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REPORTING ON ISSUES FOR INVESTMENT PROFESSIONALS IN HEDGE FUNDS AND OTHER ALTERNATIVE INVESTMENTS.

Practical Side of Compliance with Registration Requirements

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The recent flurry of financial reform legislation will result in mandatory SEC registration for investment advisers to hedge funds and private equity funds above specified asset levels and will lead to additional SEC oversight, reporting and regulation of current registrants. The time to begin constructing an effective compliance program is now.

Section 404(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) requires private fund advisers to maintain and provide reports to the SEC as necessary and appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk. For example, a registered adviser must maintain (and submit for SEC inspection) records regarding its private funds as to (i) the amount of assets under management and use of leverage, including off balance sheet leverage; (ii) counterparty credit risk exposure; (iii) trading and investment positions; (iv) valuation policies; (v) types of assets held; (vi) side arrangements or side letters; and (vii) trading practices. Some of these records will be in addition to those already required under Investor Advisers Act of 1940, Rule 202-4.

While the SEC and CFTC are in the process of drafting rules to implement the new legislation, the industry can look to existing SEC rules and releases for guidance on ways to meet the requirements. The underlying theme should be the management, control and reduction of internal risks, in order to mitigate investor risks unrelated to the performance of their investment.

Unregistered advisers seeking to register will need to satisfy at least the following 10 responsibilities listed below:

- Complete and file Form ADV Part I on the IARD system to register with the SEC;
- Conduct a Risk Assessment to identify high-risk areas in their business, including operational and compliance risks;
- Establish written compliance policies and procedures that are designed to mitigate those risks;
- Adopt a Code of Ethics;
- Appoint a qualified Chief Compliance Officer;
- Prepare and file Form ADV Part II;
- Maintain client assets with a qualified custodian;
- Maintain required books and records;
- Conduct routine forensic testing to enable, at a minimum, an annual assessment of the effectiveness of the compliance program; and

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- Be prepared for regular inspections by the SEC and the NFA/CFTC, which can take anywhere from a few days to a few months to complete.

Back-to-back NFA and SEC exams are not uncommon. Nor, should it come as a surprise that the SEC will request all of the books and records that relate to commodity transactions, even if the firm is registered as a CTA or CPO through the NFA system.

While most of the compliance guidance provided by the SEC concerns routine investment management activities, internal financial controls are absolutely essential. The SEC's most recent document request list and focus during exams shows a substantial interest in the verification of the financial records of the fund and capital balance statements. The regulators will be looking for accurate investor capital balance statements and fund NAV's, together with the evidence that the firm has adequate internal controls in place to insure the integrity of those statements. The regulators will ask for and review the balance sheet, income statement, cash flow statements, cash receipts and disbursements and the general ledger and chart of accounts. Supporting documentation, including for advisory fee calculations, is typically requested. It is also important to be able to present evidence of routine cash reconciliation and the oversight of the activities of the administrator.

Appropriate internal controls that both reflect the actual operation of an adviser and address what the SEC expects are essential. The SEC has provided guidance about the categories of policies and procedures a compliance program should address:

- Portfolio Management Process, including allocation of investment opportunities among clients and consistency of portfolios with client's investment objectives, disclosures by the adviser and applicable regulatory restrictions;
- Trading Practices, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services ("soft dollar arrangements"), and allocates aggregated trades among clients;
- Proprietary trading of the adviser and personal trading activities of supervised persons;
- The accuracy of disclosures made to investors, clients, and regulators, including account statements and advertisements;
- The accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction;
- Marketing advisory services, including the use of solicitors;
- Processes to value client holdings and the assessment of fees based on those valuations;
- Safeguards for the privacy protection of client records and information; and
- Business continuity plans.

In addition, the investment adviser should have solid risk management practices and verification of the effective implementation of those practices. Stronger whistleblower protections will become a requirement under the Act. ISDA agreement oversight has become more important as the use of derivatives has received greater scrutiny. The management process of the initial and margin variance accounts that represent the collateral for swaps and other derivatives should have solid controls and a documented compliance oversight process in place. As the manager of the funds, the investment adviser has fund-related responsibilities as well. These should be part of the compliance program and include the oversight of the subscription document process, review of offering documents, Regulation D compliance, compliance with the requirements of the funds' chosen exemptions from the Investment Company Act, and regulatory filings and reporting.

By July 2011, when most of the relevant provisions of Dodd-Frank become effective, heightened transparency will be a feature of the financial markets and may lead to greater investor confidence. The next few months will be challenging for advisers and their compliance staffs, as new regulations implementing Dodd-Frank are adopted and the full effects of the regulatory changes are felt throughout the markets. For both registered advisers and advisers who will likely be required to become SEC-registered under the new regulations, getting a head start on developing and implementing an effective compliance program is both a smart business move, and, increasingly, a legal necessity.

Guy F. Talarico is the founder and CEO of Alaric Compliance Services LLC, one of the nation's leading compliance consulting firms. Mr. Talarico has over 28 years of experience in the financial services industry and serves as the chief compliance officer to various Registered Investment Advisers and Registered Investment Companies. Alaric Compliance Services offers a broad range of compliance consulting services including outsourced chief compliance officers, to NFA, CFTC, FINRA, and SEC registered firms, as well as unregistered investment advisors. Mr. Talarico served three terms in the New Jersey State Assembly, he holds a BS ChE from Lehigh University, an MBA from Fairleigh Dickinson

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