A Confluence Whitepaper

Hedge Fund Reporting: The Change Imperative

With a perfect storm on the horizon, it’s time to sink or swim

This whitepaper explores the forces that are creating the perfect storm in the back office and offers practical advice to help hedge fund companies consider moves to ensure that their reporting processes provide the speed, control and flexibility to weather a new era of hedge fund administration.

Executive Summary

The impact of the credit crisis is having a dramatic effect on hedge fund reporting; the ensuing demand for greater transparency and due diligence is producing a perfect storm in the hedge fund back office. A myriad of forces are driving the need to change – including investor demands for greater transparency, the promise of increased regulatory oversight, accounting and auditor mandates, and requests from asset managers themselves for heightened reporting frequency and flexibility.

The hedge fund administration back office stands at the forefront of radical change. How fund sponsors will choose to cope is the big question. Outsourcing is one response. Though, due diligence will inevitably impose a new set of selection criteria for service providers to prove that they've taken the necessary steps to meet the approaching demand for greater transparency, flexibility and control. And, for fund sponsors that choose to tackle the challenges in-house, the problem can be solved in varying degrees with either additional staff or automation. This paper attempts to define significant forces driving change in the hedge fund back office and the resulting options hedge funds have to address this change. And this paper explores service provider selection criteria and the merits of responding to the problem with people versus technology.

The Storm Forces

It’s not surprising that 98 percent of hedge fund managers report that the new administration is likely to increase regulation of the hedge fund industry. But regulators aren't the only force driving change in hedge fund reporting. Regulatory mandates aside, investors are demanding holdings transparency. Auditors want to see greater control over reporting processes. And, yes, even asset managers themselves are demanding back-office staff and service providers alike to demonstrate that they have the controls in place to deal with the approaching storm – while eliminating reporting risk, reducing costs, increasing scalability and elevating service levels.

I. Investors Demand

Determined to avoid the likes of Ponzi schemes and other fraudulent activities, today's investors are cautious of both investments and investment managers. While investors can’t demand guaranteed returns or even force fund managers to divulge the nuances of their investment styles, they can demand greater transparency, frequency and timeliness of reporting, and more stringent due diligence.

Transparency. In today’s market transparency rules – and it typically starts with a review of the fund’s annual report and the associated audit opinion. And for many investors, annual financial reporting transparency isn’t quite enough. They want to know what types of securities the fund is investing in and they are demanding holdings transparency. In fact, a late 2008 State Street survey of institutional hedge fund investors found that five out of six institutions (84 percent) expect more disclosure of hedge fund positions.
Frequency. Investors want more frequent holdings disclosure – whether it’s required by the regulators or not. The same State Street survey referenced above found that nearly half (49 percent) anticipate more frequent reporting from hedge fund managers. The highly regulated mutual fund industry is already conceding to investor expectations for more frequent holdings disclosure as firms are voluntarily providing holdings reports on a monthly basis, rather than the required quarterly cycle.

Timeliness. Going hand-in-hand with more frequent reporting is the need for the information to be timely – and that need requires back-office reporting efficiency. The process of collecting report data and creating, validating and delivering reports to investors that currently takes weeks in many instances will need to be turned around in days to satisfy investors craving for up-to-date information.

Due Diligence. The demand for more transparent and frequent reporting has increased investors’ focus on auditor opinions. Likewise the audit has expanded to include evaluation and qualification of processes and controls. Instilling investor confidence is paramount. As a result, the fear of a qualified audit opinion has placed a greater burden on fund managers to satisfy their auditor’s need for increased documentation, validation and access to the fund’s back office.

II. Regulatory Oversight

Hedge fund regulation is inevitable – and it will be a global challenge as governments and their associated regulatory bodies demand increased and more transparent reporting.

While no one can predict exactly how the regulatory rules will shape up in the long term, U.S. hedge fund managers currently face many regulatory challenges including the following.


Form SH – The Securities and Exchange Commission (SEC) requires institutional investors to disclose information on their short sales positions of securities on the 13(f) list published by the SEC. A direct response to the unprecedented market dynamics of late 2008, Form SH is an example of our rapidly evolving regulatory environment. Read more about the rule at http://www.sec.gov/rules/final/2008/34-58785.pdf.


International Financial Reporting Standards (IFRS) – In an effort towards global accounting standards, FASB and the International Accounting Standards Board (IASB) are committed to the convergence of U.S. generally accepted accounting principles (US-GAAP) and IFRS are identifying current convergence projects.

In addition, the SEC has proposed Release No. 33-9005, “Roadmap for the Potential Use of Financial Statements Prepared in Accordance With International Financial Reporting Standards by U.S. Issuers.” which was made available for public comment a “road map” that could lead to the use of international financial reporting standards by U.S. issuers beginning in 2014.
Preparing for the change in accounting practices will likely be a major undertaking for fund administrators. To learn more about the convergence activities and the implications for investment funds go to http://www.kpmgifrsinstitute.com/documents/IFRS/11252008163422FASB_IASB_Convergence.pdf.

