Hedge funds and Dodd-Frank: Institutionalize, fly low or else!

Thoughts

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Hedge funds and Dodd-Frank: Institutionalize, fly low or else!

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The Dodd-Frank Wall Street Reform and Consumer Protection Act will impose much stricter regulation on the hedge fund industry. The scope of that regulation, how the industry must respond to it, and whether firms will embrace the spirit of the regulation to gain competitive advantage are open questions.

Government rulemaking will provide more answers in the months ahead. But the industry isn't waiting to act. Despite continuing uncertainty, hedge funds, prime brokers, fund administrators and other service providers are starting to reposition themselves for a vastly different industry landscape and new opportunities, guided by what they do know.

Some funds are looking to grow and consolidate so they can build the scale and infrastructure needed to meet increased compliance demands. Others are weighing whether to shrink their business below asset thresholds set by the act so they can avoid additional taxes and testing and reporting requirements. Some are simply exiting the business. Meanwhile, service providers are assessing whether they have the personnel, processes and technologies to meet the needs of customers facing intensified regulation at both the federal and state level.

This white paper examines the implications of regulatory reform and changing market conditions for hedge funds. It discusses 10 requirements hedge funds will need to consider as they decide where they fit in the fund spectrum. And it describes some practical steps that funds and service providers can take to begin positioning themselves to capitalize on the dynamics of the new environment.

Hedge fund regulation – how we got here

The idea of increasing regulatory oversight of hedge funds did not originate with Dodd-Frank. In response to the explosive growth of hedge funds' assets under management (AUM) and growing concern over their operations and transparency, the U.S. Securities and Exchange Commission (SEC) issued a rule in 2006 requiring funds to register as investment advisers. However, that same year, the U.S. Court of Appeals for the District of Columbia Circuit vacated the rule on the basis that it was not compatible with the Investment Advisers Act of 1940.

In the wake of the financial crisis, hedge funds again became a target for increased regulation. With the industry becoming more institutionalized and negative investor sentiment growing, hedge funds embraced or in some cases acquiesced to inclusion in Dodd-Frank, which became law in July 2010. The act imposes new registration and reporting requirements, risk rules, and investment limits *(Figure 1 on page 4),* as well as other safeguards *(see "A look at Dodd-Frank hedge fund provisions" on page 13).*

Along with requiring hedge funds to register with the SEC, the act imposes new reporting requirements, significant oversight of nonbank financial firms, transformation of the over-the-counter (OTC) derivatives business and limitations on proprietary trading by banks. Over the next several years, regulatory bodies, including the SEC, the U.S. Commodity Futures Trading Commission (CFTC),

