



Regulatory and Portfolio Compliance in Mutual Funds – Introduction

Informative Series 1

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Mutual funds play a pivotal role in the global financial ecosystem, serving as a popular investment vehicle for both retail and institutional investors. To ensure the integrity and safety of these investments, regulatory and portfolio compliance have become paramount concerns for fund managers and regulators alike. In recent years, the mutual fund industry has witnessed a significant transformation in regulatory requirements and portfolio management strategies. This article explores the evolving trends in regulatory and portfolio compliance within the mutual fund industry.

Exploring Global Regulatory Frameworks: UCITS, Dodd-Frank Act, Sarbanes-Oxley, MiFID

DODD FRANK ACT-

The Dodd-Frank Wall Street Reform and Consumer Protection Act is a massive piece of financial reform legislation that was passed in 2010, during the Obama administration.

The Dodd-Frank Act targeted financial system sectors that were believed to have caused the 2007–2008 financial crisis.

The massive Dodd-Frank Act aimed to protect investors and taxpayers by strengthening the regulations of the financial system, with an eye on containing risk and ending bailouts of "too-big-to-fail" banks, such as those that occurred during the financial crisis.

Here's example of clauses by Dodd Frank Act:

- **Volcker Rule:**

- Named after former Federal Reserve Chairman Paul Volcker, this rule prohibits banks from engaging in proprietary trading and restricts their investments in hedge funds and private equity funds. The goal is to prevent excessive risk-taking by banks.

- **Consumer Financial Protection Bureau (CFPB):**

- Dodd-Frank established the CFPB as an independent agency responsible for protecting consumers from predatory and unfair financial practices. It has the authority to regulate and enforce consumer protection laws in the financial industry.

UCITS

The Undertakings for the Collective Investment in Transferable Securities (UCITS) is the European Commission's regulatory framework for managing and selling mutual funds.

UCITS funds can be registered and sold in any country in the European Union using unified regulatory and investor protection requirements.

Here's example of clauses by UCITS:

- **Article 52** of the UCITS Directive (Directive 2009/65/EC), a UCITS fund must ensure that its investments are adequately diversified to reduce the risk of significant losses. There are limits on the amount of exposure a fund can have to a single issuer or a single group of connected issuers to promote diversification.
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- **Article 37** of the UCITS Directive, for instance, outlines requirements for liquidity management, including the establishment of an appropriate liquidity risk management process. UCITS funds are required to ensure that they can meet redemption requests from investors without significantly impacting the fund's net

SARBANES OXLEY

The Sarbanes-Oxley Act of 2002 was passed by Congress in response to widespread corporate fraud and failures.

The act implemented new rules for corporations, such as setting new auditor standards to reduce conflicts of interest and transferring responsibility for the complete and accurate handling of financial reports.

Here's example of clauses by Sarbanes Oxley:

- **Section 302** - Corporate Responsibility for Financial Reports: This section of SOX (Section 302) places responsibility on the CEO and CFO of public companies to certify the accuracy of their company's financial statements. Specifically, they must certify that the financial statements present fairly the financial condition and results of operations of the company.
- **Section 404** - Management Assessment of Internal Controls: Section 404 is one of the most significant and resource-intensive provisions of SOX. It requires public companies to annually assess and report on the effectiveness of their internal controls over financial reporting.

