

10 Things Hedge Funds Must Address

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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 that warrant consideration:

1. Preparation for SEC examination. The Investment Advisers Act of 1940 authorized 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.

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.

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