

INVESTMENT ADVISER **Compliance Update**

ATTORNEYS AT LAW

OFFICE: 993 LENOX DRIVE LAWRENCEVILLE, NJ 08648-2389

MAILING: PO BOX 5315 PRINCETON, NJ 08543-5315

609-896-9060 (PHONE) 609-896-0629 (FAX)

WWW.STARK-STARK.COM

www.stark-stark.com/attorney-lawyer-1011052.html

A complimentary service to our clients

Summer 2006

I. RISK ASSESSMENT - Preparation of Risk Matrix

All registered investment advisers must conduct an internal assessment of their risk in a number of compliance areas. Upon regulatory audit, examiners will review the firm's documentation in this area, including its inventory of compliance risks, minutes from risk committee meetings, and standard operating procedures for risk identification and assessment. On a substantive level, and irrespective of an advisory firm's operations, the following compliance areas should be addressed at a minimum by the advisory firm's risk assessment committee: portfolio management; trading practices, personal securities transactions; accuracy of firm's disclosures; safeguarding of client assets; record retention; marketing; valuation of fees and client holdings; privacy; and disaster planning.

Given that all advisory firms differ in some respect, each firm's level of risk in any particular compliance area may vary. As a result of the regulators' request for a risk assessment, we have devised a risk assessment methodology and matrix that we use to work with our clients to identify those areas of risk exposure. From this analysis, policies and procedures are established that are intended to mitigate and/or reduce the risk presented from a compliance standpoint. The documentation must evidence a consideration of those compliance areas that are relevant given the firm's operations, and the scope should be narrowly tailored to only those areas relevant to the firm. There must be a clear assessment of that level of risk exposure that the firm has with respect to those relevant compliance areas. To the extent that you have any questions, or are interested in Stark & Stark providing any assistance within this important area, please contact our office.

II. RISK AND THE SEC AUDIT – Are you Prepared for the SEC's New Examination Request List?

As any RIA who has been through a recent SEC examination can attest, the SEC's latest document request lists takes a "one size fits none" approach by requiring the production of many items that are unfamiliar or inapplicable to most investment advisers. While many of these items are not required by the Adviser's Act, RIAs are well advised to comply with the requests rather than face the possibility of longer, more frequent SEC inspections.

Some of the items requested that have caused the most confusion for RIAs include questions regarding the "risk management process" referenced above. Most investment advisers tend to think about risk in terms of investments and portfolio management. However, the SEC items that require the production of risk-related documents focus on operational and compliance risks. We advise RIAs to establish policies and procedures to assess the risks of compliance and operational weaknesses. Such procedures should encompass, at a minimum, the ten major areas that RIAs are required to address pursuant to Rule 206(4)-7. Documenting the risk-related items requested by SEC examiners requires time and discipline. In order to draft appropriate procedures, all employees of the RIA should be encouraged to: (1) analyze the operational areas over which they are responsible; (2) document possible areas of risk; and (3) suggest policies and procedures to mitigate such risks. The results should be codified in a formal risk assessment and matrix for presentation to the SEC during an examination (See Sec I. above).

We remain available to assist with these matters.

III. SUCCESSION PLANNING

Stark & Stark has significant expertise in assisting investment advisory firms throughout the country with succession planning. Virtually all investment advisory firms should have an up-to-date Buy-Sell Agreement. A Buy-Sell Agreement should accomplish a number of important objectives for an investment advisory firm, including: (1) providing a mechanism for the orderly transfer of the business; (2) establishing a valuation mechanism which avoids disputes between owners as well as possible disputes with the Internal Revenue Service; (3) reducing possible disputes between owners, an owner's heirs, and possible unwanted business partners to whom an ownership interest in the company may otherwise be transferred; and (4) providing financial security to a deceased or disabled owner's family.

It is important that an investment advisory firm's Buy-Sell Agreement be reviewed periodically to make certain that it is properly customized to the needs of the investment advisory firm and its owners, as well as to make certain the agreement meets the requirements of current tax laws. Two of the most important areas of periodic review are the valuation provisions in the Buy-Sell Agreement and the funding of the buy-sell arrangement set forth in the Buy-Sell Agreement. Valuation formulas based upon earnings can become obsolete and should be updated periodically based upon changes in a company's accounting and compensation practices. Funding of the buy-sell arrangement should also be periodically updated to avoid a situation where there is a gap between the value of the company and the available funding.

