CENTRL

THE IMPACT OF REGULATIONS ON INVESTMENT DECISIONS IN OPERATIONAL DUE DILIGENCE

INTRODUCTION

Investors are becoming increasingly more conscious of operational risk and the importance of including operational due diligence in their fund screening process. Hedge fund accounting errors in recent years have cost investors billions of dollars.

In addition, the sector has seen significant losses due to Ponzi schemes, embezzlement, inaccurate valuations, and other operational issues.

Meanwhile, having to frequently create and implement due diligence workflows to enforce ever increasing government regulations create a significant burden for the investment sector. More effort is required to modify administrative procedures and adapt operational processes to properly comply with new requirements.

While additional time and burden due to government regulations may be a hassle for individual financial services organizations in the short term, regulatory policies actually help the financial services sector in the long run.

Implementing new regulations might be costly, but they can provide assurance to consumers investing in financial services, increase investor trust, and improve total business investment.

THE IMPACT OF REGULATIONS ON INVESTMENTS AND INVESTMENT MANAGERS

The influence of regulations on investments is a complicated issue. Investment types and the corresponding laws vary depending on the goods, services, market participants, and countries. The inhibitory impact of regulation is often difficult to perceive and quantify.

The issue is not only with existing rules but also with those that are likely to exist in the future.
Proposed regulations should be considered as they will influence long-term investments.

Additionally, each passing regulation increases the workload for ODD professionals and investors who must ensure that investment managers are adhering to the relevant regulatory regulations.

However, the importance of these guidelines can not be understated as they help organizations refine and strengthen their internal controls and hold investmentment managers accountable.

Let’s now examine several regulations that impact investments.

The Investment Company Act of 1940

Following the 1929 stock market crash, the Investment Company Act of 1940 was enacted to develop and consolidate a more stable financial market regulatory system.

This fundamental piece of legislation governs financial institutions and their investment offerings. The act is primarily concerned with establishing a legal framework for retail financial product. But it also lays out the rules and regulations that US investment firms must follow while providing and managing investment product securities.

The Investment Company Act of 1940 stipulates that investment businesses need to register with the SEC before offering their securities on the public market. It also specifies the actions that an investment firm must take throughout the registration and other administrative procedures.

In addition, the act includes filing requirements, service costs, financial disclosures, and investment companies' fiduciary responsibility.

Finally, it specifies regulations for certain affiliated persons and underwriters' transactions, financial reporting methodologies, record-keeping provisions, auditing standards, handling changes to investment policies, and actions in case of fraud. There are standards for how securities may be shared, redeemed, and repurchased.

The Investment Advisers Act of 1940

The Investment Advisers Act of 1940 is federal legislation in the United States that governs and specifies an investment advisor's function and obligations. According to the regulation, anyone who gives advice or recommends securities is deemed an advisor.

Investment advisers are held to a fiduciary standard set by this act. Depending on the size and extent of their operation, they may be regulated by the SEC or state securities authorities.

The act establishes a duty of loyalty and a duty of care, which means that the adviser must prioritize their client's interests before their own. Furthermore, the adviser must execute transactions following a "best execution" criterion to trade assets with the optimal low-cost and efficient execution mix.

The agency with which advisers must register is mainly determined by the size of the assets they handle and whether they advise enterprise clients or merely individuals. Advisors handling high values and offering advice to investment businesses must register with the SEC. State securities authorities typically regulate lower-stakes advisors.

Dodd-Frank Wall Street Reform and Consumer Protection Act

The Dodd-Frank Act is a rule enacted by the United States government in 2010 as a reaction to the 2007–2008 financial crisis. The objective is to enhance corporate responsibility and prohibit unethical business practices.

One of the primary purposes of the Dodd-Frank Act is to bind banks to various rules and monitoring, especially if considered to be "too big to fail." To that end, the legislation established the Financial Stability Oversight Council (FSOC) to oversee these banks.

The Consumer Financial Protection Bureau (CFPB), also formed by Dodd-Frank, was tasked with stopping predatory mortgage lending and making it easier for consumers to understand mortgage terms before agreeing to them. This reflects the widespread belief that the bad loans market was the root cause of the 2007–2008 financial crisis.

The Volcker Rule, another essential component of Dodd-Frank, limits how banks can invest by restricting financial speculation and prohibiting proprietary trading. In addition, banks are not permitted to participate in hedge funds or private equity funds deemed excessively risky.

Dodd-Frank established the SEC Office of Credit Ratings after credit rating organizations were blamed for contributing to the financial crisis by issuing misleadingly positive investment ratings.

