HEDGEWEEK

INSIGHT REPORT

REGULATORY RISK:

Confronting the new global hedge fund compliance challenges

JULY 2022

EXECUTIVE SUMMARY

Following an extraordinary couple of years for global markets, financial regulators have kick-started a range of initiatives after large swathes of proposals and reviews were put on hold during the Covid-19 pandemic.

This latest Hedgeweek Insight Report examines in detail the gathering momentum of regulatory change post-pandemic and its potential impact on the hedge fund industry on both sides of the Atlantic - from the Securities and Exchange Commission's far-reaching private fund adviser proposals to the EU's wide-ranging reviews of AIFMD and MiFID/R.

The report also reflects on the ways in which broader economic and political developments - spanning ESG and sustainable investing, cryptocurrencies, and Brexit – are potentially reshaping the future investment and compliance landscape for hedge fund managers.

The insights here are drawn from a Hedgeweek survey of more than 60 hedge fund managers globally, along with a series of in-depth interviews with industry participants, and further background research.

The recent regulatory and legislative drive from the SEC, FCA and the EU means hedge funds are having to adapt in different ways in order to deal with changing reporting and compliance requirements. Our research findings indicate that, amid what has been described as a "regulatory onslaught", roughly 40% of hedge fund firms of all sizes and strategy types are now seeking guidance from external legal experts on compliance costs.

In the US, close to two-thirds of hedge fund managers are concerned about the SEC's private fund adviser proposals, which compliance experts warn could dramatically upend activist and multi-manager hedge funds' business models. In the EU, meanwhile, similar numbers are concerned about the AIFMD and MiFID/R reviews, which could usher in additional headaches for hedge funds, particularly when it comes to marketing into the bloc.

The result? As episodic bouts of volatility continue to roil markets this year, the growing burdens resulting from this seemingly-relentless regulatory push means resource-stretched hedge funds – particularly smaller managers – are facing a delicate balancing act between meeting increasingly-onerous compliance requirements and generating investment performance.

HUGH LEASK, HEDGEWEEK EDITOR
REPORT AUTHOR

CONTENTS

METHODOLOGY

Hedgeweek surveyed 69 hedge fund managers on number of key industry topics throughout Q2 2022. More than 50% of survey participants were North America-based, while over 30% were located in Europe, with responses taken from managers running a wide range of strategy types, AUM sizes and track records.

KEY FINDINGS

GROWING COMPLIANCE BURDENS ARE IMPACTING DIFFERENT HEDGE FUNDS IN DIFFERENT WAYS

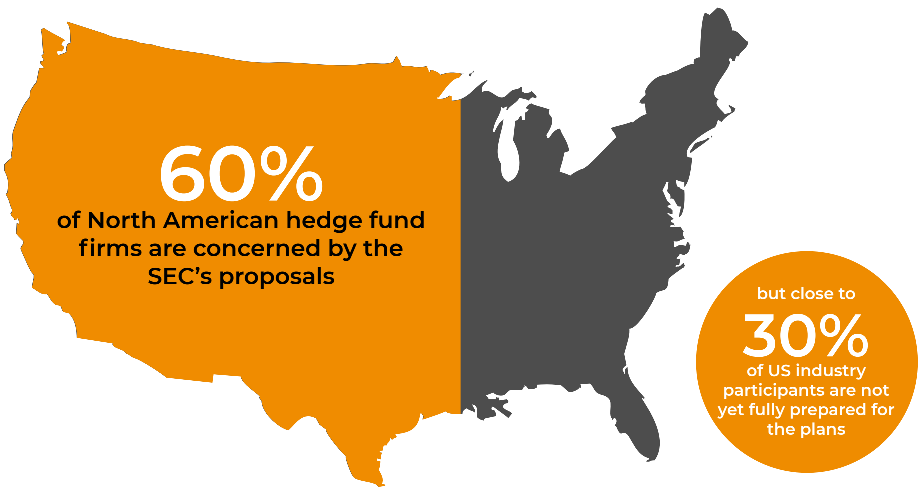
50%
of +$1bn hedge funds plan to expand their legal and compliance teams

44%
of <$250m hedge funds plan to outsource more compliance functions

MIFID/R II IS THE MOST CONCERNING ITEM OF EU REGULATION TO EUROPEAN FIRMS – INCLUDING AIFMD II

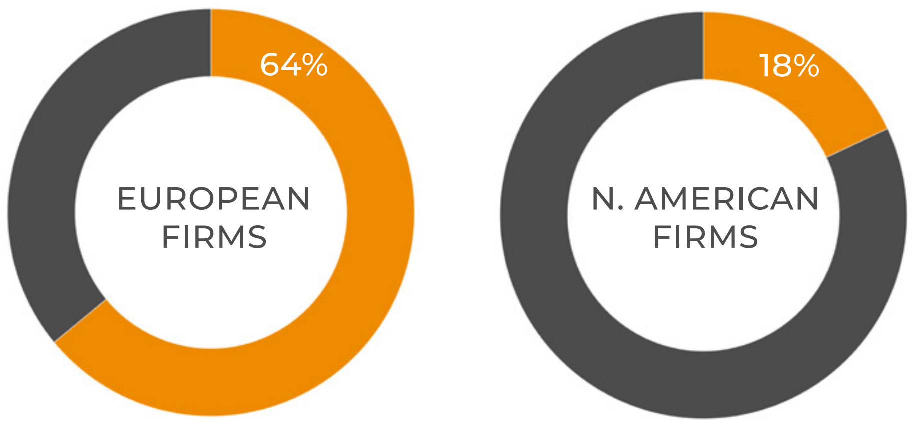
European hedge fund firms concerned by upcoming EU regulation

THE SEC'S PRIVATE FUND ADVISER CHANGES ARE HIGH ON MANAGERS' AGENDA – BUT MANY ARE UNPREPARED



THE EU'S NEW ESG RULES (SFDR) ARE ALSO CONCERNING EUROPEAN MANAGERS – US MANAGERS LESS SO

Hedge fund firms concerned by the EU's Sustainable Finance Disclosures Regulation (SFDR)



SECTION 1 | LEGAL & COMPLIANCE TRENDS

ONE SIZE REGULATION DOESN'T FIT ALL HEDGE FUNDS

A survey by Hedgeweek in June shows that 50% of larger hedge funds (>$1bn) are looking to expand their internal legal and compliance teams, with 44% of smaller hedge funds (<250m) planning to increase their outsourcing of compliance functions

Regulation has historically been perceived as a burden to hedge funds due to the difficulty for firms of varying sizes to implement the same legislation into their funds.

The burden can be immense for smaller firms who might need to outsource all their compliance requirements, but must still ensure the accuracy of the information.

Previously, regulatory concerns were often driven by larger institutional clients, such as pension funds, who were concerned with fee disclosure, expenses, and performance. But over time there has been a transition.

While the industry may have previously held a reputation for not always doing things by the book, consistency has improved over the past few years, especially with regards to transparency.

"I've certainly seen an increase in transparency, which has really been driven by investors and people like myself, on the operational due diligence front, who have asked and received a positive response. While this hasn't necessarily generated new regulation, it has forced managers to provide investors with more transparent information," notes Louis Rodriguez, head of operational due diligence at Meketa Investment Group.

But is the blanket approach to hedge fund regulation always fair to smaller funds?

Regulatory landscape

US vs UK legislation

The Securities and Exchange Commision's new proposed rules has incited the most concern by far across the hedge fund industry, with 50% of hedge funds <$250m, 41% of hedge funds $250m-$999m and 43% of hedge funds >$1bn all citing the SEC's upcoming regulation as their most prevalent concern.

The consensus among managers is that the SEC is viewed as an organisation which tries to catch funds out, whereas the Financial Conduct Authority works in a much more collaborative way.

"The SEC has a very different mindset to the FCA because the FCA tries to work with you. The FCA will try and assess what the hedge fund industry needs to protect investors, whereas the SEC takes the approach that all hedge funds are trying to cheat the system in some way," observes one manager.

"They want you to follow things within the letter of the law."

