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CHIEF COMPLIANCE OFFICERS

Conflicts From Managing Multiple Funds and Other Current Challenges to Effective Compliance at Hedge Funds (Part Two of Two)

By Helen Kim, *Hedge Fund Law Report*

With the SEC issuing a steady stream of statements promising enhanced scrutiny and new regulations, compliance professionals at private funds are scrambling to keep up. In addition to the Commission's sharpened focus on environmental, social and governance (ESG) investing, market trends have also created new versions of familiar conflicts that compliance teams must address, even as a continued remote work environment for many firms forces compliance professionals to go above and beyond to oversee employees.

Those and other issues were addressed in a Practising Law Institute panel moderated by Gibson Dunn partner Mark K. Schonfeld, which featured Eric M. Albert, CCO and legal counsel at Holocene Advisors, LP; Kenneth J. Burke, head of compliance and senior counsel at Vista Credit Partners Management, LLC; and Igor Rozenblit, founder and partner at Iron Road Partners and former Co-Head of the SEC's Private Funds Unit. This second article in a two-part series summarizes key takeaways from the discussion on current compliance challenges involving ESG investing and conflicts related to business expansion, as well as early goals for incoming CCOs. The first article covered the discussion of two recent enforcement actions involving insider trading and material nonpublic information and their implications for hedge fund managers.

For additional insights from Rozenblit, see "Barbash, Breslow and Rozenblit Discuss Hedge Fund Allocations, Restructurings and Advisory Boards" (Apr. 7, 2016).

Current Compliance Challenges

ESG Investing

ESG investing is a current principal focus of limited partners (LPs), general partners (GPs) and regulators. The SEC, in particular, has consistently telegraphed that ESG is a key examination, enforcement and rulemaking area of interest. Burke, who began his career in the SEC's Division of Examinations, identified some key risks for fund managers venturing into ESG investing. Although themes ranged from the lack of standardized definitions to strategic decisions about how much change the manager wants to effect, all roads ultimately led back to disclosure.

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Disclosures

The nature of the SEC's enforcement mechanisms means that much of the Commission's work centers on disclosure, Rozenblit said. The SEC's new marketing rule requires substantiation, which means examiners want to test material statements in fund marketing materials, and managers must have support for the statements they have made – not only when the statement was made but also throughout the life of the fund. That includes statements that the fund or its portfolio companies adhere to any particular global ESG standard, Burke added. Although the SEC does not require managers to adopt any standard, a manager that states it is adhering to one must document how it does so.

See "Two Sides of the Same Coin: SEC Commissioners Peirce and Roisman Argue Against Prescriptive ESG Disclosures (Part One of Two)" (Oct. 21, 2021).

The SEC's concerns about ESG investing have become more nuanced recently, Rozenblit said. Whereas two years ago, the Commission was mainly concerned about greenwashing, it is now focused on matching disclosure to practice. Funds must be able to prove that they are doing what they say they are doing, he summarized.

To that end, the SEC's April 2021 risk alert (Risk Alert) on ESG is a valuable resource for managers that have launched or are planning to launch an ESG product, Burke recommended. The Risk Alert provides a useful roadmap for developing, testing and enhancing ESG-related policies, procedures and controls.

See our two-part series on the Risk Alert: "Why the SEC Distinguishes ESG From Other Strategies and How to Prepare for a Potential Exam" (Jun. 24, 2021); and "Inadequate Controls, Policies and Procedures Concern SEC About ESG Practices Inconsistent With Disclosures" (Jul. 8, 2021).

Key Risks

First, ESG is not defined, so different phrases and terms can be subject to interpretation or lead to confusion. GPs must think about how to manage their ESG-related investment programs and make sure to clearly and consistently define what they are doing in the space, Burke advised.

Second, managers must carefully market and disclose their ESG investments. Disclosure about the firm's approach to ESG investing should be simple and clear, which requires managers to think about the full investment lifecycle and how ESG will or will not be considered at different stages, Burke advised. Managers should also decide whether to include ESG factors and, if so, establish a ranking system. After the investment has been made, managers must determine how to monitor those ESG factors and decide what to do if the company fails to meet predetermined indicators.

In conjunction with those efforts, managers must also periodically review and update their assessments of portfolio companies to ensure they remain aligned with the manager's representations, Schonfeld said. One way to do that is to incorporate ESG into compliance policies and procedures, so that testing and updating of ESG factors happens on the same timeline as the firm's other risk areas, Rozenblit added.

Third, managers should consider how much change they want to effect through their investments and the impact of different strategies on that goal, Burke advised. A buyout

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manager with a controlling equity stake in a company has much greater influence over that company than a credit fund manager.

Fourth, managers need to consider how they will balance ESG considerations alongside other investment factors. For example, if a portfolio company changes its business practices in a way that negatively affects its ESG rating, but otherwise performs extremely well, the manager must consider whether ESG considerations trump all other factors or whether ESG is just one of a variety of factors to be balanced with others. Funds that invest in illiquid assets (*e.g.*, portfolio companies) confront challenges in that scenario that managers with liquid securities do not, Schonfeld observed.

How managers navigate that scenario depends on their previous disclosures to investors and their fund documents, which is why managers should think through different scenarios in advance of drafting disclosures, Burke stressed. As ESG investing is rapidly evolving, managers ideally should build flexibility for themselves in case of changes in circumstances through the lifecycle of the investment.

See "Ways CCOs Are Approaching ESG in Light of Growing SEC Scrutiny" (Dec. 9, 2021).

