Hedge Fund Compliance: Risks, Regulation, and Management

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Compliance is one of the fastest growing areas in the alternative investment space, and this is particularly true for the hedge fund industry. Recent reports outline that the hedge fund industry has already spent in excess of $3 billion on compliance related efforts. Today, surveys indicate that individual hedge funds on average spend at least 5% - 10% of their operating budgets on compliance, and these percentages are expected to steadily increase.

This well written highly detailed book begins by highlighting the changing scope of hedge fund compliance, as outlined in this excerpt: "Today, hedgefund compliance has evolved into more than a regulatory exercise. Hedge fundcompliance programs are now required to regularly engage compliance risks across a wide variety of operational and investment areas, ranging from cybersecurity and conflict of interest management to trade allocation and increased oversight of the use of investment research. To meet these challenges, hedge funds, their investors and service providers must continually reevaluate the role of the compliance function to ensure that they not only meet these new regulatory requirements but also keep pace with industry best practices

One key compliance challenge hedge funds increasingly struggle with is the challenge of regulatory reporting. In this excerpt *Hedge Fund Compliance: Risks, Regulation and Management* the author outlines some key questions hedge funds face in this area and an approach to the process:

"A hedge fund manager often wants clear answers to the following questions:

- *Which reporting do I need to file?*
- *When do I need to file them?*
- *How often do I have to keep filing them?*
- *When will I have to make additional filings?*

The process of determining the answers to these questions is a multistep one. On a high level, the steps in the reporting process are:

Step 1: Evaluate a hedge fund's regulatory reporting eligibility requirements.

Step 2: Determine what specific forms and data are required.

Step 3: Develop a strategy regarding what data to provide.

Step 4: Select the appropriate method and group to transmit information to a regulator.

Step 5: Adhere to ongoing filing requirements.

Step 6: Conduct ongoing evaluations of new filing requirements

The compliance rules regarding regulatory reporting can be quite complex. Straightforward answers to these types of questions often require an analysis of each hedge fund's specific circumstances. Also influencing these answers are the specific requirements of each different financial regulator."

Hedge Fund Compliance covers topics that will be of interest not just for hedge funds and their service providers but for allocators as well. An entire chapter of the book focuses on the ways in which investors can evaluate a hedge fund compliance function during the due diligence process. The following excerpt highlights an area of increased focused for investors during due diligence, the oversight of material non-public information and expert networks often used by hedge funds during the investment research process:

"Another reason investors are increasingly focused on material non-public information ("MNPI") is because over the past few years the avenues by which hedge funds may become exposed to MNPI through the investment research process have increased. One of the drivers of this has been the growth of what is known as the expert network industry. Expert networks are companies that provide a matchmaking service between individuals who have particular experience in different industries and companies that may be useful for hedge fund's in considering different potential investment opportunities. For example, a hedge fund may be considering making an investment in a company that manufactures semi-conductors but may not be familiar with recent trends in the industry. Speaking to a recently retired executive from that industry would likely provide useful insights to the hedge fund.

Although the experts the hedge funds speak to are not supposed to provide MNPI to the hedge funds they speak to, the risks for transmission are present. Investors seeking to evaluate a hedge fund's potential compliance liabilities as it relates to MNPI therefore, are increasingly focusing on the way hedge funds interact with expert networks. In evaluating a hedge funds compliance oversight in this area important factors investors can investigate including the use of the following best practices:

1) The hedge fund performs due diligence on the expert network: It is important for hedge funds to perform due diligence on the ways in which an expert network seeks to prevent the transmission of MNPI from its experts to a hedge fund. Investors should evaluate how thoroughly a hedge fund has evaluated the expert network including understanding the compliance framework in place at the expert network itself, as well as the training and vetting processes for experts.

2) The hedge fund communicates its own compliance policies to the expert network: In addition to MNPI controls that may be in place at the expert network itself, it is also important for hedge fund's to pro-actively give the expert network the hedge fund's own MNPI related compliance policies. The reason for this is there may be differences in place between the hedge funds own policies and the expert network. In many cases, hedge funds have stricter prohibitions in place then the expert network may have. In these cases, if the hedge fund is to utilize the expert network, there should be special measures taken to ensure that the hedge funds policies are complied with. An example of how a hedge fund may bridge this gap in practice would be by having a hedge fund employee read a disclaimer prepared by the hedge fund's compliance department which would reiterate what the specific policies of the hedge fund in this area, and reiterate that the employee does not wish to receive MNPI from the expert.