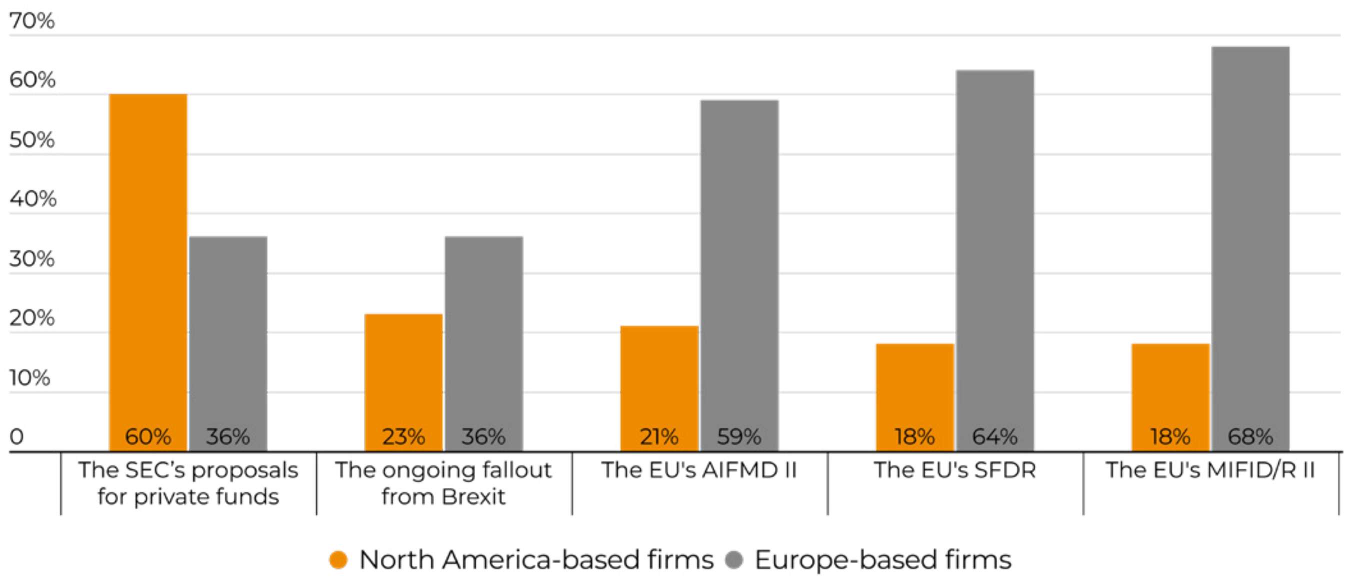
New EU legislation (AIFMD II and MiFID/R III)

Towards the end of 2021, the EU announced updates on two pieces of legislation, the Alternative Investment Fund Managers Directive and the Markets in Financial Instruments Directive.

The long-awaited MiFID III looks to empower smaller investors by giving them more security in their investments in shares or bonds. Transparency, fairness and ensuring that EU market infrastructures remain competitive at the international level are its three main priorities.

On average, the same proportion of hedge funds of all sizes are concerned about new EU regulation, with 25% of smaller funds expressing concern related to AIMFD II, and 28% regarding MIFID/R II, and 29% of mid-

Figure 1.1: Proportion of hedge fund firms concerned by upcoming regulatory developments



Source: Hedgeweek survey, Q2 2022

sized and larger hedge funds noting their concern about both initiatives.

Phillip Chapple, Monterone Partners' COO, notes how, in the past, managers may have been more willing to set up a fund or product based in the EU to access those investors, but that increasingly complex legislation may now discourage people from doing so.

"Previously, managers were more or less able to tick a box for legislation requirements. But now, managers require a lot of additional documentation and structure. They have to look at each jurisdiction as it becomes more divergent and ensure that they're complying with the correct version of MiFID and other legislation. It could mean that you have to double your reporting and compliance efforts, and of course that can get expensive," notes Chapple.

Investors

Research from SEI's latest hedge fund report shows that managers underestimate how much investors value regulation, with 22% of investors citing limited regulation as a 'major concern' compared to only 4% of managers taking note of this.

"Prospective investors are really keen to see managers' compliance presence," says Kavita Devani, head of compliance operations, Coremont. "Whether you outsource it or keep it internal, investors want to understand how you are doing it, who's doing it, and exactly what controls you have in place."

The volatility and high inflation rates experienced so far in 2022 have made it difficult for investors to specify certain regulation demands.

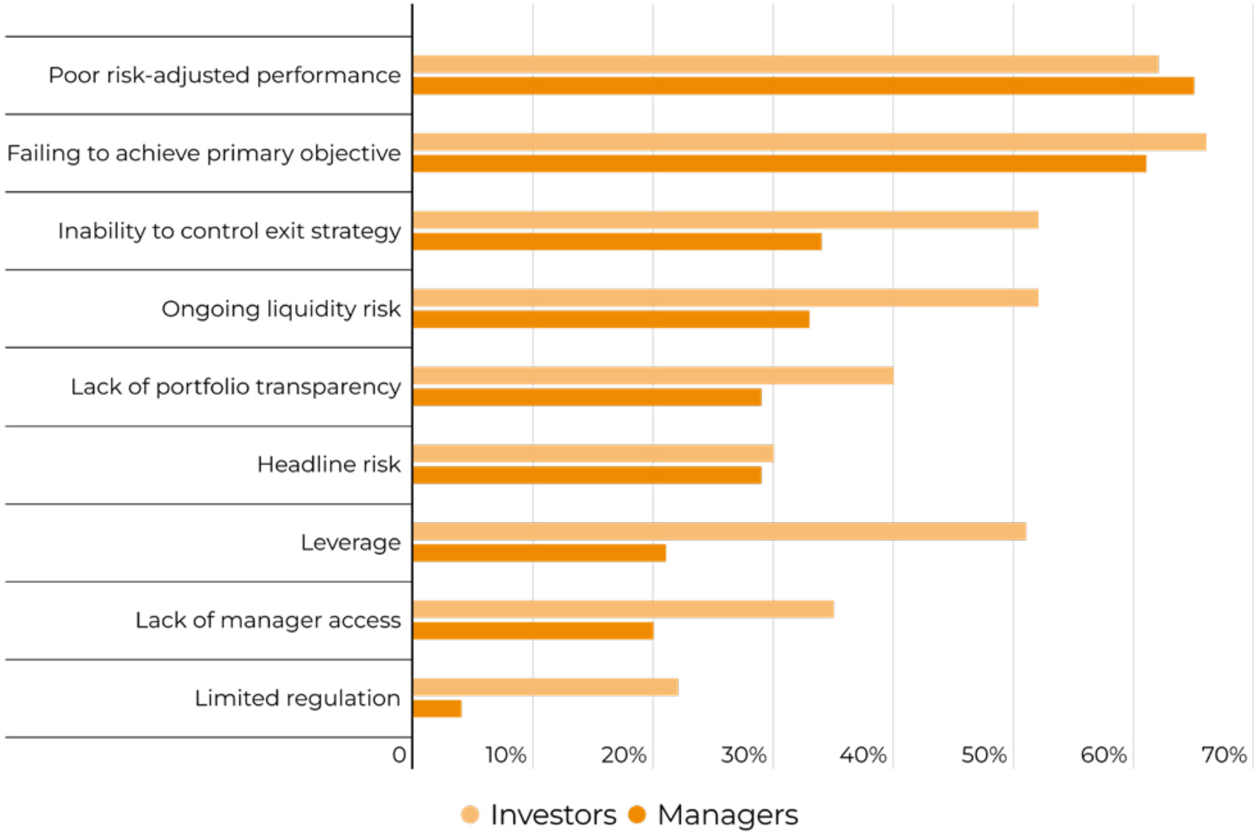
"Historically, public and private pension plans have been most attentive to regulatory oversight; however today there is no overwhelming consensus to increase the current level of regulation," notes Adrian Sales, head of operational due diligence and partner at Albourne.

There may be reason for investors to be concerned about just how much regulatory-themed paperwork fund managers deal with, especially if it stops them focusing on the portfolio and returns.

Some regulators are finding that as soon as new regulation is brought in to answer investor demands, the same requests are being repeated and risk obscuring other legislation.

"There's some frustration and confusion across the industry which has arisen from the repetition of existing regulation or minor tweaks and add-ons, which are presented to managers as entirely new regulation which needs examining and a compliance team's full

Figure 1.2: Major investor and manager concerns around hedge fund investing



Source: SEI, Back to the future hedge fund report

attention," says Rodriguez.

Genna Garver, investment management partner at law firm Troutman Pepper, notes how not all regulation needs to be framed in the same way, and that compliance reminders and risk alerts serve a purpose.

"I'm a little worried about the recent onslaught of proposed rules. Managers need to allocate sufficient resources to compliance, but also to managing their portfolios. Investors and regulators need to ask themselves how fund managers can cope with the increased compliance burden while also continuing to produce good returns on fund investments – distracting attention and resources with duplicative regulation will likely result in unintended consequences."

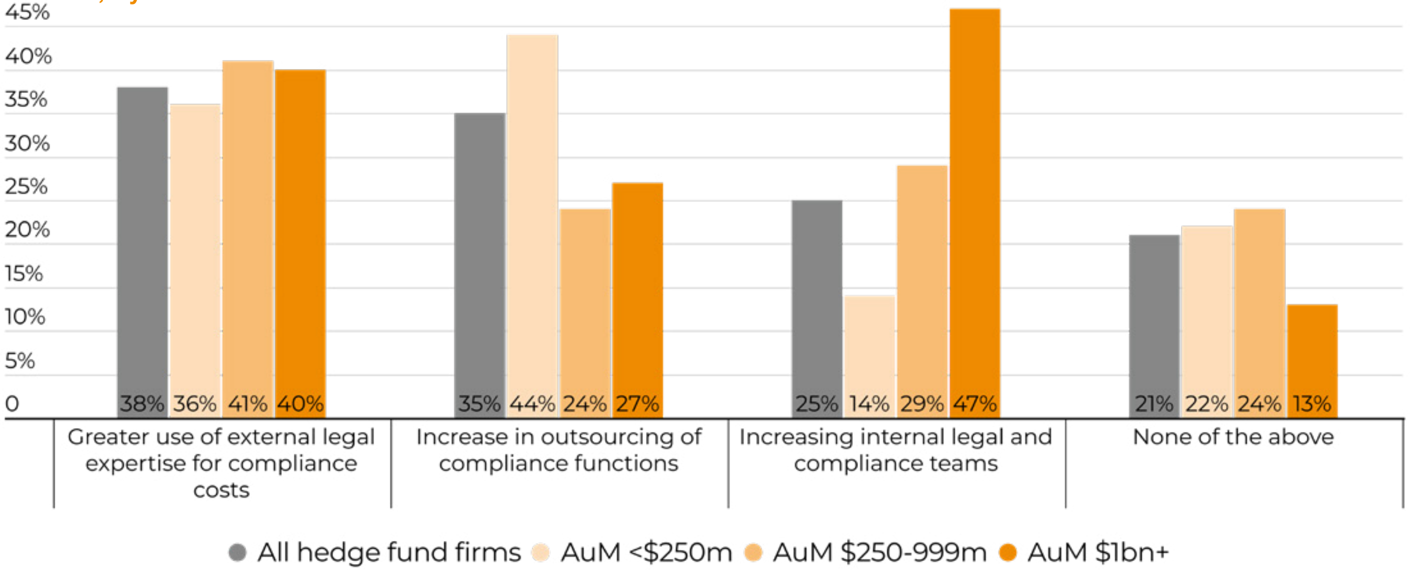
Adapting

Due to increasing regulation and legislation from the SEC, FCA and the EU, hedge funds have found themselves having to adapt in different ways in order to deal with reporting and compliance requirements.

