CHAPTER 3

The Chief Compliance Officer and Regulatory Reporting

INTRODUCTION

Chapter 1 provided a general introduction to the structure of a hedge fund compliance department, although it was emphasized that there is no one universal structure. Similarly, beyond minimum regulatory requirements, regulators across the globe do not mandate a specific compliance department structure. Regulators are instead, as discussed in Chapter 2, more focused on the actual compliance policies and procedures employed by funds.

INTRODUCING THE CHIEF COMPLIANCE OFFICER

Regardless of the structure of the compliance department, all compliance departments typically maintain an individual that holds the title of ***Chief Compliance Officer*** (CCO). The CCO is the leader of the compliance function and the nature of the position can come in many different forms, depending on the particular structure employed at the hedge fund. The more common CCO models include:

- *Dedicated CCO*—A hedge fund's CCO is focused solely on the compliance function.
- *Shared CCO*—In addition to the compliance function, the CCO has responsibilities outside of compliance, too.
- *Outsourced CCO*—A hedge fund may have a compliance structure whereby the CCO is not actually an in-house employee but a third-party individual who may work for themselves or as part of a larger firm.

Regardless of whether a CCO is in-house or outsourced, some of the compliance work may still be performed by third parties. The specific CCO

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model that is ultimately employed depends on the unique circumstances in place at each hedge fund.

Is a Chief Compliance Officer Required?

The compliance function of a hedge fund is a critical component of the firm's overall operations. Ensuring that compliance policies, procedures, and oversight are appropriately maintained, enforced, and updated requires someone to be responsible for overseeing the compliance function. Therefore, logically having an individual designated as a CCO makes good operational sense.

Not surprisingly, many regulatory agencies agree with this line of thinking and require hedge funds to maintain a CCO. For example, in the United States, Rule 206(4)-7 of the Investment Advisers Act of 1940 (Advisers Act) and Rule 38a-1 under the Investment Company Act of 1940 (Investment Company Act) require that hedge funds registered with the U.S. Securities and Exchange Commission (SEC), "designate an individual as CCO to be responsible for administering the policies and procedures" in place at a hedge fund.[1] Similarly, the UK's Financial Conduct Authority (FCA) maintains a regulatory category for a key individual involved in compliance, known as the so-called control functions with significant influence, under CF10 Compliance oversight function.[2]

The Role of the Chief Compliance Officer

Regardless whether a hedge fund's CCO is dedicated, shared, or outsourced, the industry, and most regulators as well, agree there are certain critical goals the role of the CCO should fulfill.

A central best practice in designing the CCO role is that they should have sufficient seniority and authority within the hedge fund to properly implement compliance protocols. The SEC's guidance outlines that Chief Compliance Officers should be "empowered with full responsibility and authority to develop and enforce appropriate policies and procedures."[3] A key element of this authority relates specifically to the seniority of the COO. The SEC's guidelines further outline that CCOs should maintain sufficient authority to "compel others to adhere to compliance policies and procedures."[4] The question becomes, then, how exactly is a hedge fund's Chief Compliance Officer supposed to execute these duties?

Promoting a Culture of Compliance

At a high level, the CCO seeks to promote what is commonly referred to as a ***culture of compliance***. Although this is not a technical legal term, most

hedge funds express their desire to establish such a compliance culture, but what exactly does it mean? The definition is not necessarily clear-cut.

Most regulators and hedge funds agree that a critical element toward establishing a compliance culture is for the CCO to administer a framework that ensures the fund complies with all regulatory rules and guidelines. However, this type of compliance is certainly not what many would refer to as best practice compliance but rather, simply minimal compliance. Instead, a culture of compliance seeks to impart the notion that a hedge fund not just meets minimum regulatory requirements but also exceeds them. In this way, the role of a CCO is to not only tick the box of strict compliance but also to serve in an aspirational role to promote best practice compliance oversight throughout the firm.

CCO Qualifications

A common question that arises about the position of CCO is whether specific qualifications are required to be one. From a regulatory perspective, the SEC's guidelines state that a hedge fund's CCO should be "competent and knowledgeable."

