Global Research & Analytics

CRISIL
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Hedge funds, thicket of rules and operational challenges

Strategic alliances with service providers key to efficiencies

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Introduction: Regulations increase, as do operational challenges

The global hedge fund industry had $3.2 trillion in assets under management (AUM) in September 2016, marking a growth of 5% over 2015. It has seen a major increase in inflows from new and emerging markets such as Asia-Pacific (Hong Kong, Singapore and Australia), Brazil and South Africa[1] in the recent years. Today, about 60% of the hedge funds are based in the US, while Europe houses another 19%.

The industry is facing new challenges such as having to frequently demonstrate risk management capabilities and compliance to regulators, even as their priority is to deliver alpha as they meet performance standards. Hedge funds diversify across countries and strike strategic alliances to meet their AUM targets. Each year, competition intensifies because of a raft of new entrants. Spasms in the global economy, which are more frequent than before, adds to the challenge of delivering consistent performance. The expectations of investors have also increased in the recent past. While they have always sought higher returns, their focus on risk reporting and transparency has been sharper of late.

Hedge funds are also reworking systems and procedures to adapt to new regulations and embrace change. Today, more funds are considering outsourcing in-house functions to skilled service providers. Choosing the right service provider can help save costs and increase operational efficiencies, which means managers can focus on their core competency of generating alpha.

While large hedge funds have started working with service providers for some key support functions, a few mid- and small- sized ones are still reluctant to outsource. It makes sense for them to identify service providers for customized solutions who can also be strategic business partners. Operations, technology and research are among the functions that third parties can manage. Leveraging the offerings of such partners enhances productivity and helps hedge funds diversify their offerings.