MiFID II

The Markets in Financial Instruments Directive II (MiFID II) is a piece of European Union regulation that governs companies that supply clients with services related to financial instruments and the platforms where those products are exchanged.

The act imposes additional restrictions and transaction reporting requirements, effective on January 3, 2018. The regulations are designed to:

- Increase investor safety
- Reduce the likelihood of a chaotic market
- Reduce systemic dangers
- Improve the efficiency of financial markets while reducing excessive expenditures for participants

The restrictions apply to Direct Electronic Access (DEA), algorithmic trading, high-frequency trading (HFT), and market-making, imposing stringent transaction reporting requirements.

Compliance departments are increasingly expected to create and support product governance rules and processes, including employee training. They are also expected to provide compliance-based expertise to management on strategic decision-making or new business models.

MiFID II mandatory compliance reports include detailed data about a firm's product governance mechanisms and compliance engagement in this area.

ASPECTS OF DUE DILIGENCE FOR INVESTMENT COMPLIANCE

Once operational due diligence (ODD) begins, a team is formed to carry out the activities, with both sides agreeing on the essential terms of engagement. The exercise is often carried out over a 30- to 60-day period, incorporating remote review of electronic assets and onsite visits.

A report will be created and provided to the investor, along with recommendations for any additional transaction terms and conditions. But, in the beginning, it is necessary to understand the compliance landscape by asking some questions which we explore below.

#1. What entities is the investment manager regulated by?

Two entities largely govern the investment and asset management industry: the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA).

The SEC regulates investment advisors with more than $110 million in assets under management. In addition, FINRA enforces SEC rules and regulations among its members and oversees broker-dealers and individual brokers.

Other agencies that regulate asset managers include the Federal Reserve, the US Treasury, and the FDIC.

#2. Which employees of the investment manager are responsible for compliance?

After reviewing the documents and getting an early look into the investment's operational infrastructure, your ODD team should conduct meetings with key personnel, including – but not limited to – the:

- Chief financial officer (CFO)
- Chief operating officer (COO)
- Chief compliance officer (CCO)
- Head of information technologies (IT)
- Other key operational staff

These meetings should provide a clear layout of responsibilities, the duties related to compliance, and the relationship between compliance and the investment strategy.

#3. Do the investment manager's compliance model and resources seem reasonable and appropriate given their size and activities?

Not all compliance landscapes are the same, and not all compliance programs address the specific nuances of a company. Therefore, the assessment should evaluate how well the compliance program protects the company from compliance risks in its regulatory environment.

This involves a thorough risk assessment and allocation of the necessary resources, whether manpower or technology, to identify, measure, mitigate, and monitor due diligence risks.

#4. Does the investment manager utilize an external compliance consultant?

Having an external consultant for compliance is a good indicator of a compliance culture. The compliance consultant must have the privileges and ability to adequately evaluate the risks of a company.

Their ability to provide inputs and impact decision-making is the difference between a working compliance program and one that is solely documented but not executed.

OTHER AREAS TO SCRUTINIZE FOR INVESTMENT COMPLIANCE DUE DILIGENCE

To fully accomplish its function, investment due diligence must be carried out in tandem with the other activities, and the due diligence team must actively engage with the participants.

Here are some additional factors to consider while conducting investment due diligence to avoid non-compliance.

Trade Allocation

Regulatory scrutiny of investment functions has increased steadily in recent years. This has led many firms to make their compliance processes more robust and inclusive. Asset managers also need to take prudent steps to build and manage compliance functions in their trade allocation processes.

With regulators stepping up their efforts to combat misconduct, it is more important than ever to ensure fair and equitable trade allocation practices. This requires full disclosure of allocation policies and procedures, as well as diligent maintenance of records.

Trade Execution

When you request a stock purchase or sale order, you may not consider how your broker will carry out the transaction. For trade execution, an investor using a brokerage account must first submit a buy or sell order, then be sent to a broker.

There are no SEC guidelines that require a trade to be completed within a specific time. Therefore, firms should not exaggerate or neglect to warn investors about the likelihood of severe delays if they advertise their execution speed.

Soft Dollar Commissions

A soft commission is a transaction-based payment made by an asset manager to a broker-dealer that is not paid in actual dollars.

Soft commissions allow investment companies and institutional funds to cover some of their expenses through trading commissions instead of average direct payments through real dollar commissions, which must be reported.

However, the payments must be for legitimate research and expenses of the adviser.

Personal Account Dealing

The handling of personal accounts is an area of risk for any company in the financial sector. As a result of these risks, regulators require companies to establish, implement, and maintain appropriate mechanisms to prevent employees from committing market abuse and misusing or improperly disclosing confidential information.