As the Hedgeweek survey demonstrates, larger firms have been building internal legal and compliance teams to deal with this new wave of regulation, while smaller firms have chosen to outsource their compliance to service providers.

"I've seen a rise in smaller boutique compliance consulting firms. We're all used to seeing the likes of ACA and the larger firms. But I think over the last few years there's been a proliferation of smaller boutique shops that have seen an

Figure 1.3: How hedge funds have adapted to regulation demands in the past 12 months, by firm AuM



Source: Hedgeweek survey, Q2 2022

Analyst note: Survey respondents could select more than one option. A fifth option of 'reduction in compliance spend' was offered and selected by one respondent.

opportunity to branch out and start their own businesses," says Rodriguez.

Firms of all sizes have also been seeking advice from external legal experts on compliance costs, with 36% of smaller (<$250m) and larger (>$1bn) hedge funds and 41% of mid-sized ($250m-$999m) hedge funds seeking guidance.

"For emerging managers, although funding is always going to be an issue, they do want to outsource a lot of the procedural day-to-day tasks. Of course they keep the regulatory obligation, and therefore need to be in control of what is being done, how it's being monitored, who is looking at it, to ensure they have oversight at all times," says Devani.

Gary Pitts, founder and managing partner at Tetractys Partners, acknowledges the ongoing challenges faced by hedge funds' compliance functions and points to the need for compliance staff to have ongoing discussions with senior management over risk appetite, risk assessments, three- and four-year projections, and stress tests, among other things.

"A lot of firms are too busy, and don't have the bandwidth to do the basics. It's costly to get people who are bright and experienced enough to engage with some of the things that need to be engaged with in a proportionate manner," he notes.

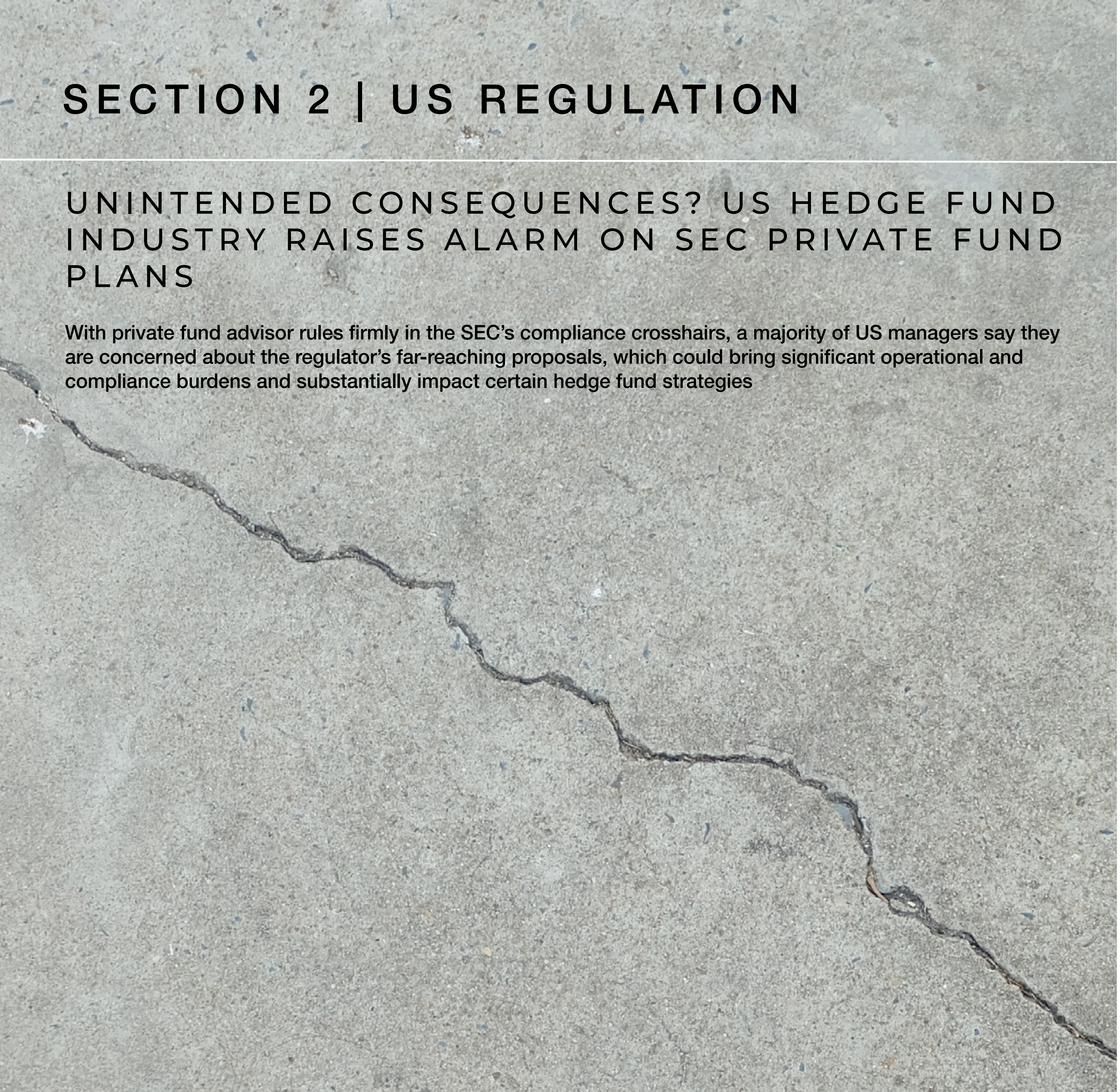
"It's taking up a lot of time for senior managers. The senior managers who aren't engaging are going to get a substandard outcome – a box half-ticked – and, while there may be a document in place, whether it's actually doing what the FCA envisages it to do is another matter. That's one of the biggest issues for managers right now," Pitts adds.

As regulation demands continue to increase, managers must learn to perform a balancing act between compliance and performance.

"Hedge funds are now having to really think about what they outsource, and how, because burdens are increasing. There is a lot more compliance oversight required – striking the right balance between outsourcing, yet maintaining control is key," concludes Devani. ■

KEY TAKEAWAYS

- **For Managers:** Current trends point to increasing regulation and legislation as the industry professionalises requiring managers to look for solutions to meet these new compliance needs
- **For Investors:** Investors must learn to balance their demands for more regulation and security and their demands for good portfolio returns as hedge funds come under increasing capacity pressure
- **For Service Providers**: As regulation demands increase and smaller managers look for solutions, the need for compliance boutiques is growing



SECTION 2 | US REGULATION

UNINTENDED CONSEQUENCES? US HEDGE FUND INDUSTRY RAISES ALARM ON SEC PRIVATE FUND PLANS

With private fund advisor rules firmly in the SEC's compliance crosshairs, a majority of US managers say they are concerned about the regulator's far-reaching proposals, which could bring significant operational and compliance burdens and substantially impact certain hedge fund strategies

The Securities and Exchange Commission is taking an increasingly strident approach towards market regulation under chair Gary Gensler, with new proposals covering private fund advisors, environmental, social and governance (ESG) disclosures, and digital assets and cryptocurrencies, among other things, potentially heralding sweeping changes to financial services in the US.

In particular, the private fund advisor rules as proposed are set to dramatically alter investment managers' relationships with clients.

Under the SEC's private fund advisor proposals, which are aimed at strengthening transparency for investors, hedge funds and other private and alternative fund managers would be required to provide quarterly statements and detailed annual audits to clients. The plans also call for changes in disclosures of cash-settled swaps, potentially upending a key element of activist hedge fund strategies' approach to campaigns, while multi-strategy, multi-PM shops could be impacted by planned curbs on pass-through expenses.

Concerns

The proposals have emerged as an increasingly live issue for the hedge fund industry in recent weeks. A survey of hedge fund managers for this report found that around 60% of North America-based firms are either 'somewhat concerned' or 'very concerned' about the proposals, compared to 40% who are 'not concerned' over the proposals.