1. Source: http://www.prequin.com

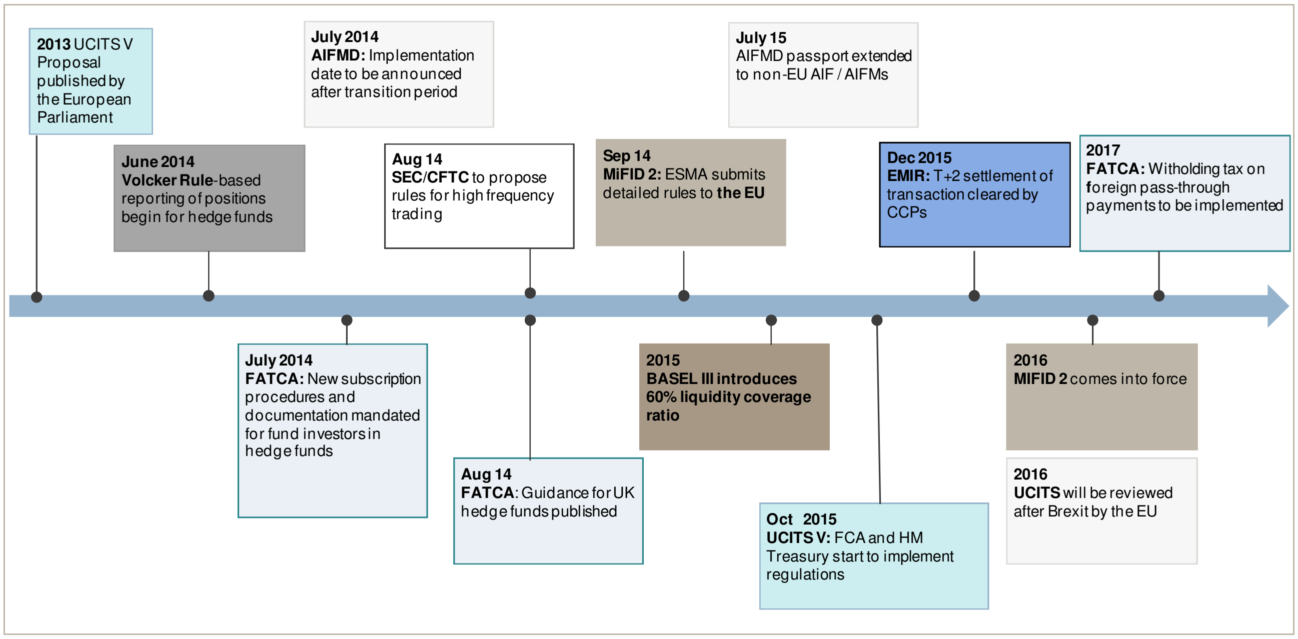
Challenges faced by fund managers

Business expansion and cross-border activity have thrown up a raft of challenges for hedge funds, such as:

- **Maintaining high performance amid headwinds:** The foremost expectation from a hedge fund is good returns in every scenario. Dynamic markets and economies make this an onerous ask, so fund managers diversify portfolio, launch new strategies, and invest globally to keep delivering alpha, after factoring in the headwinds of taxation, regulatory intervention and interest rate changes
- **Rising competition**: The hedge fund industry is hyper-competitive with new players debuting with ever-more innovative strategies and advanced technologies. Many trading houses and dealers enter the fray on the back of significant experience and some strong partnerships. In order to stay in the business, hedge funds have to quickly adapt to the changing dynamics of the market and keep innovating.
- **Cost of operations -** With the investor base, globalization and portfolio diversification all increasing, operational costs have been surging for hedge funds. Manual operations become cumbersome and difficult, and often funds invest in developing in-house tools to automate mundane tasks. The major cost drivers are investments in resources, infrastructure and technology. Ensuring best practices and innovation come at a very high price, but are industry imperatives.
- **Increase in regulatory reporting requirements**

  Today, hedge funds spend a lot more time on risk management than they did five years back. The major regulations affecting them are the Foreign Account Tax Compliance Act (FATCA) (US), Undertakings for Collective Investment in Transferable Securities (UCITS V), MiFID II, EMIR, Packaged Retail Investment Products (PRIPS) and Alternative Investment Fund Managers Directive (AIFMD) in the European Union (EU). Some regulations such as the Dodd-Frank Act and Basel III requires more liquidity management and constraints leverage, which affects capacity and economics, and complicates the challenges further.

Major regulations impacting hedge funds



- A typical US-based fund manager submits around 60 reports on average each year. These include Form PF, AIFMD, Basel III and other due-diligence reports. The data required for each is nearly similar, and report submissions are near-simultaneous. Needless to mention, accuracy and consistency of data are critically important
- Research conducted by EFAMA[2], shows that each year, on average, a large hedge fund spends ~$14 million, a medium-sized one ~$6 million and a small one ~$700,000 on compliance. That equals 5-10% of their operational costs.

2. Source: http://www.efama.org

Major regulations and reporting requirements

Serial No	Regulations	Objective	Important reporting requirements for hedge funds
1	**AIFMD**	To reduce systematic risk for the HF investors and improve transparency	1. Annual report guidelines and disclosures to investors 2. As per new guidelines remuneration disclosures (both qualitative and quantitative) for the financial year 3. Report of investment activities for the financial year, overview of AIF's performance and material changes in information 4. The disclosure of the risk profile of the AIF, the risk management systems employed, liquidity and leverage **Impact** New requirements by the fund managers include the following: • New annual reports and frequent due diligence of new funds • Quarterly risk reports
2	**UCITS V & VI**	To provide a single market for the funds in European Union (EU) through pass porting. To ensure investor interests is protected through a common EU legal and regulatory framework	Defining remuneration policies and practices with clear rules on fixed and variable components. Policies for effective risk management with disclosers on liquidity and leverage. Depository guidelines for eligible entities, oversight duties, cash-monitoring duties, safe-keeping duties, delegation and overall liability **Impact** • This has resulted in an increase in quarter reporting of new parameters in remuneration and risk management • More screening and stringent guidelines for new funds on-boarded
3	**SEC**	To provide clear AUM and exposure to U.S investments and investors	1. Form ADV and Form PF for non-exempt advisers – 90 days after the fiscal year-end for Form ADV 60/120 days after fiscal quarter/year-end depending on RAUM for Form PF 2. For managers with at least $150million in regulatory AUM attributable to private funds, an annual filing is required on Form PF from all private fund advisers within 120 days after fiscal year-end. 3. A two-part form that comprises public information about the funds and investment adviser, and the registration application itself. **Impact** This has impacted in an increase in quarterly, annual and ad hoc reporting
4	**EMIR**	To regulate derivatives trading in EU	1. Obtain a Legal Entity Identifier ("LEI") for itself and notify this to counterparties. Also, obtain an LEI from each counterparty. 2. Report all derivative contracts to a trade repository. Reporting can be delegated if the counterparty agrees. Otherwise, the fund manager needs to be a member of (have access to) a trade repository. 3. Accede to the ISDA 2013 EMIR Portfolio Reconciliation, Dispute Resolution and Disclosure Protocol, as published by the International Swaps and Derivatives Association, Inc. ("ISDA")

