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Allocation of Investment Opportunities

Trading Practices Session at SEC's Compliance Outreach Program National Seminar Addresses Need for Holistic Compliance Procedures Dealing with Allocations, Best Execution and Cross Trades

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By Amanda Pollok, *Hedge Fund Law Report*

On January 31, 2012, the SEC hosted its annual, "Compliance Outreach Program National Seminar" (Seminar). (The program was previously called "CCOutreach," but it has been "rebranded," as the SEC explained in a press release, to be more inclusive of all senior personnel at firms.) The Seminar included five sessions. Hedge Fund Law Report recently reported on the session entitled "Enforcement-Related Matters" (Enforcement Session). See "Enforcement Session at SEC's Compliance Outreach Program National Seminar Highlights Regulatory Focus on Valuation, Conflicts of Interest and Compliance Shortcomings at Hedge Fund Managers," Hedge Fund Law Report, Vol. 5, No. 7 (Feb. 16, 2012). This article focuses on the "Trading Practices" session (Trading Practices Session).

The purpose of the Trading Practices Session was to educate fund industry participants about the SEC's focus areas related to trading and to offer recommendations for structuring adequate compliance controls over trading activities. The Trading Practices Session was moderated by David Grim, Assistant Chief Counsel of the SEC's Investment Management Division. Other panelists included: Charles Senatore, Head of Compliance for Fidelity Investments; Jennifer Duggins, Vice President and Chief Compliance Officer at Chilton Investment Company, LLC, an investment adviser with more than $6 billion in assets under management; and Erozan Kurtas, Senior Specialized Examiner for the SEC's New York regional office. Kurtas specializes in the areas of quantitative algorithms, computerized trading and risk management for hedge funds and structured products.

During the Trading Practices Session, the SEC shared with industry participants ways to formulate and implement effective compliance procedures to appropriately address the most scrutinized trading practices. Specifically, the panelists described how order allocation, best execution and cross trades must be monitored to avoid securities law violations. The Trading Practices Session also included a discussion of the role that technology is playing in creating new compliance concerns with respect to the use of alpha-capture systems, high-frequency trading and trading algorithms. Speakers placed a strong emphasis on the need for a holistic compliance approach. The insight shared by the SEC can be valuable in assisting hedge fund managers in determining how to deploy limited compliance resources. This article discusses each of these focus areas and highlights best practices for addressing the identified compliance concerns.

SEC Focus Areas

Generally, the SEC's scrutiny of trading practices principally focuses on insider trading, order allocation, cross trading, directed brokerage arrangements, soft dollar practices and trading on information gathered through expert networks. See "SEC Exams of Hedge Fund Advisers: Focus Areas and Common Deficiencies in Compliance Policies and Procedures," Hedge Fund Law Report, Vol. 4, No. 38 (Oct. 27, 2011). The SEC covered insider trading extensively during the Enforcement Session and, thus, it was not discussed in detail during the Trading Practices Session. Of the remaining topics, Grim chose order allocation, best execution and cross trading as the areas requiring the most explanation and clarification.

Order Allocation

The SEC analyzes order allocations based on principles of fair and equitable treatment, focusing on how potential conflicts of interest are addressed. See "How Can Hedge Fund Managers Avoid Criminal Securities Fraud Charges When Allocating Trades Among Multiple Funds and Accounts?," Hedge Fund Law Report, Vol. 4, No. 19 (Jun. 8, 2011). For example, in allocating an order, a hedge fund manager may favor certain funds or accounts that pay performance fees over other funds and accounts that pay asset-based fees only because of the performance incentives associated with the performance fee-paying funds or accounts. Similarly, a hedge fund manager may provide preferential treatment in allocating a trade to proprietary accounts or to accounts in which its principals or employees are invested. See "Conflicts and Opportunities Offered by Concurrent Management of Employee-Owned Hedge Funds and Outside-Investor Hedge Funds," Hedge Fund Law Report, Vol. 2, No. 32 (Aug. 12, 2009). The SEC also pointed to order allocation concerns associated with investments in initial public offerings, as demonstrated by its recent settlement with Alpine Woods Capital Investors, LLC and Samuel A. Lieber. For one example of a regulatory response to IPO allocation concerns and how it affects hedge fund managers' compliance procedures, see "New FINRA IPO Allocation Rule Will Require Hedge Funds That Invest in 'New Issues' to Revisit Their Compliance Policies and Procedures and Fund Structures," Hedge Fund Law Report, Vol. 4, No. 5 (Feb. 10, 2011).