MIFID

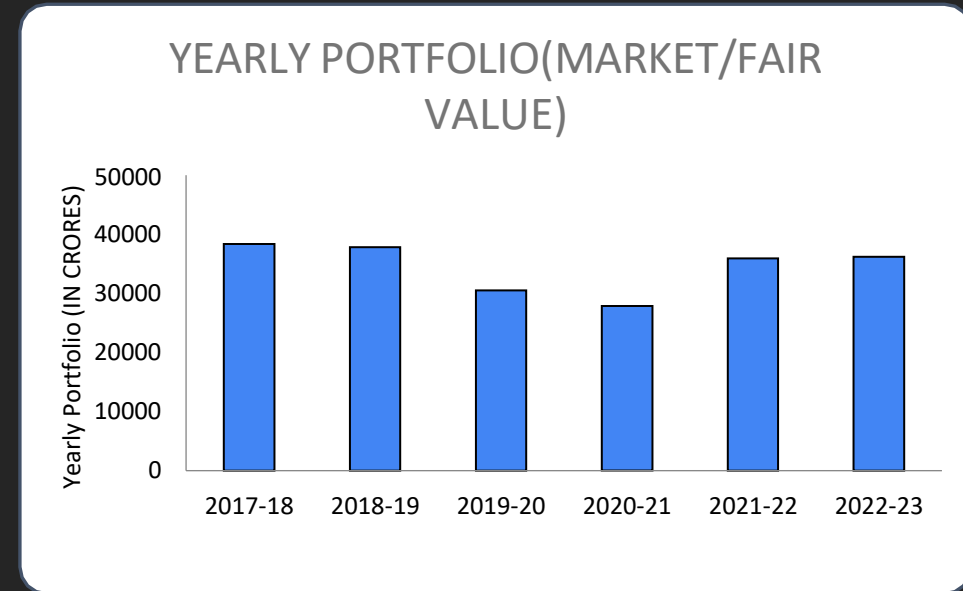
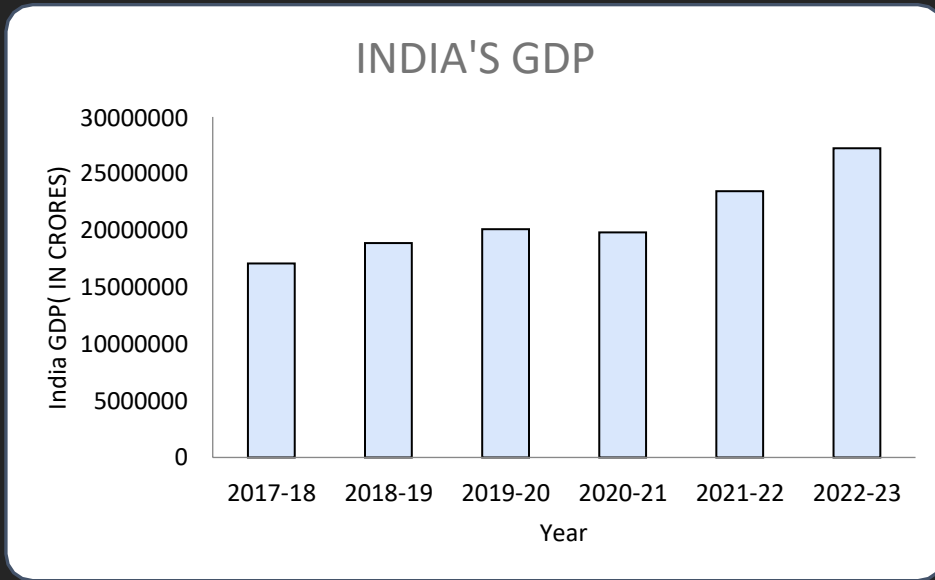
The Markets in Financial Instruments Directive (MiFID) is a European regulation that increases the transparency across the European Union's financial markets and standardizes the regulatory disclosures required for firms operating in the European Union

MiFID implemented new measures, such as pre- and post-trade transparency requirements, and set out the standards of conduct to be followed by financial firms. MiFID has a defined scope that primarily focuses on stocks.

Here's example of clauses by MIFID:

- **Client Classification (MiFID Article 19)** : MiFID Article 19 deals with the classification of clients by investment firms. It outlines the requirement for investment firms to categorize their clients into three main categories: retail clients, professional clients, and eligible counterparties. The purpose of this classification is to determine the level of investor protection and regulatory requirements that apply to each category. Retail clients receive the highest level of protection, while professional clients and eligible counterparties are presumed to have a higher degree of financial knowledge and therefore fewer regulatory protections
- **Best Execution (MiFID Article 21)**: MiFID Article 21 addresses the obligation of investment firms to execute client orders on the best possible terms. It requires investment firms to take all reasonable steps to obtain the best possible outcome for their clients when executing orders, considering factors such as price, cost, speed, and likelihood of execution.