3) Pre-clearance of experts: Prior to having a hedge fund's employees engage in any discussion with experts, it is considered best practice to have them pre-clear the use of specific experts through a hedge fund's compliance departments rather than working directly with the expert network. The purpose of this is to allow the compliance function to vet the use of any potential experts while keeping in mind any potential conflicts that may be in place as it relates to current or planned investments of the firm's funds. In this case, the compliance function could leverage off of the above referenced practice of utilizing a restricted list, which is utilized to assist in overseeing personal account dealing, to ensure that an individual does not maintain too close an affiliation with a particular company that is on the restricted list.

4) Limitations on expert public company experience: If an expert currently works or has recently worked for a publicly traded company, many hedge funds seek to maintain enhanced restrictions on any conversations a hedge fund's employees may have with this expert. The reason for this is that if the hedge fund were to make trades related to the public company where the expert has direct experience there is an enhanced risk that MNPI could be discussed that the hedge fund may then act upon.

Some hedge funds maintain policies that explicitly prohibit its employees from speaking to experts that are currently working at public companies. Additionally, hedge fund policies may also not allow employees to speak to experts that have worked at a public company within a pre-determined times period such as, last 12 months.

5) Compliance auditing of expert calls: It is considered best practice for a hedge fund's compliance function to maintain a mechanism for auditing the actual calls between the hedge fund employee and the expert. The most common mechanisms utilized is for a representative of compliance to actually listen into the calls in conjunction with the hedge fund employee as they speak to the expert. While it is ideal for compliance to listen in to every call in some cases, depending on the resources in place at the hedge fund, compliance may instead opt to randomly select the calls to audit.

6) Preparation of expert call summaries: It is also considered best practice for the hedge fund to prepare a summary memorandum of the call with the expert. These summaries serve to develop a written log of which experts were spoken on what dates. Additionally, these summaries also create documentation of the topics and specific companies that were discussed during the call. This facilitates monitoring and testing of expert activity, discussed below, as well as allows the hedge fund to provide documentation to regulators in the event questions arise relating to a hedge fund potentially trading in MNPI.

7) Monitoring and testing of expert requests and conversations: It is considered best practice for the compliance function to monitor the use of experts by employees. As part of this monitoring, the compliance function should note if a hedge fund employee, such as an investment analyst, consistently talks to the same expert. With frequent usage of the same expert there is the potential for the analyst to push too far in asking for information about a particular subject which could venture into the realm of MNPI.

Additionally, it is considered best practice for the compliance department to monitor the specific companies discussed expert calls in order to determine if a hedge fund is actively using this information in violation of MNPI rules. This can be the case even if multiple different experts are utilized. For example, if over the course of a month, a hedge fund's investment analyst talks to 15 different experts about the prospects of The Dow Chemical Company and then the hedge fund actively trades in that company over the same period, these trades should be subjected to a higher degree of scrutiny by the compliance department to determine if MNPI was a factor in executing those trades. This would include reviewing the content of the conversation between the analyst and the experts as well as evaluating the timing and specifics of the hedge funds trades and the items discussed with the expert in order to determine if any potential violations took place."

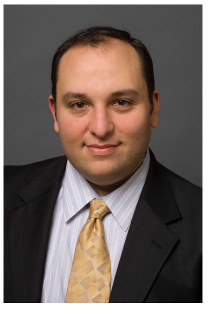
Hedge Fund Compliance concludes with an analysis of recent compliance trends including an overview of the impacts of MiFID II and AIFMD as well as the discussion of enhanced personal liability for hedge fund Chief Compliance Officers. Another interesting trend highlighted in the book is the of increasing insurance costs for hedge funds seeking coverage related to the expenses associated with regulatory examinations as discussed in the following excerpt:

"Another trend relates to the increasing compliance related insurance costs for hedge funds. In recent years, regulatory agencies such as the US SEC and the UK FCA, as well local US state regulators have increased their scrutiny of hedge funds. With this increased attention has also come increased litigation brought by these regulators as part of enforcement activity. To meet this growing demand, a recent trend has emerged whereby the hedge fund insurance industry has increasingly offered professional liability coverage to hedge fund managers that can provide them with coverage to cover the cost of mounting a legal defense when these regulatory actions were brought.

