UK and European Regulatory Trends Update

With Schulte's financial regulatory and fund lawyers

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The Hedge Fund Journal met with Schulte Roth & Zabel's London-based partners, Christopher Hilditch and Anna Maleva-Otto, to discuss a selection of regulatory matters of relevance to UK hedge fund and alternative investment managers. UK regulators' areas of scrutiny are in many cases similar to those of US regulators, though with some differences of emphasis, detail and modus operandi. Today, key regulatory risk factors for managers include: outdated documents, general complacency, insufficient accountability and attempts at 'passing the buck' to other service providers.

Oversight, inspections and examinations

The UK Financial Conduct Authority (FCA) does not issue 'deficiency letters' in the way that the US Securities and Exchange Commission (SEC) does, nor does it make regular visits to managers' offices as the US regulator does. Admittedly, when in 2014 permissions were varied so hedge fund managers could become Alternative Investment Fund Managers (AIFMs), the FCA did review policies and documents, but in general, "the FCA follows a more thematic review process, picking a topic like conflicts of interest or controls, and selecting 30-40 firms for a phone call or visit and a desk review of policies and procedures," Maleva-Otto explains. Additionally, most hedge fund managers are overseen by the FCA's Wholesale supervision team rather than by dedicated examiners. The lower frequency of FCA visits – with some firms not inspected for years – "can create a false sense of complacency," Maleva-Otto finds.

This can be manifested in the use of standardised, pro-forma, off-the-shelf compliance manuals, Hilditch notes. He stresses "compliance manuals need to be living documents, updated and amended to reflect what a firm is doing, in terms of its strategy, size, people, infrastructure and procedures." Documents need to be revised whether or not the regulator visits, partly because allocators have increasingly tough criteria.

Indeed, Hilditch suggests that the routines of Operational Due Diligence (ODD) professionals and consultants may be more demanding than those of the FCA. He has had some dialogue with the ODD consultancies and suggests that they provide managers with a clear incentive to brush up their policies and procedures to pass muster with the ODD gatekeepers. Hilditch emphasises how "compliance and legal risk is a commercial risk as well, because large investors and endowments will not be associated with firms that have deficient procedures."

Senior manager responsibility

Hilditch sees the tone of FCA speeches becoming harsher, with references to enforcement actions and sanctioned individuals being made an example of. The 'named and shamed' need not be those facing criminal penalties. The FCA is demanding greater individual accountability from all staff and particularly from senior managers. "The FCA wants to get rid of the bad apples to cleanse the industry and is frustrated that it failed to call senior managers of banks to account for their failings in 2008," says Maleva-Otto. In October 2015, the Treasury announced that the Approved Persons Regime will be replaced with the Senior Managers and Certification Regimes, now being extended to all staff who are registered with the regulator (by 2018).

Maleva-Otto points out that firms now have enhanced responsibility for pre-vetting staff and ensuring their fitness and propriety. "It is very important to read bios and carry out background checks, and costs for firms will increase." Here, some discretion needs to be exercised. A parking ticket for overstaying a meter is not necessarily a deal-breaking offence, but using a disabled parking badge when not entitled is dishonest, as is avoiding train fares, while being banned for drunk driving is also a serious error of judgment, Hilditch clarifies.

Senior managers of hedge funds will now have a statutory duty to avoid breaches of regulatory obligations by their firm. After hiring staff, there is "an ongoing responsibility over procedures and controls. All responsibilities have to be mapped out so that individuals are accountable. Collective responsibilities are not sufficient," Maleva-Otto adds.

Attestations are one tool used by the FCA and extend the same concept. Chief Compliance Officers (CCOs) are not the only responsible persons, as any and all senior managers can be held responsible for deficiencies in their firm's controls. Below we touch on a selection of topical regulatory issues.