COMPARISON BETWEEN GDP AND YEARLY PORTOLIO OF AUM



Here's the comparison between GDP and Yearly Portfolio of equity schemes investing in medium size market capitalization and large size market capitalization stocks. India's GDP showed a steady upward trajectory from 2017-18 to 2022-23, with notable fluctuations in growth rates during this period.

This portfolio shows a mixed performance, with significant fluctuations in the values of equity schemes investing in both medium and large-cap stocks. It suggests exposure to different market dynamics, potentially offering diversification benefits but requiring careful monitoring and risk management.

In both the graphs we can see that there was a stark decline in GDP as well as the yearly portfolio during the covid pandemic phase in the year 2020-21 but in no time both gradually recovered.

Recent Trends & Focus in Compliance for Asset Management Industry

- **AWM firms prioritizing digital transformation**

Asset and wealth managers have been accelerating their investment in digital transformation spurred by the popularity of remote work, by shifting investor preferences toward digital engagement and by the opportunity to drive efficiency and growth.

- **Industry intensifying focus on ESG**

The asset and wealth management sector continues on a two-prong transition into environmental, social and governance (ESG). ESG is being incorporated into investment products, and firms are integrating ESG principles into the heart of their purpose, strategy and performance management.

- **The regulatory onslaught**

Regulatory reporting burdens continue to mount in 2023. As UCITS funds transition to PRIIPS KIDs for retail investors in 2023, and the rollout of ESG regulation continues, it all follows hotly on the heels of European Securities and Markets Authority guidelines on liquidity stress testing, introduced in September 2020. Under the guidelines, fund managers must stress test the assets and liabilities of their funds, including stressing potential redemption requests to combat liquidity risk. These obligations are on top of existing extensive reporting requirements for UCITS, AIFMD, MiFID, DTCC reconciliation under EMIR, Solvency II, ANNEX IV, OPERA et al., meaning asset managers are being forced to spend more time on regulatory compliance than ever before.

Trends in Compliance for Asset Management Industry

- **Access to alternate asset classes**

There is likely to be a continued rise in interest in alternative asset classes such as venture capital, private credit, and real assets among HNWI's and family offices. While these asset classes may experience cycles, interest in them is expected to continue to grow over the long term. This requires increased focus on compliance for such new asset classes

- **A robust wealth creation engine**

The wealth management industry will continue to grow in terms of wealth creation, especially from the tech and finance sectors. However, there is also likely to be a renewed focus on manufacturing and other allied sectors, which could become new sources of wealth creation. Geographical expansion beyond metros is also expected to provide growth opportunities. This requires more integration of compliance

Major Challenges in Compliance for Asset management industry

The asset management industry in 2023 faces numerous complex challenges, from regulatory scrutiny to intense deal competition and high operational costs. And that's in addition to geopolitical tension, the threat of recession, and rising interest rates.

All these issues place considerable weight on asset managers' figurative shoulders as they navigate how to best fundraise and manage investments in an evolving and difficult environment.

Challenge 1: Achieving and demonstrating regulatory compliance

- The cost of regulatory compliance is already non-trivial, and regulatory demands are not decreasing any time soon. So, it's about working smarter rather than harder to achieve compliance.
- Furthermore, any fees earned by asset managers will face increased scrutiny from both policymakers and regulators due to the ongoing push for more transparency and more comparability. More transparency means more auditing and reporting, which unless automated costs more, and further erodes profitability.

Challenge 2: New competition

There is a growing body of competitors entering the asset management industry space. Due to their reach, lack of technical debt, knowledge and influence with banking alliances, several social media and technology heavyweights have the potential to provide their own compelling asset management services.

Challenge 3: Cost Pressures

Despite the squeeze on margins now is not the time to curb investment in technology – especially data management. Doing so will lead to firms missing opportunities to maximize their distribution, leverage new technologies to scale and reduce overheads, and keep up with increasingly rigorous regulation and reporting needs.

Challenge 4: Reliance on Human Resources

As well as managing increased costs, asset management firms also need to be aware of their resources being overstretched. The skills required to meet the added complexities posed by this evolving distribution landscape will test firms of all sizes.