Another aspect of the Buy-Sell Agreement that should be reviewed periodically is the agreement's structure. Typically, Buy-Sell Agreements are structured as either a redemption agreement, a cross-purchase agreement, or hybrid agreement. It is important to review the structure of a Buy-Sell Agreement to determine if a different structure would be more beneficial in light of the corporate alternative minimum tax on life insurance proceeds. In addition there are also basis considerations to take into account when reviewing the structure of a Buy-Sell Agreement, in order to avoid serious income tax consequences.

Lastly, a periodic review of a Buy-Sell Agreement should include a careful review of the triggering events which either allow or require a transfer of ownership. While most Buy-Sell Agreements adequately deal with the death of an owner, it is equally as important to make sure that the Buy-Sell Agreement adequately covers other triggering events such as disability, voluntary termination of employment and involuntary termination of employment.

When reviewing a Buy-Sell Agreement, it is important to take into account the unique needs of each investment advisory firm, the existing relationships between owners, as well as the individual functions of each owner. It is also important to do an analysis of the underlying economics of the investment advisory firm when considering an update of Buy-Sell Agreement. If you have any questions about Succession Planning and/or Buy-Sell Agreements, or if you would like us to review your existing Buy-Sell Agreement to determine whether any updates are needed.

IV. MEETING THE NASD'S DEADLINE FOR BRANCH OFFICE REGISTRATION

In October 2005 the NASD's new "uniform definition" of a Branch Office became effective. As part of the new "uniform definition" process Broker/Dealer firms will be obligated to assess their supervisory structure, determining whether any current places of business constitute a "branch office" or whether they constitute non-branch "unregistered locations." Places of business deemed to be "branch offices" will need to be registered on the newly created Uniform Branch Office Registration Form (Form BR) on NASD's CRD system. NASD, the NYSE, and the North American Securities Administrators Association (NASAA) collaborated in developing the Form BR to enable firms to register branch offices electronically with NASD, the NYSE, and the several states that require "branch office" registration. Form BR replaces Schedule E on Form BD (as well as the NYSE Branch Office Application Form and the forms used by states to register branches). Filing the Form BR via Web CRD is intended to streamline the branch registration process for NASD member firms. Firms will have until **July 3, 2006** to comply with a number of filing requirements. Firms will need to file an amended Form BR for each converted branch. Firms will also need to assign registered persons to a registered branch office or the main office locations from which they work. Should you have any questions about whether a place of business is a "branch office" requiring registration on Form BR or whether any of your current places of business are "unregistered locations" exempt from registration on

STARK & STARK

A PROFESSIONAL CORPORATION

Form BR, call us here at Stark & Stark. We can also assist you in completing your Form BR prior to the July 3rd deadline.

V. 13F – DOES IT APPLY TO YOU?

An investment adviser with \$100 million of qualifying 13(f) securities under its discretionary management (see below) must file a Form 13F. The initial 13F filing is due by February 14th following the initial year when the assets under management first reach \$100 million. Thus, if the adviser first reaches \$100 million on the last trading day of the calendar year (e.g. 12/31/05), the initial 13F filing is required by February 14th of the following year (e.g. 2/14/06). Thereafter, a Form 13F filing is required within 45 days after the end of each calendar quarter. The timing for discontinuing 13F filings would be the last quarter of the calendar year subsequent to the calendar year in which the adviser no longer has \$100 million in qualifying 13(f) discretionary assets under its management. Thus, if on December 31, 2005, an adviser's qualifying discretionary assets dipped below \$100 million, and remained below \$100 million during the entirety of 2006, the last required filing would be due on February 14, 2007.

