Hedge Funds

Facing new challenges

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The global financial markets are on the threshold of a new regulatory era. Technology will undoubtedly underpin hedge funds' efforts to comply and compete in this changing environment. But is it better to build tailor-made systems in-house or use a third-party provider of off-the-shelf products?

Attitudes to outsourcing differ across the market, but there are certainly benefits to outsourcing – increased efficiency, reduced costs and specialist expertise, among others – as long as the provider offers a more effective solution. And, of course, it does not have to be all or nothing; modular systems allow hedge funds to pick and choose products for integration with current platforms.

The options are endless for those that wish to outsource some or all of their compliance needs. And, while overall responsibility for compliance will remain with hedge funds, the right outsourcing partner should ease the transition into this new regulatory era, leaving funds to concentrate on the day-to-day business of managing assets.

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As hedge funds adapt to new regulations throughout the financial world, technology will play a major role in helping them to both comply and compete.

Globally, hedge funds managed $3,102 billion of assets — a record high —at the end of the first quarter of 2015, according to data provider Preqin. The US remains at the centre of the industry — assets under management in the Americas currently total $2,313 billion — but substantial hedge fund assets can also be found in other regions. In Europe, the Middle East and Africa, hedge fund assets total $631 billion and in the Asia-Pacific region, hedge funds currently manage $158 billion of assets.

Regardless of where a hedge fund is based, regulatory changes will have a major impact on front-, middle- and back-office operations. Not only have expectations of regulators changed in relation to transparency, record-keeping and reporting, investors are taking regulatory compliance as a given, and driving operational excellence as a requirement.

Hedge fund operating procedures, along with their infrastructure, need to be reimagined to ensure all internal systems and processes are not only compliant, but also as effective and efficient as possible. They need to add value and allow managers to concentrate on the day-to-day business of managing assets.

Changing rules

The US and Europe have designed separate but overlapping regulatory regimes based on measures agreed by the Group of 20 nations following the onset of the financial crisis in 2008. The resulting frameworks — the US Dodd-Frank Wall Street Reform and Consumer Protection Act, and the European Market Infrastructure Regulation — aim to increase transparency and reduce systemic risk in global financial markets. Under the new rules, both jurisdictions require most derivatives transactions to be centrally cleared. Hedge funds must ensure back- and middle-office systems can comply with initial and variation margin requirements as well as newly introduced and raised margin needed for any trades that are not centrally cleared.

The European transition from a T+3 to a T+2 settlement period towards the end of 2014 has also encouraged trading companies to re-imagine internal systems and processes. In Asia, Hong Kong, Korea and Taiwan are already on T+2. Australia has confirmed a move to the shorter settlement period, while Japan, Singapore and New Zealand are considering it.

A shorter settlement cycle reduces margin and liquidity needs, and mitigates counterparty risk. Under such circumstances, many hedge funds have started to realise the benefits of fully automated operational systems. The ability to process transactions quickly, efficiently and accurately becomes even more important with a shorter settlement cycle, particularly during times of market stress.

> Creating robust risk management systems that are accurate, updated in real time and comprehensive with necessary asset class coverage is key to gaining greater confidence of investors and meeting the needs of regulators

Data management

Managing reference data and ensuring the highest possible level of data quality is business-critical for hedge funds. Using faulty data can lead to accounting errors and adjustment of already published data, with the consequent loss of trust from counterparties and investors.

How to aggregate data and risk information from data silos (effectively, to collect, analyse and store data) has become a hot topic under regulatory regimes. In the absence of standardised data and access to relevant risk information, the European Union's Central Securities Depositories Regulation, for example, requires buy-side firms to use standing settlement instructions

(SSIs) for cross-border payments. While this will reduce settlement risk and improve straight-through processing rates, hedge funds must be able to quickly and efficiently collect SSI data — and store it securely.

Know-your-customer checks also require strong data collection systems and processes. Under standards such as the Alternative Investment Fund Managers Directive, hedge funds will need to show they have robust systems in place to help perform client and counterparty checks, as well as to ensure sales and marketing efforts are appropriately targeted.

New systems and processes

All of these new rules will impact front-, middle- and back-office activities of hedge funds throughout the global financial system. As a result, changes to current data management, trade-matching, collateral and reporting systems are inevitable. So how should hedge funds direct valuable resources when redesigning their compliance systems to satisfy these new standards?