Although these are admirable goals, they are also vague and hedge funds grapple with what "competent and knowledgeable" actually means in practice. CCOs generally are not required to have any special education, training, or compliance experience to be named to the position. This means, for example, that an individual who has training as an accountant and has never worked in any aspect of compliance could hold the CCO title at a hedge fund. Why would this be allowed? Wouldn't some experience with compliance make sense? To understand the vagueness behind the guidelines, it is helpful to frame the development of the CCO role in the hedge fund industry.

Historically, particularly in many smaller hedge funds, the CCO role was viewed by many as ceremonial in nature, with the heavy lifting of compliance often performed by third-party groups, such as a firm's legal counsel. As an extension of this, the CCO would often have another primary job such as Chief Financial Officer or Chief Operating Officer. Alternatively, as discussed in Chapter 1, if a hedge fund was large enough to maintain a dedicated individual responsible for the legal function (General Counsel), that individual may have shared the CCO role as well. The fact that the CCO role was often filled by individuals with multiple titles likely contributed to the development of vague regulatory guidelines on CCO qualifications. The regulators likely did not want to create a disconnect between required CCO qualifications that were too strict and the actual practices that were in place at hedge funds of having individuals in multiple roles and with noncompliance backgrounds acting as CCOs. Today, a different trend has emerged, particularly in larger hedge funds,

where CCOs often have specialized legal and compliance backgrounds. Indeed, as the hedge fund industry has matured, today's CCO may have extensive experience in compliance or may have even previously worked at financial regulators.

In smaller hedge funds, it is sometimes not feasible for a firm to employ a dedicated CCO. In those cases, a shared CCO with a limited compliance background coupled with sufficient outsourced compliance support resources may be an appropriate compromise. This type of structure would typically still employ an in-house employee with the CCO title, as opposed to an entirely outsourced CCO structure.

CCO Duties

While there are a certain core set of compliance duties that every hedge fund CCO must perform, in practice the specific tasks and volume of work varies among hedge funds based on a number of factors. The size of the hedge fund often influences the level or activity and specific duties of the CCO. For example, a hedge fund with 500 employees will have more practical compliance challenges in place than a hedge fund with five employees.

Another influencing factor is the ***regulatory complexity*** of a hedge fund's investment activities. This is the amount of regulatory oversight applied to different hedge fund strategies. For example, consider an equity hedge fund that follows a long-short investment strategy that does not have a high *trading volume* and conducts fewer than 50 trades a month. Compare this to a different hedge fund that follows a ***high frequency trading (HFT) strategy*** and executes high volumes of trades. Software programs, subject to oversight by humans, typically manage the large volume and speed by which HFT trades are executed. From a compliance perspective, the larger volume of trading presents a greater set of activity to be monitored by the CCO. Therefore, an HFT strategy has a greater degree of regulatory complexity as compared to the more straightforward long-short strategy. Of course, this does not mean that the long-short manager may not also present regulatory and compliance challenges; however, from the perspective of the volume of trades alone, a CCO at an HFT manager would have more compliance work in this area.

At its most basic level, the role of a hedge fund's CCO is to lead the compliance function. What does that mean exactly? There are a number of common tasks expected of the compliance function. They include:

- Compliance training
- Compliance testing
- Compliance policy maintenance and new policy development
- Company secretarial services for committees
- Managing the work of compliance consultants

The level of CCO involvement in these tasks varies. In a smaller hedge fund, the CCO may be the sole compliance employee and perform all compliance tasks. In a larger hedge fund, the day-to-day compliance work may be performed by other compliance personnel or outsourced to third parties, and the CCO oversees the work of these individuals in a mostly managerial capacity.

As we noted in previous chapters, a key compliance task traditionally overseen by the CCO is managing the reporting made to financial regulators.

REGULATORY REPORTING

As introduced in Chapter 2, an area of increasing responsibility for hedge funds is regulatory reporting. Routine examinations, targeted examinations, and sweep inquiries are all instances in which a regulator proactively reaches out to a hedge fund to collect information. In most jurisdictions, hedge funds are also required to take the initiative to provide information to regulatory agencies without a specific request. This is known as ***regulatory reporting***.