To address the conflicts of interest in such situations and to mitigate the risks of securities law violations, Grim recommended that hedge fund managers institute pro rata allocations of orders or an order rotation system designed to ensure fair and equitable treatment for all funds and accounts over time. He added that robust disclosures describing a hedge fund manager's order allocation methodology and a policy outlining deviations from such a fund manager's order allocation methodology represent vital disclosures for clients. Grim also stressed the importance of monitoring order allocation policies to ensure that such policies and procedures lead to fair and equitable treatment for all clients and operate in the way they were intended to operate. For further SEC guidance concerning order allocations, Grim referred to two separate no-action letters provided to SMC Capital, Inc. (Sep. 5, 1995) and Massachusetts Mutual Life Insurance Company (Jun. 7, 2000) as well as an administrative proceeding brought against Melhado, Flynn & Associates, Inc.; George M. Motz and Jeanne McCarthy. For a thorough discussion of the Melhado, Flynn & Associates matter, See "How Can Hedge Fund Managers Avoid Criminal Securities Fraud Charges When Allocating Trades Among Multiple Funds and Accounts?," Hedge Fund Law Report, Vol. 4, No. 19 (Jun. 8, 2011).

Cross Trades

The SEC has also heightened its regulatory scrutiny of cross trades because of the potential conflicts of interest often associated with such trades. See "When and How Can Hedge Fund Managers Engage in Transactions With Their Hedge Funds?," Hedge Fund Law Report, Vol. 4, No. 45 (Dec. 15, 2011). In identifying such conflicts and potential conflicts, the SEC often asks the following questions:

- Are different fee structures employed among the different funds or accounts involved, thus motivating execution of the cross trade?
- Are manager or employee stakes in particular funds or accounts driving the cross-trades?
- With respect to municipal bonds, is a hedge fund manager transferring a municipal bond from a smaller fund or account to a larger fund or account merely to absorb the short-term performance hit that is expected to be followed by long-term profits?

Grim made two other points with respect to cross trading. First, he noted, "We understand that, in many instances, firms follow an overnight rule: if it [the security] is in the hands of an unaffiliated broker overnight, that exposes it to the market sufficiently to break the link . . . it is not an affiliated transaction anymore. We are interested in whether that overnight rule makes sense in all situations." Second, Grim noted that the SEC is looking into the use by investment advisers of pricing service valuations (PSVs). According to Grim, certain no-action letters permitting investment advisers to use PSVs with respect to municipal bond space have been relied on with respect to securities other than municipal bonds. The SEC is examining whether reliance on those no-action letters for securities other than municipal bonds is appropriate.

Best Execution

An investment adviser owes a fiduciary duty to execute trades on behalf of clients in accordance with its best execution obligation. Grim recommended reading the following cases for a better understanding of how hedge fund managers may violate their best execution obligations:

- In the Matter of Value Line, Inc.; Value Line Securities, Inc.; Jean Bernhard Buttner; and David Henigson;
- In the Matter of Jamison, Eaton & Wood, Inc.

Grim acknowledged the need for more best execution guidance from the SEC for those managers trading fixed income instruments or derivatives. However, Grim cautioned that such additional guidance may not be forthcoming anytime soon. "Given the other priorities of the Commission right now," he said, "I would not predict that that is going to happen anytime in the near future."

Consolidated Audit Trail Initiative

The SEC is also focused on adopting a consolidated audit trail initiative. In 2010, the SEC's Division of Trading and Markets issued a concept release which introduced the idea of a consolidated audit trail, an idea Grim believes will have "a tremendous impact on trading." As Grim explained, "Right now, different exchanges have different audit processes of the trading that goes on in those exchanges, and it hinders the SEC's ability to review trading in a holistic way. The consolidated audit trail proposal is intended to remedy that."

Holistic Compliance Approach

While awareness of the SEC's regulatory focus areas is useful, hedge fund managers must also understand how to mitigate risks in these areas. Senatore observed that firms focus too much attention on individual trading issues instead of taking a holistic approach to compliance. He asked, rhetorically, "How strong is the fiduciary culture? This is central in . . . how management walks the walk and talks the talk in terms of the direction and modeling of behaviors that involve the day-to-day decision-making of investment professionals and stakeholders in the trading process." See "What Do Hedge Fund Managers Need to Know to Prepare For, Handle and Survive SEC Examinations? (Part Three of Three)," Hedge Fund Law Report, Vol. 4, No. 6 (Feb. 18, 2011) (discussing how to set the "tone at the top").