Conflicts Arising From Business Expansion

The identification, management and disclosure of conflicts of interest is one of the biggest and most central issues a CCO faces. Addressing conflicts early when forming a fund is much easier than having to address them after the fund is formed, Rozenblit advised. Business teams are open to designing processes ahead of time, but going back and redoing them can raise issues – including optics with investors – that can be unpleasant, he elaborated.

Launch of New Products

New product launches and business line expansions are rife with potential conflicts, including perennial issues, such as how to allocate investments and expenses, as well as emerging areas, such as capital stack investment conflicts (*i.e.*, captive investing).

Launching a new fund is an opportunity for CCOs to holistically review disclosures and engage the business teams by discussing – with internal teams, as well as outside advisors and counsel – the fund's objectives, Burke suggested. Looking outside the organization could also include reviewing Forms ADV of peer firms, reflecting on how the business has changed and considering what on the horizon may affect it, he added.

If a manager is bringing on separately managed accounts, investing in the same strategy as the core fund or expanding in other ways (*e.g.*, sponsoring a special purpose acquisition company), how investments are allocated between those vehicles becomes a much more significant issue than if the manager had only one fund, Rozenblit said. Managers must also determine how to allocate costs incurred in pursuing transactions in a multi-platform firm, he added.

See our two-part series on avoiding parallel fund conflicts: "New SBAI Standards and Case Study Provide Guidance for Mitigating Conflicts" (Jun. 11, 2020); and "Common Challenges for Hedge Fund and Credit Strategies" (Jun. 18, 2020).

Further, managers that have raised credit funds face capital stack investment conflicts in which simultaneously investing in the debt and equity of a portfolio company creates conflicts around pricing and entry, Rozenblit continued.

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Should the portfolio company experience stress or distress, the manager will need to balance its duties as the manager of the equity fund versus the credit fund.

Flexibility in Fund Documents

Investors – and soon, Rozenblit suggested, perhaps the SEC as well – are particularly focused on the accuracy of key person provisions in product-line expansions. Smaller managers especially need to examine how much time and attention a key person, or multiple designated key individuals, can devote to a new business line. Therefore, when drafting documentation for new products, fund managers may want to include broader time and attention provisions.

See "Key Person Provisions in Hedge Fund Documents: Structure, Consequences and Demand from Institutional Investors" (Sep. 17, 2009).

In recognition of the popularity of GP-led restructurings, firms should incorporate processes into their fund documents that would enable them to raise a continuation fund in the future, which could remove some of the disclosure obligations around those transactions, Rozenblit suggested.

Early Goals for Incoming CCOs

Learning the Business

For CCOs hired into an existing business, understanding the business and its people are key initial goals. CCOs should learn the firm's history, organizational chart, products and funds, Albert said. Reviewing the results of previous regulatory examinations – as well as any litigation or regulatory matters that still implicate current and future business – can help a CCO become grounded quickly in the firm's compliance history.

In addition, getting out in front of the team early and integrating quickly into key aspects of the business is important, Burke advised. Establishing a presence gives employees an avenue to raise questions or concerns. That can be accomplished by putting together and presenting a training session, which can also allow the CCO to review all key controls and gain a sense of what needs to be improved or enhanced. The annual review of compliance programs required under Rule 206(4)-7 of the Investment Advisers Act of 1940 is another good opportunity for CCOs to dive deep into key policies and procedures – either alone, with the compliance team or with a third party, he added.

See "First 100 Days As GC/CCO: Developing Knowledge and Forging Key Relationships (Part Two of Three)" (May 6, 2021).

Meeting the People

Developing human relationships is crucial for a new CCO, the panelists agreed. CCOs should not forget to develop good working relationships with key internal stakeholders – such as HR, investor relations, finance, trading, IT and IT security – with whom compliance will be working, Albert suggested. Although investment professionals may be compliance's biggest clients in the firm, individuals in those departments contribute to an effective compliance environment. CCOs can glean valuable input by asking in initial conversations what the employee thinks the CCO should be focused on or needs to know, Burke recommended.

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See "How Compliance and HR Can Work Together" (Mar. 26, 2020).

To that end, CCOs may want to consider setting a goal to meet each individual in the firm. Although it is easier to meet all employees at a smaller firm in the first days or weeks, a CCO at a bigger organization can employ video conferencing to reach employees, Albert suggested. Citing a real-life example of a CCO at a fairly large firm, Rozenblit suggested that setting a meeting with every person at the firm over a one- or two-year period could be effective, under the theory that non-confrontational personal relationships with everyone at a firm are important for someone who needs information from the field.

Externally, a CCO should become familiar with third-party service providers, such as fund administrators; outside counsel; compliance consultants; research and data providers; and others. Even organizations with robust compliance programs can benefit from a fresh set of eyes, Albert reasoned. CCOs coming from another firm may see ways to enhance testing and surveillance protocols based on a past employer's protocols. They can compare service providers with whom they have worked before with the current firm's providers and choose vendors based on fit and performance.

Notably, a remote working environment requires CCOs to go above and beyond to make the human connection, Burke observed. In the office, CCOs may bump into employees or hear news organically. The act of deliberately calling or messaging a compliance team member can raise the bar for employees about the types of issues they should be contacting compliance officers for, he noted. Thus, it is important for CCOs to be very proactive and establish relationships early.

See "First 100 Days As GC/CCO: Managing Daily Work, Performing Risk Assessments and Looking Ahead (Part Three of Three)" (May 13, 2021).

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