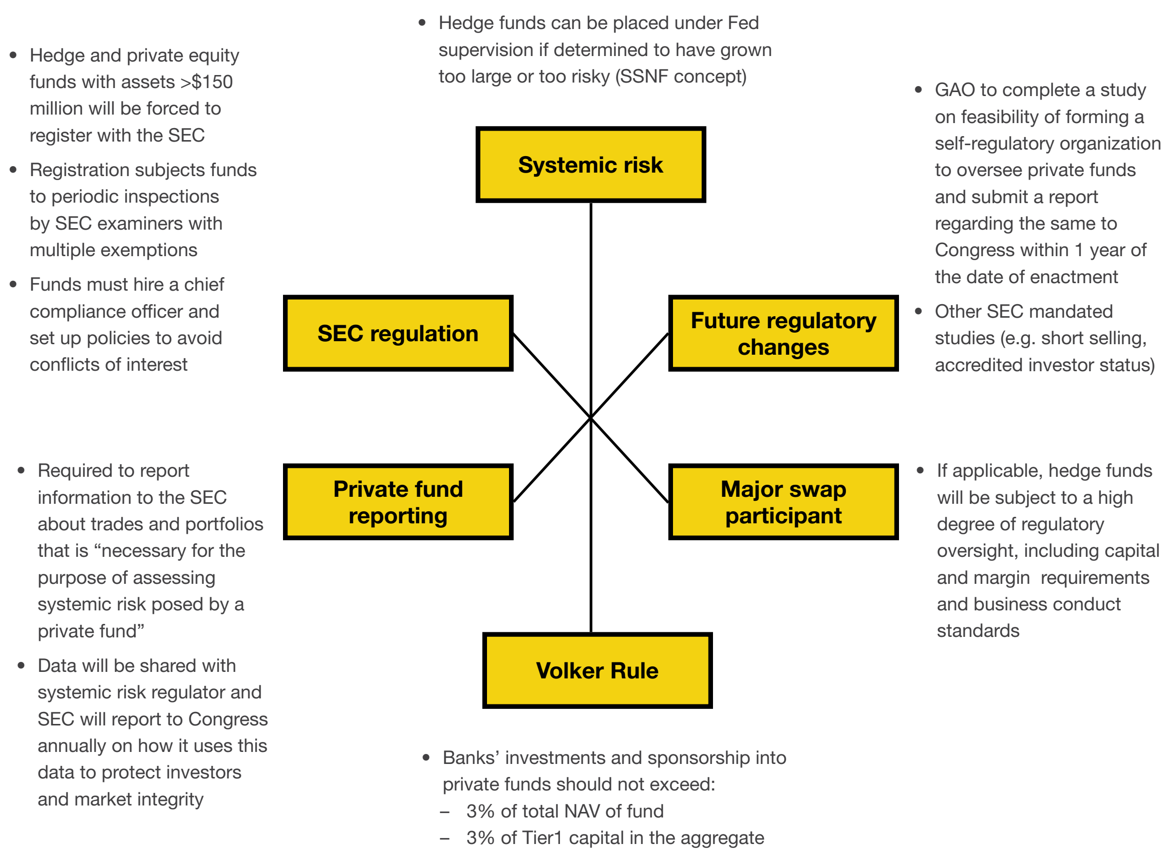

Figure 1. Hedge funds face intersecting Dodd-Frank requirements

the Federal Reserve and the new Financial Stability Oversight Council (FSOC), will conduct rulemaking and expand regulatory powers over the industry. These actions will fuel already growing investor demand for increased fund transparency and improved risk management.

Where is the industry heading?

Amid the upheaval caused by the financial crisis and regulatory reform, alternative investments remain an important element in diversified portfolios. In many cases, hedge funds can offer higher and more stable returns with low correlation to other assets and increased return potential.

Hedge fund flows overall remained relatively flat for the first half of 2010. Strategies such as global macro, event-driven and fixed-income arbitrage enjoyed the largest capital inflows, while emerging markets, long-short equity and multi-strategy funds saw the biggest outflows.[1]

What is in store for hedge funds in the months ahead? The largest firms are expected to look for consolidation opportunities so they can achieve the scale needed to meet their clients' transparency and risk management demands and growing compliance requirements.

Large firms also hope to maintain their appeal to pension funds, endowments and other institutional investors that seek the security of dealing with a major institution. According to Hedge Week, investors prefer established firms with more than $5 billion in assets under management.[2] Such firms manage approximately 48 percent of total industry capital *(Table 1 on page 6).*

Further, according to a leading hedge fund industry researcher, "The current environment in the hedge fund industry continues to be dominated by investor preference for robust fund infrastructure, encompassing enhanced liquidity and transparency. Investors have exhibited strong interest in products such as UCITS III-compliant funds and separately managed accounts, as well as in the larger funds in the industry. Further growth in transparent investment vehicles and greater clarity on global financial reform legislation will continue to shape the landscape of the alternative investment industry for the next decade."[3]

Some industry participants will likely try to exploit loopholes in Dodd-Frank, such as taking a registration exemption provided to family offices. Others will choose to keep or adjust fund size to below $10 billion in assets to avoid additional taxation and the requirement to conduct annual stress tests and report results to regulators. Even with such moves, smaller firms will face expanded transparency and reporting requirements necessitating new processes and systems, which may be provided by outsourcing utilities.

With larger firms consolidating to achieve desired scale and others jockeying to duck under regulation, a decline in the number of mid-tier firms appears likely to accelerate, resulting in more of an hourglass-shaped industry.

In assets under management

Assets in billions of dollars	Number of funds	Assets in the bucket in billions of dollars	Percentage of the industry
20	10	200	14%
10	25	250	17%
5	50	250	17%
1	100	100	7%
NA	185	800	55%
Assets in millions of dollars	**Number of funds**	**Assets in the bucket in billions of dollars**	**Percentage of the industry**
70	9315	650	45%

