewaterhouseCoopers will be issuing a white paper on trust, transparency and controls assurance later in 2010.

³ Published in March, 2010.

Regulators insist on higher standards

The days of hedge funds being lightly regulated are almost over. With the ultimate aim of increasing the financial system's stability, and protecting investors' assets, the authorities are increasing their oversight of the sector.

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Notwithstanding that the G20 has exonerated hedge funds of any blame for the crisis, there is still a belief that they could be a potential threat to stability in the future.

Managers need to be aware that becoming registered in another jurisdiction for the first time takes planning and preparation. In the United States, the SEC has recently increased its expectations for managers' compliance programmes and has become far less forgiving, expecting compliance programmes to be tailored to managers' activities. For their part, investors regard regulatory compliance as a key risk that needs to be properly managed and increasingly, they want to know that compliance activities are being monitored by management to ensure that they are being performed effectively. They also want to know that management can present evidence of effective compliance activities to the SEC.

Both the SEC and the Financial Services Authority (FSA) have hired more staff for their enforcement divisions and stepped up enforcement activity. The SEC's Chairman, Mary Shapiro, has been quoted as saying "we value toughness and speed", and in the UK Margaret Cole, the FSA's Director of Enforcement, has been clear that "light touch regulation" is no longer the mantra. These statements indicate an intention to be more timely, relevant and aggressive. If granted, the SEC's increased 2011 budget would allow it to launch many more enforcement actions and, if warranted, pursue them to trial. Although less publicised, regulators beyond the major centres of the United States and United Kingdom are also building their resources.

Although compromises are being sought, if the AIFMD were to spark retaliatory protectionist initiatives, the hedge fund industry might become divided along geographical lines.

Within Europe, the planned AIFMD has been fiercely debated. At the time of writing, its final form is still not clear, but it may lead to managers having to maintain high levels of regulatory capital, and having to adopt detailed internal policies and procedures to deal with, for example, liquidity management, conflict identification and compliance. They may also have to install reporting mechanisms to report significant amounts of information to investors and regulators, much of which would legitimately be regarded as confidential and commercially sensitive, as well as disclosing significant amounts of information regarding remuneration.

The AIFMD would grant a European Union passport to EU-domiciled hedge fund managers, allowing them to market across member states. There are fears, however, that this passport would not easily be granted to managers from outside Europe, which would damage the businesses of non-EU managers. US Treasury Secretary, Tim Geithner, has stated that the Obama administration would view such a move as protectionist and there are similar sentiments in Asia. Although compromises are being sought, if the AIFMD were to spark retaliatory protectionist initiatives, the hedge fund industry might become divided along geographical lines.

In the United States, there is far more certainty around regulatory change. The exemption under the 1940 Investment Act which allowed many hedge fund managers based in the US to avoid registration with the SEC is being removed. The changes will affect not only US managers, but also any managers based outside the United States with either material numbers of US clients or material assets attributable to US clients. As yet, it is increasingly uncertain whether non-US managers will be able to operate under a "registration-lite" regime.

In Asia, too, hedge fund managers may soon have to apply for formal licensing and registration in Singapore, one of the region's most popular hedge fund centres. The Monetary Authority of Singapore has been consulting with the hedge fund industry since late 2009 and has recently issued a consultation paper which details revised requirements, most notably the need for certain managers, many of whom are currently exempt, to register with regulators and be subject to a detailed rule book.

Tax authorities seek revenue

Throughout the world, tax authorities are in search of greater revenue to help fill local deficits.

04



For hedge fund managers, this has widespread implications. There are more regular tax audits, some structures for holding cross-border investments are becoming less efficient, staff are facing higher income tax and, perhaps most significantly, a drive to identify the investors in offshore funds may lead to far-reaching changes in how these funds are established.

As managers adjust to these developments, they may need to build more advanced tax functions, as well as an approach to tax that will be less open to question from the authorities. Across the United States, Europe and Asia, tax audits of hedge fund managers are becoming more common. The US Internal Revenue Service (IRS), for example, has set up a task force for visiting hedge fund managers. Additionally, in Asian countries such as Japan asset managers are being closely scrutinised and the PRC tax authority is tightening up on tax collections having recently issued new tax circulars which reinstate withholding tax on dividend income paid out of PRC listed companies. It has also stipulated clearer rules around the issuance of tax clearance certificates before capital gains derived by QFIs can be repatriated out of China.

Perhaps the most significant new trend is the drive to stamp out tax avoidance and evasion by tax authorities through further reporting of investors' identities. Most notably, the US FATCA⁴ that became law in March 2010 requires fund managers to tell the IRS whether US citizens are beneficial owners of offshore funds. Other major hedge fund centres

are also demanding that managers provide more information about the identities of their investors.

