OPERATIONAL CHALLENGES FOR INVESTMENT ADVISORS IN MULTIPLE JURISDICTIONS

NICHOLAS TSAFOS OF **EISNERAMPER LLP** EXPLAINS THE DIFFICULTIES INVESTMENT ADVISORS FACE IN COMPLYING WITH REGULATORS' VARIOUS REPORTING REQUIREMENTS

Nicholas Tsafos, CPA, is an audit partner at EisnerAmper LLP with more than 20 years of diversified accounting and auditing experience. He works with hedge funds, private equity funds and registered investment advisers.

The compliance requirements of the US Dodd-Frank Act and the AIFMD have put tremendous regulatory challenges and increased investor oversight on investment advisors who operate in multiple jurisdictions. In connection with the increase in regulation, investment advisors have to develop operational and compliance infrastructures, obtain technology and hire service providers and personnel – all to meet the reporting requirements of the various regulators.

The financial crises of 2008 gave rise to the Dodd-Frank Act and the registration of investment advisors to hedge funds with the Securities and Exchange Commission (SEC). Registration with the SEC requires hedge fund advisors to file Form PF if they meet certain thresholds. The reporting requirements become very onerous for hedge funds that use leverage in their investment strategy and have regulatory assets under management that exceed US$1.5bn, since they are deemed to pose systemic risk to the financial system. These investment advisors must report, among other items, the composition of their funds' investment portfolios, amount of leverage and industry and investee company concentrations. They must also disclose information on the investors in the hedge funds that they manage (the AIFMD has similar reporting requirements). Investment advisors incurred substantial costs developing or acquiring technology to meet these reporting requirements; these costs have had a significant effect on the operations of certain investment advisors. Larger investment advisors have been able to absorb these costs; smaller advisors have less capacity to absorb such costs.

> "INVESTMENT ADVISORS SHOULD DEVELOP A COMPLIANCE CULTURE OF ADAPTING TO THE JURISDICTION WITH THE MOST RIGOROUS REQUIREMENTS"

Hedge fund service providers must not only be knowledgeable of the various regulatory requirements of the jurisdictions that the funds operate in; they must also meet the service provider criteria set by the various regulators. For instance, hedge funds registered in Ireland that want to be compliant with the AIFMD must hire prime brokers and fund administrators that are based in Ireland. Ireland has service providers that meet the needs of hedge funds; however, other jurisdictions that have similar requirements might not. The use of service providers that cannot meet the needs of the hedge fund also has a significant effect on investor perceptions. Investors are asking and requiring hedge funds to obtain qualified service providers, since they believe that some of the recent hedge fund failures are due to subpar service providers.

Investment advisors should develop a compliance culture of adapting to the jurisdiction with the most rigorous requirements. The investment advisor's employees must have the expertise to monitor service providers in regards to the quality of services provided and set the tone as to the level of service needed. Simply saying that a compliance function has been contracted out to an outside service provider is not enough; the investment advisor has a responsibility to its investors and regulators to monitor the service to ensure that the services provided are going to meet the scrutiny of the regulators. Key employees must constantly be aware of the changes in the regulatory environment and develop a process in which they communicate the changes to the rest of their organisation and the service providers; they must also develop processes to monitor the required changes in compliance and determine if the new compliance requirements are being met.

The increase in regulation for hedge funds operating in multiple jurisdictions has resulted in greater transparency and oversight. Crises and increased scrutiny have brought to the forefront issues that hedge fund advisors must protect against. Investors are also demanding more controls and monitoring from hedge fund managers. The increase in regulation and investor demands have brought about increased costs for hedge fund advisors. The larger hedge fund advisors and the ones which operate mutual funds and/or Ucits will be better prepared to absorb such additional costs. Smaller advisors will not be able to absorb the costs as easily as larger advisors or those that have investment vehicles that are already highly regulated. The additional regulatory costs and investor demands have created a barrier to entry for small hedge fund advisors. The challenges that regulatory compliance has brought the hedge fund industry will make it stronger and more viable in the future; yet at the same time they will limit the amount of new fund advisors in the industry. ■