

16th Annual Private Investment Funds Seminar

Spotlight on Compliance: Key Issues for 2007

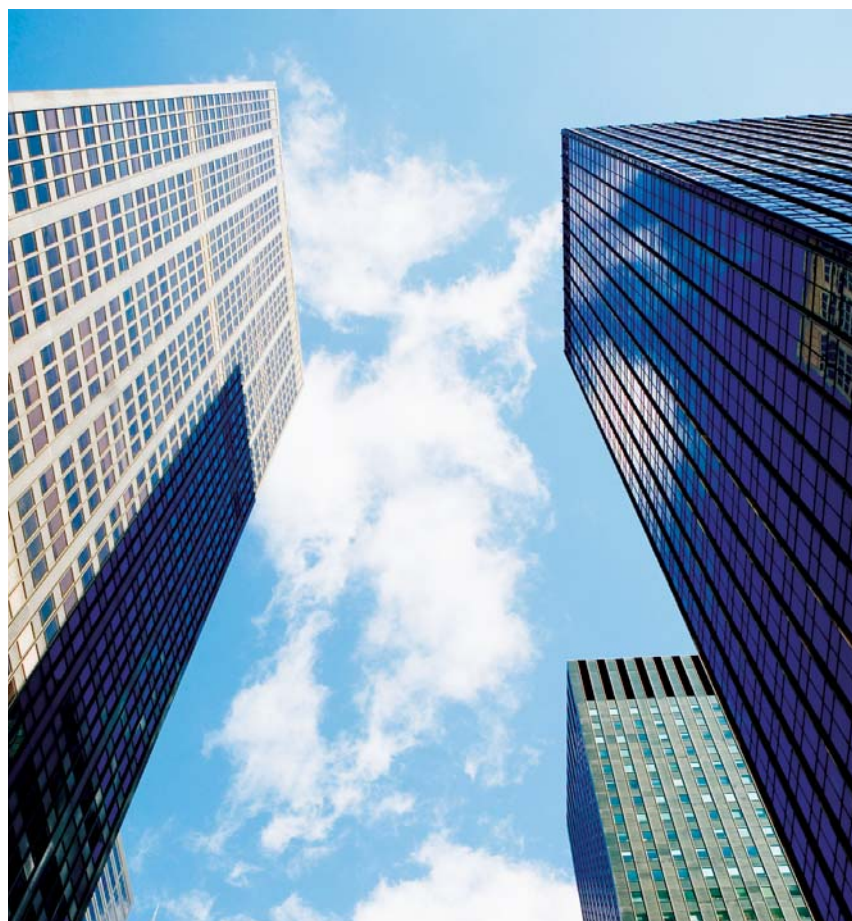
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Thursday, January 18, 2007

I. About the Speakers

II. Outlines

III. Presentation



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David Efron is a partner in the Investment Management Practice Group at Schulte Roth & Zabel LLP. His practice focuses on domestic and offshore hedge funds, including structuring seed capital and joint venture arrangements. Additionally, he represents hedge fund managers in connection with SEC regulatory issues and on compliance-related matters.

David is a 1993 graduate of Syracuse University College of Law and has an LL.M. degree in securities regulation, *with distinction*, from the Georgetown University Law Center. He received his B.A. in 1990 from Vassar College.

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Kenneth S. Gerstein is a partner in the Investment Management Practice Group at Schulte Roth & Zabel LLP. He represents investment advisers, broker/dealers and banks in the organization and operation of investment funds and services, including mutual funds, hedge funds, closet-end investment companies, business development companies, wrap accounts, and 401(k) and IRA products. He also advises clients on securities regulatory and compliance matters.

Ken has worked with clients in developing novel hybrid fund products, including registered hedge funds and registered hedged fund of funds.

Ken is a 1975 graduate of the James E. Beasley School of Law at Temple University, where he was a member of the school's *Law Quarterly*, and a 1978 graduate of the Georgetown University Law Center, where he received an LL.M. in taxation. He received his undergraduate degree in 1972 from the Wharton School at the University of Pennsylvania.

Ken is a member of the American Bar Association's Committee on the Federal Regulation of Securities and its Subcommittee on Investment Companies and Investment Advisers, and is a member of the New York City Bar Association's Committee on Investment Management Regulation. He is a frequent speaker and author on issues related to investment funds and investment advisers. Prior to entering private practice, he served as special counsel in the SEC's Division of Investment Management in Washington, D.C.

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Udi Grofman is a partner in the Investment Management Group at Schulte Roth & Zabel LLP. His practice focuses on hedge funds, private investment funds and their sponsors, in connection with fund formation, formation of management companies and compliance and trading matters.