Depending on a number of factors, including the CCO's background and familiarity with the regulatory requests and forms, as well as the resources of the hedge fund, the level of involvement of the CCO may vary. For example, the CCO could be the one to collect the required data and complete the regulatory forms. Alternatively, the CCO could instead review the work of those who collect this data and prepare the filings. Typically, as the lead compliance professional, the CCO serves as the key point of contact for questions or requests for additional information regulators may have regarding the reporting. In certain instances, a hedge fund's CCO may also be required to sign the filings. The thought process being that if the CCO is required to attest to the information's accuracy and, in turn, has subsequent liability associated with these attestations, they will be incentivized to ensure it is properly reported.

REGULATORY REPORTING IN MULTIPLE JURISDICTIONS

A hedge fund may be required to file regulatory reporting in multiple jurisdictions. Consider, for example, a hedge fund headquartered in the United Kingdom that also conducts business in the United States. Depending on the nature of the hedge fund's activities, it may be required to report information to regulators in both the UK and the United States.

A UK-based CCO may be familiar with UK regulatory reporting requirements but less familiar with the intricacies of U.S. reporting requirements. In these instances, the CCO's level of involvement with the U.S. reporting

process will likely be different as compared to the UK filings. In such a case, many hedge funds will work with a U.S.-based third-party service provider, such as a law firm or a compliance consultant, to assist with the filings.

COMMON REGULATORY REPORTING QUESTIONS

When it comes to regulatory reporting, a hedge fund manager and its compliance employees often wants clear answers to the following questions:

- Which reports do I need to file?
- When do I need to file them?
- How often do I have to file them?
- When do I have to make additional filings?

The compliance rules regarding regulatory reporting can be quite complex. Straightforward answers to these questions often require an analysis of each hedge fund's specific circumstances and the specific requirements of each different applicable financial regulator. As the subsequent examples relating to Form ADV will demonstrate, it is not practical to provide detailed responses to these questions for every manager scenario here. Instead the goal in this reading is to focus on the general process by which a hedge fund would approach these questions.

In practice, specific expertise with each regulator is often required to facilitate the regulatory reporting process. This is why many hedge funds employ not only in-house legal and compliance personnel to analyze the issues raised by the above referenced reporting questions but also utilize third-party compliance consultants and external legal counsel to provide guidance. In some cases, other service providers, such as hedge fund administrators, may be involved in the regulatory reporting process also.

A MULTISTEP PROCESS

Regulatory reporting is a multistep process of providing information to hedge fund financial regulators. 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.

Step 1: Evaluate a Hedge Fund's Regulatory Reporting Eligibility Requirements

A hedge fund must first determine whether it is under the jurisdiction of a particular regulator for filing purposes.

Consider a U.S.-headquartered hedge fund with a one-person client service office in the United Kingdom. Is this hedge fund required to make any regulatory filings with the United Kingdom's regulator, the FCA? Likely not, because it is not managing any client funds in the UK but, rather, is simply conducting client outreach and servicing.

Let's make the scenario more complex. What if the UK office has both a client service professional and a single trader? Regulatory reporting is likely required because trading activities are conducted in the office, which would also likely trigger a UK FCA registration requirement.

There are any number of scenarios to consider. What if the UK office has a client service employee and a second employee with a nontrading role who assists U.S.-based traders in processing trades? What if someone conducts investment research in Europe, including the UK, but does no trading from the UK office? Do the regulatory reporting requirements change? The various iterations of scenarios present unique situations for hedge funds that require individualized evaluations as to whether regulatory reporting is required.

Regulatory Reporting Does Not Always Imply Regulator Registration It may seem intuitive that if a hedge fund has gone through the first step in the process and determined it is required to make certain filings with a regulator, that the hedge fund must have first been required to be registered with that regulator. In fact, it is not always the case that hedge fund registration goes hand in hand with filing obligations. In certain circumstances, based on factors such as the nature of a fund's trading activity, a hedge fund may not be required to register with a regulatory agency but still may be required to make filings.

Step 2: Determine What Specific Forms and Data Are Required

Once a hedge fund has determined that it is indeed required to make filings with a regulator, what data must be provided and what forms are needed?