As with all insurance policies there are a number of exceptions and specific requirements for the hedge fund to be eligible for the coverage. One of the key items in this area that has increasingly come under contention has been a push for hedge funds that enter into settlements with financial regulators such as the SEC to actually admit guilt, as opposed to settling with the regulator in which they neither admitted nor denied guilt. The way many of these professional liability policies have been traditional drafted, if a hedge fund were to admit guilt the way the settlement would be structured with the regulator could exclude it from coverage of defense costs under the insurance policy under what are known final adjudication or judgement exceptions. While this specific issue is still developing in the hedge fund industry, as regulators increased their enforcement efforts there is also a growing concern that hedge fund insurers will have to pay increased defense costs under these policies as regulators increase their enforcement activity across the board. This consequently, has caused many in the industry to speculate that the costs of these policies to hedge funds will continually increase as well."

To add further perspective on the real-world applications of compliance the book also includes interviews regarding the benefits of hedge fund compliance consultants with ACA Compliance Group, and on the increasingly important compliance role played by technology consultants, including in the area of cybersecurity, with Eze Castle Integration. The book also features an accompanying website which includes examples of core compliance documentation and forms commonly used by hedge funds. Hedge Fund Compliance: Risks, Regulation and Management is currently available for order from booksellers worldwide including Amazon.

Author's Bio



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Jason Scharfman is the Managing Partner of Corgentum Consulting, a specialist consulting firm that performs operational due diligence reviews and background investigations of fund managers of all types, including hedge funds, private equity, real estate, and long-only funds on behalf of institutional investors, including pensions, endowments, foundations, fund of funds, family offices, and high-net-worth individuals.

He is recognized as one of the leading experts in the field of due diligence and is the author of the forthcoming *Hedge Fund Compliance: Risks, Regulation and Management* (Wiley Finance, 2016), *Hedge Fund Governance: Evaluating Oversight, Independence, and Conflicts* (Academic Press, 2014), *Private Equity Operational Due Diligence: Tools to Evaluate Liquidity, Valuation, and Documentation* (John Wiley & Sons 2012), and Hedge Fund Operational Due Diligence: Understanding the Risks (John Wiley & Sons, 2008). He has also contributed to the Chartered Alternative Investment Analyst (CAIA) curriculum on due diligence and has served on the organization's Due Diligence, Risk Management and Regulation Committee.

Before founding Corgentum, Mr. Scharfman previously oversaw the operational due diligence function for a $6 billion alternative investment allocation group called Graystone Research at Morgan

Stanley. While at Morgan Stanley, he was also a senior member of a team that oversaw all of Morgan Stanley's operational due diligence efforts, allocating in excess of $13 billion to a firm-wide platform of more than 300 fund managers across multiple investment strategies. Before joining Morgan Stanley, he held positions that primarily focused on due diligence and risk management within the alternative investment sector at Lazard Asset Management, SPARX Investments and Research, and Thomson Financial.

Mr. Scharfman received a BS in finance with an additional major in Japanese from Carnegie Mellon University, an MBA in finance from Baruch College's Zicklin School of Business, and a JD from St. John's University School of Law. He is admitted to the practice of law in New York and in New Jersey. In addition, he holds the Certified Fraud Examiner (CFE) and Certified in Risk and Information Systems Control (CRISC) credentials. He has consulted with the US House Judiciary Committee on hedge fund regulation and has also provided training to financial regulators on hedge fund due diligence. Mr. Scharfman has served as a consultant and testified as an expert in hedge fund litigation and has lectured on the subject of hedge fund operations and operational risk as an adjunct professor at New York University. He is a member of several industry organizations, including the Information Systems Audit and Control Association, the American Bar Association, the New York State Bar Association, and the New Jersey State Bar Association. He has written extensively on the subject of due diligence and speaks worldwide on due diligence and operational risks.