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# Hedge Fund Compliance

*Risks, Regulation, and Management*

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JASON A. SCHARFMAN

WILEY

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*Risks, Regulation, and  
Management*

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Published by John Wiley & Sons, Inc., Hoboken, New Jersey.

Published simultaneously in Canada.

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*Library of Congress Cataloging-in-Publication Data is available*

ISBN 978-1-119-24023-5 (Hardcover)

ISBN 978-1-119-24027-3 (ePDF)

ISBN 978-1-119-24026-6 (ePub)

Cover Design: Wiley

Cover Images: (top) © g0d4ther/Shutterstock; (bottom) © Rawpixel.com/Shutterstock

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

*For R, Y, and Z*

# Preface

**C**ompliance is one of the fastest-growing areas in the hedge fund industry. Contributing to this change is a seemingly steady drumbeat of new global regulatory activity. In the United States and in Asia, for example, regulators have steadily enhanced their hedge fund compliance enforcement and surveillance activities. In Europe, broad shifts in the laws, such as the Alternative Investment Fund Managers Directive (AIFMD) and the Markets in Financial Instruments Directive (MiFID), have directly influenced the way hedge funds carry out their investment activities.

Today, hedge fund compliance has evolved into more than simply a regulatory exercise. Hedge fund compliance 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 and 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. This book is written to assist these groups in embracing this challenge.

Readers of this book will come from different levels of sophistication, ranging from those in an academic setting and new to hedge fund industry to experienced hedge fund compliance professionals working in the compliance field. To assist in highlighting important compliance terminology as you read through each of the chapters, you will find key terms italicized and in boldface. Regardless of your previous compliance experience, this book can also serve as a reference source on specific compliance topics. To facilitate this, the chapters of this book have been organized by key compliance topic area for ease of navigation.

Specifically, this book is structured to provide an understanding of the core concepts of hedge fund compliance across three sections. The first section, Chapters 1 through 4, focuses on topics relating to the structure and duties of a hedge fund's internal compliance function. It begins by providing an introduction to the compliance function and the role of regulators. The Chief Compliance Officer (CCO) role, as well as the responsibilities of other shared and dedicated compliance personnel, are then discussed. This

section concludes with an analysis of the function of internal compliance mechanisms, such as fund committees.

The second section of the book, Chapters 5 through 8, focuses on specific topics in compliance as well as the role of third parties in the process. This section begins by addressing the emerging role of technology in compliance management. The use of technology in performing a wide variety of compliance activities, including trade surveillance, archiving, and monitoring employee communications, is also covered. Next, the role of third parties that assist in compliance management, including compliance consultants, is discussed. Examples of key compliance documentation, including the Compliance Manual and Code of Ethics, are then presented. Finally, the process by which prospective and existing investors conduct due diligence on hedge fund compliance functions is addressed with a focus on the analysis of compliance policies regarding employee personal account dealing and material non-public information (MNPI).

The third and final section of the book, Chapters 9 through 12, applies critical compliance concepts directly to the real world. It begins by focusing on historical case studies and illustrative scenarios as well as common compliance pitfalls. Interviews with third-party compliance service providers are presented to demonstrate the practical opportunities and challenges facing hedge funds in working with third parties to implement and manage their compliance programs. Finally, the book concludes with a discussion of emerging topics and trends in the compliance space.

Compliance has evolved from a rote exercise of strictly following regulatory rules to one of the most prominent, dynamic, and multidisciplinary areas of hedge fund management. A strong compliance program can improve the overall operating efficiency and level of communication throughout a hedge fund. Similarly, hedge fund investors benefit from the additional oversight and transparency that comprehensive compliance programs can provide. Regardless of your role in the hedge fund industry, as compliance continues to evolve, developing a fundamental understanding of core compliance concepts is now an essential requirement for success.

Jason Scharfman  
December 2016

# **Hedge Fund Compliance**

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# Introduction to Hedge Fund Compliance

## INTRODUCTION

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Nearly every profession, whether it is asset management, healthcare, construction, or scientific research, has some areas that require rules and regulations to be followed. At its most basic level, the term *compliance* refers to the processes and procedures by which an organization adheres to these guidelines. These guidelines may come from a variety of sources. Traditionally, the government is the primary initiator of compliance rules for different industries, but they may come from other sources as well.

Compliance has become a critically important component of investment management and this is particularly true in the hedge fund space. Key questions this book will seek to answer include:

- What exactly is hedge fund compliance?
- How can hedge funds design and improve their compliance function?
- What constitutes best practice compliance?
- What role do financial regulators play in implementing and monitoring compliance?
- Why should investors care about hedge fund compliance?
- What role can third-party service providers play in compliance?
- What global compliance trends are emerging in the hedge fund industry?