Source: Introduction aux hedge funds. 2nd edition. *Economica* 2010

Table 1. Hedge fund assets under management

Another key Dodd-Frank provision is the Volcker Rule. With limited exceptions, this rule prohibits banks and nonbanking entities regulated by the Federal Reserve from proprietary trading, as well as investment in and sponsorship of private equity and hedge funds. Although some restrictions won't go into effect for several years, firms are examining their proprietary trading desks and internal hedge funds, in part due to concern over employees moving to other funds. Anticipating the rule, Morgan Stanley has relinquished full control of its in-house hedge fund unit FrontPoint Partners and reduced its investment to 20 to 25 percent[4], and it is considering a spin-off of its quantitative proprietary trading desk.[5] Nine employees left Goldman Sachs last October to start a unit at private equity firm KKR & Co., and others have retired, been hired elsewhere or departed to form their own hedge fund.[6]

In this environment, we see three trends emerging:

Hedge funds and other alternative investment firms will increasingly be challenged by comprehensive, wide-ranging financial market reform. Preparation for a significant operational overhaul is a new, key priority for hedge funds. Funds grew accustomed to unparalleled capital growth over the past 15 years; however, for the past three years they have struggled with a renewed negative perception. A recent survey of hedge fund investors reveals that investors are increasingly deselecting funds not because of performance but because of concern over insufficient transparency, compliance and risk management.[7] However, even as regulatory changes continue to materialize, recent hedge fund surveys show that corporate pension funds, public pension funds, endowments and foundations will allocate more to hedge funds than any other alternative asset category. Further, while endowments and foundations are the primary investors, public funds, which currently have the smallest hedge fund allocations and lowest participation rate, are expected to have the fastest rate of growth in hedge funds across institutional segments.

Market conditions will drive hedge funds to reconsider their operating model and increasingly turn to third parties. Self-sustaining funds are becoming increasingly untenable. To focus on what managers do best—deliver a controlled and consistent rate of return on investments—more hedge funds are turning to outsourcing. Prime brokers and fund administrators are increasingly providing the experienced personnel and technologies needed to deal with complex products, transactions and volumes. In addition to the continued expansion of back-office and middle-office functions, new and existing providers will strive to offer capabilities that provide hedge funds with more flexibility to meet increased regulatory demands.

Technology will continue to play a key role. In addition to reducing costs, becoming more efficient and better managing operational risk, hedge funds have to scale to better leverage technology to cope with upcoming regulatory requirements.

10 things hedge funds need to address

Hedge fund managers and third-party service providers, depending on their size and the maturity of their operational and technology infrastructure, face varying challenges in meeting the new regulatory mandates. Here are 10 issues warranting consideration:

1. Preparation for SEC examination. The Investment Advisers Act of 1940 authorizes the SEC to conduct examinations of registered advisers, with a focus on risk. In most cases, the commission staff considers the quality of the registrant's compliance systems and its internal control environment when determining the scope of the examination and the areas to be reviewed. Key issues for hedge funds to consider include how to prepare for the examination and how long will it take for the fund to be confident it is ready.

2. Policies and procedures. Hedge funds must have documented policies and procedures. Valuation policies and procedures are critical, especially as they relate to illiquid securities. Fund managers will want to research the leading practices for documenting policies and procedures and valuing various asset classes.

3. Compliance programs. Hedge funds will need to develop robust compliance programs that introduce a new governance model and appoint a chief compliance officer. It will be important to establish the mandate of the compliance group, determine what policies and procedures are needed, and consider how frequently audits and assessments will be required to comply and identify key risks and gaps.

4. Regulatory reporting. Regardless of the specific requirements emerging from regulatory rulemaking, hedge funds and third-party service providers are going to be affected dramatically. It will be important to determine immediate state and federal reporting requirements as quickly as possible so operating model changes and technology enhancements can commence. Key questions include what the new models will need to look like and how to prepare a road map for establishing them. The depth of recordkeeping information required will increase operating costs for funds-of-funds and funds specializing in illiquid, hard-to-price assets. Report generation environments will need to be flexible enough to evolve with the FSOC's shifting reach and interests.

5. Risk management. All registered hedge funds will have to enhance their risk management practices and provide related reporting on topics including AUM, trading and investment positions, counterparty credit exposure, use of leverage, and contribution to systematic risk. Any fund designated as a systemically significant nonbank financial firm (SSNF) will also need to stress test its portfolio, maintain living will plans, and comply with new risk-based and contingent capital requirements. Hedge funds designated as "major swap participants" will need to factor in the risk management implications of central clearing. Spin-offs of proprietary units will potentially need to recapitalize to comply with the Volcker Rule, which limits bank investments in hedge funds to 3 percent of Tier 1 capital.

While service providers have always played a significant role in servicing the operations of hedge funds and investment managers, Dodd-Frank could provide a significant opportunity to expand as the reporting requirements prove to be onerous for mid-tier hedge funds.