As is often the case within compliance, the answer depends on the specific circumstances of each hedge fund. Elements including a fund's assets under management and the type of securities traded will influence reporting decisions. Even factors such as the volume of trades may determine whether certain regulatory reports have to be filed. For example, the Large Trader Data reporting requirements of the U.S. Commodity Futures Trading Commission (CFTC) implements enhanced reporting requirements for funds that engage in trading above certain predetermined trading volume thresholds.[5]

Hedge funds typically adhere to particular investment and trading strategies. While there are differences among fund managers, the broad characteristics of managers within strategies do not generally differ radically from a compliance perspective. Those familiar with the regulatory reporting process can often provide initial guidance based primarily on familiarity with certain groups of strategies. For example, two different hedge funds that follow the same general strategy, but are different in their implementation, in many instances would likely be required to make the same core regulatory filings in the same jurisdiction. Likewise, a hedge fund with multiple strategies will have different filing requirements with different regulators across for each strategy type.

Step 3: Develop a Strategy Regarding What Data to Provide

It is a common misconception that regulatory reporting and data provision is a rote, straightforward, rules-based exercise. This is not the case for several reasons.

- **Special technical definitions of regulatory data points**. The definitions of commonly requested data points in the regulatory reporting process is not always straightforward, and may not have the same meaning across different filings. For example, if a fund is asked to provide assets under management (AUM) to an investor based on U.S. Generally Accepted Accounting Principles (GAAP), the figure that is typically provided is the sum total of the assets of each of the firm's different funds on a net basis. However, SEC Form ADV and Form PF ask instead for ***regulatory assets under management*** (RAUM), which reflects gross assets without subtracting debt or leverage.[6] RAUM figures tend to make a hedge fund appear larger than they are.
- **The interpretation of regulatory guidelines can influence the scope of filings**. Continuing the RAUM example, there are assumptions a hedge fund is required to make when calculating this figure. Two examples of areas where these estimates come into play is when a hedge fund makes its leverage calculations and aggregates data across multiple funds.

The way these assumptions are made may vary among hedge fund managers. This was particularly true when RAUM calculations were first introduced in 2012. This was because first-time filers were unsure of what regulators considered reasonable assumptions. As a result, the details in RAUM filings varied significantly among funds.

Why do figures like RAUM matter? For starters, no manager wants to intentionally mislead regulators or deviate radically from common industry wisdom about how to appropriately interpret regulatory data requests. Equally important, figures such as RAUM directly influence the scope of regulatory filings. Under SEC Form PF, for example, a hedge fund's RAUM calculation determines which sections of the form must be completed and how frequently it must be updated. Conservative RAUM estimates may fall below a predetermined threshold, which result in less frequent filings. Conversely, less conservative assumptions result in overreporting RAUM and unnecessary overfilings.

- **Concerns about misinterpretation of data by different parties**. Hedge fund managers may have concerns that data reported to regulators in a specific requested format could be misinterpreted by parties for which the reporting was not originally intended.

  Continuing the RAUM example, the calculation methodology required by the SEC makes it not uncommon for RAUM to be higher than GAAP's AUM, which as noted above is the figure commonly provided to investors. These differences can lead to confusion among investors who may not be educated in the specifics of RAUM calculations or unfamiliar with the assumptions made in calculating RAUM. As a result, hedge funds want to avoid these types of situations and may wish to not share certain regulatory reporting with investors. In certain cases, regulators are sensitive to these types of issues and do not make certain filings, including Form PF, available to the public. Nor is there a requirement that a hedge fund is required to release certain filings to investors or prospective investors, even if it is requested. As a compromise, many hedge funds provide partial filings to investors on request and often highlight the assumptions used in making the filings. While these approaches do not influence how a manager completes a particular regulatory request, they do influence the way in which data may be shared with investors.
- **Estimated data may change over time**. A hedge fund may be required to make certain estimates with regard to items that have not been finalized at the time of regulatory reporting.

  For example, on Form PF a hedge fund manager is required to make a good faith estimate regarding potential investor ***redemptions***

likely be to be triggered during conditions of significant market stress.[7] A redemption is when an investor submits notice to a hedge fund that it would like to withdraw capital from the fund. Due to the fact that an investor may see some portion of this regulatory filing, it is not unreasonable to see why a hedge fund may wish not to overestimate the likely volume of potential withdrawals in the event of market stresses. Therefore, how to best determine such estimations requires discretion and strategy by the hedge fund to address both the direct, intended audience—the regulators—as well as secondary audiences—investors.