When determining if it has \$100 million in "13(f) securities," the adviser should count all assets representing equity securities that are admitted to trading on a national securities exchange or quoted on the automated quotation system of a registered securities association. The term "equity security" means any equity security of a class which is registered, or any equity security of any insurance company which would have been required to be so registered except for an exemption, or any equity security issued by a registered closed-end investment company (this includes closed-end mutual funds). An adviser can confirm if it has \$100 million in 13(f) securities by cross-checking the securities that the firm manages with those on the 13(f) list published by the SEC on a quarterly basis: <http://www.sec.gov/divisions/investment/13flists.htm>. In addition, if the adviser has discretion to allocate assets among sub-advisers, the securities purchase by these sub-advisers may need to be included when determining if the adviser has reached the \$100 million threshold.

Once the adviser determines that it has \$100 million of 13(f) securities, the firm should then register with EDGAR. While the EDGAR registration process is underway, it is prudent to begin compiling and formatting the required 13(f) securities information.

We will continue to remain available to assist with 13F filings.

VI. RULE 206(4)-7 ANNUAL REVIEW

Please remember that pursuant to the requirements of Rule 206(4)-7, each advisory firm must have already completed an initial annual review of its compliance policies and procedures. The purpose of the review is to ascertain the extent to which the firm's current policies, as well as the procedures implemented to effect the policies, require amendment. The review should be conducted by the Chief Compliance Officer, or his/her designee, who should consider the following four items in addition to other relevant issues:

- Compliance matters that arose during the previous year;
- Changes in the advisory firm's business;
- Changes in the activities of any of the firm's advisory affiliates; and,
- Changes in the regulations applicable to the advisory firm, including changes to the Investment Advisers Act of 1940, and Rules promulgated thereunder.

Please be cognizant that the SEC's new focus on internal risk assessment could impact your firm's policies and procedures. It is advisable that this annual review requirement be memorialized in an organized and coherent manner. To the extent that your firm requires any assistance with this requirement or is interested in obtaining an annual review form, please contact our office.

VII. STATES ADOPT SEC POLICIES AND PROCEDURES RULE

Please note that many states now require state registered investment advisers to comply with SEC Rule 206(4)-7. Because we fully expect the vast majority of states to adopt the Rule, we strongly recommend that all registered investment advisers comply with the SEC Rule at this time. Compliance requires advisers to (i) adopt policies and

procedures designed to prevent violations of applicable securities laws, including the Investment Advisers Act of 1940; (ii) annually review their established policies and procedures for their adequacy and the effectiveness of their implementation; and (iii) designate a chief compliance officer responsible for administering the policies and procedures. To the extent that you require any assistance or have any questions, we will remain available to assist you.

If you are a state registered investment adviser and have not yet implemented written policies and procedures, please make contacting Stark & Stark a priority in order to confirm the extent of the relevant state's adoption of the SEC's written policies and procedures requirement.

VIII. HAS YOUR CLIENT SUFFERED LARGE LOSSES AT ANOTHER FIRM?

So often, clients seek to change investment professionals after having suffered losses they did not have to incur. Stark & Stark can help. Our Securities Arbitration Practice Group, which customarily defends investment industry professionals, will review and pursue customer claims when referred to us by our investment professional clients. We do limit this representation to substantial cases, usually involving \$500,000 or more in damages.

IX. REMEMBER: COMPLIANCE IS AN ONGOING PROCESS

Please remember that compliance is an ongoing and constantly evolving process. Laws and rules applicable to your practice and representatives are subject to change. Agreements and disclosure statements may require review and update due to regulatory or state law changes and/or changes in your business operations. Existing restrictive covenant agreements may no longer reflect state law changes. Please do not become complacent with respect to compliance matters. The scope of SEC examination issues continues to grow and becomes more complex. Policies and Procedures must also be reviewed and revised as required by regulatory changes and/or changes in your business operations. A ripe area for SEC deficiencies is either failure to have Policies and Procedures that appropriately reflect your business operations and/or the failure to follow them. As always, we will continue to remain available to assist with these matters.

X. RECEIVE IMPORTANT NEWS AND COMPLIANCE UPDATES VIA RSS

We are always striving to provide our clients with tools to make receiving information important to them as easy as possible. Accordingly, we have recently made available a RSS (really simple syndication) feed through which we will distribute our Compliance Update Newsletter, client alerts, and news about important industry developments.