Senatore also urged hedge fund managers to question the accountability of traders to management, fund boards and other senior stakeholders to avoid undetected trading errors. Additionally, hedge fund managers should take steps to minimize human error in trading through automation.

While compliance, management and trading functions should be separated, personnel in each of these areas should work together. According to Duggins, the most successful compliance officers act as "a partner, a best friend, a colleague to the traders . . . someone our traders trust, see as an advocate and an ally . . . it is essential to get in early with the Head Trader and to build alliances with those other departments that are talking to the traders all day – the Head of Operations, the operations staff and the accountants." See "Who Should Newly Registered Hedge Fund Managers Designate as the Chief Compliance Officer and How Much Are Chief Compliance Officers Paid?," Hedge Fund Law Report, Vol. 4, No. 7 (Feb. 25, 2011).

According to Senatore, a holistic approach to compliance would encompass best practices at least with respect to best execution, order allocation and broker selection.

Best Execution

When evaluating whether best execution practices have been followed, a hedge fund manager must look beyond the individual factors, such as the commission rate, price realized, size of the order and speed of execution. Senatore urged managers to ask qualitative questions about the circumstances surrounding any given trade. For example, is it possible that the best commission was sacrificed to maintain anonymity? Is it possible that a strong motivation to acquire the security could legitimately fuel a large upfront purchase even though prices continued to decline over time? According to Senatore, senior management must engage in this type of analysis and must convey the message that "the metrics should be the beginning of the conversation. However, they should not be the entire conversation."

To monitor whether a hedge fund manager is achieving best execution on behalf of its clients, Duggins recommended that a hedge fund manager review the following: trade/cost analyses, trade blotters and third-party software used to analyze trading data. See "How Hedge Fund Managers Can Use Technology to Enhance Their Compliance Programs," Hedge Fund Law Report, Vol. 4, No. 41 (Nov. 17, 2011). However, she explained that monitoring will not be sufficiently effective without the Head Trader's participation. The Head Trader must understand the firm's compliance obligations and what the data is showing to the extent necessary to answer questions about best execution compliance from investors or the SEC.

Order Allocation

Senatore believes that order allocation is another area where the culture of a firm is integral to ensuring compliance. He encouraged senior hedge fund manager principals to adopt compliance policies and procedures that will be followed by firm personnel. Human error should be mitigated by automation wherever possible. However, firm personnel should take responsibility for following up when the firm must deviate from its order allocation methodology. Compliance personnel should be monitoring order allocations in real time and engaging in a meaningful review of any deviations or allocations resulting in odd lots. Senatore stressed that such deviations could be legitimate. Therefore, compliance personnel must take the time to talk to people and understand the context surrounding the situation resulting in the deviation.

Hedge fund managers can monitor order allocations by analyzing the performance of all client accounts being managed with similar investment styles, analyzing blotters, looking at sample block trades, recalculating certain allocations, checking allocations of securities purchased in initial public offerings and engaging consulting firms. Duggins noted that SEC has published helpful guidance on the specifics of forensic testing.

Broker Selection

As noted above, when choosing a broker to execute trades, a hedge fund manager must select brokers that provide best execution. However, without proper oversight, the broker selection process can be fraught with conflicts of interest. To avoid this problem, Senatore suggested that managers separate the management functions and the trading functions wherever possible.

Tips for Creating a Holistic Compliance Approach

In light of the need for individual departments to work together to provide effective compliance oversight, Duggins provided five tips for compliance officers at hedge fund managers:

- Actively involve the Head Traders on various committees that have compliance oversight functions. These individuals should be appointed by the fund boards and be given responsibility to report to a committee with compliance oversight. She recommends appointing the Head of Operations to a committee providing compliance oversight as well.
- Train traders on the relevant compliance rules. Make an effort to understand areas of concern for traders and discuss the areas ripe for potential conflicts of interest with respect to their day-to-day responsibilities.
- Work with traders to develop a uniform and comprehensible language to be used in exception reports and any other documents identifying compliance issues. When an issue arises, communicate directly with the trader involved to understand why an exception was granted.
- Prepare traders for conversations with investors that are likely to arise during the due diligence process. Ensure that traders can speak intelligently about the business.
- Conduct mock examinations relating to trading activities to satisfy the firm that traders can adequately explain their actions. See "Legal and Practical Considerations in Connection with Mock Examinations of Hedge Fund Managers," Hedge Fund Law Report, Vol. 4, No. 26 (Aug. 4, 2011). Ensure that managers provide clear instructions to the trading desk. Ask traders to explain: how they ensure that trading practices comply with investment guidelines disclosed to investors; how partially-filled orders are filled to ensure fair and equitable treatment; and how client requests for a specified broker are handled.