Step 4: Select the Appropriate Method and Group to Transmit Information to a Regulator

Regulators have differing requirements for how information must be submitted, and hedge funds must comply with these rules. Common submission formats include:

- *Web-based regulatory systems*—Many regulators utilize web-based systems to facilitate regulatory filings. Such a format can include special forms on their websites. Common web-based systems include:
  - SEC Investment Adviser Registration Depository (IARD) website: www.iard.com
  - Cayman Islands Monetary Authority (CIMA) Regulatory Enhanced Electronic Forms (REEF): reefs.cimaconnect.com
  - The United Kingdom Financial Conduct Authority (FCA) GABRIEL: www.fca.org.uk/firms/systems-reporting/gabriel
- *E-mail filings*—Certain regulatory forms, or questions regarding clarification on forms, are transmitted via e-mail. For example, see the UK FCA's "Where to submit your returns" guidelines at www.fca.org.uk/firms/systems-reporting/where-to-submit-your-returns

Additionally, the format of data submitted through websites or e-mail may be subject to certain restrictions or considerations unique to the regulator. For example, hedge funds can submit their Form PF filings in an electronic file format called XML, a coded format that makes the information readable by either humans or machines.

Who actually prepares and submits the regulators' filings? In certain instances, a hedge fund will work with an external service provider, such as legal counsel or a compliance consultant, to perform these tasks. Depending on factors including the level of complexity of the filings, the frequency of filings required, and the internal compliance resources in place at the hedge

fund, it may be more efficient to leverage on service providers, to support the filings process. As a reminder, just because a third-party group is utilized to assist in preparing the filings does not remove the requirement to have the CCO involved. Ultimately, the CCO is responsible for the filings and, in some cases, actually signs them.

Step 5: Adhere to Ongoing Filing Requirements

Once initial filings are completed, there is often a requirement to update the forms and information provided. The frequency of updates depends on a number of different factors. Certain regulatory forms, for example, have a predetermined frequency, such as annually, for when information must be updated. The size of the figures such as the reported regulatory assets under management also influences the frequency of updating information. As stated earlier, the SEC's Form PF has more frequent filing requirements for larger hedge funds.

Step 6: Conduct Ongoing Evaluations of New Filing Requirements

When a hedge fund enters into certain types of new investing activities, previously filed forms may require updating or entirely new forms may need to be filed. Depending on the nature of these new activities, a hedge fund may be subjected to further regulatory scrutiny as well. A common example would be a hedge fund that launches an affiliated broker-dealer entity to facilitate the marketing of its funds. In the United States, this entity would traditionally be subjected to additional oversight by FINRA.[8]

CHAPTER SUMMARY

In this chapter, we focused on the role of the CCO. We first introduced the three common CCO models: dedicated, shared, and outsourced. Next, we discussed considerations relating to the CCO's role in promoting a culture of compliance. The technical requirements to maintain a CCO role, as well as the absence of specific regulatory mandated requirements for CCOs was also addressed. The common tasks of hedge fund compliance departments and the CCO's efforts in those areas was also discussed. Finally, we analyzed the six steps of the regulatory reporting process and the CCO's role in it.

With the role of the CCO now established, the next chapter will focus on the role of other compliance professionals and mechanisms.

NOTES

1. See National Exam Program Risk Alert, "Examination of Adviser and Funds That Outsource Their Chief Compliance Officers," vol. 5, no. 1 (November 9, 2015).
2. Financial Conduct Authority, "Controlled Functions," May 12, 2015.
3. U.S. Securities and Exchange Commission, "Final Rule: Compliance Programs of Investment Companies and Investment Advisers," www.sec.gov/rules/final/ia-2204.htm.
4. Ibid.
5. U.S. Commodity Futures Trading Commission, "Large Trader Reporting Program," press release, www.cftc.gov/IndustryOversight/MarketSurveillance/LargeTraderReportingProgram/index.htm.
6. See M. Celarier, "Leverage Isn't What It Used to Be," *Alpha*, June 1, 2012.
7. See U.S. Securities and Exchange Commission, "Form PF," paper version, www.sec.gov/about/forms/formpf.pdf.
8. See FINRA, "Register a New Broker-Dealer Firm," www.finra.org/industry/new-bd-firm-registration.