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- Structuring and organizing domestic and offshore private investment funds, including hedge funds, hybrid funds and fund-of-funds;
- Structuring and negotiating joint venture arrangements between advisory firms, and providing legal advice on the regulatory aspects of advisory joint ventures;
- Organizing investment advisory firms;
- Providing legal and regulatory advice on the acquisition, sale and restructuring of advisory firms; and
- Advising on securities laws matters and regulatory compliance.

Udi is a *magna cum laude* graduate of the Tel-Aviv University School of Law and received an LL.M. from the New York University School of Law. He began his legal career at Yigal Arnon & Co., one of Israel's largest law firms. He also practiced with David Liabi & Co., a litigation firm headed by a former Minister of Justice of the State of Israel. Udi lectured at the School of Law and the School of Business Management at the Interdisciplinary Center in Herzliya, Israel. He is a captain (*res.*) in the Israeli Defense Forces.

Outline



Spotlight on Compliance: Key Issues for 2007

David J. Efron, Kenneth S. Gerstein and Udi Grofman

January 18, 2007

1) Background and Current Regulatory Environment

Over the past several years, there has been considerable focus on matters relating to the regulation of hedge funds.

- a) The growth of the hedge fund industry led to an investigation of and report on hedge funds by the staff of the Securities and Exchange Commission (the "SEC"), *Implications of the Growth of Hedge Funds* (September 29, 2003). The report included a recommendation that the SEC adopt a rule requiring registration of hedge fund managers under the Investment Advisers Act of 1940 (the "Advisers Act") and was followed by a proposal to adopt such a rule.¹
- b) In December 2004, the SEC adopted Rule 203(b)(3)-2 under the Advisers Act (the "Registration Rule"), which essentially required most hedge fund managers to register as investment advisers with the SEC.² Approximately 2,000 hedge fund managers registered with the SEC as a result of the Registration Rule.
- c) On May 16, 2006, Susan Ferris Wyderko, the then-Director of the Office of Investor Education and Assistance at the SEC, testified before the Subcommittee on Securities and Investment of the U.S. Senate Committee on Banking, Housing, and Urban Affairs about hedge funds, the role they play in the securities markets and the SEC's role in their oversight.³
- d) On June 23, 2006, the United States Court of Appeals for the District of Columbia Circuit issued its decision in *Goldstein v. SEC* (the "Goldstein Decision"), which vacated the Registration Rule. The court held that the SEC lacked the authority to require that investors in private funds be counted as "clients" in determining the availability of the exemption from registration provided by Section 203(b)(3) of the Advisers Act, under which investment advisers that have had fewer than 15 clients during the preceding 12 months and do not hold themselves out generally to the public as investment advisers are not required to register.
- e) On September 26, 2006, the Director of the SEC's Division of Enforcement, Linda Chatman Thomsen, testified before the U.S. Senate Committee on the Judiciary regarding insider trading.⁴ She emphasized the SEC's focus on enforcing the securities laws, especially rules relating to insider trading, on hedge funds and their managers.⁵
- f) On December 27, 2006, the SEC proposed the adoption of two new rules in response to the Goldstein Decision.⁶

¹ Release No. IA-2266 (July 20, 2004).

² Release No. IA-2333 (December 2, 2004).

³ Written testimony available at: <http://www.sec.gov/news/testimony/ts051606sfw.htm>.

⁴ Written testimony available at: <http://www.sec.gov/news/testimony/2006/ts092606lct.htm#asterik>).

⁵ "More recently, globalization, the technology boom, a renewal of merger activity, and our concern about insider trading by hedge funds have shifted our enforcement focus yet again." *Id.*

⁶ Release No. IA-2576 (December 27, 2006).

- i) Proposed Rule 206(4)-8 under the Advisers Act would make it a "fraudulent, deceptive, or manipulative act, practice, or course of business" within the meaning of Section 206(4) of the Advisers Act for an investment adviser (whether registered or unregistered) to a pooled investment vehicle to make false or misleading statements of material facts or to "otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in a pooled investment vehicle." The rule is intended to assure a basis for the SEC to bring enforcement actions under the Advisers Act against hedge fund managers that defraud hedge fund investors or prospective hedge fund investors in light of statements in the Goldstein Decision that investors in a hedge fund are not clients of the fund's manager.
 - ii) Proposed Rule 509 under the Securities Act of 1933 (the "1933 Act"), together with a proposed amendment to Rule 501, would add an additional qualification requirement that would need to be met by natural persons investing in hedge funds relying on Section 3(c)(1) of the Investment Company Act of 1940 (the "Investment Company Act") in order for such persons to be deemed "accredited investors" as defined in Rule 501 of Regulation D under the 1933 Act.⁷ Under this new requirement, a natural person would need to be an "accredited natural person," which is defined to mean a person who has "investments" of at least \$2.5 million.⁸ Natural persons would continue also to be required to meet either the net worth test or the income test set forth in Rule 501 of Regulation D. The SEC believes that the new qualification requirement will help assure that investors in hedge funds are capable of evaluating and bearing the risks of their investments.
- g) The Goldstein Decision has also led to renewed Congressional interest concerning the regulation of hedge funds and hedge fund managers. For example:
- i) Rep. Mike Castle, R-Del., introduced legislation (passed by the House on September 27, 2006) that would require the President's Working Group on Financial Markets to study the hedge fund industry and analyze various issues, including whether hedge fund investors are able to protect themselves adequately from the risks associated with their investments and to make recommendations concerning, among other things: the need for legislation imposing disclosure requirements on hedge funds; and the oversight responsibilities that members of the President's Working Group have over hedge funds.⁹
 - ii) Rep. Barney Frank, D-Mass., introduced legislation that would amend the Advisers Act to authorize the SEC to define the term "client" for purposes of Section 203(b)(3) so as to include hedge fund investors.¹⁰
 - iii) Sen. Chuck Grassley, R-Iowa, sent a letter to members of the President's Working Group on October 16, 2006, soliciting their views on how Congress can improve hedge fund transparency.¹¹