For instance, wealth managers will now be shifting focus to dealing with the decumulation of wealth among their clients rather than accumulation, as baby boomers manage their retirements and transfer wealth to the younger generation. This will present different and increased pressures on resources in an already resource-intensive industry.

Trends in Compliance for Asset Management Industry

In today's ever-evolving regulatory landscape, the asset management industry finds itself at the forefront of significant changes and challenges. As financial markets become increasingly complex and interconnected, the need for stringent compliance measures has never been more critical. In this article, we will delve into the key trends shaping the compliance landscape for the asset management industry, exploring how these developments are influencing the way firms operate, manage risk, and navigate a constantly shifting regulatory environment.

- **Evolving Operating Models**

Asset management firms are reevaluating their traditional operating models and embracing innovative strategies to enhance efficiency, reduce costs, and streamline processes. Technology-driven automation, data analytics, and artificial intelligence (AI) are being leveraged to optimize operations, improve risk management, and deliver superior investment outcomes.

- **Rise of Passive Management**

Passive investment strategies, such as index funds and exchange-traded funds (ETFs), continue to gain popularity. Investors are attracted to their low fees, broad market exposure, and simplicity. Asset managers are increasingly incorporating passive strategies into their offerings to meet client demands while ensuring cost-effectiveness.

- **Active ETFs**

The emergence of actively managed ETFs is blurring the line between traditional active and passive management. These funds combine the benefits of active management, such as stock selection expertise, with the flexibility and transparency of ETFs. Asset managers are exploring this hybrid approach to provide investors with more diversified and dynamic investment options.

- **Emphasis on ESG Integration**

Environmental, Social, and Governance (ESG) considerations have moved from the periphery to the mainstream. Investors are increasingly seeking investment products that align with their values and promote sustainable practices. Asset managers must integrate ESG factors into their investment decision-making processes, demonstrate transparency, and deliver ESG-aligned solutions to attract and retain clients.

- **Focus on Alternative Investments**

With traditional asset classes becoming crowded and yields compressed, asset managers are turning to alternative investment options. Private equity, real estate, infrastructure, and hedge funds offer diversification, potential higher returns, and lower correlation to traditional markets. Asset managers are expanding their expertise and product offerings in these areas to meet investor demand.

- **Soaring Inflation**

This means that asset managers have to rethink operating structures, processes, and the technology component in the cost of ownership, in order to keep a lid on costs. Increasingly, companies are thinking of outsourcing activities like risk management to external service providers, to improve efficiency. Asset managers have to be innovative to protect assets from the damaging effects of the inflation which doesn't look like climbing down any time soon.

Technology in Asset Management Compliance & It's Implementation

Regulatory Reporting and Documentation:

- **RegTech Solutions:** Regulatory Technology (RegTech) solutions can automate the process of gathering, analyzing, and reporting data required for compliance. These solutions use technologies like AI and machine learning to ensure accurate and timely reporting.
- **Blockchain and Distributed Ledger Technology:** These technologies can provide immutable records of transactions and asset ownership, making it easier to track compliance with asset management regulations.

Risk Management:

- **Data Analytics:** Advanced data analytics tools can help asset managers identify and assess risks in their portfolios. Machine learning algorithms can analyze historical data and provide insights into potential compliance issues.
- **Scenario Analysis:** Technology can enable asset managers to run various scenarios to assess the impact of different market conditions on their portfolios and compliance with regulatory requirements

Technology in Asset Management Compliance & It's Implementation

Data Management and Security:

- **Algorithmic Trading Monitoring:** Automated systems can monitor algorithmic trading strategies in real-time, flagging any irregularities or potential market manipulation.
- **Market Abuse Detection:** Machine learning models can detect patterns indicative of market abuse, such as insider trading or front-running.

Client Onboarding and KYC (Know Your Customer):

- **Digital Onboarding:** Technology can streamline the client onboarding process by automating identity verification, risk assessment, and regulatory checks.
- **Regulatory Screening Software:** Tools that screen clients against various watchlists and sanctions lists help ensure compliance with anti-money laundering (AML) and counter-terrorism financing regulations.