Trade Errors

A trading error could be a simple typo or blatantly misallocating a trade to the incorrect client or fund. Failing to perform a transaction or doing it at the wrong time are also examples of trade errors. A trading error may result in a financial gain or loss to the client.

Material Non-Public Information Controls

Material non-public information (MNPI) is information that is not commonly disclosed publicly or accessible to stakeholders in general that a reasonable investor would consider as relevant inputs for making an investment decision, such as whether to purchase, sell, or hold shares.

For example, it might involve investment strategy plans, significant capital investment plans, acquisition or disposal discussions, big new contracts, and financial performance. This material is deemed non-public if it has not yet been made available to the public by a press release, corporate statement, or other means.

Failing to handle MNPI appropriately constitutes a high-risk area for compliance; organizations must have comprehensive and proactive policies and processes to manage MNPI and insider lists to reduce risk.

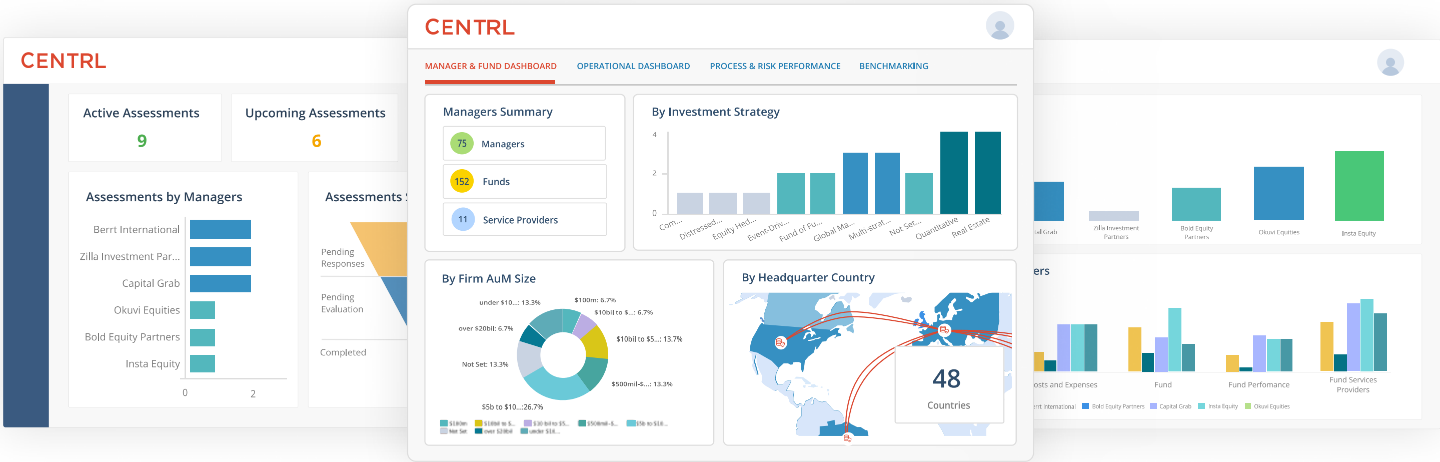
Code of Ethics and Conflicts of Interest Monitoring

As described by the Organisation for Economic Co-operation and Development (OECD), codes of conduct are the first step in enhancing management practices to promote legal and ethical compliance.

Following that, it's necessary to put in place mechanisms of management control geared to drive compliance. Financial reporting, record-keeping systems, instruction, administrative controls, compliance departments, whistleblowing facilities, recruiting policies, manufacturing controls, internal incentive systems, and internal and external audits are standard instruments used by these systems.

Conflicts of interest can be challenging to track and monitor, as it depends on the honor system, to be honest about their financial holdings. Some financial conflicts of interest cases are not disclosed because someone either did not consider it a conflict of interest or overlooked it.

INTRODUCING CENTRL'S DD360



When doing operational due diligence, especially regarding investments, there are many things to be wary of, as it often means the difference between profits and losses. It is often too much for spreadsheets and other traditional means, but technology is here to help you streamline this process.

DD360 is a cross-functional software that investors and asset managers use to track all types of regulations and improve the operational due diligence process. DD360 includes an easy-to-use user interface, solid automation, and analytics.

It provides managers with simple, straightforward, and rapid access to data for due diligence, increases consultant productivity, and enables them to deliver a better solution to their customers. These benefits create new business opportunities and differentiate you from the competition.

Request a demo with an expert to see how we can automate assessments, due diligence, and onsite audits.

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