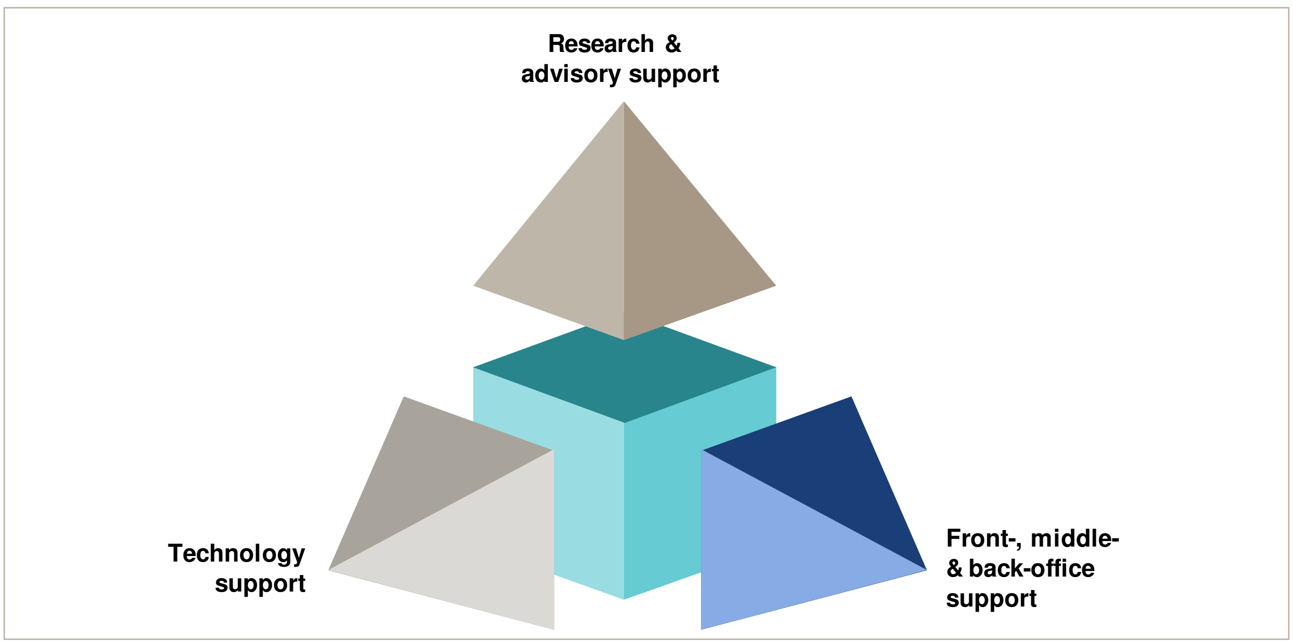
Serial No	Regulations	Objective	Important reporting requirements for hedge funds
			Impact Increased oversight and central clearing of derivatives transactions is required by the fund managers
5	**FATCA**	To prevent tax evasion by US citizens and residents through the use of offshore accounts	Investment funds domiciled in the US will be required to withhold the 30% FATCA withholding tax on payments they make to any foreign entity investors, including FFIs and NFFEs that fail to provide adequate documentation of their FATCA compliance. As a result, US funds also will be required to perform extensive due diligence reviews to classify their foreign entity investors for FATCA purposes. **Impact** More reviews and screening of investors make the process of investment longer
6	**Form PF**	To ensure reporting for investments declaration by investors	1. A quarterly filing on Form PF is required from large hedge fund advisers ($1.5billion in RAUM) within 60 days after the end of the relevant fiscal quarter. 2. A brand new filing that is periodically required by registered investment advisers (exact frequency dependent on RAUM). This provides significant information around the exposures of the fund to US institutions, risk data and other exposure information. **Impact** Requires fund managers to produce new reports on a quarterly basis
7	**Basel III**	To improve supervision of firm-wide risk management; and provide detailed reporting on regulatory capital and the calculation of capital ratios	1. Additional charges and higher capital requirements for services such as prime broking, which is a lot more about tier 3 securities. 2. Regulates internalization, using the assets of one client to cover shorts within another, can only be counted at 50% for the LCR **Impact** Requires fund managers to produce new reports on an ad hoc basis