**eXtensible Business Reporting Language (XBRL)** – To improve the usefulness and investor access to information the SEC has adopted several rules requiring use of XBRL by both corporate filers and mutual funds. XBRL requires financial information to be submitted as XML tagged data files using a specified schema.


While the SEC has not required hedge funds to adopt XBRL for reporting, the recent actions strongly signal that, like mutual funds, hedge funds are likely candidates for XBRL as a reporting standard.

**Hedge fund regulation and registration** – Calling for a “21st century regulatory framework to restore accountability, transparency, and trust in our financial markets,” the Obama administration has hedge fund regulation clearly in their cross hairs. As of this writing, many believe that by the fourth quarter of 2009, Congress will pass The Hedge Fund Transparency Bill of 2009, which would require investment companies or advisers that are currently exempt from registration, but have at least $50 million in assets under management (AUM), to register with the SEC.

Regulatory oversight is a global priority. At a February 2009 summit of German, French, Italian, Spanish, Dutch and British leaders held in Berlin, Chancellor Angela Merkel of Germany stated the need for increased oversight, regulation and reporting of all alternative investment funds. “We have today underscored our conviction that all financial markets, products and participants must be subject to appropriate oversight or regulation, without exception and regardless of their country of domicile. This is especially true for those private pools of capital, including hedge funds, that may present a systemic risk,” Merkel said. The meeting of European leaders was aimed at devising and endorsing the single EU policy before the summit of G20 conducted in London in April 2009.
III. Accounting and Auditing Mandates

Hedge fund auditors are playing a pivotal role in preparing hedge funds to respond to both investor demands for greater transparency as well as possible new legislation, such as the anticipated Hedge Fund Transparency Act of 2009.

For example, Grant Thornton LLP’s Financial Services practice is launching Hedge Fund Internal Control, Governance and Regulatory Compliance Services. “Those funds that have already registered must be prepared for additional oversight and a more aggressive examination and enforcement agenda; those funds that have not yet registered may be required to create a complete internal control and compliance infrastructure in order to be prepared for the regulatory examination process,” said Jack Katz, national managing partner of Grant Thornton’s Financial Services practice.

Putting the pending imminent demand for transparency and increased oversight aside, auditors are discovering that even today hedge fund back offices lack the internal processes, control and scalability to accommodate the reporting challenges already dealt to them in recent months. “The 2008 hedge fund year-end financial reporting cycle was the most challenging yet,” said Charles F. Plaveczky, CPA, Principal, Rothstein Kass. “The increased reporting demands of FAS 157 tested manual processes and spreadsheets and illustrated their lack of flexibility to deal with the increasing complexity of hedge fund reporting.”

Financial Reporting Best Practices

While deploying a successful financial reporting process is more art than science, Beacon has learned that organizations that do it well, consistently apply some or all of the following practices:

- The first draft is created in a timely manner, and is accurate and complete before distribution to others.
- Pre-period reviews are scheduled to attempt to get a head-start on resolving issues such as those that often accompany the purchase of new securities or changes to regulations.
- “Static” components of the report are completed and reviewed prior to period end.
- A library of standard language is maintained.
- Reviewers’ roles and responsibilities for each level of review are well-defined.
- A financial reporting application that has built-in automated proofs is utilized.
- Analytical tools for those reviews that cannot be built into the system are utilized.
- A materiality policy is developed and adhered to, particularly when considering making changes late in the reporting cycle.


Making the Essential Moves to Gain Back-Office Control

While change is imperative, what’s the best path to success? Fund administrators have options and the right move depends on multiple factors, including size of organization, management objectives, staff expertise, auditor’s advice, internal processes and technological savvy.

I. Maintain Status Quo

Wisely or not, there will be instances where fund sponsors elect the status quo. Perhaps they already have the internal controls in place and invested in a technology infrastructure that they believe will give them the flexibility and control to deal with the storm that is about to hit their back office. Or, perhaps they underestimate the impact of the impending demand for transparency and increased regulation.

II. Invest in People

The traditional response to increased back-office demand has been to add staff. Prior to the economic downturn, a talent drought in the hedge fund industry made it difficult to meet demand as the industry grew. Now that problem is more perplexing, as firms face budget cuts and staff reductions.

Especially in large fund complexes, however, investing in people isn’t a prudent long range strategy for two reasons: risk and cost. Meeting operational demand by
adding people increases the risk of manual error – which can result in rework and potential reporting errors. Plus, talent is expensive. Building an infrastructure that requires additional man hours any time a new fund, new regulatory requirement or new report is added may not only be cost prohibitive, it may not be scalable.

