Hedge Fund Compliance
Building a best-practice framework
This paper explores the current regulatory environment, and explains how technology can help improve efficiency and potentially offset some of the costs involved in meeting the requirements.

Since the financial crisis, the hedge fund industry has had to contend with an unprecedented barrage of regulatory changes. While firms have largely adapted to the new regulations, the compliance burden poses a significant and ongoing challenge. This paper explores the current regulatory environment, and explains how technology can help improve efficiency and potentially offset some of the costs involved in meeting the requirements.

The growing burden
In just a few short years, the alternative investment market has had to adjust from being relatively unfettered to tightly regulated. In this new, more controlled and scrutinized environment, regulatory and investor compliance capabilities have become increasingly important—both for hedge funds and their service providers. Regulatory reporting demands have exploded. Examinations and audits have become a way of life. Institutionalization of the industry—which has seen institutional investors now account for the majority of capital flowing into hedge funds—continues to force fund managers towards greater transparency. The industry on the whole has adapted, but it comes at a price, with many firms complaining that the cost of compliance has become a quantifiable drag on profitability.

Still, a “culture of compliance” appears to have taken root in many segments of the industry. Traditionally, compliance was seen as a purely legal and regulatory focused activity. Today, the emphasis is on introducing effective, end-to-end governance oversight throughout the organization.

Fund managers are making investments in technology and working with their service providers in an effort to streamline compliance activities, reduce the associated costs, and integrate the processes into all aspects of their everyday operations, from investment research and trading through to client servicing and fund reporting. For instance, a joint study by KPMG International, the Alternative Investment Management Association (AIMA) and Managed Funds Association (MFA) found 90% of hedge fund managers cite improved controls and compliance as a primary reason for investing in technology.

Moreover, many hedge fund managers are recognizing that compliance can be good business. In its 2017 predictions, Agecroft Partners forecast the industry will see redemptions of 3% of total assets during the year, offset by performance-based gains of 5%. With smaller managers continuing to outperform, Agecroft predicts an increase in flows to small and mid-sized hedge fund managers.

Competition for those assets is intense, with performance clearly of key importance. But the ability to demonstrate disciplined processes and a sound operational infrastructure can be a major differentiator in the investor due diligence process. Equally, a weak compliance infrastructure will be a red flag to investors.

However, implementing and maintaining a robust, yet flexible and scalable compliance environment demands focus, an enterprise-wide commitment to best practices and investment. This white paper provides an update on the regulatory landscape that hedge funds must navigate. And it explores the technology and operational options firms should consider that can help ease the administrative burden and costs of compliance.

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1 Transformative Change: How innovation and technology are shaping an industry, KPMG International, the Alternative Investment Management Association (AIMA) and Managed Funds Association (MFA), October 2016, https://home.kpmg.com/xx/en/home/insights/2016/10/transformative-change-fs.html

For the foreseeable future therefore, hedge funds around the world must continue to comply with extensive and often onerous rules and regulations in the markets in which they want to operate.

Swing to regulatory divergence?

Since the financial crisis, there has been a progressive increase in hedge fund-related regulation and an emphasis on global regulatory harmonization. Is that about to change?

A Goldman Sachs Asset Management (GSAM) note points to the potential for competitive de-regulation and regulatory divergence going forward. In the US, for example, the Trump administration has vowed to overhaul financial sector rules, including rolling back chunks of the Dodd-Frank Act.

“How far the US pendulum swings from regulation to de-regulation will hold important implications for financial regulation in Europe and the UK, which have adopted more than 80 new rules and pieces of legislation between 2007 and 2015,” notes GSAM.

The outlook is further complicated by Brexit. As AIMA highlights, one key question for the hedge fund industry is whether the UK will be granted regulatory equivalence status to allow continued cross-border market access rights. Another is “the future policy direction of existing and future EU financial services legislation, in particular the maintenance of private placement regimes under AIFMD and the Capital Markets Union project.”