⁷ Regulation D provides a "safe harbor" for private offerings made in reliance on the private placement exemption from registration made available by Section 4(2) under the 1933 Act, including offerings of interests in hedge funds. Under its provisions, there may not be more than 35 purchasers in a private offering; however, "accredited investors" are not counted as purchasers for purposes of this limitation.

⁸ The term "investments" is defined similarly to the definition of such term in Rule 2a51-1 under the Investment Company Act (which defines "investments" for purposes of determining whether an investor is a "qualified purchaser" eligible to invest in a hedge fund that relies on Section 3(c)(7) of the Investment Company Act). The \$2.5 million threshold would be adjusted for inflation every five years, beginning April 1, 2012.

⁹ H.R. 6079, 109th Cong., 2d Sess.

¹⁰ H.R. 5712, 109th Cong., 2d Sess.

¹¹ Press Release, U.S. Senate Committee on Finance, "Grassley Seeks Multi-Agency Response on Lack of Transparency, Expresses Alarm at Risk to Pension-holders" (October 16, 2006). Available at: <http://www.senate.gov/~finance/press/Gpress/2005/prg101606.pdf>.

- iv) Hedge fund regulation has also been a subject of interest to state attorneys general, foreign regulatory organizations and international securities regulator associations.

2) The SEC Examination Program

An important part of the regulatory framework established by Section 204 of the Advisers Act is the authority of the SEC to conduct periodic, special, or other examinations of the books and records of registered investment advisers. Pursuant to this authority, the SEC staff conducts examinations of registered advisers. If violations of the securities laws or SEC rules are identified in an examination, the examination staff may send a deficiency letter to the adviser identifying the violations and requesting that remedial actions be taken or may refer the matter to SEC enforcement staff for possible enforcement action.

- a) The SEC staff conducts three types of examinations:¹²
 - i) Cause examinations: These examinations are conducted when there is reason to believe that there is a compliance problem at a firm. Examinations of this type may be conducted in response to investor complaints, tips or media reports, or in the case of advisers that have had "a high probability of problematic activities."¹³
 - ii) Sweep examinations: These examinations are special reviews that focus on a single issue.
 - iii) Routine examinations: These examinations are conducted on a periodic basis. In these examinations, the SEC staff reviews a broad range of compliance matters at the firm subject to the examination.
- b) The frequency of routine examinations is generally based on a firm's risk profile as determined by the SEC staff.¹⁴ The staff classifies advisers into two categories: those perceived to have a high-risk profile and those perceived to have a low-risk profile. Advisers deemed to have a high-risk profile are typically subject to routine examination on a three-year cycle. Advisers deemed to have a low-risk profile are selected for examination using a random selection methodology and are not examined on a cyclical basis. The three factors used to determine an adviser's risk profile are:
 - i) The adviser's assets under management;
 - ii) The adviser's Form ADV responses; and
 - iii) The strength or weakness of the compliance environment of the adviser.¹⁵

¹² Memorandum from Lori Richards, Director, Office of Compliance, Inspections and Examinations, to Chairman William H. Donaldson (March 10, 2004) (describing the SEC's investment company and investment adviser examination programs). Written remarks available at: <http://www.sec.gov/news/extra/apx-ts031004lar.pdf>.

¹³ Remarks of Gene A. Gohlke, Associate Director, Office of Compliance Inspection and Examinations, before the Fund of Funds Forum (Nov. 14, 2005). Written remarks available at: <http://www.sec.gov/news/speech/spch111405gag.htm>.