Role of Technology in Trading Compliance Issues

The Trading Practices Session concluded with a discussion about the effect that technology is having on the trading-related compliance reviews performed by the SEC. Kurtas explained that compliance challenges have been compounded by the availability of round-the-clock news, global social networks and the increasing number of financial engineers and behavioral economists entering the hedge fund industry. See "Does Social Media Have a Place in the Hedge Fund Industry?," Hedge Fund Law Report, Vol. 5, No. 6 (Feb. 9, 2012). Kurtas identified alpha capture systems, high-frequency trading models and algorithms as three of the challenges now capturing the SEC's attention. Each of these topics is discussed separately below.

Alpha Capture Systems

Alpha capture systems are web-based systems designed to capture trading ideas generated by a growing population of contributors such as sales desk personnel and research analysts. The information captured includes not only buy and sell recommendations, but also rationales for trading decisions, time horizons and descriptions concerning the bullish or bearish tendencies of a particular contributor. In short, a process that once involved a sell side firm calling a buy side firm on the telephone has evolved into the prolific dissemination of real-time information from which useful trading information is extracted. This development makes compliance oversight extremely difficult. According to Kurtas, the SEC is focusing on the following five concerns when reviewing the use of alpha capture systems:

- The transmittal of material nonpublic information;
- The existence (or lack thereof) of safeguards to detect compliance issues at either the contributing or receiving firm;
- Problems with the compensation structures surrounding these alpha capture systems;
- The existence (or lack thereof) of robust compliance programs to monitor these alpha capture systems. The SEC does not believe that reviewing the information once a quarter is sufficient;
- The effect of a lack of control over overseas markets on the propriety of these systems.

High-Frequency Trading

According to Kurtas, the percentage of trading that involves high-frequency trading grew from 21% in 2005 to over 70% today. Opinions are mixed as to whether this expansion reflects a positive or negative development, and whether such trading should result in more stringent regulation. Regardless of one's belief about the benefits of high-frequency trading, it is undisputed that it is harder to regulate this behavior given the fact that there are billions of data points to capture to accurately depict what any given trader is doing and on what information he is relying. Kurtas noted that the SEC is cognizant of this trend and focused on finding ways to effectively monitor high frequency trading more effectively.

Trading Algorithms

The SEC is also focused on trading algorithms. Kurtas recommended that managers using electronic trading platforms with built-in algorithms ensure that they keep proper documentation with respect to their trading models, systems and procedures. He cautioned that providing the SEC with a copy of the source code is not sufficient. Testing of the models and systems must be regular and robust to prevent and detect any errors. Hedge fund managers should test how the models work both individually and in the aggregate and should be prepared to explain how changes in the model are monitored. Compliance personnel should be knowledgeable about the substance of the processes they are overseeing. Kurtas recommended that a firm's compliance department "build robust control systems and hire or work with people who have financial engineering backgrounds" to effectively address the compliance challenges that arise. The use of software to track algorithmic behavior is beneficial but not sufficient. Human beings must analyze the output of these systems to ascertain what is actually transpiring.

Overall, Kurtas stated that the advancement of technology in the trading space has led to a disconnect between the data a hedge fund manager shares with the SEC and what the SEC finds during an on-site examination. Specifically, what appears on paper to be a properly functioning process of data collection, data normalization and resulting trades is often, in reality, a chaotic and disjointed process. SEC staff members often talk to a variety of people including compliance personnel, system developers, source code authors, risk management personnel and execution personnel and then try to morph what these people say into a comprehensive explanation of how the trades are executed.

As Kurtas put it, "we do not look at one dimension of risk when we are evaluating companies. We have to look at many dimensions. We have to take a holistic view of this. Our compliance friends are often not able to talk to the people who are talking C++ or optimization risks. That creates a systemic risk in our financial markets." Therefore, hedge fund managers should prepare all of their personnel to speak intelligently and consistently with the SEC about their job responsibilities and how they are carried out on a daily basis. Managers should also inform all employees that it is permissible and appropriate to direct SEC staff to an employee more equipped to talk about a specific issue – technology-related or otherwise. See "Business Issues with Legal Consequences: A Wide-Ranging Interview with Dechert Partner George Mazin about the Most Important Challenges Facing Hedge Fund Managers," Hedge Fund Law Report, Vol. 4, No. 40 (Nov. 10, 2011) (section entitled "Algorithmic or High-Speed Trading").