Money laundering controls

CCOs are often the Money Laundering Reporting Officer and there have been fines for weak controls in this area. Maleva-Otto has not seen cases of proven money laundering involving hedge funds or asset managers in London, but weak controls can be enough to warrant a fine and destroy a CCO's career. It is not sufficient to rely upon administrators carrying out money laundering checks; managers should conduct their own due diligence on the administrator's AML controls, train staff and pay attention to the recommendations of the Joint Money Laundering Steering Group. "The industry over-relies on controls put in place by administrators," underscores Maleva-Otto. The fact that managers may not handle subscriptions or redemptions, nor hold client money, does not absolve them of responsibility for inadequate controls over client due diligence and reporting of suspicion.

Trade allocation and controls

Trade allocation amongst accounts and best execution are also in regulators' crosshairs. In one case, a UK asset manager was found to have been allocating profitable trades to an account that paid higher fees while leaving less profitable trades in a lower fee account. Here there was a clear incentive whereby the company, and some staff, profited at the expense of clients. But consequential loss is not a precondition for regulatory sanctions – in another case a UK manager was fined for inadequate controls over unauthorised trading, trade errors and best execution. Fines generally have not reached the tens of millions levied by US regulators, but are still material amounts.

Fees, costs and expenses

Fees, costs and expenses, and the allocation thereof, are under the regulatory spotlight in both the US and UK. In Europe, the Ongoing Charges Figure (OCF) has replaced the Total Expense Ratio for retail funds. Increasingly paternalistic regulators do not seem to assume that sophisticated investors are able to make an informed judgement about costs and fees. Indeed, the FCA's review, announced in November 2015, will look at value for money for both retail investors and wholesale investors, such as pension funds. All of this comes under the mantle of its 'investor protection' mandate. Maleva-Otto recalls how "the topic started here when the FCA did a thematic review of conflicts of interest for alternative investment managers back in 2012, and now, AIFMD adds another layer of regulation."

Various line items in an OCF can be charged directly to funds or charged to managers (and thus paid out of fees already charged to funds). Hilditch elaborates at high-level "some things, such as trade commissions, are clearly fund expenses but there is some debate over whether other items, such as passporting notifications or regulatory reporting costs, should be manager or fund expenses". A brand new prospectus may be explicit on such matters but an older one may not. Explains Hilditch: "Managers, regulations and practices have changed so new types of spending have emerged. We did not have Form PF or Annex IV costs 10 years ago."

Expenses policies "should be disclosed in multiple places and primarily the OM," Hilditch adds. He views the DDQ as "complementary to, and expansive of, the OM." Policies should be consistent across documents. Hilditch adds that "disclosure needs to be comprehensive, and it is not acceptable to argue that a firm's expense allocation policy is just 'industry standard practice'." It is audacious to assume that an all-encompassing, catch-all expenses clause in an offering document permits managers to charge any and all costs to the fund, and as Hilditch warns, "investors and regulators might not agree." If managers decide to update their offering documents, to clarify expense issues or for other reasons, then investor consent may need to be sought for what is in effect a change in the contract.

Many UK managers are already registered with both the FCA and SEC, so the highest common denominator of oversight sets the bar. If managers plan to register with the SEC when they start raising assets in the US, it is worth getting into good habits ahead of time. The SEC examiners go through expenses with a fine-tooth comb, scrutinising literally every line item. "Third party service provider and vendor bills are being closely looked at, particularly in terms of allocation. Allocating the entire expense to one client when several benefited is not acceptable."

There has also been scrutiny around the allocation of broken deal expenses. Maleva-Otto thinks one cause of problems can be that relatively junior staff have sometimes been making decisions on allocating costs whereas the Chief Financial Officer should be involved. "It is very easy to get a deficiency letter and there is no de minimis exemption," she adds. 'Tit-for-tat' or reciprocal offsets, whereby one client bears one expense and another has borne a second cost of similar size, are not an acceptable defence. Expense allocations must be correct in principle, even if their practical impact is immaterial.

