

## INVESTMENT ADVISER Compliance Update

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### I. HEDGE FUNDS – NEW HEDGE FUND RULES PROPOSED BY THE SEC

- The SEC has proposed rules that raise the hurdle investors must meet in order to enter the world of hedge funds. The proposed rules also seek to create a new anti-fraud provision under the Investment Advisers Act of 1940, which would apply to managers/investment advisers to pooled investment vehicles. These proposed rules were presented by the SEC during an Open Meeting which took place on Wednesday, December 14, 2006.
- The presentation of these new proposed hedge fund rules has been eagerly anticipated, and expected, after the D.C. Circuit Court Decision, Goldstein v. SEC, struck down a rule earlier this year which would have required most hedge fund managers to register with the SEC.
- In the wake of the Goldstein decision, it was widely believed that the SEC would not move to appeal this decision. Rather, it was expected that the SEC would move quickly to develop new proposed rules to address certain concerns about the hedge fund industry. Specifically, subsequent to the Goldstein decision SEC Chairman Cox warned that hedge funds were too risky for “mom and pop” type investors and commented that the increasing use of hedge funds by so-called retail investors carried with it the potential for retail exposure to hedge fund risk.
- The two (2) new proposed hedge fund rules the SEC has presented for comment are as follows:
  1. An **anti-fraud provision** under the Advisers Act of 1940 which would make it a fraudulent, deceptive or manipulative act, practice or course of business for an investment adviser to a pooled investment vehicle to make false or misleading statements or to otherwise defraud investors or prospective investors in that pool. The rule would apply to all investment advisers to pooled investment vehicles, regardless of whether the adviser is registered under the Act. Under the proposed rule, a pooled investment vehicle would include any investment company and any company that would be an investment company but for the exclusions in section 3c-1 or 3c-7 of the Investment Company Act of 1940.
    - ❖ Commentary during the SEC Open Meeting confirmed that this proposed anti-fraud rule will not give rise to private right of action
    - ❖ The proposed rule does not seek to impose any specific disclosure obligations upon investment advisers to pooled investment vehicles.
  2. The second proposed rule involves amendments to private offering rules under the Securities Act of 1933 which would **define a new category of accredited investor** that would apply to offers and sales of securities issued by hedge funds and other private investment pools to natural persons, but would not apply to venture capital funds. The proposed definition would include any natural person who meets either the net worth test or income test specified in Rule 501(A) or rule 215 (i.e., the current Accredited Investor test) **AND** owns at least \$2.5 million in investable assets, as to be defined in the proposed rules.

- ❖ How will this proposed rule affect those investors who are already invested in hedge funds and will there be a “grandfather clause” provision? Based upon commentary provided during the SEC Open Meeting, the new test is meant to apply *at the time an investor makes an investment in a pooled investment vehicle*. Accordingly, investors who are already invested in private/hedge funds will not necessarily be affected, but may be affected to the extent they wish to make additional contributions to their existing hedge funds or any others. Thus, there appears to be a somewhat limited “grandfather clause” in the new proposed rule.

The proposals will be published in the Federal Register and open to public comments over a sixty (60) day-period before a final policy is adopted.

## **II. “SOFT DOLLARS” - SEC ADOPTS REVISED INTERPRETATIONS**

The Securities and Exchange Commission recently issued updated interpretations regarding the treatment of certain services offered by broker-dealers for investment advisers that may be treated as “soft dollars” under Section 28(e) of the Securities Exchange Act of 1934. There are primarily two categories of soft dollars addressed in the SEC’s latest interpretations: research and brokerage.

While the interpretations cover a broad range of products and services offered by investment advisers, of particular importance to most in the industry is the limited application of soft dollar treatment to publications of general circulation and certain software, such as portfolio management programs. In general, research publications that address such topics as performance in a particular sector or specific securities and issuers, are treated as eligible research under Section 28(e). However, mass-marketed publications, defined by the Commission as those intended for and marketed to a broad, public audience, are no longer eligible for soft dollar treatment. To qualify as soft dollar eligible research, publications must be intended for a smaller, more specialized readership. Otherwise, the publications will be considered ineligible overhead.

Similarly, the Commission has adopted some nuance to the interpretation of certain uses of software, such as order management programs, under the definition of eligible brokerage. Software is eligible as brokerage to the extent that it assists the adviser in executing securities transactions. The eligibility of brokerage products and services runs from the point at which the adviser communicates with the broker-dealer to execute an order through the point at which funds or securities are delivered or credited to the advised account. As demonstrated, certain software may have mixed uses, both eligible and ineligible, that require an adviser to examine how it applies the product. Portfolio or order management programs, for instance, may provide an adviser with numerous uses, which could be deemed eligible research or brokerage. Those same programs, however, may also provide the adviser with bookkeeping capabilities. The latter use is ineligible for soft dollar treatment. Such products and services are classified as “mixed-use.” If an adviser uses a particular product for both eligible and ineligible purposes, the adviser must make a good faith determination regarding the extent to which the use is eligible, and must pro-rate the charge accordingly. A thorough record should be maintained of the adviser’s calculation of this ratio and the materials used to make the calculation.