Technology will play a key role in helping hedge funds meet compliance expectations of regulators and investors, while also allowing them to continue to thrive in a highly competitive, fast-paced market. Whether these new systems are built in-house or outsourced to third-party providers, they will be a major area of focus for hedge funds.

The discussion of benefits of in-house systems versus outsourcing evolves around cost and complexity. Data management, for example, essential to risk management, is not an area of differentiation for hedge funds. Many funds entrust data management to their administrators while it is not necessarily a core competency of the intermediary. Outsourcing data management and trade matching to third-party vendor solutions addresses complex reporting requirements, is cost-effective and reduces risks. Third-party solutions can be implemented on a hosted basis or into existing order management systems, creating the possibility of an integrated system across asset classes.

“When considering outsourcing a certain middle- or back-office function, think about whether it can be performed more efficiently and effectively by a third party,” Leigh Walters, managing director, global head of sales and partners, DTCC, says. “If it can, and the third-party service enables the client to comply with regulatory and investor requirements, you should outsource the function while maintaining overall control of operations in-house. You can outsource the function, but you will not outsource the responsibility.”

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> **Leigh Walters, managing director, global head of sales and partners, DTCC**

Risk management

As hedge funds consider how risk impacts managing their portfolio, it is also important to keep in mind how investors and regulators perceive risk. Risk transparency, regular insights and reporting have increased.

Creating robust risk management systems that are accurate, updated in real time and comprehensive with necessary asset class coverage is key to gaining greater confidence of investors and meeting the needs of regulators. A first step is often to eradicate the need for manual data entry, which often leads to human input error, to reduce operational risk.

The automation of post-trade processes will prove to be extremely useful in helping hedge funds meet regulatory obligations and manage risk more efficiently, particularly for those funds that operate in multiple jurisdictions, according to Walters. “Moreover, robust operational controls can deliver additional benefits such as increased efficiency and reduced costs. As firms increasingly look to automate and streamline these processes, we are seeing them turn to providers such as DTCC and Omgeo in the post-trade space. Our

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services can help clients improve their operational processes, enabling them to comply with local regulatory requirements."

The role of technology in risk management has evolved and hedge funds should integrate cybersecurity into their risk management and operational processes. Third-party providers offer systems to support the processing of cyber-threat information, providing greater visibility and allowing hedge funds to respond to any potential security breaches quickly and efficiently. This will be crucial, as reliance on technology throughout the financial services industry continues to increase.

New offerings

Third-party providers of these new systems must continue to re-examine their offerings as the global financial markets continue to evolve, shaped by new rules and standards. By closely following the process of drafting, confirming and implementing new regulations in each region of the world, providers can ensure their products and services are not only compliant but also ahead of the game when it comes to the current and future functionality and needs of hedge funds. Providers must work with financial services clients to deliver the speed and accuracy required by traders in today's markets, as well as the range and type of products and services required. This is already happening, for example, with the recent trend among trading companies towards a more modular approach to outsourced back- and middle-office systems. Rather than an entire system, many funds are now interested in acquiring certain packages or services from third-party providers that can then be bolted on to existing platforms or linked to different partners, vendors and providers.

Demand for outsourcing will continue, if not increase, as hedge funds and other financial firms face more oversight throughout the global financial markets. The providers of technology that can ease the transition to new, more heavily regulated markets will be in high demand. It is vital to monitor regulatory changes, as well as the needs and demands of hedge fund clients, in order to continue to develop strong, effective technology solutions that can help firms to trade compliantly and competitively. ●

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DEPOSITORY TRUST & CLEARING CORPORATION

With more than 40 years of experience, DTCC is the premier post-trade market infrastructure for the global financial services industry. From operating facilities, data centres and with offices in 16 countries, DTCC – through its subsidiaries – automates, centralises and standardises the post-trade processing of financial transactions, mitigating risk, increasing transparency and driving efficiency for thousands of broker/dealers, custodian banks and asset managers worldwide. User-owned and industry-governed, the firm simplifies the complexities of clearing, settlement, asset servicing, data management and information services across asset classes, bringing increased security and soundness to the financial markets.

In 2014, DTCC's subsidiaries processed securities transactions valued at approximately $1.6 quadrillion. Its depository provides custody and asset servicing for securities issues from more than 130 countries and territories, valued at $64 trillion. DTCC's global trade repository maintains approximately 40 million open over-the-counter positions and processes roughly 280 million messages each week.

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