Likewise, there is uncertainty as to whether the UK will seek to remain in lock-step with the EU’s regulatory framework post-Brexit, or amend its rules in a bid to enhance its global competitiveness.

According to Deloitte, the risk of fragmentation of global regulatory approaches is rising. That brings its own complications for internationally-active hedge funds keen to streamline their firm-wide compliance activities to reduce costs and risks. Any prospective changes will require ongoing monitoring and remedial action by compliance, operations and technology teams.

Meanwhile, “the regulations that have already been implemented to date are unlikely to be materially watered down—at least not soon,” says Deloitte.

For the foreseeable future therefore, hedge funds around the world must continue to comply with extensive and often onerous rules and regulations in the markets in which they want to operate. And whatever happens to the specific frameworks, the drive toward greater transparency from both regulators and investors only looks set to grow.

Key regulations affecting hedge funds

Hedge funds face a daunting array of often complex and resource-intensive regulatory requirements, a challenge exacerbated for firms that fall under multiple regulatory regimes.

**AIFMD**

Implemented in 2013, the Alternative Investment Fund Managers Directive (AIFMD) requires alternative investment fund managers in European Union countries, as well as non-EU managers that market their funds to European investors, to obtain authorization, meet ongoing operating conditions, and comply with transparency and reporting requirements. Complying firms are conferred a “passport” that allows them to market their funds to professional investors across the bloc.

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A key requirement of the US Dodd-Frank Act is that private funds, including hedge funds and private equity funds, must register with the SEC as investment advisors.

The primary reporting component of AIFMD—and the biggest challenge—is the Annex IV report. This is a quarterly accounting to regulators of various fund characteristics, such as holdings, strategies, leverage, exposure, investor information and other variables. Comparable to Form PF in the US (see below), Annex IV gives a comprehensive picture of the composition, management and risk factors of a fund. And as with Form PF, the Annex IV reporting process is time consuming and complex. Typically, all the data required will not reside in a single platform, but must be aggregated from multiple sources, both internal and external, then formatted to the Annex IV template.

MiFID II
When they take effect on 3 January 2018, the updated Markets in Financial Instruments Directive (MiFID II) and accompanying regulation (MiFIR) will transform the way financial markets operate and how trading activity is conducted in the European Union. And its reach is extensive. In effect, any firm with a footprint in Europe, or that is involved in distributing and trading financial instruments in the EU will be subject to aspects of the rules.

While much of the regulation is targeted at the sell-side, the investment management community will be affected by many of the provisions. These include:

- Transaction reporting – Firms will need to report complete and accurate details of any financial instrument transactions to the competent authority no later than the end of day on T+1.
- Best execution – Firms will have to gather, analyze and publish extensive information on where they execute trades and the details of those transactions to prove best execution.
- Costs and charges – All costs must be aggregated in client disclosures on both an ex-ante and ex-post basis, requiring an additional layer of data exchange.
- Research unbundling – Research will become a distinct service that must be assessed and paid for out of firms’ own resources or from a defined research payment account (RPA).

SEC registration (Dodd-Frank)
A key requirement of the US Dodd-Frank Act is that private funds, including hedge funds and private equity funds, must register with the SEC as investment advisors. This means hedge funds are now subject to the same reporting requirements as traditional advisors. They must also demonstrate compliance with business conduct rules, publish and maintain a code of ethics, file Form ADV describing their firms, have policies for managing potential conflicts of interest, and be prepared for visits by SEC examiners.

Form PF
Form PF, introduced as part of Dodd-Frank, is designed to actively monitor and track the risk exposures of three types of private funds: hedge funds, liquidity funds and private equity funds. The rule applies to SEC-registered investment advisors managing private funds of $150 million or more. Affected firms must provide regulators with regular, detailed and often extensive portfolio, performance and risk information about their funds within tight filing timeframes.

