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THE LONG VIEW

MARC E. ELOVITZ (PICTURED) AND BRAD L. CASWELL explains why working through every item on an extensive checklist may obscure the bigger risks – particularly conflicts of interest

"WHEN IT COMES TO REGULATORY COMPLIANCE, WELL-INTENTIONED MANAGERS MAY MISS THE FOREST FOR THE TREES"

Checklists are popular as the year end approaches. For hedge fund managers, Dodd-Frank and the Alternative Investment Fund Managers Directive make these checklists even more challenging. Most managers have devoted more resources than ever before to understanding and complying with all of the applicable requirements.

But when it comes to regulatory compliance, well-intentioned managers may miss the forest for the trees. Working through every item on an extensive checklist may obscure bigger risks. Identifying and addressing these bigger risks should be a critical part of every manager's regulatory compliance programme.

One piece of this exercise is to focus in on the risks that are specific to a manager's structure. Managers with multiple funds and managed accounts that participate in some of the same investments should examine their allocation of investment opportunities. How objective are the criteria for making non-standard allocations? How consistently are any subjective determinations documented? Managers with offices around the world should map out how regulatory requirements are satisfied in each jurisdiction, noting potential gaps.

Another piece of this exercise is to focus in on the risks that are specific to a manager's investment strategies. Long/short equity managers should examine their potential sources of non-public information, such as expert network consultants. Algorithmic trading firms should consider the risk of errors in their models.

All hedge fund managers should focus in on conflicts of interests in their business. Regulators are fond of warning managers about this, but what are they really talking about? The key to understanding conflicts of interest is that hedge fund managers are fiduciaries – managers must act in the best interests of their clients. Managers must therefore identify situations where their own interests may conflict with those of their clients. Once identified, material conflicts should be mitigated and/or disclosed.

Both the SEC and the FSA have focused on situations where costs of doing business are paid for by the funds, rather than by the manager. Many such expenses are commonly understood as being appropriately charged to the fund or managed account. But managers should review what they are charging to clients and compare it with what is provided for in the fund documentation and what is disclosed in marketing materials, including due diligence questionnaires. Expenses like the cost of investment research, travel expenses and even costs of complying with the increasing regulatory demands should be critically evaluated.

How expenses are allocated among various funds and accounts should also be examined. Even though there could be very good reasons for non-standard allocations, it is critical to document these reasons. Otherwise, non standard allocations may be viewed in hindsight as motivated by the manager favouring certain clients, such as those in which the manager's portfolio manager is personally invested.

Cross-trades of securities between client accounts also may be viewed in hindsight as improperly motivated by the manager's interests. Highly liquid securities present much less risk. But if a manager is invested in illiquid investments, there should be more structure in place around cross-trades and around valuation more generally. Even where external valuation consultants are utilised, regulators are questioning the valuation processes and outcomes.

Conflicts of interest are precisely the kind of bigger risks that managers should be identifying and addressing. This is much more than a box checking exercise. As year end approaches, hedge fund managers should prioritise a focused regulatory review by people who understand the firm and the regulatory requirements. ■

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