Industry participants say the SEC proposals mark a break from a predominantly disclosure-based regime, which recognises hedge fund allocators and managers as highly sophisticated investors who can freely contract the terms of their relationships, towards a more proscriptive rules-based framework governing relationships between advisors, private fund clients, and investors in the private funds.

The Managed Funds Association said in a letter to the SEC in April that the proposed rules will "fundamentally alter the fruitful, longstanding relationships" between private funds and their sophisticated investors, and warned of "unintended costs associated with the proposals."

One of the major planks of the mooted reforms centres around the prohibition of pass-through expenses, such as fees or expenses associated with regulatory examinations or investigations, or for regulatory and compliance expenses of the investment manager.

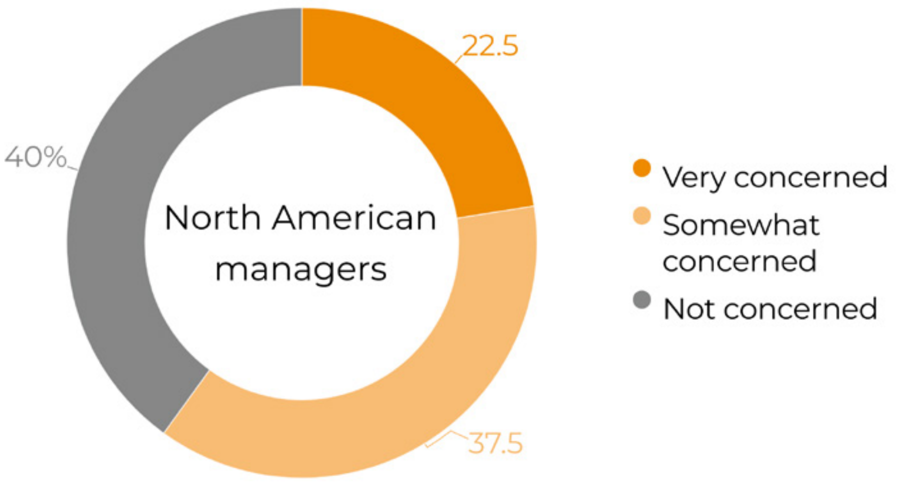
Large multi-strategy hedge fund firms, which typically have different portfolio management teams, often have high fixed costs. Instead of having a normal asset-based management fee, their economic model tends to reduce or eliminate management fees, instead passing through management company expenses onto clients.

"If passed as proposed, managers that utilise a full pass-through expense model would likely have to build in some sort of flat asset-based charge to pick that up," Nicholas Miller, partner at Seward & Kissel, tells Hedgeweek. "This strikes at the heart of the business model and the economic relationship that these managers have set out with their private fund clients and which investors have signed on to."

'Smother'

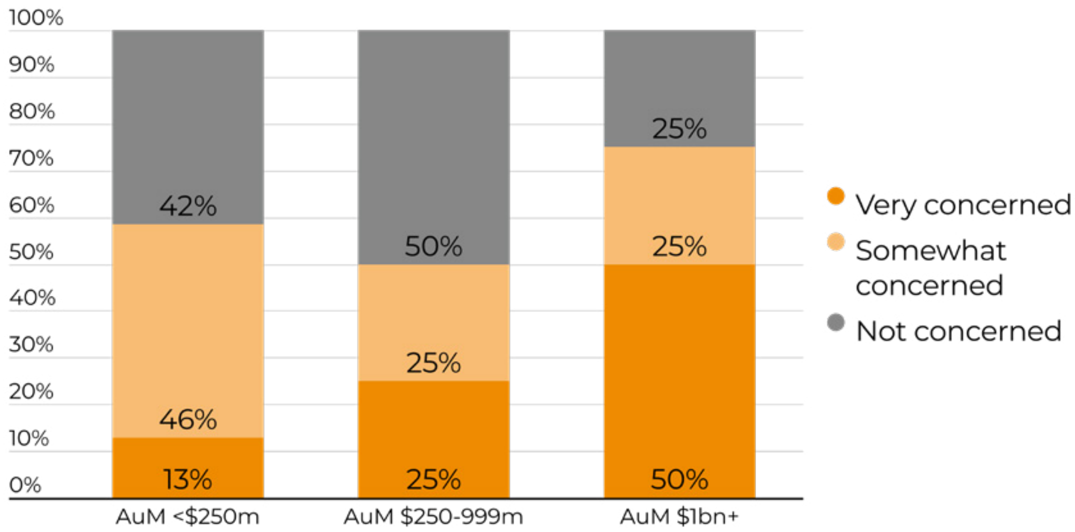
Another key focal point for the hedge fund industry relates to proposed new SEC disclosure requirements for investors with a 5% stake or more in public issuers in the US. Under the planned reforms, certain hedge funds and other asset managers will need to include their holdings of cash-settled derivatives towards the 5% threshold if the derivatives are held with the purpose of influencing the control of the issuer of

Figure 2.1a: North American hedge fund firm sentiment towards the SEC's new proposals for private funds



Source: Hedgeweek survey, Q2 2022

Figure 2.1b: North American hedge fund firm sentiment towards the SEC's new proposals for private funds, by firm AuM



Source: Hedgeweek survey, Q2 2022

the reference security.

"Requiring such managers to include cash-settled derivatives towards their beneficial ownership, such that they have to report them, makes it much harder for them to build an effective stake such that it would be worthwhile for them to actually wage the campaign in the first place," Miller says.

The rule change is expected to have a major impact on those hedge funds running activist-type strategies - often considered to play a vital role in markets and the process of price discovery, rooting out fraud and driving efficiencies – who build up large positions in companies, but often delay reporting.

Richard Zabel, general counsel and chief legal counsel of Elliott Management, Paul Singer's activist hedge fund giant, believes the SEC's plans would "effectively smother activism" in US capital markets.

"Proposed Rule 10B-1's mandated next-day disclosure of cash-settled security-based swap transactions would severely impair the ability of activist investors to catalyse positive change at companies," Zabel wrote in a letter to the SEC in March. "We are mystified as to why the Commission, charged with the protection of investors and the promotion of efficiency, competition and capital formation, has proposed rules that would impair the ability of activists to spark healthy debate and create long-term value for all shareholders."

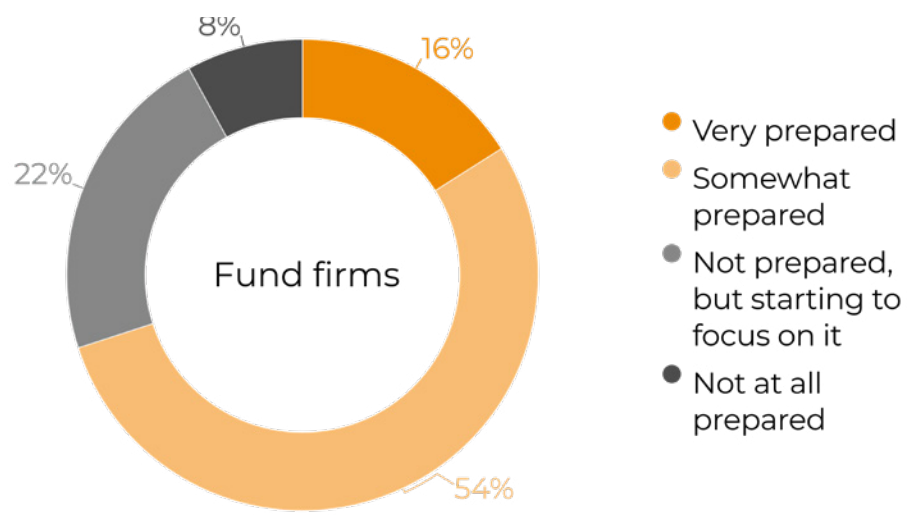
Miller says: "The challenge facing large activist managers is that the moment they disclose their positions, the market moves. Anything that minimises their activities will have some costs and impact on the market."

Barrier

Elsewhere, the implosion last year of Archegos Capital Management, which dealt hefty losses to prime brokerage businesses run by Credit Suisse and Nomura, forms the basis for planned new amendments to the SEC's Form PF rules relating to systemic risk and market stability.

While the US watchdog sees the proposed reporting requirements as enhancing systemic risk assessment and investor protection efforts,

Figure 2.2: Fund firms' feelings of preparedness for the SEC's forthcoming requirements regarding private funds



Source: EisnerAmper webinar: 'Impact of Private Fund Regulations on Finance, Tech & Compliance Managers', June 2022 particularly during periods of market volatility and stress, hedge fund industry trade groups are pushing back.

The MFA believes that imposing costs on large hedge fund advisers would raise the barrier to entry for new hedge fund advisers, eliminate new entrants and decrease competition in the marketplace.

The Alternative Investment Management Association meanwhile believes data collection and analysis needs to be improved in order to justify reporting requirements, adding that the reporting of certain key events could exacerbate a crisis.

"Asking for real-time, ex-ante information in a manner that will impose significant operational and compliance burdens on private fund advisers is not justified by the desire to have such information for ex-post outreach, examinations or investigations and that submissions of this information on a longer deadline would not affect the value of the information for those purposes," Jiří Król, AIMA's deputy CEO and global head of government affairs, wrote in a letter to the SEC.

Other SEC proposals stem from the perennially-thorny issue of fees, and the perception among investors that hedge funds have long charged high fees for often patchy performances, despite industry data showing fees have steadily come down over the past decade.