## DIFFERENCES IN HEDGE FUND AND OTHER ALTERNATIVE FUND COMPLIANCE

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Within the sphere of alternative investment fund managers, the lack of homogeneity creates a number of unique compliance challenges. Indeed, separate books could be written about the different compliance frameworks

required to address the intricacies of different alternative asset classes, such as real estate and private equity.

Hedge funds, too, are unique from a compliance perspective. In particular, they tend to be one of the more complex fund management entities. Why? For starters, let us clarify what the term *hedge fund* refers to. *Hedge fund* is a broad umbrella term used to classify many different types of managers that may be organized under differing fund legal structures. The broad nature of the term is one of the reasons that make the category of fund managers known as hedge funds unique and challenging from a compliance perspective. Other key reasons for the increased complexity of hedge fund compliance include:

- *Variety of different strategies employed*—Hedge funds utilize a number of different investing strategies. Common hedge fund trading strategies include global macro; long-short equity; market neutral; event-driven strategies, including merger arbitrage and special situations; convertible arbitrage; sector funds, including healthcare or energy funds; quantitative strategies; and even multistrategy funds. Although other types of alternative investment categories contain distinctions, the variety of investment strategies employed by hedge funds is relatively large in comparison.
- *Trading and operating on a global scale*—In many cases, hedge funds may conduct not only trading but also fund-structuring and asset-raising activities in multiple jurisdictions around the globe. This global landscape contributes to the complexity of the compliance environment surrounding hedge funds.
- *Wide range of instrument types traded*—To facilitate both the trading activities of a wide number of strategies, as well as the broad investment flexibility within different strategies, hedge funds often trade a wide variety of instruments. These can include equities; swaps; swaptions; forwards; futures; options; various types of bonds, including treasuries, convertible bonds, and catastrophe bonds; bankruptcy claims; syndicated loans, including bank debt, mortgage-backed securities, private investments in public equity (PIPEs), repos, and reverse repos; commercial mortgage-backed securities (CMBS); and credit default swaps (CDS). The use of different strategies can-not only subject hedge funds to the oversight of different financial regulators and exchanges but the combined effect of utilizing multiple instruments also increases the complexity of administering compliance across various security types.

- *Variety of trading implementation strategies*—To implement trading strategies, hedge funds may employ a wide variety of trading procedures. These may include variations on:
  - i. Who is actually deciding to trade? (i.e., a human being, an automated computer trader, or some combination of the two)
  - ii. The timing of trades—Are they spaced into the market over time or all at once?
  - iii. The process of executing trades—Hedge funds may provide instructions to counterparties to execute trades in a number of different ways, including over the telephone or through electronic methods, such as instant message or e-mail. The reasons for this may depend on a number of factors, including the size of the hedge fund, the sophistication of a hedge fund's trading platform, the markets they trade in, and the way they work with trading counterparties. This variety presents a number of unique compliance challenges.
- *Use of multiple prime brokers and other counterparties*—**Prime brokers** are companies that facilitate the implementation of a hedge fund's trading strategy. Companies that provide prime brokerage services are typically referred to as **broker-dealers**. In their work with hedge funds, they typically offer hedge funds a number of services, including trade clearing, execution, and leverage financing. Today, it is common for hedge funds to utilize multiple prime brokers.

Hedge funds do this for a variety of reasons, including diversifying their exposure across multiple counterparties as opposed to putting all of their eggs in one basket. The risk in using a single prime broker was highlighted after the 2008 failure of Lehman Brothers. There may also be other types of brokers utilized in addition to prime brokers. One example is brokers known as **executing brokers**. These brokers typically work directly with prime brokers or, in some instances, directly with the funds, in executing trades. Another type of broker is called a **futures commission merchant** that facilitates trading in futures.

Hedge funds may also utilize a number of other trading counterparties for securities, such as swaps. These swap counterparties are commonly referred to in the industry as **ISDA counterparties**. This name comes from the standard master agreement often used to implement these arrangements that is provided by the International Swaps and Derivatives Association (ISDA).

The use of these multiple prime brokers and counterparties often creates unique needs among hedge funds for specific compliance oversight of the ways in which they interact with these groups.

- *Enhanced research techniques*—From an investment research perspective, hedge funds traditionally employ a relatively wide array of techniques as compared to other fund managers. These avenues may include research activities, such as discussion with industry experts, and the utilization of *expert networks*. Expert networks are for-profit companies that organize databases of individuals with expertise in particular subjects or with particular companies. Expert networks then coordinate conversations between fund managers and these individuals in order to facilitate the fund manager's research. Accompanying the use of these research avenues are a series of additional layers of compliance oversight that would not otherwise be present in other alternative managers that do not engage in such techniques.

Each item listed above presents a specific set of compliance challenges that we will address in more detail throughout this book. The important takeaway at this stage is that, while there are certain core principles of compliance that can be applied across all asset classes, and within alternative investments in particular, based on the broad trading activities, strategies, and global scope of hedge funds, they present distinct compliance challenges that merit specialized compliance considerations.