When added to the Organisation for Economic Co-operation and Development (OECD) proposals on information reporting and the EU Savings Directive, rules on tax reporting are challenging the traditional model where funds could be quickly established in offshore tax centres, with minimum fuss and reporting. The rise of regulated onshore centres such as Hong Kong, Ireland and Luxembourg reflect these changes. The current US FIN 48 rules regarding disclosure of uncertain tax positions have only added to the momentum for change. However, the traditional model may still survive, with significant support from legal counsel in the main centres (who are familiar with the offshore vehicles) and, indeed, a willingness by offshore centres to adapt as needed.

New information reporting requirements are likely to lead to a need for more tax-transparent funds – where the beneficial owners of assets are identified. In future international markets are likely to mirror the position of the US domestic market, where there are both tax-transparent and opaque structures. The implications for product design and service providers are profound.

In developing countries, tax authorities are attacking the offshore holding structures that private equity and hedge funds have historically set up in order to make investments in a tax-efficient manner. Investments have historically been made through investment holding

companies based in offshore centres meaning that investment profits have not been taxed within these developing countries. But tax authorities in countries such as China and India – currently two of the world's fastest growing investment destinations – are now seeking to establish that profits are being made within their countries, thus rendering them subject to local taxation.

Taxation of employee compensation is also becoming an important issue. In the United Kingdom, the introduction of a 50% income tax rate for high earners from April 2010 is adding significantly to hedge fund traders' tax bills. They are likely, therefore, to consider taking a greater proportion of remuneration in the form of capital. This could be deferred into the equity of the management company, which would be in line with the Financial Stability Board's desire to see significant portions of performance bonuses being deferred.

Perhaps the most significant new trend is the drive to stamp out tax avoidance and evasion by tax authorities through further reporting of investors' identities.

4 Foreign Account Tax Compliance Act of 2009.

Towards a new maturity

Taken together, the evolving requirements of investors, regulators and tax authorities may drive significant change for hedge fund managers.

05



Clearly managers must improve operational controls, compliance effectiveness and tax expertise. And, they should consider the new investing models that investors are seeking.

At the investment vehicle level, there will have to be different types of vehicles tailored to the needs of different investors. Managers should review the future of different fund structures. Will more managers look to maintain their assets onshore, rather than domiciling their funds in other jurisdictions? Do they need to develop tax-transparent structures?

One positive but unexpected consequence of the crisis may well be an expansion in the number of well-resourced hedge fund managers. Following Barack Obama's so-called 'Volcker rule', which aims to restrict deposit-taking banks from proprietary trading and owning hedge funds, the number of independent managers may grow.

If the hedge fund investor base expands over time following the strong performance of the best hedge funds, and their improved operational controls, the financial crisis may have the unexpected consequence of lifting the hedge fund industry to a new level of maturity. This could create a larger number of 'institutional' type managers, with a more diverse investor base. In short, the crisis could endow the hedge fund sector with a far more sustainable investment proposition that is accepted by a wider group of investors.

In order to seize the opportunity offered today, however, managers need to prepare for greater scrutiny. The sector will reach new levels of sophistication and maturity, and be of interest to a far wider investor base if it reacts judiciously to the changing external environment.

10 keys to unlock the door to the new maturity

- 1 Review safe-keeping / custody of assets, as well as your prime broker terms of business and service offerings
- 2 Examine the structures and domiciles of your product range, considering your clients' demands and the impact of proposed legislation
- 3 Enhance your operational controls in a world of increasingly demanding investors
- 4 Demand that your service providers provide independent assurance in order to aid investor due diligence (consider it for your own business)
- 5 Be prepared for the new regulatory demands which will come your way (readiness checks will be essential in preparation)
- 6 Consider compliance function effectiveness
- 7 Assess your reporting systems' capabilities in light of increasing regulatory oversight of potential "systemic risk"
- 8 Optimise your tax positioning across management group, funds and investment structures, and consider whether the skills needed are in-house or whether outsourcing is required
- 9 Review your offering documentation for compliance with new regulatory requirements and prepare for investors' increasing demands for transparency
- 10 Seek suitable staff remuneration structures in light of global G20 focus and local tax changes

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Now online

This year, our comparison of the regulation, taxation and distribution of hedge funds around the globe can be found online. Visit pwc.com/asecondwind today and select your country of interest to view the detailed information. The online tool allows you to compare multiple territories simply and easily, as well as contact the right PricewaterhouseCoopers contact if you have a specific enquiry.



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Hedge fund leaders

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