FOCUS ON

OPERATIONS – THE RISING BAR

A suite of new regulations and heightened investor scrutiny are raising the bar for achieving an effective and efficient hedge fund operation. Mark Schoen of Northern Trust outlines how this is driving a new relationship between hedge funds and their administrators

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Hedge funds face a series of operational challenges as a consequence of rising regulatory requirements and investor demand for greater supervision and control of funds' activities. As a result, hedge fund managers are increasingly looking to external service providers to support their middle office obligations.

RESILIENCY PLANNING

The UK's Financial Services Authority (FSA)* letter issued at the tail end of 2012 has set the tone for operational resiliency planning in 2013. The open letter sent to a number of CEOs of UK-based investment firms urged them to exercise care and diligence with their outsourcing arrangements to ensure contingency for critical and important regulated activities. This is a clear indication of the growing number of asset managers turning to external parties for support in meeting rising operational challenges.

It is also reflective of a wider global trend that is seeing administrators increasingly supporting an array of middle office functions in addition to their core back office services. Middle office functions – confirmations, daily P&L, collateral management, strategy tagging and market risk exposure reports – which were once considered 'value-added' are now increasingly becoming standard practice.

The focus on resiliency is leading investment managers to consider consolidating outsourcing with one provider, to benefit from a uniform approach to pressing operational issues such as global regulatory developments, and risk or performance monitoring. The largest managers are also going a step further and looking at a multi-administrator 'shadow' model. Under this arrangement one administrator performs standard administration services and another performs the same work independently, providing an additional layer of oversight, control and resiliency.

While not every hedge fund will be willing to appoint two external administrators, the ongoing regulatory interest in robust operations, as typified by the letter of December 2012, is only likely to increase among global regulators including the FSA's successors, the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA). Therefore hedge funds need to be seeking resiliency plans that can be mobilised quickly and are flexible enough to support hedge funds' constantly evolving operations.

> "MIDDLE OFFICE FUNCTIONS WHICH WERE ONCE CONSIDERED 'VALUE-ADDED' ARE NOW INCREASINGLY BECOMING STANDARD PRACTICE"

REGULATORY PERSPECTIVE

In the current raft of regulatory developments, hedge funds face a number of direct impacts. For example, the imposition of central clearing for over-the-counter (OTC) derivatives in 2014 is a looming operational issue for hedge funds, with deep ramifications. The development will demand the appointment of clearing brokers and the development of new capabilities to deal with compression, reconciliation of clearing accounts and margin calls. But more importantly central clearing will require the posting of an independent amount at the clearing house. This could potentially trigger an industry-wide shortage of the appropriate collateral and create a market-place liquidity squeeze. Therefore, the ability to optimise and transform collateral will likely be a key requirement for hedge funds as well as sovereign wealth funds and other firms.

THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE

The Alternative Investment Fund Managers Directive (AIFMD) imposes new regulatory provisions on non-Ucits that actively market to European Union (EU) investors. This is creating new obligations for operators of alternative investment funds (AIFs) and service providers.

The most significant impact is around the depositary liability which is likely to increase costs and over time change the operating model between prime brokers, hedge funds and depositaries. It imposes new liability provisions on the depositary for assets that are lost while in safekeeping, including where the event of loss is at a sub-custodian, prime broker and/or counterparty. This highlights the need for enhanced custody review and network management oversight, including an obligation on the depositary to ensure segregation of the hedge fund's and prime broker's assets.

The industry is already seeing a trend for long only cash to be held away from the prime broker at a depositary. At Northern Trust we have deployed a model that holds both unencumbered and encumbered (margined) assets. It is likely this model will form the foundation of how prime brokers, hedge funds and depositaries will work together in order to fulfil the AIFMD's obligations. However, it may take time for a fully mature industry model to develop which reconciles the AIFMD's requirements with the financing relationship between a prime broker and hedge fund.

FORM PF

Today's globalisation of the investment funds industry means hedge fund managers must be alert to regulatory

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changes in other parts of the world, regardless of where they are based. For example, hedge fund managers that have funds domiciled in the US have new and exacting compliance obligations from the Securities and Exchange Commission's new regulatory filing requirement for private funds (Form PF).

CHANGING RELATIONSHIP

Hedge funds also face greater scrutiny from their investors in the wake of the fall-out from the financial crisis in 2008 and the Madoff Ponzi scheme. Service providers now face on-site visits from institutional investors who want to see not just how the fund is managed but how it is administered, how the back-office processes function, how the valuations are calculated and how the funds are secured and segregated.

The combination of these regulatory developments and investor oversight is changing the relationship between an administrator and a hedge fund from a largely static end-of-month arrangement to an intra-day, dynamic partnership covering an array of middle office functions.

This is being made possible by technology advancements which are supporting the expanding service suite by creating a virtual office between the administrator and the hedge fund's middle office: for example the ability for the hedge fund manager, the account managers and the domain experts to all view the same real-time data. This also reduces errors and resolves potential issues in a more timely manner.

Today's hedge fund administrators are now, in addition to their core offering, providing support for middle office functions including trade flow processing, cash and collateral management, profit and loss (P&L) reporting, strategy tagging, intra-day risk modelling tools, performance attribution and regulatory compliance.

In this context, access to domain expertise is vital as the administrator becomes an integral part of the hedge fund manager's daily operation. This means the administrator must have global market knowledge and a level of domain expertise that enables it to understand the investment processes of the hedge fund manager and the local regulatory issues it faces. Moreover, it should offer a scalable service to support the manager in all stages of the operational process.

> "HEDGE FUND MANAGERS FACE EVER-RISING CHALLENGES TO PROVIDE A ROBUST, GLOBAL OPERATIONS INFRASTRUCTURE FOR THEIR INVESTORS' ASSETS"

Hedge fund managers face ever-rising challenges to provide a robust, global operations infrastructure for their investors' assets. By leveraging the experience and expertise of their fund administrator for a growing suite of functions, they are being supported to negotiate these hurdles and turn their focus to managing their innovative investment strategies. ■

**The Financial Services Authority was replaced by the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) in April 2013.*