Key performance drivers

Hedge funds continuously seek and adopt new strategies for growth and expansion, but do not want to increase costs from investing in infrastructure and resources. Consequently, outsourcing some in-house tasks is a solution that fund managers look up to. This includes key front office operations such as trade order management, FX hedging, portfolio pricing and valuation etc. The other areas that managers seek support in are research, advisory and technology. Some benefits of seeking support from a strategic partner are listed below:

- **Cost saving:** Helps save cost incurred by fund managers on technology, headcount and operations.
- **Reduce operational risk:** Major Service providers offer highly standardized processes and good oversight, reducing operational risk.
- **Growth prospects:** Fund managers can focus on global expansion with operations managed by a third party. The service providers also offer expertise and help in increasing revenue and efficiency. Hedge fund managers also get access to expert services that are not always possible to get in-house.

Major support areas of service providers



While service providers can be key performance enablers, fund houses should always oversee them. Fund managers should do proper due diligence and regular audits. The approach to the outsourcing process can be summarized as follows:

Requirement identification and scoping

- Identifying the areas to be outsourced
- Analyzing the financial model and legal angle if any

Implementation

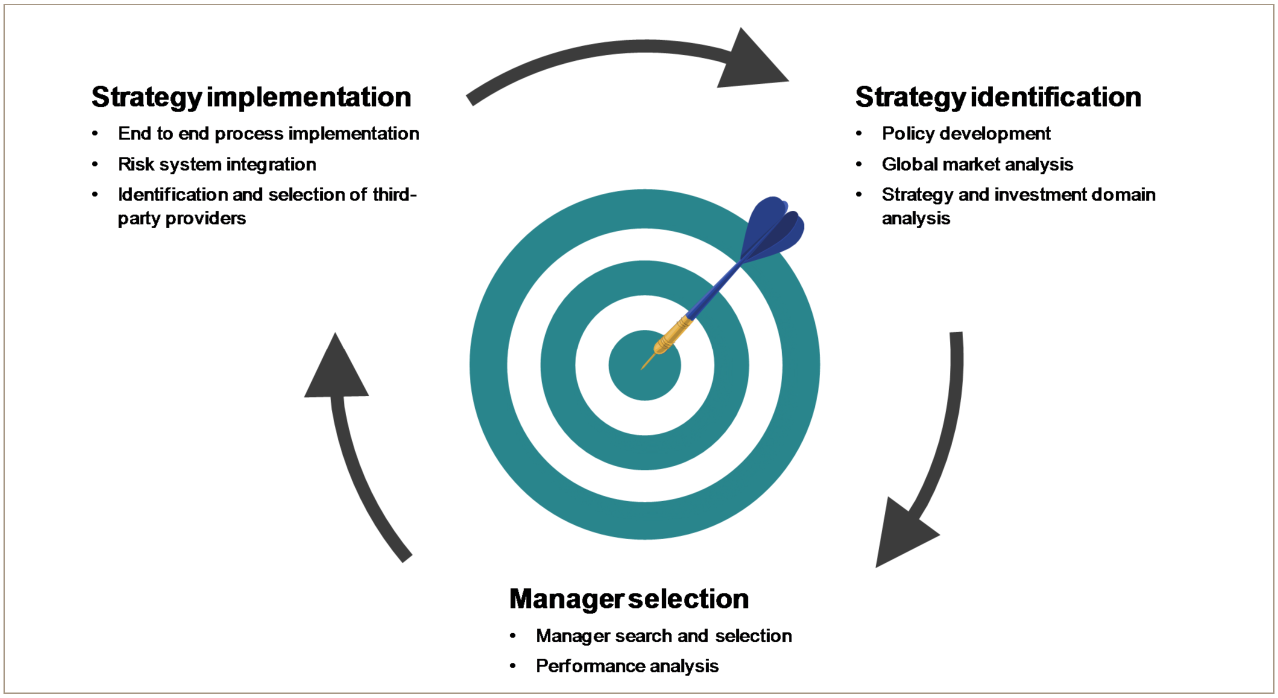
- Finalizing high-level road map with the service provider
- Deciding the operating model
- Data migration and testing

Oversight

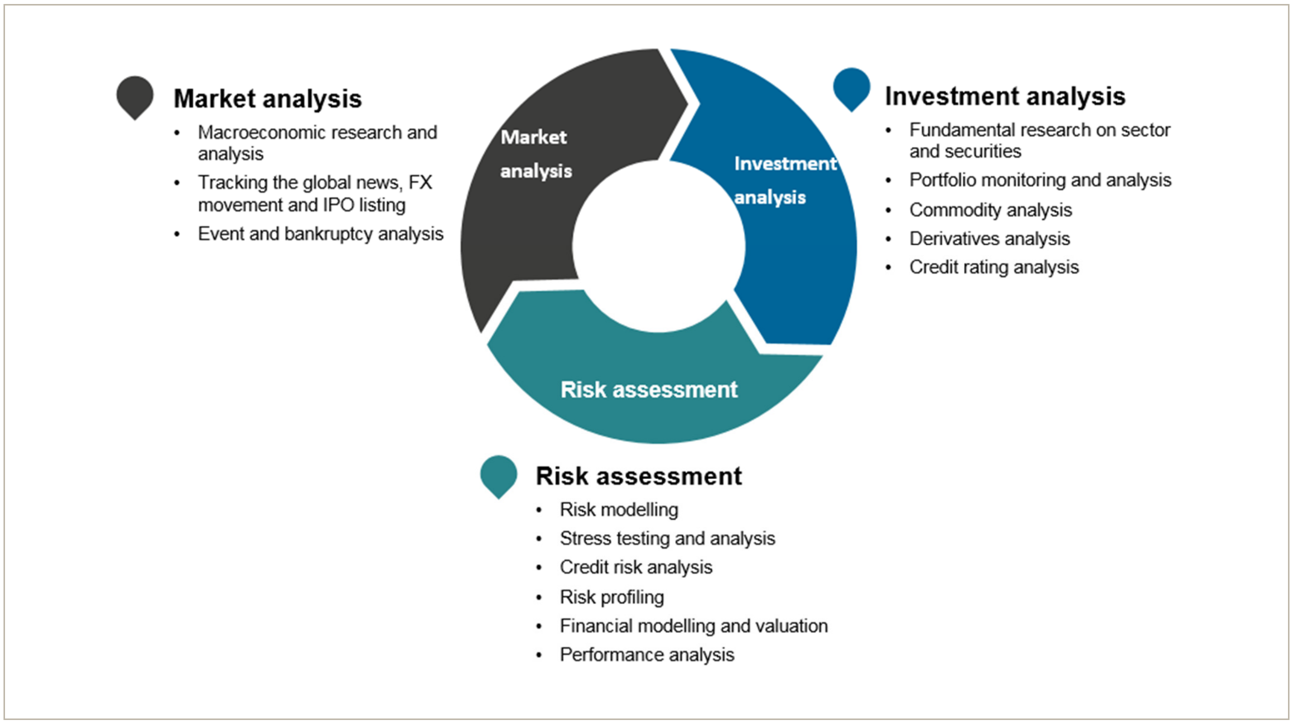
- Timely due diligence - security, privacy and policy control
- Conducting regular audit
- Reviewing the reports

