Deloitte Ireland Hedge Fund Symposium highlights

Leading global experts gather in Dublin to discuss the state of the industry

Financial Services Industry

On 31 August Deloitte Ireland hosted a Hedge Fund Symposium, bringing together leading experts to discuss the critical issues affecting the industry in the US and Europe. The event, held for the first time in Dublin, is part of the Deloitte Hedge Fund Symposium Series, which takes place in over ten cities across the globe.

Topics for discussion included the future of the hedge funds industry, risk and governance, global regulation and operating models. The panels included commentators from the US, UK, the Deloitte network and local industry in Ireland. Below are just a few of the many pressing issues and intriguing topics discussed at the event.

The future of the hedge funds industry

Three major themes emerged from the discussion: the proliferation of institutional investors and the implications for servicing these clients; the complexity and cost of regulation; and performance challenges under current market conditions, despite the availability of capital.

The proportion of institutional investors in hedge funds has grown exponentially since the financial crisis and this has increased the amount of capital available to hedge fund managers. While institutional investors are willing to invest in start-ups and smaller hedge funds that somehow differentiate themselves from the market, smaller managers may face challenges in terms of the infrastructure required to support institutional investors.

Regulatory requirements are also increasing the demands placed on hedge fund managers from an operational and compliance perspective. The requirement to register with the SEC and submit Form PF in the US added costs beyond initial estimates, according to the panel. Demands for this reported information by institutional investors will also add further complexity. In the EU the Alternative Investment Fund Managers Directive (AIFMD) continues to generate controversy while the industry grapples with the new post Lisbon Treaty process. Awareness among US-based managers of the implications for distribution into Europe post AIFMD was considered generally low and service providers in Europe therefore need to continue to educate US managers on the actions needed around AIFMD.

Soft economies, super low interest rates, Central Bank bond purchases, Eurozone dynamics and liquidity constraints are all making it more difficult for hedge funds to replicate previous returns. Despite the availability of capital, big wins are proving elusive and managers now have to adopt a more nimble approach to investing, according to the panel. Notwithstanding these challenges, panellists saw strong growth prospects for assets under management, due to demand from pension funds and opportunities in distressed debt and emerging markets.

Discussing hedge fund domiciling options, it was noted that the use of traditional offshore jurisdictions are still viable for US managers. Managers like to have a number of domicile options and it was considered that this trend is likely to continue. Ireland was considered a very attractive location for US managers due to the availability of suitable, regulated structures, the servicing expertise and the support infrastructure which hedge fund managers increasingly need due to regulatory requirements and institutional investor expectations.

Risk and corporate governance

The panel discussed how risk has become a key focus of the regulatory agenda with regulators around the world concerned about systemic risk monitoring. At fund level the panel explored two categories of risk concerning boards – portfolio risk and operational risk. The risk management function sits within the portfolio manager and is a highly complex area for the board to oversee. Monitoring this activity can prove challenging for boards and it was noted that boards need to be careful to ensure they oversee the risk management function without becoming overly involved in the risk process. Operational risk can include everything from counterparty exposure monitoring to succession planning. It was noted that smaller managers may find it more difficult to address issues such as succession planning.

Discussing board composition, the importance of a diversity of backgrounds on the board was highlighted as a key way to ensure board effectiveness. These include board members with investment management, legal, accounting and administration experience and expertise. Given the regulatory and compliance agenda, it was noted that it can be easy for boards to become formulaic in their approach and overly focus on compliance checklists. While this is sometimes unavoidable for boards given the nature of their duties, it was considered beneficial for boards to delegate certain issues to board committees, only raising matters of greater concern at the full board meetings. The importance of agenda setting and asking probing questions on performance and administration was also seen as a way to enhance board effectiveness and shift from 'conforming' boards to 'performing' boards.

The panel discussed how regrettably investors have not been significantly engaged in setting the regulatory agenda or in the regulatory process itself. Typically from a US perspective, engagement from the investor community may be seen when the cost estimates of regulation have been underestimated.

Global regulation

Discussing the new registration requirements for private advisors in the US, it was noted that the number of entities under the supervision of the SEC has increased by 32% since Dodd Frank. The response of the SEC to this challenge has been to educate hedge fund managers about SEC supervisory requirements and to issues information requests, which may be followed by examinations or enforcements.

Attendees heard how the time and resources required to complete reporting under Form PF was underestimated by both regulators and industry, involving large amounts of data aggregation. While there has been some hiring in operational functions to facilitate this new reporting, firms are constrained in the current environment and solutions should focus on operational efficiencies. It was noted that the upside of the reporting is availability new data for which managers are finding other uses. Managers who create data warehousing functionality will be better placed to make use of this data than those who undertake the regulatory reporting in a more manual and ad hoc manner.

Under AIFMD, it was noted how the role of the depositary will change significantly. Cash monitoring is a new function for which custodians will need to develop new systems and processes. The depositary liability provisions require the custodian to return assets held in custody without undue delay in the event of loss. Depositaries are currently going though the process of identifying assets that fall under their custody under the definitions, as opposed to ‘other assets’ for which monitoring is required. However, it was noted that even with regard to the other assets there are operational challenges, since the depositary will be required to produce an inventory at any time of these assets which will require new information flows with prime brokers and other OTC derivative counterparties.

In relation to assets held in custody, custodians will need to reserve additional capital in the event that assets need to be restored. The impact on depositary costs is yet to be fully determined but will not be as high as initial industry estimates. It was considered that costs will be higher for the holding in custody of complex assets or assets held in frontier markets.

In relation to the Foreign Account Tax Compliance Act (FATCA), attendees heard the importance of putting in place the robust process and systems to handle investor identification and the treatment of recalcitrant account holders. The progressing of FATCA Partner country agreements with the US was seen as a potentially positive development in facilitating compliance.

Operating models in the funds industry

The demands on hedge fund operating models have increased significantly in recent times, requiring ever more resources, processes and technologies to deliver services to the hedge fund through an extended enterprise. The panel discussed how start up and smaller managers eventually face a decision point in whether they wish to remain a ‘cottage industry’ or develop the infrastructure to serve a wider range of investors and scale up their business.

The importance of aligning a firm’s operating model to business planning and strategy was highlighted. The evolution of fund administration, from it beginnings as pure processing and reconciliations to increasingly more value added services was discussed. Complex pricing and valuations, reporting as well as depositary oversight services were highlighted in this regard.

While administrators are providing additional services, scope creep may mean that these services are not necessarily enhancing profitability at the same time. In order to address such challenges and provide added value it was proposed that fund administrators seek to move to ‘self-service’ type data portals that give clients access to tools that enable them to extract the data they need.

The need for powerful data aggregation technologies to facilitate new reporting was highlighted. Services to complete reporting under Form PF and AIFMD as well as to facilitate information flows under new derivatives clearing were seen as key action areas for operations. Fund administrators that have the functionality to produce the right data at the right time to facilitate different types of reporting and fulfil varying data requirements will have a competitive advantage.