6. Data governance and documentation management. Funds will need to implement sufficient processes and controls for accuracy of key data. Factors to consider include the requirements for storing, archiving and retaining data and documentation, and what systems and processes will be needed for compliance.

7. OTC derivatives trading. Some OTC derivatives have been migrating to central counterparties for clearing. The migrating contracts are mainly select, single-name credit default swaps (CDSs) and index CDSs. Dodd-Frank will drive contracts away from bilateral contracts toward central counterparties. Hedge funds and third-party service providers must prepare for this by determining which central counterparties are likely to emerge as winners and what will be involved in connecting with them or selecting partners through which to do so.

8. Continuing uncertainty regarding further regulation. Regulators will be conducting rulemaking proceedings related to Dodd-Frank for some time to come. The act requires completion of more than 60 studies, and the issuance of some 200 additional regulations is expected over the next few years. Hedge funds will need the flexibility to adjust as new rules emerge. They will face decisions on whether to use vendors and service providers to meet these new requirements or embark on their own program to develop flexible and scalable systems.

9. Human capital. Hedge funds will need to address new regulations with additional people, including those with specific skills, such as a chief compliance officer. The SEC's information requirements may necessitate additional technical personnel focused on master data management and business intelligence software. The spin-off of proprietary trading desks and investment banks' desire to keep top employees could create additional front-office compensation demands. At the same time, investment banks' exit from alternative investments could spur a further exodus of talent to hedge funds. It remains to be seen whether the regulatory bifurcation of small and large firms will lead to employee shifts in either direction.

10. Technology spending. As OTC derivative trading migrates to central counterparties for clearing, electronic and algorithmic trading will continue to expand to other asset classes. Prime brokers will need to continue to provide the capabilities necessary to execute client trades, test models, and maintain secure and controlled technology environments.

Where to start?

More than half of hedge fund managers in the United States have already registered with the SEC.[8] But regardless of whether they have previously registered, hedge funds and third-party service providers will need to review their operations thoroughly to prepare for regulatory compliance. Given the continuing regulatory uncertainty, hedge funds and their service providers will need to invest in flexible, scalable operating models for front-, middle- and back-office activities.

Hedge funds' increasing reliance on prime brokers, custodians, hedge fund administrators and other service providers is significant and likely to grow. While service providers have always played a significant role in servicing the operations of hedge

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funds and investment managers, Dodd-Frank could provide a significant opportunity to expand as the reporting requirements prove to be onerous for mid-tier hedge funds.

Prime brokers and fund administrators will be able to further differentiate themselves by providing the technological resources and reporting capabilities necessary to meet regulatory demands. They have the technological capabilities and scale to handle the massive amounts of data and reporting requirements, provide valuation services, control access to investor funds, and support middle- and back-office operations.

Capco research has identified several operating models with strong capabilities to help hedge funds address the challenges they will face. Leading vendor technologies featuring enhanced integration tools, coupled with experienced operations and technology talent from the broader investment banking community, are accelerating the trend toward service providers. In our work with hedge funds and other investment institutions, we have seen a trend among leading organizations in this segment to invest in building scalable and robust internal operating environments to manage front-to-back business activities. Most common is to integrate a range of best-of-breed applications to support core functions from investment and risk analysis to portfolio accounting and investor reporting.

A number of vendor applications are establishing themselves as core components of the hedge fund architecture. Traditional buy-side order management systems vendors, such as Eze Castle and Charles River, have invested in extending their capabilities to support investment and risk analysis, intraday positions and risk management. Similarly, traditional sell-side trading system vendors, such as Murex and Sophis, have made significant inroads among multi-strategy hedge funds by offering front- and middle-office capabilities across asset classes. Portfolio management and accounting systems for hedge funds tend to be dominated by a few vendors, including Advent Geneva and SunGard.

Practical next steps for funds and service providers

Hedge fund managers can benefit from thinking strategically about Dodd-Frank's business implications rather than strictly in compliance terms. They can view the regulations from an investor due diligence point of view and explore opportunities to capitalize on the coming changes. Such an exercise might include examining questions like these:

Organization and capital structure

- What changes have you made in anticipation of Dodd-Frank passage?

- Are you prepared for institutional investors incorporating Dodd-Frank implications in their financial and operational due diligence?

- How is Dodd-Frank affecting your business counterparties–prime brokers, custodians, banks and investors? What impact will it have on your relationships with them?

- Is your current operating model properly aligned to embrace your next phase of growth? Have you conducted an operational assessment recently?