## **III. PRIVACY AND IDENTITY THEFT**

When evaluating the advisory firm’s risk inventory and assessing its internal compliance exposure, it has become exceedingly important for the firm’s Chief Compliance Officer to focus upon privacy and identity theft issues. Advisory personnel should evaluate the extent to which the firm’s information safeguards and protection systems are adequate in preventing unauthorized access to client-sensitive nonpublic personal information. In fact, during a recent speech by a Commission representative, this very question was posed as one that should be asked by all investment advisers.

Identity thieves using client nonpublic personal information may be able to gain access to clients’ custodial account(s) for purposes of: (1) liquidating the accounts and rerouting the proceeds to third-party account(s), (2) laundering money, and (3) engaging in fraudulent pump and dump schemes. Often the evidence reflects that the account holder was engaged in the unlawful activity, and not the true perpetrator. Naturally this will impact the

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advisory client's financial situation (e.g., credit score, etc.), and if the information was accessed as a result of that client having a relationship with its investment adviser, it certainly will impact their relationship with their investment adviser.

Using the federal securities laws and Regulation S-P as support, the SEC has commenced actions against identity thieves. Capitalizing on the momentum gained through the discovery of evidence during these actions, as well as the general heightened media attention given to the subject; the SEC has increased its focus on this area. Commission inquiries into the financial services firm's safeguards pertaining to protection of client nonpublic personal information are now customary, where past audits merely requested a review of privacy notices and policies. The firm should be in a position to show that its then current privacy initiatives are sufficient given its level of technological complexity.

Among the proactive measures that a financial services firm can take are the following:

- Conducting an annual meeting between the Chief Compliance Officer and firm personnel, which acts as a forum to discuss the threat of identity theft and the firm's procedures to safeguard client information.
- Involving the firm's information technology department in the development of procedures to protect electronic information.
- Requiring all employees, third-party service providers, and independent contractors to enter into a confidentiality and restrictive covenant agreement.
- Alerting clients to the dangers of identity theft as well as the need for them to protect their confidential information.
- Establishing internal controls with respect to the flow of client information.
- Limiting access to client nonpublic personal information to only those parties who need that information for the firm to service client accounts.

**The above are illustrative of actions that the advisory firm should take on this issue and should not be construed as wholly sufficient for regulatory compliance or liability protection purposes. Our firm welcomes questions pertaining to identity theft, information security, and the issues that revolve around this area of risk.**

#### **IV. STATES IMPOSE COMPLIANCE MANUAL REQUIREMENT**

Many states now **require** state registered investment advisers to establish and implement internal policies and procedures akin to those required of SEC registered investment advisers under Rule 206(4)-7 since October 2004. The primary purpose of the policies and procedures is to prevent violations of applicable securities laws. In order for a firm to devise appropriate policies and procedures, the firm should analyze its operations and review its exposure to compliance failures in a number of compliance areas. The result should be the drafting of applicable policies and the subsequent implementation of corresponding procedures to effect compliance with those policies. It is recommended that the resulting documents be maintained in a policies and procedures manual. The policies and procedures should be viewed as a tool that can be used to mitigate the firm's compliance and operational risks, which has become a major focus of current SEC regulatory examinations (*See* corresponding discussions below at Items V, VI and X).

The vast majority of states that require policies and procedures have followed the parameters of the SEC Rule. In many states, the regulatory requirements are straightforward, while in others the requirement is implied from various statutory sections. Because we fully expect the majority of states to either adopt the SEC's "compliance manual rule" (i.e., Rule 206(4)-7) or establish a similar rule, we strongly recommend that all registered investment advisers comply with the SEC Rule at this time. 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.

#### **V. 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* Section VI below).

We remain available to assist with these matters.

#### **VI. RISK ASSESSMENT - Preparation of Risk Matrix**

As discussed above, 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.

#### **VII. NASD RELEASE: EXAM PRIORITIES/FREQUENT VIOLATIONS**

The NASD recently released its "Examination Priorities" and "Frequently Found Violations". High on NASD's list of "examination priorities" is Anti-Money Laundering, Branch Office Sales Practices, and Heightened Supervision and Supervisory Controls. High on NASD's list of "frequently found violations" includes violations of Rule 3010 (the written supervisory procedures rule), Rule 3011 (the anti-money laundering rule), and Rule 3012 (the supervisory controls rule).

NASD's AML examination focus is on your firm's Customer Identification Program (CIP). Many firms utilize the NASD's online AML template when drafting the firm's compliance manual but stop short of undertaking a bona

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vide assessment of the firm's risk for money laundering and terrorist financing. This risk assessment is premised upon identifying customers, and linking this identification to each investment vehicle offered by the firm – each investment vehicle having its own relative risk for laundering money and terrorist financing. Failure to establish, document, and maintain a written customer identification program tailored to your firm's business will result in a violation of Rule 3011.

