Redesigning operations for the new regulatory era

by Samer Ojjeh and Jim Kickham
Asset managers face transformational regulatory mandates that will require investments in compliance infrastructure. An integrated, strategically driven approach to meeting these regulatory mandates can result in better risk management, investor relations and performance.

Regulatory changes and investor demands are forcing many US asset managers to redesign aspects of their operating models. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) brings nearly all US hedge funds and private equity firms under the purview of the Securities and Exchange Commission (SEC), greatly increasing their compliance requirements. Concurrently, the Foreign Account Tax Compliance Act (FATCA) calls for detailed disclosure of investor information.

Investor concerns related to the regulatory initiatives are motivating asset managers to take action. Among their main concerns are:

- How the new era of regulation will affect the asset manager’s performance
- How new regulations will improve funds’ corporate governance, disclosure and transparency
- Whether asset managers’ third-party administrators and other external service providers are reliable
- Whether the organization’s controls over difficult-to-price assets will be adequate

Before deciding how to respond to these concerns, it is important for asset managers to step back and take a holistic view of how investor expectations and the new regulatory mandates will affect their businesses — and then to plan how they can be addressed efficiently with little to no duplication of effort. Reactive ad hoc changes often just waste time and resources. Therefore, rather than address each new mandate separately, in a piecemeal fashion, firms should attempt to anticipate the operational consequences of all of these factors together.

Building a culture of compliance
The consequences of the new regulatory environment will ripple through asset managers’ operating models. Organizationally, compliance departments will likely grow in size and responsibility, and their relationships with the front, middle and back office, investor relations and risk management will change. Functionally, firms’ operational relationships with, and expectations of, their administrators and counterparties will need to be clarified and possibly modified to ensure each party agrees to the distribution of responsibilities for meeting the regulatory and investor mandates.

Making compliance a priority for everyone at the firm, but especially for management, is critical. It is no longer possible to relegate regulatory issues to a compliance officer laboring in the shadows. The board, chief executive officer, chief operating officer and other senior executives need to be involved as well. There are several reasons why senior management must be actively involved. First, a culture of compliance needs to be established and prioritized by the firm’s senior executives so that it takes root throughout the organization. Brute-force approaches to implementing regulations will be less effective in the long run. Instead, having the right tone at the top can help ensure the entire firm makes compliance issues a priority.

Second, senior executives possess the firmwide view needed to ensure that the organization undertakes coordinated and economical responses to the regulatory mandates. For example, data gathering and reporting requirements for Dodd-Frank could be leveraged for use in complying with FATCA.

Another key reason for senior management to focus on compliance is its bearing on performance. An integrated response to regulatory initiatives might generate significant business advantages. For example, it could surface valuable data on the markets or competitors that would otherwise go unnoticed and unexploited.

Finally, senior management is best positioned to build good working relationships with regulators. The idiosyncratic, non-standardized nature of the asset management industry poses a challenge to regulators. Thus, to be measured on the basis of their own merits, asset management executives must articulate and demystify their investment strategies and demonstrate that compliance is a priority for their firms from the top down.

Rising expectations
Advanced compliance and risk management expertise that might have distinguished a firm a few years ago now “just gets you into the game.” Satisfying rising investor expectations, as well as new regulatory requirements, can prove very costly, especially for an industry still recovering from the financial crisis. In many cases, IT infrastructure will need to be improved to allow prices and risk metrics to be gathered from trusted sources and reported to regulators and investors rapidly. And data architecture will need to be flexible enough to maintain more granular records and produce them on demand.

The role of those service providers is also undergoing change. The operational challenge of extracting and managing the necessary data is daunting. Asset managers have to ensure they are capturing all the data they have to report, that it is complete and accessible, and that it is consistent across different parts of the organization and its service providers.

The most recent FATCA notice, published on 9 May 2011, states the chief compliance officer or another equivalent-level responsible officer of a foreign financial institution (FFI) must certify to the IRS as to the completion of certain customer identification procedures outlined in the notice related to the identification of pre-existing accounts as US accounts for purposes of the FATCA provisions.

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SCORE no. CK0462

1108-1278855 BSC NY

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