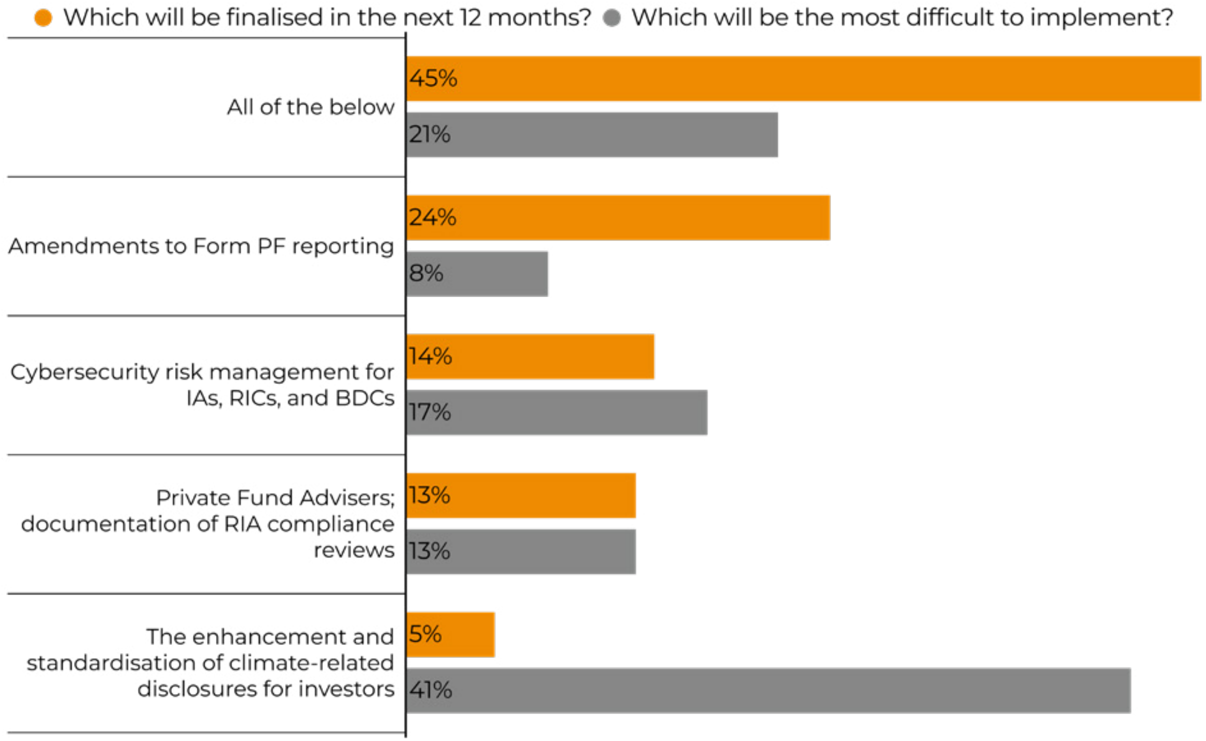
"Some of the private fund advisor rules would prohibit certain types of preferential treatment, and then they would require extremely detailed and granular disclosure on others,

"The SEC's proposals would require much more significant and granular disclosure on preferential treatment, even down to disclosing what the actual fee rate and fee break is that you're giving people," says Miller.

'Critical'

So what next? While the reforms remain at an initial proposal stage, compliance experts believe they provide an informative guide as to the US

Figure 2.3: Fund firms' expectations of upcoming US regulation



Source: EisnerAmper webinar: 'Impact of Private Fund Regulations on Finance, Tech & Compliance Managers', June 2022 regulator's overall direction of travel.

"At the end of the day, these are still only proposed rules, but that doesn't mean you can ignore them," observes Miller. "In the day-to-day, to the extent that you're doing something that comes within the ambit of these proposals, it is useful to see this as a reference guide to better understand how the SEC is thinking about these issues."

Pointing to the "significant industry push-back", he continues: "Many of these proposals strike at currently accepted and highly routine matters in the private fund industry. If you fall into a bucket where these proposals would really strike at important parts of your business, think about getting engaged with an industry group, or writing comment letters or engaging in some other way.

"There is also a significant open question as to the scoping of these rules for non-US managers, both registered and unregistered, and so I think non-US managers should also be very aware of these of these proposals."

Kavita Devani, head of compliance operations at Coremont, notes that the current regulatory proposals from the SEC are "driving one of the busiest periods in a number of years" and will impact both SEC-registered and unregistered private fund managers.

"This is going to be quite cumbersome and time-consuming for compliance departments across the US because there is just so much going on – from the short-selling disclosure rule, proposed quarterly statements for investors detailing information such as fund fees, expenses and performance and updating the beneficial ownership reporting requirements," Devani continues.

"If all these rules come into play, it's going to be a very, very busy time and critical to get right." ■

KEY TAKEAWAYS

- More than half of of US-based managers are concerned about SEC proposals to overhaul rules on private fund advisors, which industry participants fear may negatively impact certain fund strategies – particularly activist approaches - and damage client relationships

- As the SEC takes an increasingly strident approach towards regulatory oversight under chair Gary Gensler in light of calls for greater investor transparency post-Archegos, experts warn that hedge funds' compliance teams could face a busy and time-consuming period ahead

SECTION 3 | EUROPEAN REGULATION

EUROPEAN MANAGERS EYE AIFMD, MIFID OVERHAUL, AS IFPR TAKES CENTRE STAGE IN UK

Regulatory change in Europe is gathering pace following the pandemic, and as ESMA's plans for enhancing AIFMD and MiFID remain on managers' radars, the post-Brexit FCA implementation of the new IFPR may bring added headaches

Designed to bolster investor protection in the aftermath of the 2008 Global Financial Crisis, the EU's Alternative Investment Fund Managers Directive (AIFMD) – which took effect in 2013 – brought substantial changes to how hedge funds and other investment managers operated in Europe, putting them under closer regulatory scrutiny and subjecting their activities to greater transparency.

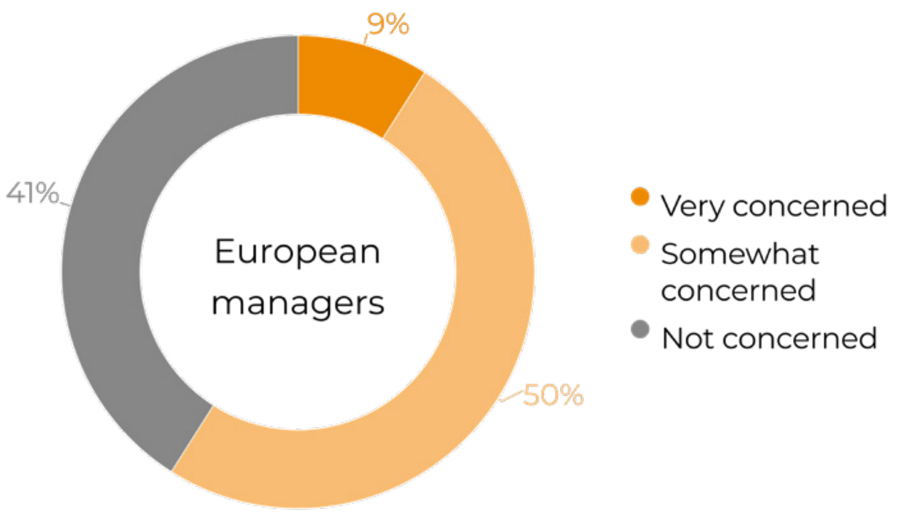
As part of its review of the bloc's Capital Markets Union, the EU and the European Securities and Markets Authority (ESMA) have set out plans to update certain parts of the directive with new rules covering marketing, delegation, liquidity and reporting.

The AIFMD II proposals – which are expected to be ratified by the European Council and EU parliament in the second half of 2022 – have split the hedge fund industry in the region. A survey of European managers conducted by Hedgeweek shows 50% are 'somewhat concerned' by the AIFMD II plans, with a further 9% 'very concerned', while 41% say they are not concerned.

'Problems'

Among other things, AIFMD II will introduce tighter curbs for hedge funds and other asset managers looking to delegate parts of their portfolio management to non-EU entities, as well as stricter rules on the pre-marketing process. Specifically, investment

Figure 3.1a: European hedge fund firm sentiment towards the EU's AIFMD II



Analyst note: AIFMD is an abbreviation of Alterntive Investment Fund Managers Directive

Source: Hedgeweek survey, Q2 2022

firms looking to pre-market in Europe are subsequently prohibited from reverse solicitation for 18 months. In practical terms, this measure could potentially upend capital-raising activities for some hedge funds, as well as impacting certain firms who offer marketing services, says Gary Pitts, founder and managing partner of boutique compliance and governance consultant Tetractys Partners.

"The pre-marketing issue has, for a number of distribution models, caused a few problems for firms pre-marketing in Europe," Pitts tells Hedgeweek, adding there is growing degree of "regulatory discomfort" over the concept of seconding people to other entities in Europe to market a fund where a UK firm has no other marketing options available in the EU.

In response, hedge fund firms are now drafting in additional legal counsel or compliance support in order to be able to decide which jurisdictions to go into and how to make an initial foray into certain countries, particularly since they can no longer rely on reverse solicitation.