1. Advisory and research support

Fund managers have had to rethink their core strategies because of increasing globalization and competition. Most of them are now considering taking support from expert advisors on their pre- and post-investment decisions wherever required. The services include identifying the strategy, selecting managers and implementing strategy. Advisors help fund managers to make investments based on their strategies, legal proceedings and country-specific regulations.



Research has always been considered a core function of hedge funds. With changing times, managers are looking at the possibility of outsourcing this function as well. Hedge funds seek customized research provided in a timely manner. Services provided by research firms to fund managers include fundamental research, asset allocation, market analysis, global macroeconomic analysis, and M&A analysis; most of them are bespoke services.



2. Key risk management and operations support

Given the increased reporting requirements, fund managers have to ensure that they have strong middle-office and back-office systems in place to collect data and produce the required reports. New funds may face challenges due to resource constraints, while large funds may face problems due to their high AUM.

Hedge funds also exhibit high level of operational risk due to huge data and processes. Efficient data management is very important to mitigate the risk. The specialised platforms of the service providers offer some protection from the operational risks.

As per a research conducted by Alternative Investment Management Association (AIMA)[3] some of the largest hedge fund failures were due to inefficient risk management. As hedge fund's operations involve many entities such as brokers, prime brokers, administrators, back-office processing providers and external risk management. So managing data flows has become a significant challenge for hedge funds' operational teams. In the context, reconciliation can be considered one of the most important constraints on hedge fund operations.

Fund-related accounting is also being outsourced to third-party administrators. The responsibilities of administrators now include full valuation of the funds, reporting to investors and provision of risk monitoring services. They also support with independent NAV calculation and risk reporting. Some of the service providers have independent risk measurement systems and can provide real time risk reports. They also have direct connectivity with the brokers and financial service providers.

The service providers have global platforms to fulfil the unique needs of derivative transactions. The systems can provide valuation of complex derivative product and can also produce risk reports with required parameters.

3. Source: https://www.aima.org/

With highly customized solutions the service providers support the fund managers with end to end solutions for all the operational activities. Some of the key activities which are now being done by a third parties are:

Investment Management

- Investment decisions support
- Fund swap valuation, position trading
- End-to-end support in new fund launches
- Performance analytics
- Trade orders management
- Daily cash collateral and repo management
- Trade order management
- Trade execution
- Strategy implementation
- Trade confirmation and settlement
- Fund reconciliation

Fund Risk Management

- Fund risk analysis on parameters including VaR, stress testing, and scenario analysis
- Preparing risk monitoring models
- Ratio analysis
- Risk monitoring and reporting
- Active and passive breach analysis
- Fund portfolio analysis and compliance reporting
- Monitoring regulatory changes and updating the teams
- Cash and collateral management
- Performance analytics

Investor Relations

- Fund database management
- Fund documentation –
    - Fund presentation
    - Fund factsheets
    - Fund prospectus
    - KIIDs
- Fund website management- updating fund related information and documents
- Daily NAV report distribution
- Investor queries resolution
- Due diligence questionnaires
- Request for proposals