Key Issues & their Mitigations for Compliance

Lack of Clear Compliance Strategy:

- **Issue:** Implementing compliance solutions without a well-defined strategy can lead to confusion and inefficiencies.
- **Mitigation:** Develop a comprehensive compliance strategy that outlines the firm's goals, regulatory requirements, and technology needs. Ensure alignment between compliance objectives and the chosen technology solutions.

Data Quality and Integration:

- **Issue:** Inaccurate or incomplete data can hinder the effectiveness of compliance solutions. Integrating data from various sources can be challenging.
- **Mitigation:** Invest in data quality tools and establish data governance practices. Ensure data integration capabilities within the compliance technology stack. Regularly audit and clean data sources.

Key Issues & their Mitigations for Compliance

Regulatory Changes:

- **Issue:** Regulations can change frequently, leading to the need for constant updates and adjustments in compliance solutions.
- **Mitigation:** Stay informed about regulatory changes through regulatory intelligence tools. Build flexibility into compliance systems to accommodate updates and changes. Maintain strong relationships with regulatory bodies for guidance.

Cost Overruns:

- **Issue:** Implementation projects can exceed budgetary constraints, leading to financial strain.
- **Mitigation:** Conduct a thorough cost-benefit analysis before initiating the project. Taking an Agile approach and breaking releases in Tranches help monitor and control projects better.

Key Issues & their Mitigations for Compliance

Resistance to change:

- **Issue:** Employees may resist adopting new compliance solutions, leading to low adoption rates.
- **Mitigation:** Provide comprehensive training and support for employees. Involve key stakeholders early in the project to gain buy-in. Communicate the benefits of the new system clearly.

Security and Privacy Concerns:

- **Issue:** Security breaches or data leaks can occur if compliance solutions are not adequately secured.
- **Mitigation:** Implement robust cybersecurity measures, including encryption, access controls, and regular security audits. Comply with data privacy regulations (e.g., GDPR) and ensure client data is protected.

Key Issues & their Mitigations for Compliance

Vendor Reliability:

- **Issue:** Relying on third-party vendors for compliance solutions can be risky if they experience downtime or service interruptions.
- **Mitigation:** Choose reputable vendors with a proven track record. Include service level agreements (SLAs) in contracts that specify uptime guarantees and penalties for non-compliance. Have a backup plan in case of vendor issues.

By proactively addressing these issues and having a robust project management approach, asset management firms can increase the chances of successful compliance solution implementation while minimizing disruptions and risks. Additionally, ongoing monitoring and continuous improvement efforts are essential to maintain compliance and adapt to changing regulatory landscapes.

Conclusion

- In the ever-evolving landscape of asset management compliance, one thing remains clear: technology is the driving force behind transformative change. As regulatory requirements continue to multiply and deepen, asset managers must embrace innovative solutions to meet these challenges head-on. This article has explored the pivotal role of technology in reshaping compliance within the asset management sector, shedding light on how it enhances efficiency, accuracy, and overall regulatory adherence.
- From regulatory reporting and documentation powered by RegTech solutions to risk management bolstered by data analytics and scenario analysis, the possibilities offered by technology are vast. Trade surveillance, data management and security, and client onboarding and KYC processes have all seen significant improvements thanks to technological advancements. However, it's essential to navigate the implementation of these solutions carefully, addressing common challenges such as a lack of clear compliance strategy, data quality and integration issues, and the ever-present threat of regulatory changes.
- As the asset management industry continues to grapple with these challenges, those who successfully harness the power of technology will gain a competitive edge. The ability to adapt, innovate, and demonstrate unwavering commitment to compliance will not only ensure the protection of clients' assets but also secure the long-term success and sustainability of asset management firms in an increasingly complex regulatory environment.
- In conclusion, the asset management landscape is undergoing a profound transformation, and compliance is at the heart of this evolution. Embracing technology and proactive strategies is not just a necessity; it's the path forward to thrive in a dynamic industry where regulatory scrutiny, competition, and operational efficiency are paramount.

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This article is part of a multi series where we will publish information about actual operational details of systems and process in each of the departments of Asset and Wealth Management companies

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