III. Invest in Technology
For many firms, the most viable response to meet the challenges of today and tomorrow is technology. These firms use technology as leverage to improve services and maximize their administration team. At the same time these firms have been able to reduce the high cost and error associated with manual processes.

Technology can provide significant, sustainable benefits. That said, technology investments are long-term strategic decisions and these decisions should not be taken lightly. The challenge is to find a technology partner who can help anticipate the future, envision what the world will look like five, ten or 15 years from now, and provide a solution that meets the immediate financial reporting needs and future needs for whatever comes next. For more insight on how to select a financial reporting software partner, download the Confluence whitepaper 8 Points to Consider When Selecting Financial Reporting Software at http://www.confluence.com/en-us/resourcecenter.shtml.

IV. Adopt an Outsourcing Strategy
Hedge fund administration can be undertaken in-house or outsourced to a service provider. Many expect outsourcing to be on the rise as asset managers seek to avoid scrutiny of their self-managed back-office operations by hiring independent third-party administrators, especially in light of recent industry scandals. Other arguments for outsourcing include access to state-of-the art technology and a belief that fund managers should stick to their core competency – investing. But then, others maintain that internal control over operations can provide a fund with a competitive advantage and the flexibility to deliver the reporting their investors need; which are solid reasons for keeping at least some administration functions in-house.

Either way, whether the asset manager sticks with a "do-it-yourself" approach or elects to outsource their back office, the fund sponsor is accountable to ensure that their fund administrator has the infrastructure and process controls in place to meet the growing demand for investor and regulatory transparency and control.

Conclusion
In the wake of the credit crisis, change is imperative when it comes to hedge fund reporting. Prevailing hedge fund reporting operations are about to be put to the test as three major forces to drive change in the hedge fund back office – investors, regulators and auditors. As investors take due diligence seriously, transparency will rule. And there is no debate that amplified hedge fund regulation and reporting is coming globally. Hedge fund auditors play a key and increasing role as they oversee hedge fund reporting as well as the administrative processes and controls in today’s challenging and expanding reporting environment.

Back-office financial reporting processes which depend on manual processes and error-prone spreadsheets will be rendered inadequate in the new era of hedge fund administration. While some hedge fund sponsors may choose to meet the demand for additional and more frequent reporting by adding staff, others will invest in technology – especially larger firms where building scale through...
technology delivers a greater ROI. Still others will elect to outsource the burden of back-office reporting. But, even then, the change imperative will create a new set of service provider selection criteria as responsibility cannot be outsourced. As a result of the forces of change process controls and infrastructure have become key requirements of the hedge fund back office.

Confluence recommends that fund sponsors actively define a strategy to meet their administrative needs of today and prepare for the increased regulatory and reporting demands of the future.

About the Authors

Scott Powell has been with Confluence for more than three years and is the Senior Market Analyst for the Unity™ platform, which automates a broad array of fund administration reporting processes. Prior to joining Confluence, Scott was the Product Sponsor Market Manager at Thomson Financial. Scott also worked at Gartmore Global Investments and The Vanguard Group of Investment Companies. Scott has more than 12 years of experience in the financial industry and holds a BS from the University of Wisconsin-Stout in Industrial Technology and a MBA from Villanova University, concentrating in Finance. Scott is Pragmatic Marketing Certified (PMC) and a National Investment Company Service Association (NICSA) Certified Mutual Fund Specialist.

Joan Tesla joined Confluence in 2006 as Director of Marketing where she is responsible for brand management, strategic marketing and communications and internal communications. Joan began her marketing career with Federated Investors where she managed institutional marketing initiatives, including corporate cash management, defined contribution plans, variable annuities and separate accounts. She has also held marketing management positions in the information technology, healthcare and non-profit industries. Joan holds a MBA from Robert Morris University and a BS in Marketing from The Pennsylvania State University. Joan is a contributing author for the Product Strategy Network, a member of The National Investment Company Service Association (NICSA) Technology Committee, and Pragmatic Marketing Certified (PMC).
About Confluence

Founded in 1991, Confluence is a global leader in fund administration automation. Confluence helps investment management companies gain unprecedented control by automating the fund administration process—including the collection, creation, confirmation and delivery of investment product data—while maintaining control of the process. Results are lower costs, reduced risk, decreased reporting turnaround times and the scalability to automate more processes without additional resources. Confluence solutions are used by 40 percent of the leading global investment managers, and more than 60 percent of U.S. mutual funds.

The Unity™ platform from Confluence addresses a wide range of problems from performance measurement to financial reporting for a full array of domestic and international managed investment products, including mutual funds and variable products, as well as hedge funds and other alternative investments. Major fund companies such as T. Rowe Price and Russell Investments, and service providers such as The Bank of New York rely on Confluence. Headquartered in Pittsburgh, PA, Confluence serves the international fund industry with key locations in London and Luxembourg. For more information, visit www.confluence.com or e-mail info@confluence.com.

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