Completing the Form PF reports entails aggregating data from multiple disparate sources and putting it into a standardized format following SEC guidelines. It can be a time-consuming drain on staff resources and carries a high risk of errors when done manually. The requirement has motivated many firms to upgrade their reporting capabilities with more automation and integration, while other firms have decided to outsource much or all of the process to third-party solution providers.
The core role of technology in hedge fund management is to streamline operations, systematize practices, improve productivity and accuracy, and reduce costs and risks.

**FATCA/GATCA**

Although the Foreign Account Tax Compliance Act (FATCA) is a US law administered by the Internal Revenue Service, it targets non-US financial institutions. FATCA requires financial institutions outside the US to report on deposits or assets owned by US citizens or residents. Its purpose is to curtail tax evasion by US investors attempting to conceal assets and income in foreign accounts, including offshore hedge funds.

To comply, firms have had to implement processes to enable ongoing investor due diligence, and many have had to revamp their fund reporting and documentation procedures substantially. The US has succeeded in generating a high level of compliance among countries and institutions—in part by levelling a 30% withholding tax on institutions that fail to comply.

The Common Reporting Standard—otherwise known as the Global Account Tax Compliance Act (GATCA)—is a similar international initiative. Developed by the OECD, it allows the tax authorities in signatory countries around the world to automatically share information on residents’ assets and incomes to combat offshore tax evasion.

**Improve compliance with technology**

Advanced technology that improves data quality and delivers real-time information has become both a competitive and regulatory necessity as hedge funds wrestle with their expanding compliance obligations and risks. Technology allows firms to spend less time managing paper and people, and more time actively managing risk—something regulators around the world like to see. Meanwhile, increasingly tech-savvy and operational risk-aware investors are taking an ever-closer look at hedge fund managers’ systems in the course of their due diligence processes.

**Creating an integrated compliance infrastructure**

The core role of technology in hedge fund management is to streamline operations, systematize practices, improve productivity and accuracy, and reduce costs and risks. At a higher level, technology enables hedge fund managers to manage complex fund structures, make better informed investment decisions and implement sophisticated strategies. The systems that deliver these advantages have the ancillary benefits of improving compliance readiness and creating a competitive advantage in the eyes of prospective clients.

**1. Transparency in Portfolio Management Systems**

Today’s state-of-the-art portfolio management systems play a critical role for hedge funds, delivering real-time information with a high degree of accuracy. A dynamic portfolio management system also demonstrates a strong culture of compliance. It shows clients and regulators alike that a firm has instituted best practices to price and value holdings accurately.

Numbers used to demonstrate (and promote) a hedge fund’s performance track record must be supportable based on industry standard calculations. The CFA Institute’s Global Investment Performance Standards, or GIPS, are widely recognized as that industry standard. Using performance numbers that are compliant with and presented in accordance with GIPS demonstrates a firm adheres to industry-standard measurement guidelines when measuring performance, affirming the integrity and credibility of their numbers. That should further enhance the firm’s ability to attract clients.
A comprehensive data management strategy—incorporating a sophisticated data technology infrastructure and policies, backed by clear definitions of what data is owned by which departments and systems—will provide enhanced data timeliness, accuracy and access.

2. Order Management Systems for Accurate and Efficient Trading
Improved trading is another important element in strengthening a hedge fund’s compliance infrastructure. For the trader, speed is of the essence. But from a compliance perspective, speed creates risk—the risk of error or a violation of policy. Because trading is inherently risky, each firm needs a trading program comprised of at least three components:

- Risk identification.
- A process to manage risk.
- Periodic assessment of risk.

Implementing an advanced trade order management system that can handle higher volumes and instrument sophistication, while simultaneously addressing the demand for flawless accounting and reporting, error correction and efficiency of execution is the most effective way to manage those trade-related risks.