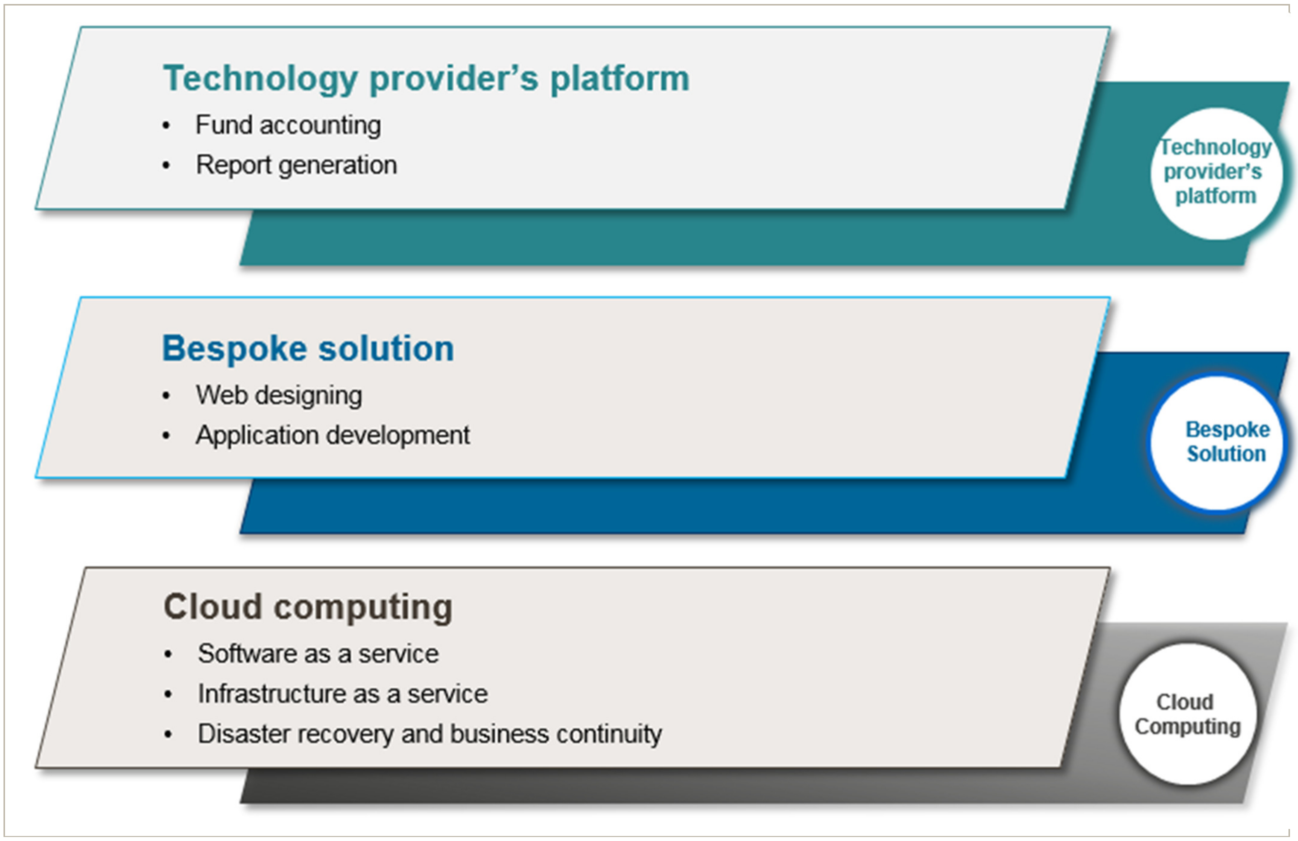
Currently, informed institutional investors demand the involvement of third parties for valuation of complex or illiquid assets such as OTC derivatives.

3. Technology support

To achieve operational excellence, hedge fund managers have to source or develop robust operational and compliance workflows, which can give them the flexibility to grow across geographies and strategies. Technology enables them to work independently and gain better oversight of processes. They are either developing in-house tools to handle fund accounting, portfolio analysis, order management, compliance reporting, and trade booking, or spending on a tool/software created by third-party providers.