¹⁴ *Id.*

¹⁵ "Having a strong compliance culture with a strong compliance program is in the best interests of securities firms, because what's good for investors, is good business for those who serve investors.... A firm that has a strong compliance program should be predictably more compliant, and thus not as deserving of our examination. **"We spend our limited examination resources focusing on those firms and those areas within firms, where compliance is relatively weak."** Remarks of Lori A. Richards, Director, Office of Compliance and Inspections, before the National Membership Meeting of the National Society of Compliance Professionals (Oct. 19, 2006) (emphasis added). Written remarks available at: <http://www.sec.gov/news/speech/2006/spch101906lar.htm>.

- c) In recent years, use of the examination program as a tool to identify matters for possible enforcement referral has grown. At the same time, the threshold as to the nature of conduct that should be the subject of an SEC enforcement action has been lowered, and actions have been brought in situations where non-intentional violations have resulted in losses to fund investors, notwithstanding the absence of fraud or any intent to harm investors.¹⁶

3) The Advisers Act Compliance Rule

Rule 206(4)-7 under the Advisers Act requires a registered adviser to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act by the adviser or any of its supervised persons. Under the Rule, registered advisers must review, no less frequently than annually, the adequacy of their compliance policies and procedures and the effectiveness of their implementation. Rule 206(4)-7 also requires an adviser to designate an individual (who is a supervised person of the adviser) to be responsible for administering the adviser's compliance policies and procedures (*i.e.*, a chief compliance officer).

- a) Taken together, the requirements of Rule 206(4)-7 and the SEC's examination program make it imperative that a registered adviser maintain and update, as needed, a compliance program that appropriately addresses: new regulatory requirements; regulatory developments; and compliance risks associated with new products or services offered by the adviser.
- b) Although hedge fund manager that are not SEC registered are not subject to Rule 206(4)-7 or the SEC examination program, it is nonetheless important that such advisers implement compliance programs.
 - i) The SEC has authority to bring enforcement actions against unregistered advisers, including actions based on an adviser's failure to reasonably supervise, with a view to preventing violations of the federal securities laws by, another person if such other person is subject to the adviser's supervision.¹⁷
 - ii) An important available defense to a claim that an adviser has failed to supervise its personnel is that the adviser established procedures, and a system for applying those procedures, which would reasonably be expected to prevent and detect, insofar as reasonably practicable, violations by such personnel, and has reasonably discharged the duties imposed under those procedures and system without reasonable cause to believe that they were not being complied with.
 - iii) Relying on this authority, in 2003, the SEC brought its first enforcement action against a principal of an unregistered adviser based on a failure to supervise.¹⁸
- c) Now that Rule 206(4)-7 has been in effect for over two years, the SEC staff is interested in how advisers have conducted annual reviews of their compliance programs. The staff believes that advisers must be able to demonstrate that they have conducted meaningful annual reviews in a manner consistent with the requirements of the Rule.
 - i) Rule 206(4)-7 does not require a written report regarding the annual review. However, Rule 204-2(a)(17)(ii) under the Advisers Act requires an adviser to maintain any records documenting the annual reviews of its compliance policies and procedures. Such records

¹⁶ *In the Matter of Bridgeway Capital Management, Inc.*, Release No. IA-2294 (September 15, 2004) (violation of Section 205(3) of the Advisers Act based on use of improper method to compute mutual fund performance-based advisory fee).

¹⁷ Section 203(e)(6) and Section 203(f) of the Advisers Act.

¹⁸ *In the Matter of Robert T. Littell and Wilfred Meckel*, Release No. IA-2203 (December 15, 2003) (principal of unregistered investment adviser sanctioned for failing to supervise associated personnel of the adviser who violated various antifraud provisions of the federal securities laws).

could include the report on the annual review, as well as all work papers, testing procedures and other documents relating to the review process, its findings and its recommendations.

- ii) If an adviser has not prepared a written report that fully summarizes the annual review process and the findings and recommendations of the review, it is likely that SEC examination staff will ask to see various documents relating to the review process in order to determine whether the kind of annual review contemplated by Rule 206(4)-7 was conducted.

4) Creating and Maintaining an Effective Compliance Program

Given the requirements of Rule 206(4)-7 and the prospect of SEC examinations, it is essential that registered advisers implement comprehensive compliance programs that are tailored to their operations and the particular risks of their businesses. The requirement that advisers conduct annual reviews of their compliance programs, which must include a review of the adequacy of the programs and the effectiveness of their implementation, means that an important part of any compliance program is to establish a process for identifying new areas of risk and new regulatory requirements that need to be addressed and to revise compliance procedures accordingly.