Subscribing to our RSS feed allows you to receive news and updates from us in a convenient and simple manner. Using RSS frees you from constantly revisiting our website to see what new information has been added since your last visit. Receiving updates via RSS also helps to keep your desk clear of hard copy mailings and reduces the amount of email alert messages coming into your inbox.

RSS feeds are read in a program called an aggregator. This aggregator program runs invisibly and only notifies you when new information has been published through the feed. There are many choices of aggregators for you to use, and we have included a list of them below.

RSS is a relatively new technology that has the potential to revolutionize how businesses communicate in the same way that email has. Realizing the potential of RSS, we encourage our clients to become involved by subscribing to our feed and experiencing for themselves this simplified method of communication.

It is important to note that we will still continue to provide information to you in hard copy form, including client alerts and compliance updates, until you direct otherwise. The main benefit, though, of subscribing to our RSS feed is that you will receive this information on your computer the instant we publish it, and will no longer have to sort through your inbox or shuffle papers on your desk.

Should you have any questions regarding RSS technology and how it can be used, please contact our Director of Business Development Richard DeLuca at rdeluca@stark-stark.com or 609-791-7014. He regularly provides advice on RSS technology to Stark & Stark clients.

STARK & STARK

A PROFESSIONAL CORPORATION

Securities Compliance & Arbitration RSS Feed

<http://www.njlawblog.com/feed-wbsecuritiesblogpostings.rdf>

Aggregators That Can Be Used to Receive RSS Feeds

Abilon - <http://www.activerefresh.com/abilon/>

Displays headlines from RSS Channels in an easy to read format. It is a small, fast, and free program. Adding new channels is as simple as right-clicking and entering the address of the feed.

FeedDemon - <http://www.bradsoft.com/feeddemon/>

Enables you to quickly explore the world of RSS from your desktop without having to visit hundreds of sites. FeedDemon makes RSS as easy to access as your email.

***This is the aggregator program used by Stark & Stark.**

Additional aggregators for Windows based operating systems can be found here -
<http://allrss.com/rssreaderswindows.html>

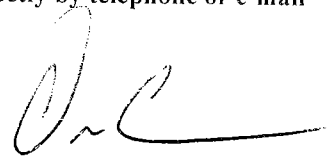
Stark & Stark continues to remain available, at your convenience, to assist you relative to the applicability of any of the above issues to your specific practice. As always, we can be reached directly by telephone or e-mail as listed below.



Thomas D. Giachetti
(609) 895-7255
tgiachetti@stark-stark.com



Brian A. Carlis
(609) 895-7313
bcarlis@stark-stark.com



Oren M. Chaplin
(609) 895-7394
ochaplin@stark-stark.com



Cynthia S. Ham
(609) 791-7002
cham@stark-stark.com



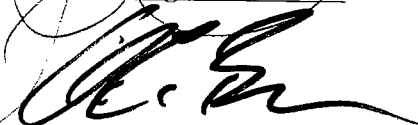
Joseph C. Cascarelli
(609) 791-7007
jcascarelli@stark-stark.com



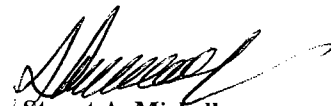
Nino Ciappina
(609) 219-7421
aciappina@stark-stark.com



Raymond Amoroso, III
(609) 791-7022
ramoroso@stark-stark.com



Aaron C. Buser
(609) 219-7435
abuser@stark-stark.com



Stuart A. Mickelberg
(609) 895-7277
smickelberg@stark-stark.com

No portion of the *Compliance Update* should be construed or relied upon as legal advice, nor should it be construed, in any manner whatsoever, as the receipt of, or a substitute for, personalized individual advice from Stark & Stark or from any other compliance professional.

Stark & Stark, a 100+ attorney firm with offices in Princeton, New Jersey, Cherry Hill, New Jersey, New York, New York, and Philadelphia, Pennsylvania, represents investment advisers, financial planners, broker-dealers, CPA firms, registered representatives, public and private investment companies (e.g., mutual funds, hedge funds, etc.), and investors throughout the United States.