"We have a lot more queries coming in from hedge funds," says Kavita Devani, head of compliance operations at Coremont. "With stricter guidance, they need legal counsel, or compliance support, to be able to make that decision on when and how to enter the marketplace. They are asking what the rules are in each particular country - is it better to register or not register? Should they pre-market or not?"

Expanding on this point, Devani tells Hedgeweek how hedge fund managers can no longer expect to simply organise investor roadshows across EU countries. Each country's rules need to be reviewed individually, she explains.

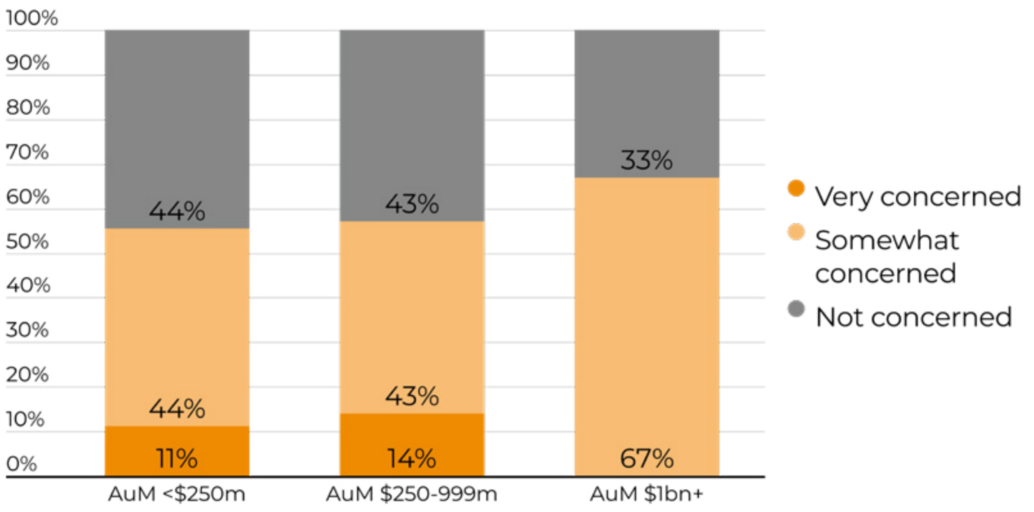
"Before they were able to speak to many more potential investors - but it's not so easy now," she says. "Managers need to really think about what countries they are targeting. Due to the new regime on pre-marketing it can preclude relying on reverse solicitation for a period of 18 months following the start of pre-marketing and fund managers will need to notify the relevant regulator of their pre-marketing activities, within two weeks of starting to pre-market."

Pitts adds: "Whereas in the past, you would normally spend 20% of your effort getting to 80% of your AUM, and just focusing solely on that because of limited bandwidth, I have seen some managers now who are sufficiently AUM-desperate to the extent that 80% of their efforts are going to try and capture that final 20%, with all sorts of costly regulatory contortions to try and distribute to sophisticated retail investors either in the UK or throughout Europe. It's an ad-hoc process, and it's becoming quite difficult."

'Focus'

Meanwhile, as part of the ongoing review of the Markets in Financial Instruments Directive (MiFID), the EU last year spelled out a package of measures designed to further

Figure 3.1a: European hedge fund firm sentiment towards the EU's AIFMD II



Analyst note: AIFMD is an abbreviation of Alterntive Investment Fund Managers Directive

Source: Hedgeweek survey, Q2 2022

strengthen transparency and the availability of market data, as well as levelling the playing field between execution venues, which the bloc hopes to will help "ensure that EU market infrastructures can remain competitive at international level."

MiFID II, which took effect in January 2018, brought sweeping transparency and transaction reporting requirements across the financial services industry and, for hedge funds, heralded new rules on how managers source, pay for, and utilise third party research – as well as the unbundling of research from brokerage fees – aimed at offering greater transparency for investors and curbing the risk of inducements to trade.

Industry consensus suggests MiFID II has led to a reduction in hedge funds' research spend, though anecdotal evidence indicates portfolio managers have sought to capitalise on the reduced amount of stock analysis with targeted research budgets to help them gain an edge.

Well over half (59%) of European hedge fund managers are 'somewhat concerned' about the MiFID/R III review, while 9% are 'very concerned'. In contrast, only a third of European hedge funds (32%) say they are are not concerned about the proposals.

"There is talk of transaction reporting being required for both AIFMs and MiFID firms further down the line, but this has not been confirmed," Devani says of the MiFID plans.

"This was previously one of the key advantages for a firm to be regulated as an AIFM instead of a MIFID firm, as transaction reporting takes up so much of a firm's time and costs," Devani explains.

Such additional burdens are often the reason for managers outsourcing certain processes to third party service providers. "If it means that both regimes will require that reporting, it puts the regimes onto a more level playing field," she adds.

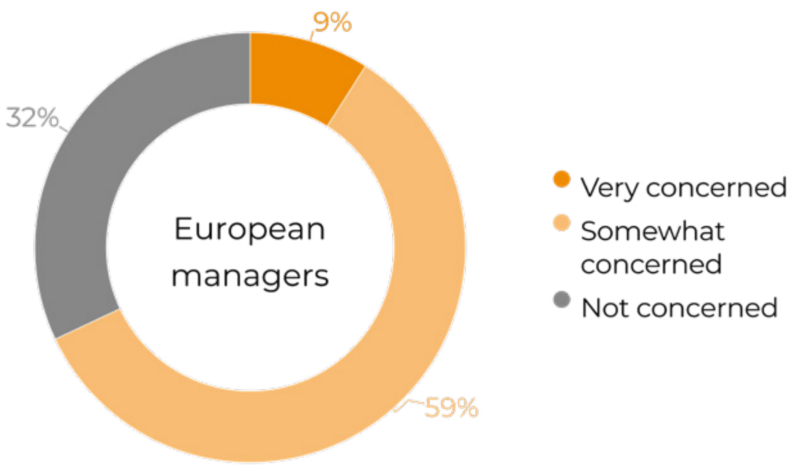
Delving deeper, key for the alternative asset management industry is a potential shake-up to rules covering UK firms with European operations and exposures, and the way MiFID rules may ultimately be applied by the Financial Conduct Authority to UK managers following the UK's withdrawal from the EU.

In a recent market commentary, Linda Gibson, director of regulatory change, BNY Mellon | Pershing, suggested that regulatory divergence "should very much be the focus" for those at EU and UK firms tasked with reviewing and advising the business on the impact of proposed changes to MiFID II.

'Surprises'

While EU-based MiFID investment firms are bound by the Investment Firms Regulation (IFR) and the Investment Firms Directive (IFD), which took effect in June 2021, UK-based MiFID investment firms are subject to a comparable set of rules, the Investment Firms Prudential Regime (IFPR), which kicked in from January 2022.

Figure 3.2a: European hedge fund firm sentiment towards the EU's MIFID/R II



Analyst note: MIFID/R is an abbreviation of Markets in Financial Instruments Directive/Regulation

Source: Hedgeweek survey, Q2 2022

Specifically, one central issue currently facing many managers in the UK hedge fund space are the MiFIDPRU provisions which apply where the hedge fund manager also has permission to manage individual managed accounts, and the accompanying ICARA document requirements which form part of the new IFPR.

"The FCA in theory did not have to do MiFIDPRU. It only decided to do MiFIDPRU because the rest of Europe was doing it and the FCA was originally one of the main drivers in creating MiFIDPRU in Europe in the first place," says Pitts.

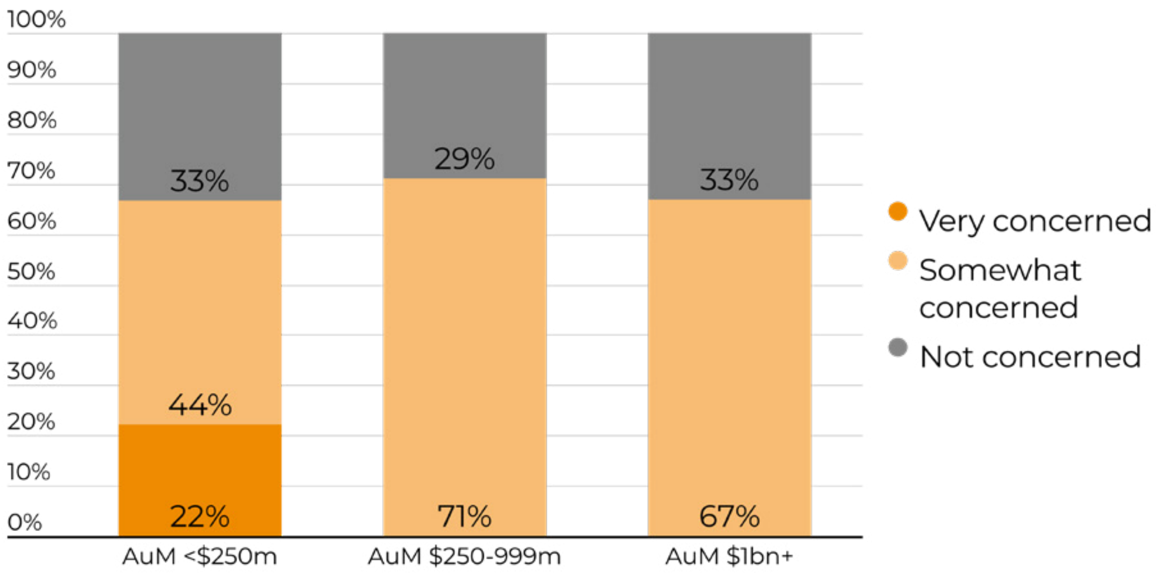
The new framework has brought a number of "nasty little surprises" for certain hedge fund managers, Pitts says, including the degree to which certain elements of the IFPR rules will apply to those fund managers considered SNI (small and non-interconnected investment) and non-SNI firms.