- a) In a speech before the National Society of Compliance Professionals,¹⁹ Lori Richards, Director of the SEC's Office of Compliance and Inspections, outlined the key components of an effective compliance program.
 - i) Oversight of Compliance: Senior management must set a "tone at the top" and communicate the expectation that personnel will act ethically and in a manner consistent with the adviser's fiduciary and legal obligations. The actions of management should make clear that non-compliance will not be tolerated (e.g., violations should be dealt with promptly and in a meaningful way).
 - ii) Standards, Policies and Procedures: A firm should have a code of ethics or code of conduct, and operating and compliance policies and procedures that implement those standards.
 - iii) Exercise Due Diligence in Delegating Responsibilities: Significant compliance monitoring responsibilities should not be delegated to individuals who have engaged in misconduct or conduct inconsistent with an effective compliance and ethics program. The specific responsibilities of particular individuals with respect to monitoring compliance should be clearly defined.²⁰ Compliance should be incorporated in employee evaluation standards and be a factor that is considered in setting compensation.
 - iv) Communication, Education and Training: A firm should ensure that its personnel clearly understand their obligations under the firm's compliance policies and procedures; particularly, those persons who have specific responsibilities under the firm's procedures.
 - v) Monitoring and Auditing: Compliance procedures should include processes to detect violations. These may include surveillance, exception reporting, hotlines to report violations and internal audit departments. Greater use of technology to automate compliance monitoring may be an effective way to identify problems and to simplify the process of reviewing large amounts of data. Testing procedures should be used, either as part of the annual review process or on an ongoing basis, to assess whether compliance procedures are working as intended.
 - vi) Enforcement and Discipline: A firm should encourage compliant actions and appropriately sanction non-compliant actions. Immediate action should be taken to discipline personnel

¹⁹ See note 15, *supra*.

²⁰ One effective practice to help assure proper delegation is the use of a responsibility matrix that assigns particular compliance related responsibilities to specific persons. The matrix should be kept up to date and procedures should be implemented to assure that personnel are performing their assigned responsibilities.

who engage in intentional violation of the law. Problems should be dealt with quickly and appropriately through discipline, disgorgement of profits, and amendments to existing policies and, if appropriate, by notifying regulators or making a public announcement.

- vii) Response, Prevention and Evaluation: A firm must respond to indications of problems and periodically assess its compliance program to ensure that compliance risks are being effectively addressed.
- b) A risk assessment process should be implemented to assure that new legal requirements and risks are identified and appropriately addressed in a firm's compliance procedures.
- i) In adopting Rule 206(4)-7, the SEC noted that: "[e]ach adviser, in designing its policies and procedures, should first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures that address those risks."²¹
- ii) With respect to the required annual review of compliance programs, the SEC noted that: "the review should consider any compliance matters that arose during the previous year, any changes in the business activities of the adviser or its affiliates, and any changes in the Advisers Act or applicable regulations that might suggest a need to revise the policies or procedures."²²
- c) In developing a risk assessment program, the following points should be considered:
- i) An inventory of risks needs to be created and those risks should be "mapped" to the firm's compliance procedures to assure that there are procedures that deal with the risks that have been identified. Checklists may be used as part of this process. However, as the SEC staff has noted, every firm has "unique risk exposures due to its personnel, business model, structure, or affiliations. If these exposures are not widely shared by your peers, they may not appear on a checklist."²³
- ii) A review to identify and inventory conflicts that have the potential to be a source of compliance issues.
- iii) The effectiveness of a firm's compliance procedures should be tested by utilizing transactional, forensic and periodic testing. Some firms make use of third-party service providers to gauge the firm's culture of compliance and to identify areas where revised or additional procedures may be needed.
- iv) Compliance procedures should be amended, as needed, to incorporate procedures to assure compliance with newly adopted regulatory requirements.
- v) New products and changes in organizational structure can give rise to new types of risks and additional regulatory requirements that need to be identified and addressed.
- vi) Careful attention should be paid to announcements of enforcement actions against other firms (and news reports and other disclosures of pending investigations of other firms). If the issues associated with them are relevant to your firm's operations, they need to be addressed in your firm's compliance procedures. Similarly, no-action and interpretive letters issued by

²¹ Release No. IA-2204 (December 17, 2003).

²² *Id.*

²³ Remarks of John H. Walsh, Associate Director and Chief Counsel, Office of Compliance and Inspections, before the NRS 21st Annual Spring Compliance Conference (April 18, 2006). Written remarks available at: <http://www.sec.gov/news/speech/2006/spch041806jhw.htm>.

the SEC staff and speeches of SEC staff should be used to spot emerging issues and areas of regulatory concern.

- vii) It is important to implement new or amend existing procedures to prevent compliance deficiencies that come to light as a result of the annual review of compliance programs or SEC deficiency letters. An enforcement action, which included a finding of violation of Rule 206(4)-7, was brought against an advisory firm that failed to implement new procedures after an SEC examination revealed the firm was including inaccurate information in its responses to requests for proposals ("RFPs").²⁴
- viii) The process and responsibilities for risk assessment should be formalized to be part of a firm's compliance program and should include the involvement of appropriate investment, accounting, marketing and operations personnel (and not just legal and compliance personnel). Some firms have established risk assessment committees to assume responsibility for assuring that their compliance procedures are updated as may be required by both internal and external developments.

