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Incorporating BuySideIT

Compliance is not a four-letter word

Compliance is still perceived by many buy-side firms as a necessary evil and not a potentially key differentiator in an increasingly competitive market. But as Cogency's Jeffrey Axelrod explains, technology enhancements have made it possible to automate certain compliance procedures, allowing organisations to focus on alpha generation.

Many believe that compliance is one of the alternative investment industry's four-letter words; it evokes government regulation, bureaucracy and other 'Big Brother' type behaviours. That's a fallacy. Compliance is in fact at the heart of self-imposed and client-defined norms to mitigate risk while pursuing the generation of alpha. While hedge funds are increasingly coming under external pressure to define formal compliance policies and procedures, funds of hedge funds (FOHFs) – arguably one of the growth engines for the alternative investment ecosystem, especially with the inflow of institutional capital – have typically been 'self-compliant'. The policies and systems that most FOHFs use to define and monitor their compliance, however, are generally *ad hoc* and call out for a technology-based solution that can match their growth and complexity needs.

Today's typical structural environment

It is not unusual for a start-up FOHF to have all its back-office accounting done by a fund administrator. But as the firm grows in assets, in the number of funds and share classes, in complexity and in sophistication, these functions are predominantly brought in house. From portfolio and fund accounting to analytics, investor management and reporting, numerous systems are required to both run the business and to provide the value-add marketing edge that helps firms differentiate themselves. Typically these systems fall into one of the functional groupings of FOHF operations: commodity functions and value-add functions.

Commodity functions

On the commodity side, core accounting and investor management systems are the keys to providing organisation to the firm's operational workflow. Many firms currently use Excel-driven worksheets for the following functions:

portfolio accounting – fund investments, manager performance, allocation and attribution;

● fund accounting – fees, expenses, and net-asset value (NAV) calculation; and

● investor management – investor investments, fee calculation, and capital allocation.

While FOHFs are justifiably proud of their in-house built systems, this component of the infrastructure does not provide any added value beyond keeping the firm's operations running. Owing to the custom-built nature of the systems and the lack of custom application development and maintenance resources, it is difficult for firms to continually enhance functionality as their business evolves. Thus, over time, FOHF operations may evolve to meet the needs of the spreadsheet systems instead of meeting the needs of the business.

Value-add functions

On the value-add side of the business, firms typically customise data collection, analytics and investor reporting, enabling them to distinguish their business from a marketing and performance perspective. This information is fed from the accounting worksheet environment and helps to address the following areas:

● guidelines and processes for evaluating and bringing new managers into the portfolio;

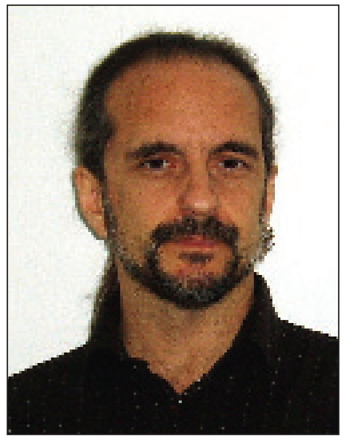
● guidelines and processes for keeping existing managers in the portfolio. This requires firm-wide portfolio risk monitoring sliced-and-diced using data from the managers and from industry databases;

● investor reporting and transparency, including visibility in the portfolio selection and risk management processes; and

● maintaining a professional public image of the firm, enabling it to instil confidence in prospective investors.

FOHF compliance

FOHF compliance focuses on the firm's ability to track and monitor the value-add aspect of its systems. While compliance rules are rarely based on the commoditised functionality directly, they do depend on these systems to supply accurate and timely data. Investors and potential investors who are performing due diligence reviews on a fund (particularly the large institutional investors) look for and expect compliance with published guidelines. The search for alpha drives the internal guidelines and rules by which a fund operates. This is often considered the 'proprietary strategy' of a fund.



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Guidelines may be grouped as follows:

● public guidelines that monitor and alert on items defined in a fund prospectus, such as new manager selection, years in the business, track record, and so on;

● portfolio composition and firm-wide exposure by manager, fund family and strategy;

● risk and volatility levels of the portfolio as a whole, and of each investment within the portfolio;

● internal guidelines that monitor and alert on items of fiscal responsibility, such as liquidity of fund investments, leverage levels, availability of cash, upcoming redemption dates, and fees and other non-portfolio related fund expenses; and

● soft guidelines that are less quantifiable, such as research done into a manager's background and personal meetings with managers.

In most cases, data that drives the guidelines is not centralised and comes from various sources, including: Excel spreadsheets, accounting, industry databases and from often incomplete data received from managers.

Compliance tools

Excel seems to be the primary tool used to monitor and alert on guidelines. The main problem with Excel is its inability to handle the complexity of the business. Thus, as a firm adds funds, share classes and series, and its history and investor lists grow, Excel quickly reaches its operational limits. In some cases, a firm may employ a portfolio accounting package created for hedge funds with market positions rather than fund investments, and then attempt to shoehorn their operations into this model. Occasionally, a firm will use a partnership accounting package, which becomes its own data silo.

How can a FOHF-specific solution help?

A FOHF-specific solution can bring structure, efficiency and accountability to both the commodity and value-add components of this environment. The characteristics of these solutions provide firms with FOHF-specific vocabulary, workflow and user-defined compliance functionality. By bringing a well-defined and efficient workflow to the commoditised aspect of the business (for example, portfolio and investor accounting), firms can eliminate the dependency on custom-built Excel spreadsheets and reduce their operational risk. Additionally, this frees up the valuable time and money firms spend on developing and attempting to maintain an in-house custom solution.

To enhance their value-add component, firms can use these systems to define *ad hoc* compliance rules and thresholds, enabling them to better define both internally and externally facing compliance guideline checks. The systems can also generate analytical and performance views, and provide more detailed and faster access to transparency, which enables better decision-making.

From a data perspective, they provide a centralised data hub that integrates a firm's wide-ranging data. This not only improves the accuracy and timeliness of operational data, it enables custom compliance definition, greater transparency throughout the firm, and the generation of on-demand, custom reports for each audience within the firm.

Lastly, with security being at the forefront of our industry, these systems understand the concern and typically provide role-based data security, application security and screen security. With these security components in place, each department (investor relations, accounting, risk and so on) can feel like they have a custom application that meets their specific security requirements.

What's on the horizon for FOHFs?

Both internal (investing in their own funds only) and external FOHFs are experiencing and will continue to experience huge growth. To keep up with this expansion and to provide investors with the information they need, the industry has to move towards the equivalent of straight-through processing for FOHFs. A key facet of this strategy is the development of standardised reporting, both in content and in form. This includes having standard data elements and a standard format for the managers' weekly performance estimates and for their bucketed portfolio information (for example, portfolio concentration by sector, geography, strategy, etc).

As for the reporting mechanism, this too needs to be standardised as technology is developed to support a much needed 'push/pull' concept. In this scenario, technology at the hedge funds would automatically create the standard formats and push out this information to investors, such as FOHFs. Meanwhile, technology in the FOHF products would be able to both pull data automatically from their invested hedge funds, and make web forms available for direct data entry by the managers.

The real wild card is whether the SEC implements FOHF-specific regulations, although those are probably some way off, owing to the SEC having its hands full with hedge fund compliance issues at present.

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