As part of the overhaul, the existing Internal Capital Adequacy Assessment Process (ICAAP) framework – which stems from EU legislation covering banks and other financial institutions' capital adequacy, in force since 2006 – is being replaced by the Internal Capital and Risk Assessment (ICARA), a new way of measuring not just institutions' capital adequacy, but their liquidity and "overall financial resources".

"One of the issues here is helping firms to understand their group structure, for example. It's quite complicated, and part of the issue with the ICARA itself is that historically the ICAAP for most firms was a tick-box exercise," says Pitts. "Additionally, if you are now one of those firms that has been suddenly surprised and has become a non-SNI simply because of the way you trade, then suddenly being told you have to submit your ICARA is a shock, rather than just having it on file in case you are asked to show it."

The new framework also heralds

Figure 3.1b: European hedge fund firm sentiment towards the EU's MIFID/R II, by firm AuM



Analyst note: MIFID/R is an abbreviation of Markets in Financial Instruments Directive/Regulation

Source: Hedgeweek survey, Q2 2022

additional compliance challenges for hedge funds and other investment managers, including more extensive wind-down plans and detailed risk assessments, and the introduction of so-called K-factors in capital calculations, which are required of asset managers meeting certain thresholds including £1.2 billion or more in MiFID AUM, or total gross revenues from investment activity of £30 million or more.

"One of the things that firms - small hedge funds, especially - have been very reliant on is a fairly standard template risk assessment which has been pre-populated by a consultant. Firms are actually having to go back to scratch and do a proper risk assessment of their own business," Pitts says.

"It takes time and effort – the wind-down plans are done off the back of stress scenarios, and the FCA has guidance on how to do these things, they've been doing virtual visits to firms, asking to see the wind-down plan."

He adds: "In reality it's making it a lot harder, and the barriers to entry now for the smaller hedge funds are quite significant. Having seen the FCA's expectations on the ICARA when people are asked to show the documents at authorisation stage, there's quite a high expectation – it's becoming much harder to get regulated, much harder to operate, barriers to entry are going up, and I think the days of starting off with $30 million and hope are long gone."

KEY TAKEAWAYS

- A majority of European hedge fund managers surveyed by Hedgeweek are concerned about the potential impact of the EU's AIFMD and MiFID regulation, which could significantly alter firms' business models. As a result, many managers are said to be drafting in additional legal counsel or compliance support to handle the additional work
- The FCA's new ICARA documents, which form a key a part of the UK regulator's new IFPR regime and introduce new methods of measuring firms' capital adequacy and liquidity, carry extra requirements and potential "surprises" for hedge funds

SECTION 4 | OUTLOOK

REWRITING THE RULES: KEY ISSUES SHAPING THE COMPLIANCE LANDSCAPE

As hedge funds' compliance teams get to grips with a byzantine array of plans from market authorities on both sides of the Atlantic, wider economic and political developments are continuing to recalibrate the investment and regulatory environment

ESG

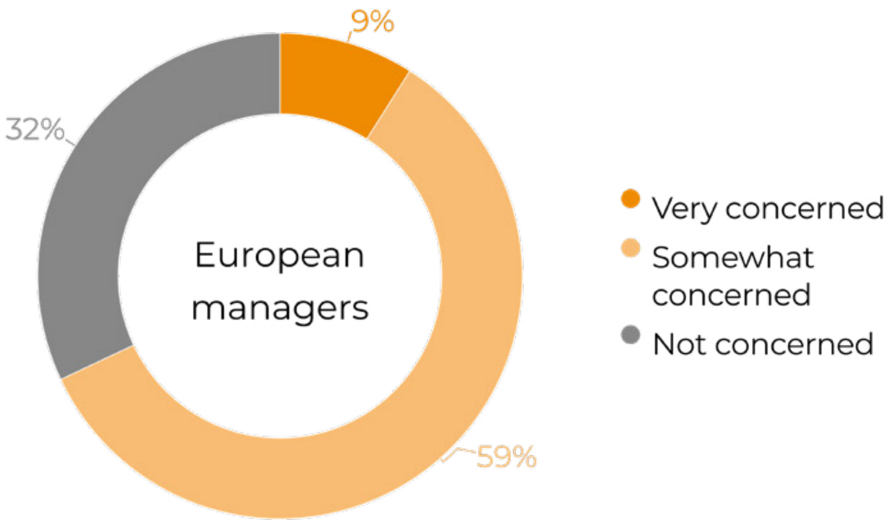
As environmental, social and governance (ESG) trends have gathered momentum within the financial services and investment management sectors over the past decade, the EU has led the charge globally in setting the benchmark for sustainable investing guidelines, predominantly through its far-reaching Sustainable Finance Disclosure Regulation (SFDR).

Introduced in March last year, the SFDR – which applies to a wide range of financial firms, advisers and products, including hedge funds – sets out a formalised framework to report sustainability risk factors, with affected firms required to either 'comply-or-explain' how they will or won't integrate ESG considerations into their business and investment processes. Further Level 2 requirements, which take effect in January 2023, will add mandatory principle adverse impact statements and other disclosures relating to environmental-linked valuation risks.

With hedge funds increasingly building ESG and responsible investing into their portfolios, the SFDR is now high on the industry agenda in Europe. Around one in four hedge fund managers globally are concerned by the regulations, according to Hedgeweek's survey. Among European hedge fund firms, that number soars to over two-thirds, with 68% of managers either 'very' or 'somewhat' concerned, against 32% who are not concerned.

"Europe is not going to be alone in its efforts as the UK and other jurisdictions look to define their takes on 'avoiding harm' and 'doing good'

Figure 4.1a: European hedge fund firm sentiment towards the EU's SFDR



Analyst note: SFDR is an abbreviation of Sustainable Finance Disclosures Regulation

Source: Hedgeweek survey, Q2 2022

in terms of economic activities and entity-level conduct," says My-Linh Ngo, head of ESG investment at BlueBay Asset Management.

"With ESG data and ratings increasingly emphasised as the basis for firms evidencing their credentials, the quality, reliability and comparability of these mean providers will also come under greater scrutiny this year."

Across the Atlantic, in May this year the Securities and Exchange Commission set out wide-ranging plans for increased disclosures for ESG-focused investment funds, aimed at providing more detailed information on funds' and advisers' incorporation of ESG factors to help bolster transparency for investors. The measures include specific disclosures in fund prospectuses, annual reports, and adviser brochures based on the ESG strategies they pursue.

The proposals follow on the heels of SEC plans for mandatory climate disclosures for US corporates, with factors such as greenhouse gas emissions included in audited financial statements, and the establishment of a dedicated Climate and ESG Task Force in the Division of Enforcement at the US regulator.

Hedge fund industry experts note how most managers – except for certain quantitative and high-frequency-type traders – have been evaluating ESG factors as a risk mitigation tool for some time, in advance of the SEC's new measures.

"I think that the upshot is going to be that managers are going to need to be thoughtful about their stance on ESG, and having a policy that reflects what they're doing and that they are clearly disclosing it to investors, and that everything is consistent across the various disclosures in term of fund documents, investor meetings, pitch book, Form AD," says Nicholas

Miller, partner, Seward & Kissel.

"The key point is that there is a strong system to document their process on ESG, and to really back up that they are doing what they are telling people they are doing regarding ESG."

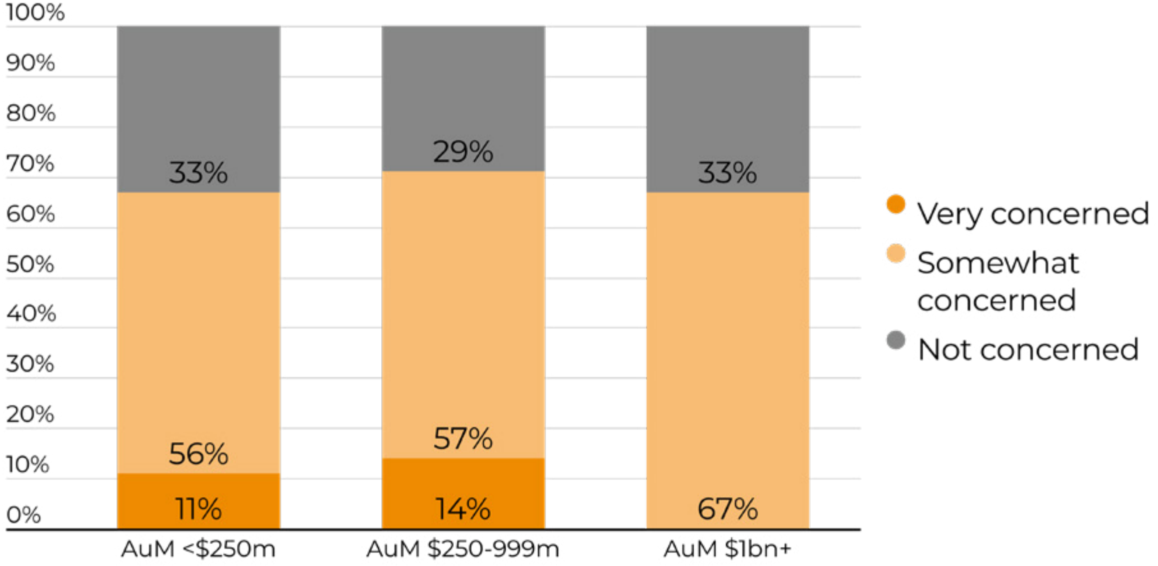
Digital assets

With cryptocurrencies experiencing ongoing volatility shocks this year, the ways in which the evolving digital asset space can be brought under closer regulatory scrutiny by market authorities globally has emerged as an increasingly live issue.