5) Key Compliance Issues for 2007

Regulatory developments during 2006 provide helpful guidance in identifying areas that will likely be the focus in SEC staff examinations of hedge fund managers this coming year. In addition, recent statements by the SEC staff have noted specific issues relating to hedge funds that will be reviewed in SEC examinations.²⁵ Hedge fund managers that are registered with the SEC should review their compliance procedures to assure that these areas and issues, to the extent relevant, are addressed.

- a) Side-by-Side Management: Some hedge fund managers also serve as advisers to other accounts, including mutual funds and other "long only" accounts, that do not pay performance fees (or performance-based incentive allocations). In these situations, there are conflicts that create incentives for a manager to favor its hedge funds over other clients in allocating trades.
 - i) The staff intends to focus on whether appropriate controls and procedures are in place to address these conflicts and on whether the manager has favored its hedge funds in allocating trades.
 - ii) Hedge fund managers that also manage non-performance fee paying accounts should review their trade allocation procedures to assure that the full range of potential conflicts are addressed. They should also periodically review allocations to determine that, in practice, all clients have been fairly treated.
 - iii) Potential conflicts in trade allocations may also arise if a firm manages proprietary accounts (or if the amount of proprietary capital in different funds varies) and should also be addressed in trade allocation procedures.
- b) Side Letters: Hedge fund managers sometimes enter into "side letter" agreements that provide certain investors preferential terms or rights that are not given to all investors in a fund. Some types of side letter provisions are not of concern to the SEC staff (e.g., rights relating to "capacity" or agreements to charge lower management fees or incentive allocations). However, the staff believes that other types of provisions can raise troubling conflicts (e.g., provisions that give certain investors enhanced liquidity rights or transparency to portfolio holdings).
 - i) The staff has said that it will focus on whether appropriate disclosure of these arrangements and the related conflicts are being made to investors.

²⁴ *In the Matter of CapitalWorks Investment Partners, LLC*, Release No. IA-2520 (June 6, 2006).

²⁵ Testimony of Susan Ferris Wyderko, note 3, *supra*, and also "As hedge fund industry awaits further regulation, SEC official lists exam focus areas." *IA Week*, October 16, 2006 (reporting comments of Thomas Biolsi, Associate Regional Director for Examinations, Northeast Regional Office of the SEC).

- ii) Hedge fund managers should review existing disclosures relating to side letters to assure that conflicts are properly disclosed and should implement procedures to assure that any new side letters do not require additional disclosures.²⁶
 - iii) It should be recognized that side letters relating to capacity and lower fees may create conflicts that should be disclosed to investors and, in addition, that certain side letter provisions may raise issues that cannot be cured simply by means of disclosure.
- c) Information Sharing with Other Firms: Professional and personal relationships among investment professionals at different firms may lend themselves to a sharing of trading information and investment ideas between different advisory firms or provide a hedge fund manager access to information that might not generally be available to others. The SEC staff is concerned that relationships of these types pose a potential for front running of trades by another firm, trading on material non-public information and market manipulation.
- i) Relationships that appear to be of interest to the staff include: portfolio managers or analysts that are investors in hedge funds managed by other firms; and personal relationships with colleagues at other hedge fund management firms or at brokerage firms or investment banks.
 - ii) The SEC staff will expect advisers to identify these types of relationships involving their personnel and to adopt policies and procedures to address related compliance risks. In addition to insider trading policies prohibiting the use of material non-public information, an adviser should include provisions in its code of ethics or its business conduct code prohibiting its personnel from disclosing portfolio positions and investment plans to personnel of other firms.
 - iii) Another focus of the SEC staff in this area will be on joint trading activities and whether there are any agreements to act as a "group," within the meaning of Section 13(d)(3) of the Securities Exchange Act of 1934 (the "Exchange Act"), that have not been disclosed in a Form 13D.
- d) "Value Added" Investors: The SEC staff has expressed concern that investors in hedge funds who are affiliated with other hedge fund firms or are senior executives at public corporations may provide trading information relating to other funds or non-public information to the managers of the funds in which they invest, and that this information will then be used by those managers to earn profits to the detriment of other investors.²⁷
- i) Firms should have policies and procedures that are designed to prevent this type of trading.
 - ii) Given the staff's concerns about "value added" investors, it is possible that in connection with the examination of one firm that manages a fund in which a professional of another firm is an investor, the staff may want to obtain and review trading information of funds that are managed by the other firm to determine whether there was any abusive trading.
- e) Conflicts from Service Provider Relationships: The SEC staff said its examinations of hedge fund managers will focus on whether personnel of the managers have personal or other relationships with personnel at brokerage firms or other organizations that provide services to the manager's hedge funds, or financial interests in such firms, that create conflicts of interest. It will expect advisers to have policies and procedures requiring disclosure of relationships with service

²⁶ In March 2006, the U.K. Financial Services Authority (the "FSA") issued a Guidance Note under which FSA registered managers are required to disclose material terms of side letters.

