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HFs focus on details of SEC compliance

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Get ready. The rules are changing. No longer can hedge funds be considered the renegades of the financial services industry.

Hedge funds managers registering as investment advisors with the US Securities and Exchange Commission are moving into the mainstream—a development some managers have melodramatically called the beginning of the end of their innovative culture.

Most hedge funds argue that they already conform to many of the best practice standards required of any responsible financial institution. Come early next year, they will be required to prove it.

Working out the intricacies of exactly *what* they will need to prove when the SEC comes knocking is in full swing as managers seek to ready themselves for the registration deadline of February 2006.

Compliance

The SEC's compliance requirements fall into three main categories: the hiring of a chief compliance officer, the implementation of compliance policies and procedures, and the implementation of a process by which these policies and procedures are reviewed at least annually.

Although the requirements look straightforward enough on the surface, the differences among hedge funds and the nature and size of their businesses have raised questions about how best to implement these requirements.

One size, it seems, does not fit all.

Several questions still want answers: Can the CCO function be outsourced, and if so, how should this be implemented? What is the personal liability of a chief compliance officer?

Also, what are the pros and cons of a hedge fund manager's general counsel doubling as its CCO? Should a fund manager consider forming a compliance committee?

Compliance will be burdensome for many hedge funds because it will force even small start-up managers to address infrastructure issues, which some consider to be at odds with the innovative and free flowing culture of hedge fund managers.

These infrastructure issues include the tedious but critical task of document retention and personal trading surveillance, for which technology solutions are available. 14▶

HEDGE UPDATE

Man's profits up, but fee income hit

Preliminary results for the year to March 2005 showed London's Man Group posting pre-tax profits of $784 million, up 10% on the previous year. After fund sales of $12 billion, the group's total assets under management now stand at $43 billion.

However, poor returns from Man Investments' directional strategies 3▶

◀1 MARHedge will evaluate technology solutions such as those provided by McDonald Information Services, Ozmosys, Complinet and StarCompliance in a future issue.

Activities that some managers have until now engaged in as a matter of course will come in for scrutiny to ensure they adhere to compliance requirements. For example, hedge funds that have provided midmonthly estimates to their clients as a courtesy will now need to ensure that these estimates comply with the SEC's required level of valuation support for any communication with clients.

Outsourcing

When it comes to implementing a compliance program, the questions about outsourcing range from whether to use vendor-provided technology programs to automate some aspects of compliance requirements, to how much of the actual CCO function a manager can outsource.

"It seems that the SEC has been careful not to prohibit outsourcing," Theresa Messina, a partner at Ernst & Young, said at a recent Managed Funds Association seminar in New York.

But even if it isn't prohibited, some say that just because one *can* outsource the function of a CCO doesn't mean one *should* do so.

"It is very difficult for the CCO to be effective if they do not understand your business, and someone outside the business is never going to really understand the nuances of how you trade and how you manage money," says Messina.

Terrance O'Malley, a partner at Schulte Roth & Zabel, agrees that it's very difficult to delegate out the function of a CCO. "There is probably certain repetitive monitoring and checking where you could get the assistance of somebody, but ultimately there needs to be somebody in-house who knows what is going on."

The temptation to outsource the CCO function is strongest for small hedge funds with limited staff and resources. In these cases, it is anticipated that the job of compliance will fall on the firm's general counsel.

"Unfortunately, the hedge fund industry in many cases has not grown to be able to handle two people doing these jobs," says Kenneth Raisler, a partner at Sullivan & Cromwell.

> "Many general counsels are going to temporarily if not permanently take up the CCO title"

"My guess is that there are going to be many general counsels who are going to be temporarily if not permanently taking up the CCO title."

The dual performance of general counsel responsibilities and that of CCO by the same person within a hedge fund is sure to give rise to sticky situations. For example, during an examination, the SEC will want to see all documentation, including emails, pertaining to compliance issues at the firm.

But what happens when a compliance issue pertaining to a particular client arises? Would not an email discussing such a matter from general counsel be protected under attorney-client privilege? In this case, which of the CCO/general counsel's job functions would take precedence?

In the event that someone other than the general counsel can be appointed CCO, opinions vary on the issue of where the role should fall within the hierarchy of the firm.

Although the place of a CCO in a hedge fund's pecking order hasn't been specified by the SEC, Gene Gohlke, associate director of the SEC's Office of Compliance Inspections and Examinations, has said he would like to see the CCO report directly to the chief executive officer, thereby elevating the position's stature.

However, according to Messina, where the CCO sits doesn't really matter as long as he or she has access to everyone in the firm. "They have to be able to walk into the principal's office and have a discussion about what they think or don't think is working as well as have access to all data," she says.

Whether or not the CCO reports to the chief executive, the experts seem to agree that hedge fund managers would be wise to institute a compliance committee that meets regularly to support the CCO.

"The SEC really loves to see committees as evidence of a cultural change; it shows them that you take compliance seriously," says O'Malley.

It is also a win-win for the CCO and the hedge fund manager.

A compliance committee will make it less likely that the CCO will develop a reputation as the bad guy standing in the way of business innovations. At the same time, its existence will give rise to a culture of compliance in an organization while still keeping a firm handle on how the business is run.

"From the CCO's perspective, they do not want to be vulnerable out there developing policies," says Messina. "You also don't want the CCO to be dictating your business. The CCO must have the ability to influence policy, but policy and compliance need to be owned by the business."

Liability and committees

Within any fund manager outfit, when it comes to compliance, the buck ultimately stops with the CCO. That's why it's important, says O'Malley, that policies and procedures be drafted in a way that makes it clear that the CCO is not required to supervise members of the firm.

O'Malley says the business entity itself should take responsibility for training staff as to what is required of them. This includes putting procedures in place so that any infringements come to the surface and, therefore, to the CCO's attention.

This means establishing milestones at which point staff will be required to take action on specific issues that could result in future infringements of policy.

Although it isn't in the interests of the SEC to go after CCOs if it wants to attract good people to the role, it will be important for CCOs to be able to answer comprehensive questions in the event of an SEC examination.

Some likely questions: What do you consider to be the risk in your environment? What are the problems you as a firm have encountered? Have you been able to get the resources you need to do your job? What have you found during the course of your annual risk assessments to be the issues? ■