Regulation continues to be the number one obstacle in preventing managers from launching a digital assets hedge fund strategy. A Hedgeweek survey conducted in January found close to a third of managers placed regulatory and compliance complexity surrounding crypto ahead of key challenges relating to custody risk, investor appetite and launch cost/complexity when it comes to rolling out a digital assets-focused fund.

Industry participants note how crypto and digital assets are becoming increasingly interlinked with regulated markets, with regulators increasing pressing for more disclosure in order to avoid blow-ups, which can potentially have greater knock-on effects to broader markets. Given the perceived lack of transparency in the market, SEC chair Gary

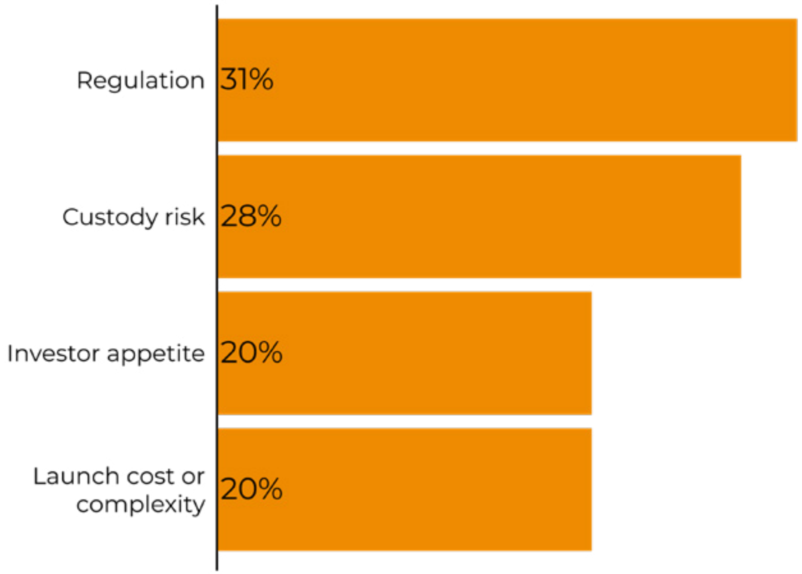
Figure 4.1b: European hedge fund firm sentiment towards the EU's SFDR, by firm AuM



Analyst note: SFDR is an abbreviation of Sustainable Finance Disclosures Regulation

Source: Hedgeweek survey, Q2 2022

Figure 4.2: The greatest obstacle to launching a digital assets hedge fund strategy, according to hedge fund firms



Source: Hedgeweek survey, January 2022

Gensler has pushed for tougher oversight of digital assets, with a view to regulating them in line with traditional securities.

"The SEC has taken a broad view as to what would be considered a security - a lot of this goes towards the perception that an advisor to a private fund which trades digital assets may take the view that they are not securities, and their fund is not an investment company, and they can avoid significant amount of securities-based regulation.

"This is a constantly-changing situation. Where it looks like we're heading with the SEC is that there's going to be a very expansive view of categorising digital assets as securities. This is going to be a key point for digital asset managers."

Meanwhile, the EU has unveiled new bloc-wide Markets in Crypto-Assets (MiCA) regulations, aimed at replacing the patchwork and fragmented nature of current guidance. The new rules, set out in early July, include authorisations for crypto-asset service providers and tougher measures to ensure investor protection.

Gary Pitts, founder and managing partner, Tetractys Partners, says: "NFT funds, funds of crypto funds are starting to emerge, while exchange traded products appear to be the quickest way to get to market if you want to do something in crypto – you set up the SPV, you become the issuer and have the basket of securities, so your credit risk is less of a concern if you have a segregated basket. Again, with some of the blow-ups recently, where things appear to be pegged to the dollar but still manage to go to zero, one questions whether these underpinning baskets will be effective."

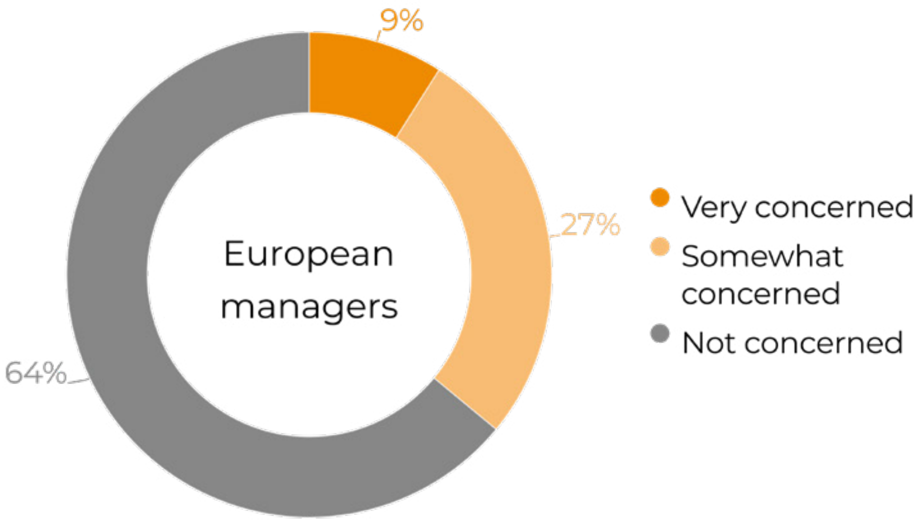
Brexit

The UK's withdrawal from the European Union continues to loom large over the European hedge fund industry, owing to London's traditional dominance – in terms of asset volume – of the sector on this side of the Atlantic.

With far-reaching reviews of AIFMD and MiFID/R ongoing, the extent to which the UK's Financial Conduct Authority diverges from established EU frameworks remains a key area of focus for managers.

According to Hedgeweek's survey of hedge fund managers, more than a third (36%) of UK

Figure 4.3: European hedge fund firm sentiment towards the ongoing fallout from Brexit



Source: Hedgeweek survey, Q2 2022

and Europe-based respondents said they remain either 'very concerned' or 'somewhat concerned' about the continued fallout from Brexit. In comparison, 64% of managers in the region said they were not concerned.

As a result of the UK's withdrawal from the European Union, the volume of hedge fund industry assets across the European Economic Area's 30 member states has tumbled from €354 billion in 2019 to just €89 billion in 2022, according to the European Securities and Markets Authority's Annual Statistical Report on EU Alternative Investment Funds.

ESMA's report, which was published earlier this year, said: "In terms of size and composition of the AIF sector, Brexit had its largest impact on hedge funds.

"HFs managed by UK AIFMs accounted for more than 75% of the NAV of UK and EEA30 HFs and more than 97% of AuM. Since UK HFs tend to be larger and use more leverage than EEA30 AIFs, leverage measures have declined when comparing EEA30 data for 2020 with the 2019 data published in the previous report (which included the UK in the EU)," ESMA observed.

Linda Gibson, director, head of regulatory change at BNY Mellon | Pershing, said in a recent market commentary: "We now have two regulators moving in different directions and with different priorities which will have a significant impact on firms who need to be able to integrate the amendments into their wider business strategy and look out for more amendments to be announced as they are drip fed through." ■

KEY TAKEAWAYS

- As the EU has taken the lead on formalising rules on ESG, two-thirds of European hedge fund firms are concerned about the potential challenges brought about by the bloc's SFDR.
- Both the SEC and ESMA are moving towards tightening up oversight of digital assets markets against a backdrop of soaring cryptocurrency volatility, as Hedgeweek research shows regulation continues to be the number one obstacle in preventing managers from launching a digital assets hedge fund strategy
- The dominance of London-based managers within the European hedge fund industry meant the UK's withdrawal from the EU has had a substantial impact on asset volumes among European AIFs

HEDGEWEEK

CONTRIBUTORS:

Hugh Leask
Editor
hugh.leask@globalfundmedia.com

Fiona McNally
Reporter
fiona.mcnally@globalfundmedia.com

Scott Newman
Art Director
scott.newman@globalfundmedia.com

Tony Griffiths
Head of Content, Hedgeweek
Tony.Griffiths@globalfundmedia.com

FOR SPONSORSHIP & COMMERCIAL ENQUIRIES:

Jamie Home
Associate Commercial Director, Hedgeweek
jamie.home@globalfundmedia.com

Published by: Global Fund Media, Lion Court, 25 Procter St, London WC1V 6NY