Valuation and remuneration

Valuation is another area of growing scrutiny, not least as fees generally derive from valuation. The appropriate disclosure, independence and consistency of application for valuation methodologies are the key three areas. "Valuation rules have not been tested with regulatory challenges since AIFMD came in," says Maleva-Otto, but this is no reason to relax. She suggests that a number of US cases around valuation reveal lessons in terms of "which policies are applied, what is disclosed versus what is implemented in practice, and who is involved in any change of valuation method." Maleva-Otto thinks that best practices codified in AIFMD are similar to what the SEC expects.

An independent valuation function is essential, but not sufficient. Maleva-Otto points out that administrators' service level agreements generally define them as "calculation agents rather than valuation agents, so most do not view themselves as being responsible for valuation." Where models are used for valuation, questions to ask include "who designs them, who has oversight, where the objectivity exists, who decides and who sits on valuation committees." The composition of such committees is important in gauging governance and independence. For instance, "if a head of risk reports to the Chief Investment Officer there might be questions about their meeting regulators' criteria for independence," Maleva-Otto points out. Here she notes that AIFMD has guidance on defining independence, so that valuation processes, amongst others, should be independent of portfolio management functions. "Risk, valuation and compliance control functions should also be remunerated independently of fund performance with their bonus tied to their function and not the fund," she adds. For investment staff, the AIFMD strictures on deferral of bonuses and reinvestment have, in fact, been disapplied for the majority of UK staff, under proportionality rules.

Any hope that charging performance fees on illiquid assets (e.g. level three assets or side pockets) only on realised profits could relieve or reduce managers' responsibility for valuations, is dismissed by Hilditch, who points out that "managers could still be receiving management fees based on valuations, and their stated performance also gives rise to potential conflicts of interest in marketing."

This brings us onto the CFA Institute's Global Investment Performance Standards (GIPS), which have been used as the basis for at least one enforcement action in the US. A manager was fined and struck-off for misrepresenting compliance with GIPS. "The GIPS are not prescribed in European legislation, but disclosure and consistency are still critical matters. If you tell investors you are applying certain methods and then do not, there can be issues with advertising," Hilditch stresses.

Trade reporting and shorting

The GIPS are one example of technical rules, while short selling and trade reporting are others. "In both the US and Europe, there has been much enforcement of technical violations around trading compliance, notifications, short-selling and naked short selling," reflects Maleva-Otto.

For instance, Greece's Hellenic Capital Market Commission (HCMC) applied a very narrow interpretation of what constitutes a 'covered' short sale in a number of recent cases where fines were levied on hedge fund managers in the context of share sales following a rights issue. The extended settlement period on the issuances of the shares resulted in some trades failing. "Fines have been levied for failure to cover positions but not necessarily where the trade failed," reflects Maleva-Otto. The Greek regulator's stance seemed contrary to European Securities and Markets Authority (ESMA) guidance that shares simply need to be available in time for settlement. "Trade bodies have complained to ESMA and to the HCMC and could go to court in Greece, but appeals have not yet been successful." This illustrates how "it is not very easy to stay inside technical rules," observes Maleva-Otto, and short selling reports are another contentious area where fines have been levied for late filings.

Though some managers have reportedly used special purpose entities to obscure ownership stakes, it seems there are very few places to hide. Derivatives, such as Contracts for Difference, have to be included in major shareholding reports under the EU Transparency Directive. Member states can set a lower threshold than applies under the Directive and so thresholds for disclosure vary by country. Spain has set the lowest threshold, at just 1% for Cayman Islands funds, due to concerns that shareholders could be associated with tax avoidance or evasion.

Multiple overseers

Regulators are only one of many bodies that are enforcing rules. Self-regulatory organisations such as the National Futures Association, and exchanges such as CME Group, are also active. "Exchanges are pursuing Exchange For Related Positions violations and other anti-manipulation rules, all of which are quite technical," says Maleva-Otto. This only adds to the burden of compliance. **THFJ**