Technology service providers are coming up with customized solutions based on the needs of hedge funds. A few technology providers work near clients' locations to understand the needs of fund managers and offer customized solutions. The service providers' solutions are based on the fund's strategy and its location.

Other service providers come up with innovative products for every stage in the fund lifecycle. They leverage the cloud environment and support managers in every domain, including risk management, fund management operations, and investor relations and marketing.



The key benefits provided by the technology service providers can be summarized as below:

- **Customized solutions –** Managers have quick access to customized solutions. Service providers come up with templates for new regulations and compliance reporting and provide readymade solutions.
- **Proper data management –** Some new developments in the technology space enable managers to handle data well and facilitate meetings and calls. Archived data and information get uploaded on the cloud and the data could be downloaded and used whenever required by managers.
- **Increased investor reach –** Technology services providers are also offering web portals that can be accessed from mobile phones and tablets.

Conclusion

Amid intense competition, sharp scrutiny by both regulators and investors, and pressure on profitability, hedge funds have a palette of services and offerings to improve their performance. Funds that consistently innovate and respond to changing situations will continue to grow, even as the industry model changes with service providers emerging as natural strategic partners.

Hedge funds clearly need to act proactively and strategically choose their service providers, especially those that deliver customised solutions for crucial operations. Selecting the right partner can promote process excellence and enable managers to progress. Funds can also save costs related to maintaining in-house technology, headcount and operations. It will also help the fund manager to concentrate on growth and expansion. If strategically selected, the service partners can solve most of the problems faced by the managers and act as a key solution provider. The time has come for hedge funds to make necessary changes to their business models.

CRISIL GR&A is a preferred partner for hedge funds

CRISIL GR&A is working with multiple hedge funds and acting as a strategic partner with comprehensive offerings. With our rich experience in research and front and middle office support we have emerged as most preferred partner.

Hedge funds pick partners who offer a one-stop solutions to all the business requirement, CRISIL offers a plethora of services to choose from. This ranges from research and advisory support, business analysis and technology support, risk management and investment management support. CRISIL also offers extreme flexibility and works as an extended part of the hedge fund’s own team.

CRISIL has provided its support to regulated funds such as UCITS, AIFMD in their investment management and risk reporting areas. The offerings ranged from monitoring portfolios on a daily basis, NAV reconciliation and reporting and risk reporting for the regulators. CRISIL has worked closely with the fund managers and other stake holders like administrators, custodians and transfer agents. We have also provided support to the marketing, onboarding and sales team with various documentation like fund factsheet, fund presentation, prospectus and KIIDs. Our technology solutions include fund platform development and business analysis. We also provide web based solution to hedge funds. We have also placed a key role in strategy execution, regulation implementation and research reporting.

Our expertise and experience across hedge funds have helped us execute industry wide best practices across various projects in hedge funds.

About CRISIL

CRISIL is a global analytical company providing ratings, research, and risk and policy advisory services. We are India's leading ratings agency. We are also the foremost provider of high-end research to the world's largest banks and leading corporations.

CRISIL is majority owned by S&P Global Inc., a leading provider of transparent and independent ratings, benchmarks, analytics and data to the capital and commodity markets worldwide.

About CRISIL Global Research & Analytics

CRISIL Global Research & Analytics (GR&A) is the world's largest and top-ranked provider of high-end research and analytics services. We are the world's largest provider of equity and credit research services. We are also the foremost provider of end-to-end risk and analytics services to trading and risk management functions at world's leading financial institutions and corporations. We offer corporate strategy, competitive intelligence and key account management support to corporations globally. We operate from research centers in Argentina, China, India and Poland, working with our clients across several time zones and in multiple languages. We are proud to be an organization that has the vision to proactively invest in its people and get them future-ready. We are committed to delivering cutting-edge analysis, opinions, and solutions. This underscores our proposition of "Making Markets Function Better".

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