Even with all the right tools in place, trading errors may still occur. When fixing errors it is important to document their cause. The ability to create a clear audit trail of a fund’s trading activity is vital from both an operational and compliance perspective. If a firm can demonstrate it had the policies and procedures in place to catch an error and then correct it before damage was done, it sends a powerful message.

In evaluating trading systems, hedge funds should look for such important features as connectivity to prime brokers, fund administrators and trading partners, a FIX interface for order execution, and automated P&L reporting.

3. Investor Accounting and Servicing
A less understood yet no less critical area of hedge fund accountability is investor accounting. Due to the flexibility of fund partnership structures, investor accounting can be extremely complex, tedious and error-prone. However, a modern investor accounting system can automatically perform book and tax allocations among investors through multi-tiered fund structures. These systems automate rate of return calculations and NAV computations, and send account statements to investors.

Using a proven investor accounting system underscores a firm’s commitment to data accuracy and integrity. It also ensures equitable distribution of assets and promotes transparency to fund partners.

4. Data Management and Analytics
Global regulatory initiatives—from OTC derivatives reform and accounting standards changes to FATCA/GATCA, Form PF, MiFID II, AIFMD, UCITS and the EU’s upcoming General Data Protection Regulation (GDPR)—require fingertip access to a cornucopia of accurate and timely customer, position, transaction and exposure information to populate extensive and frequent report filings. For example, MiFID II transaction reports will contain up to 65 fields that firms must complete on all trades across asset classes, more than double the previous number.

To complicate matters, in many cases the data must be enriched to meet the particular filing requirements of each regulation, which often vary from country to country. Plus firms have to prove the data’s accuracy and show where it comes from. Any failings could result in censure, fines and subsequent reputational damage.

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will enable firms to better meet their regulatory obligations with fewer resources and less risk.

Meanwhile, advanced data analytics can help firms take a more proactive approach to compliance by enabling them to identify and address risks and questionable activities before regulators do, notes Deloitte⁶. “In addition, asset managers that invest in data analytics capabilities—even if only for regulatory reasons—may find those same investments yield significant fringe benefits for the business, including increased operating efficiency and better decision making.”

5. Research Management Systems: Documenting Due Diligence

A purpose-built investment research management solution (RMS) allows firms to maintain all the documents pertaining to their investment decisions. The RMS provides a centralized repository for organizing external and internal research data around specific investment theses, as well as a firm’s own records of meetings and deliberations leading to each buy and sell decision. An RMS also helps demonstrate to investors that the fund manager follows a rigorous, disciplined and repeatable due diligence process in decision making.

The Outsourcing Option

Outsourcing some or all components of the technology and operational infrastructure is increasingly viewed as an effective way to improve efficiency, control costs, reduce risks and achieve compliance goals. In this way, fund managers can leverage the specialized expertise of providers that have developed best practices from working with a wide range of clients. For instance, a firm can choose to outsource the hosting and maintenance of its core portfolio management system, reaping the advantages of the technology while reducing the need for in-house IT expertise. Specific operational functions—such as reconciliation, data management or performance measurement—can also be outsourced to specialists.

A note of caution though: it’s critical to perform due diligence on prospective technology and service providers to ensure they are highly knowledgeable on regulatory issues and that their processes meet current compliance standards.

The compliance opportunity

Instead of a burden, compliance may in fact create an opportunity for hedge funds. The worlds of hedge fund management and mainstream asset management are converging. Institutional money managers increasingly incorporate hedge funds into their strategies. In this world, the ability to demonstrate compliance and best practices will only increase in importance in attracting institutional money.

Regulation is the reality. It is here to stay and will likely become even more complex. That makes it incumbent on hedge fund firms to institute compliance practices and invest in the technology infrastructure that supports them. As competition, volume and complexity accelerate, technology that makes a firm’s operations more transparent and its data more reliable will deliver a powerful competitive advantage. And a culture of compliance, ingrained in a firm’s everyday business, may well prove to be good business.

Who we are

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