²⁷ See, *SEC v. Michael K.C. Tom*, Release No. Lit-19729 (June 15, 2006) (consent to issuance of injunction based on insider trading where bank employee provided material non-public information about a planned acquisition by the bank to manager of hedge fund in which the employee and her husband were investors prior to public announcement of the acquisition).

provider firms and their personnel as well as policies relating to the receipt of gifts from service providers.

- i) Two recent SEC enforcement actions involved excessive gifts and entertainment given by a brokerage firm salesman to traders at a large mutual fund advisory firm that were intended to obtain more business from the traders.²⁸
 - ii) In the case of managers of hedge funds of funds, policies and procedures should be established to prohibit the "gate keepers" from receiving gifts or other forms of personal benefits from managers of the underlying hedge funds.
 - iii) Monitoring procedures should be established to identify conduct inconsistent with a firm's policies. For example, a significant increase in a firm's direction of trades to a specific broker should trigger a review and appropriate inquiries of personnel responsible for selecting brokerage firms for the execution of trades.
- f) Portfolio Valuation: The SEC staff will be looking at whether portfolio investments of hedge funds are valued in a manner consistent with applicable pricing guidelines and procedures, and the fairness of valuation procedures being used, in view of the conflict managers have to inflate values to increase their compensation.²⁹
- i) Compliance procedures should include monitoring of valuation of portfolio holdings; particularly in the case of "manually priced" investments such as private placements and derivatives.
 - ii) It has been reported that the SEC staff has been looking at the improper use of side pockets to conceal poorly performing investments and to increase performance compensation derived from non-side pocket investments.³⁰
 - iii) Managers of funds of funds need to consider how interests in side pockets of underlying hedge funds are being valued for purposes of valuing the assets of the funds of funds and whether their practices are consistent with applicable valuation policies.
- g) Fund Expenses: The SEC staff says it will look at disclosures relating to expenses that are "passed through" to hedge funds, including through the use of "soft dollars."
- i) The staff expects clear and complete disclosure of arrangements where a fund pays expenses of its manager either directly (e.g., paying travel costs associated with investment research) or indirectly (e.g., use of soft dollars for non-research services).
 - ii) Services that a hedge fund manager receives from a prime broker that are not brokerage or research services, as well as any benefits a manager receives from an administrator or other service provider to a fund, would be expenses of the type that should be disclosed.³¹

²⁸ *In the Matter of Jeffries & Co., Inc.*, Release No. 34-54861 (Dec. 1, 2006) and *In the Matter of Kevin W. Quinn*, Release No. 34-54862 (Dec. 1, 2006).

²⁹ Recent SEC actions relating to valuation include: *SEC v. Joseph W. Daniel*, Release No. Lit-19427 (October 13, 2005) (securities fraud action against hedge fund manager who failed to write down value of private placement investments) and *SEC v. Conrad P. Seghers*, Release Lit-19631 (March 30, 2006) (injunction against hedge fund manager who marketed fund without disclosing that assets of fund were overstated and that substantial losses had been incurred by fund investors).

³⁰ See, e.g., "The SEC Isn't Finished With Hedge Funds," *Business Week*, July 17, 2006.

³¹ See, e.g., *In the Matter of BISYS Fund Services Inc.*, Release No. IA-2554 (September 20, 2006) (administrator of mutual funds that agreed to pay expenses of the funds' advisers was found, among other things, to

- iii) The SEC barred a hedge fund manager from association with any investment adviser based upon the manager's guilty plea to a criminal indictment alleging violations of the antifraud provisions of the Advisers Act resulting from the failure to disclose arrangements under which companies in which the fund invested agreed to issue stock to the manager or to pay personal expenses of the manager.³²
 - iv) Any directed brokerage arrangements where a hedge fund manager directs a fund's trades to brokers who sell interests in the fund should be fully disclosed.
- h) Use of Soft Dollars: In 2006, the SEC issued revised guidance relating to the use of "soft dollars," interpreting the scope of the safe harbor provided by Section 28(e) of the Exchange Act for the use of client brokerage commissions to obtain brokerage and research services.³³ Generally, Section 28(e) provides that a money manager will not be deemed to have acted unlawfully or to have breached any fiduciary duty under state or federal law solely by reason of having caused a client account to pay a broker a commission for effecting a securities transaction in excess of the commission another broker would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by executing broker. In general, the new guidance narrows the scope of brokerage and research services that fall within the safe harbor, but expands the availability of the safe harbor to third-party research services.
- i) Services constituting research are limited to: (i) advice regarding the value of securities, the advisability of investing in, purchasing or selling securities; and (ii) analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy and the performance of accounts. Services considered outside the safe harbor include: mass-market publications of general circulation; tangible products and services, such as travel, entertainment and meals associated with attending seminars; overhead items, such as office equipment, furniture, rent, business supplies, salaries, membership dues, professional licensing fees and software to assist with administrative functions, and the cost of computer hardware and delivery mechanisms associated with the delivery of research.
 - ii) Brokerage services include those products and services that relate to the execution of a trade from the point at which the money manager communicates with the broker for purposes of transmitting an order for execution, through the point at which funds or securities are delivered or credited to the advised account. Connectivity services (e.g., a dedicated line to a broker or settling custodian) and trading software used in routing trades are considered to be brokerage services. However, hardware (such as computers and telephones), software used for recordkeeping or administrative purposes, and software used to test hypothetical situations are not considered to be brokerage services. Also outside the safe harbor are products and services used for compliance testing, trade financing, error correction, and custody and recordkeeping services provided after the settlement of transactions.
 - iii) Soft dollar arrangements and compliance policies and procedures relating to the use of soft dollars should be reviewed and revised as necessary to conform to the new SEC guidance on Section 28(e). (The compliance date is January 24, 2007.)