## **HEDGE FUND COMPLIANCE IS NOT SPECIFIC TO ONE COUNTRY**

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Compliance is a heavily rules-based exercise. These rules are driven by the laws and regulations of the different countries in which hedge funds operate. Although we will address certain key aspects of different hedge fund regulations in the major countries in which hedge funds operate, this book is meant to provide practical compliance advice on a global basis rather than focus too heavily on the laws of any specific country. There are many other more technical resources that can provide in-depth specific guidance on the applicable compliance laws in any particular country.

### **Regional Compliance Expertise Used by Hedge Funds**

In practice, many hedge funds engage in business activities in multiple countries. It is not practical for these hedge funds to maintain internal compliance experts who have expertise in all of the countries in which they may operate. To solve this problem, a hedge fund's interpretation and implementation of compliance guidelines in different countries often comes about as a result of consultation with a number of different country-specific specialists.

To clarify some terminology, individuals or firms that are not employees of the hedge fund but provide services to it are commonly referred to as

*third parties, third-party firms, or service providers.* Although not every service provider provides compliance-related services to a hedge fund, many do in one form or another. One of the most common compliance-focused service providers is known as a *compliance consultant*. Another type of hedge fund service provider heavily involved in compliance is a *law firm*, which is also sometimes referred to as a hedge fund's *legal counsel*. The country-specific compliance specialists that hedge funds heavily rely on in the compliance area are typically either compliance consultants or legal counsel.

Another reason that many hedge funds utilize third-party compliance consultants when operating in different countries is because compliance is an evolving subject. As the laws and rules in different countries change, external expertise can often provide valuable insight into trends in compliance practices in specific countries.

### **Benefits to Developing a Global Understanding of Compliance**

When studying the area of hedge fund compliance, there are benefits toward first establishing a general understanding of the subject on a global basis before delving too deeply into the rules of any one country. From the perspective of hedge fund employees, while individuals who are experts in the compliance practices of any single country are, of course, valuable, developing a global understanding of general compliance policies coupled with third-party country or region-specific compliance expertise as needed often produces a much more holistic compliance program.

From the perspective of hedge fund investors seeking to evaluate hedge fund compliance protocols, first developing a more general understanding of core hedge fund compliance principles prior to any country-specific knowledge is also advisable. This is because investors may allocate capital to hedge funds in multiple jurisdictions, which are subject to different compliance regimes. By developing this general compliance foundation first, which is then complemented by country-specific compliance knowledge, a more universal compliance due diligence program for investors will result.

Keeping both the hedge fund employee and the hedge fund investor perspectives in mind should assist you as you work through the material.

### **DO ALTERNATIVE INVESTMENTS MERIT SPECIAL COMPLIANCE CONSIDERATIONS?**

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Hedge funds are commonly grouped into an asset class known as *alternative investments*. Alternative investments differ from other types of investments, such as long-only mutual funds, commonly referred to as *traditional investments*. For reference, a *long-only fund* is one that only engages in the



purchasing and selling of investments, such as buying or selling equities. These are long-only investments because the fund's general strategy is to make long-term predictions that the value of the investments will increase over time. Long-only funds do not follow a strategy of selecting investments by betting that the value of certain investments will decrease over time.

By contrast, an approach that seeks to profit from the decline in value of a potential investment, such as betting for a decline in the price of the shares of a publicly traded company, is known as *short selling*. Short selling is typically carried out through the use of equity options. One hedge fund strategy that combined both long- and short-selling techniques is known as a *long-short strategy*. In addition, other hedge fund strategies may also typically involve the use of options and other short-selling techniques. Other common types of alternative investments, often grouped alongside hedge funds in this category, are private equity, real estate, and commodity funds.

Within the area of fund manager compliance, the question may be raised whether alternative investment managers merit special compliance considerations as compared to traditional investment managers. When we refer to a *fund manager*, unless otherwise stated, we are not referring to a specific individual, such as a portfolio manager, but rather to the management company organization for which an individual known as a fund manager or portfolio manager typically works. Prior to answering the question of whether a special classification category is required for hedge funds, we must first understand the notion of market and regulatory classifications.

## Contrasting Regulatory and Market Classifications

Most regulators have big categories by which they categorize similar types of financial entities. This is in contrast to the smaller distinctions among different types of asset managers that may be made in the real-world marketplace. When it comes to hedge funds, the majority of global financial regulations do not maintain a separate classification for entities that may be classified as a hedge fund, private equity fund, or any other alternative investment vehicle. Instead, within the broad umbrella of regulatory fund manager entities, financial regulations are primarily more driven by the activities of these fund managers. This concept highlights the distinction between what may be referred to as a *regulatory classification* and a *market classification* of a fund manager.

**Understanding Regulatory Classifications** A regulatory classification is the way a fund manager would be classified based on predetermined regulatory classification requirements. One way to think about regulatory classifications is the way in which a fund manager is viewed from a legal perspective.