- How will the Volcker Rule affect your current capital structure and operations? Will you consider divesting an internal hedge fund management business or, conversely, acquiring spun-off proprietary trading groups?

- As a major swap participant, what additional business costs and benefits will your migration to central clearing create?

Finance

- How will regulatory changes affect your fee structure and what are the financial implications?

- If, as a smaller manager, you face a difficult fundraising environment, how can you employ more-developed marketing and distribution infrastructures (e.g., more effective use of the Internet and social networks)?

Compliance

- Have you appropriately budgeted for the increased compliance costs associated with Dodd-Frank?

- Have you discussed the increased compliance focus with key service providers, including legal counsel, compliance consultants and risk consultants?

- What changes in compliance policies and procedures have you undertaken? How have these changes been communicated to staff and documented in the firm's compliance manual? If changes have not been made yet, when will they be?

Registration

- If you are registering, have you considered what changes will be needed in your internal control structures?

- If you are already registered, are you in the category of managers who may need to potentially de-register? If so, are you prepared to comply with local state registration requirements?

Risk management

- Have you developed a risk infrastructure that is both adequate to meet the new requirements and applicable to your organization, whether a private fund, SSNF or major swap participant?
- What type of risk analytics do you plan to implement, and how will you define stress testing?
- How will the new risk-based capital requirements affect the conduct of your business?

Transparency and reporting

- What levels of financial and operational transparency do you intend to provide various constituents?
- Have you developed a reporting and technology infrastructure to meet new requirements?
- How well does your data strategy support new reporting requirements?

Preparing for the journey

For hedge funds, responding to regulatory reform is a marathon, not a sprint. Many requirements are still to be established over the next few years. In the meantime, large firms will need to decide whether and how to grow to capture greater market share. Smaller hedge funds will be subject to state regulations, and they may have to meet the demands of more than one state. Third-party service providers will need to adapt to shifting client requirements as funds reposition for the new regulatory order. Everyone involved can benefit from looking beyond compliance to consider how regulatory reform may open doors to business growth and competitive advantage.

Footnotes

1. "Hedge funds still attracting billions in new cash," *Reuters,* 7/22/10, http://www.reuters.com/article/2010/07/22/us-hedgefunds-cash-idUSTRE66L4YE20100722
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8. "Majority of hedge funds are SEC-registered," *HFMWeek,* 5/2/09, http://www.hfmweek.com/news/166211/majority-of-hedge-funds-are-secregistered.thtml

A look at Dodd-Frank hedge fund provisions

While the final form of many new hedge fund regulations remains to be determined, their impact will be significant. Here are some of the provisions that it will be important for funds to consider:

Investment adviser registration:

- The exemption for funds with fewer than 15 clients is eliminated.
- The assets under management (AUM) threshold for U.S. Securities and Exchange Commission (SEC) registration increases to $100 million from $25 million. Advisers with less than $100 million in AUM will be subject to state regulation.
- Exemption from registration for certain groups, including advisers to private funds with an aggregate AUM in the U.S. under $150 million, advisers to venture capital funds, foreign private advisers and family office advisers.

Records and reporting requirements

- The SEC will spell out provisions relating to maintenance, filing and inspection of records within the next 12 months.
- The SEC will provide the Financial Stability Oversight Council (FSOC) with any private fund information collected by the SEC and deemed by the FSOC to be necessary to assess the systemic risk posed by such a private fund.

Prudential safeguards

- Dodd-Frank establishes a new class of systemically significant nonbank financial firms (SSNFs) that will be subject to new regulations. SSNFs will be subject to Federal Reserve oversight, including Federal Reserve examinations. The FSOC could extend this definition to large hedge funds.

Large firm stress testing

- Any financial company, including any private fund, with more than $10 billion in total assets, regardless of SSNF status, must conduct annual stress tests and report results to the Federal Reserve and its primary financial regulatory agency.

The Volcker Rule

- With limited exceptions, banks and nonbanking entities regulated by the Federal Reserve will be prohibited from proprietary trading, as well as investment in and sponsorship of private equity and hedge funds.

Major swap participants

- The SEC and the Commodity Futures Trading Commission (CFTC) will share oversight of swaps and will register nonbank "swap dealers," which may include hedge funds.

Clearing requirements

- The SEC and CFTC will publish a list of derivatives required to be cleared, which may include derivatives positions held by hedge funds. Funds will need to adjust their trading and clearing activities to adapt to specified clearing methods.

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