have aided and abetted violations of the antifraud provisions of the Advisers Act under circumstances where the arrangements were not disclosed to independent directors of the funds or fund investors).

³² *In the Matter of Vincent Montagna*, Release No. IA-2551 (September 22, 2006). *See also, In the Matter of James A. DeMatteo*, Release No. IA-2556 (September 26, 2006) (president of mutual fund advisory firm barred from association with any investment adviser based on submission of inflated and fictitious third-party invoices, and submission of invoices for services provided to the fund adviser, to fund administrator as part of fraudulent scheme in which fund assets were used to pay salaries, rent and other expenses of the adviser).

³³ Release No. 34-54165 (July 18, 2006) (Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Exchange Act).

- i) Insider Trading: The SEC staff has also indicated that one focus of examinations of hedge fund managers will be on trading activities and whether there has been trading on material non-public information.
 - i) During 2006, there were a number of enforcement actions relating to insider trading by hedge funds,³⁴ and insider trading by hedge funds "remains a substantial concern" and a "significant focus" of the SEC's enforcement efforts.³⁵
 - ii) The retention of consultants (including "match" services) to provide information regarding products, industries or issuers or to provide scientific or other expertise that may be useful in making its investment decisions can create the potential for trading on material non-public information. Policies should be developed that govern contacts with consultants to help assure that consultants do not provide material non-public information and to avoid any improper use of information obtained from consultants.
- j) Marketing Materials: The SEC staff can be expected to focus on marketing materials used in offering hedge funds and, in particular, whether statements in those materials are consistent with the funds' investment programs and with disclosures made in the funds' offering memoranda.
 - i) An effective compliance program should include procedures to assure pre-use review and approval of all marketing materials. These procedures should apply to all materials sent or made available to investors or prospective investors.
 - ii) Responses to RFPs and due diligence questionnaires and information provided to database services should also be included within the types of marketing materials subject to review and approval. In 2006, the SEC brought enforcement actions against advisers that made inaccurate statements in response to RFPs and provided false information to database services.³⁶
 - iii) Although hedge fund managers that registered with the SEC because of the Registration Rule are not required to maintain records that form the basis of or demonstrate the calculation of performance prior to February 10, 2005,³⁷ the SEC staff may nonetheless scrutinize how a fund's investment performance for periods prior to its manager's registration has been computed.

³⁴ See, e.g., *SEC v. Nelson J. Obus*, Release No. Lit-19667 (April 25, 2006) (complaint alleging trading in advance of public announcement of merger agreement); *SEC v. Deephaven Capital Management, LLC*, Release No. Lit-19683 (May 2, 2006) (hedge fund and its portfolio manager consent to injunction based on short sales of stock of issuers prior to public announcement of PIPE deals by the issuers); and *SEC v. Langley Partners, L.P.*, Release No. Lit-19607 (March 14, 2006) (same).

³⁵ Testimony of Linda Chatman Thomsen, Director, Division of Enforcement, before the U.S. Senate Committee on the Judiciary, December 6, 2006. Written testimony available at: <http://www.sec.gov/news/testimony/2006/ts1205061ct.pdf>.

³⁶ *In the Matter of CapitalWorks Investment Partners, LLC*, Release No. IA-2520 (June 6, 2006) (false and misleading responses to RFPs were found to be violation of antifraud provisions of the Advisers Act) and *In the Matter of Warwick Capital Management, Inc.*, Release No. IA-2530 (July 6, 2006) (adviser distributed false and misleading information regarding its assets under management, number of clients, investment performance and other matters through third-party subscription service).

³⁷ See, Letter to Subcommittee on Private Investment Entities of the American Bar Association (pub. avail. August 10, 2006).

Presentation



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