NASD's "supervisory controls" examination focuses on your firm's ability to identify those branch offices supervised by "producing managers" and your firm's solution to how you will supervise these branch offices to prevent, among other things, prohibited sales practices, including misappropriation of customer funds. Again, firm's written supervisory procedures generally recite the "supervisory controls" rule (Rule 3012). However, NASD's examiners will be looking to see *how* your firm targets indicators of prohibited sales practices at the branch office level, how your firm supervises "producing managers" on a day-to-day basis, and *how* your firm tests and reports to senior management the current status of your firm's commitment to compliance and whether the firm, in fact, has a process in place to establish, maintain, and enforce your firm's "culture of compliance" evidenced by your written supervisory procedures. Failure to implement policies – that is, failure to have adequate procedures (not just policies) that are regularly enforced – will result in a violation of Rule 3012.

This leads to a third "frequently found violation" that is a focus of NASD examination – the failure of firms to comply with the requirements of Rule 3010, the written supervisory procedures rule. NASD examiners frequently find WSPs that do not include a description of the controls actually used by the firm to reasonably detect and prevent misconduct. In other words, the firm's WSPs simply recite the firm's policies, frequently nothing more than a recitation of Rules requirements. For example, a firm will say that its policy is to not allow its reps to sell investments unsuitably; however, the firm then falls short of saying what controls are in place to enforce this policy.

NASD is looking for the firm to say *how* unsuitable sales will be prevented by the firm. The *how* can be as varied as having different levels of suitability review by supervisory principals at the branch, OSJ, and/or home office, for example. This, in turn, opens the door to the second focus of an NASD examination, which is an examination of the firm's choice of supervisory principals. This is a subjective test that focuses on the competence, qualification, and experience of individuals who have been delegated supervisory responsibility. Failure to meet NASD's objective and subjective testing of your firm's WSPs can result in a violation of Rule 3010, the written supervisory procedures rule.

*Stark & Stark* can assist broker-dealers on all of these examination issues. We routinely conduct broker-dealer inspections and draft written supervisory procedures that address these NASD examination priorities. If you have any questions, please do not hesitate to contact Joe Cascarelli at [jcascarelli@stark-stark.com](mailto:jcascarelli@stark-stark.com).

## **VIII. 13F-HAVE YOU COUNTED ALL OF YOUR ASSETS?: Use of Sub-Advisers and Hedge Fund Managers.**

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.

**Use of Sub-Advisers:** In determining the total amount of assets under management, an adviser should include those client assets that the adviser has engaged (on a discretionary basis) sub-advisers to actively manage. Thus, a discretionary investment manager cannot avoid its 13F filing requirement because it utilizes sub-advisors to actively manage any or all of the \$100 million asset threshold. Instead, the use of sub-advisors will dictate the type of 13F filing that is required.

**Hedge Fund Managers:** Private investment managers such as hedge fund managers are generally not exempt from the 13F-filing requirement. These managers could be considered an “institutional manager” for purposes of 13F regardless of SEC registration. Thus, for example, any hedge fund that exercises investment discretion over (or owns) \$100,000,000 or more invested in securities traded on stock exchanges and the NASDAQ must report its holdings quarterly via a Form 13F.

**Starting Point:** 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. If you have any questions relative to 13F filings please do not hesitate to contact Nino Ciappina [a-c@stark-stark.com](mailto:a-c@stark-stark.com).

## **IX. 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.

## **X. 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.**

## **XI. 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.

## **XII. 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.

## **XIII. RECEIVE IMPORTANT INDUSTRY 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 a RSS (really simple syndication) feed through which we 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. RSS frees you from continuously revisiting our website to see what new information has been added and helps to

keeps your desk clear of hard copy mailings and your inbox free of email alert messages. RSS delivers to you the information you want, seamlessly and effortlessly.

In order to learn more about RSS and to view a list of feeds produced by our firm go to [www.stark-stark.com](http://www.stark-stark.com), click on **Blogs** and then **What Is RSS**.

**Securities Compliance & Arbitration RSS Feed**

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

Should you have any questions regarding RSS, please contact our Director of Business Development Richard DeLuca at [rdeluca@stark-stark.com](mailto:rdeluca@stark-stark.com) or 609-791-7014. He regularly provides advice in RSS to Stark & Stark clients.

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.



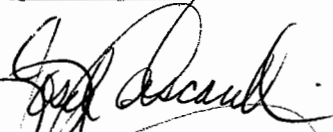
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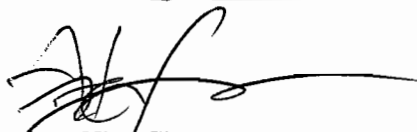
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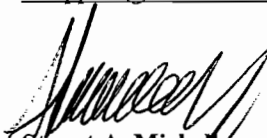
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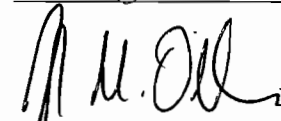
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