

# Spotlight on Compliance: Key Issues for 2008

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# About the Speakers

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Marc Elovitz is a partner in the Investment Management and Litigation Groups at Schulte Roth & Zabel LLP. His area of concentration is regulatory compliance and enforcement.

Marc counsels clients on securities law matters including registration and compliance under the Investment Advisers Act of 1940. He also represents advisers in SEC examinations, investigations and enforcement proceedings. Marc advises clients with respect to insider trading, market manipulation and anti-money laundering. His litigation practice has included representing clients in civil and regulatory matters through discovery and trial, including defending securities class actions, fraud claims, and accounting and professional liability claims.

A 1990 graduate of New York University School of Law, Marc is a member of the American Bar Association's Litigation Section and the New York City Bar Association. He is a former adjunct professor at Rutgers University School of Law and has written extensively in the areas of securities regulation, market manipulation and Investment Advisers Act compliance. He speaks regularly on securities law issues and conducts securities law compliance training for a wide range of financial institutions.



## Udi Grofman

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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 formation of funds and management companies, and on compliance and trading matters.

Udi's experience includes:

- Structuring and organizing domestic and offshore private investment funds, including hedge funds, hybrid funds and funds 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
- 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.



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Christopher Hilditch is a partner in the Investment Management Group at Schulte Roth & Zabel LLP in London. His practice focuses on the formation and operation of hedge funds and other investment funds, joint ventures and various other corporate transactions.

Chris is a graduate of the College of Law, Guildford. He received his M.A., with honors, from Pembroke College, Oxford University. He is a regular speaker at industry conferences and is active in several industry committees, including the Alternative Investment Management Association's Sound Practices Committee.

Chris was named one of the leading hedge fund lawyers in London by *Legal 500* and is also listed in *The International Who's Who of Private Fund Lawyers*, *Who's Who of Professionals*, *Chambers and Partners* and the *PLC Cross Border Investment Funds Handbook*.



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Kelli Moll is a partner in the Investment Management Group at Schulte Roth & Zabel LLP. Her areas of concentration include the formation and ongoing operation of hedge funds and private equity funds, and counseling investment advisers.

Kelli represents numerous hedge funds and their managers in connection with formation, compensation and vesting arrangements for employees, spin-offs of proprietary trading groups, acquisition of trading groups, seed capital arrangements and private equity co-investments.

Kelli is a 1989 graduate of the University of Illinois at Urbana-Champaign, where she received a B.A. in finance. She received her law degree in 1993 from Loyola University of Chicago, where she was a staff editor of *The Business Lawyer* and case editor of the *Loyola Consumer Law Reporter*.

Kelli lectures extensively on hedge funds. She delivered a presentation on "The Regulation of Hedge Funds" for the Investment Management Institute, lectured on "Establishing a Framework of Internal Policies, Practices, and Controls" for the American Conference Institute and has spoken at numerous firm-sponsored seminars. She has also written extensively on a variety of issues affecting hedge funds and their managers.

# Outline



## Spotlight on Compliance: Key Issues for 2008

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### 1) Background and Current Regulatory Environment

Over the past year, considerable attention has been paid to matters relating to the regulation of hedge funds. The intense regulatory focus on hedge funds is the result of pressure on the SEC and other regulators by Congress and the media to find and pursue instances of misconduct by hedge funds.

- a) The Director of the SEC's Division of Enforcement, Linda Chatman Thomsen, gave a speech at the 9th Annual Investment Advisor Compliance Best Practices Summit on March 22, 2007, highlighting the commission's enforcement agenda with respect to hedge funds. She explained that the SEC is "following the money" and finding more and more instances of wrongdoing by hedge fund managers, including fraudulent valuations, false or misleading investor communications and trading violations. She noted an increasing number of hedge fund managers who do not start out intending to commit fraud, but later find themselves facing losses and try to avoid massive redemptions. Director Thomsen also noted that her "pet peeve" is managers who turn a blind eye to how their big producers are making money.
- b) A record number of insider-trading cases involving hedge funds were brought in 2007, many involving personal trading by hedge fund employees and their spouses and family members. A significant number of cases against hedge funds also were brought alleging violations of short-selling and market-manipulation rules, including in the context of PIPEs and secondary offerings of public securities.
- c) SEC Chairman Cox announced on July 31, 2007, that the SEC had formed a Hedge Fund Task Force comprised of personnel from various SEC divisions. On December 4, 2007, he announced the launch of a new computer system at the SEC called "The Hub" which will provide easy access by SEC personnel to data and information regarding the more than 30,000 SEC enforcement investigations.
- d) *SEC Examination Program.* The SEC's Office of Compliance Examinations and Inspections ("OCIE") stepped up its investment advisers examination program in 2007. Most notably, the SEC's New York Regional Office implemented, on a "pilot program" basis, an extremely broad request letter in its investment adviser examinations. Major areas of focus in the 27-page letter included: insider trading, conflicts of interest, performance marketing and compliance reporting.
- e) New SEC Rules:
  - i) *New Anti-Fraud Rule.* On August 3, 2007, the SEC issued a release adopting the investment adviser anti-fraud rule it had proposed on December 27, 2006, in the wake of the *Goldstein* decision invalidating the SEC's hedge fund adviser registration rule. The new anti-fraud rule—Rule 206(4)-8—became effective as of September 10, 2007, and makes 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 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.” Rule 206(4)-8 applies to both registered and unregistered investment advisers, and only requires the SEC to show negligent—not intentional—misconduct.

- ii) *New Short-Selling Rule.* The SEC also finalized its new version of Rule 105 of Regulation M, governing short-selling in connection with a secondary offering of securities. The old Rule 105 prohibited a person from covering a short sale effected during the restricted period (typically five days prior to the offering) with securities purchased in the offering. In recent years, the SEC has charged more than a dozen hedge fund managers with violating Rule 105, including several for engaging in so-called “sham transactions” designed to evade Rule 105. The amendments to Rule 105 adopted on August 6, 2007, are intended to create a bright line rule providing that a person can either short an equity security in the restricted period, or purchase shares in the offering, but not do both. In adopting the amendments, however, the SEC included exceptions which make the rule less than clear. For example, the SEC indicated that “separate accounts” at the same firm may be treated as separate persons for purposes of Rule 105, but suggested that there may be a heavy burden to show that different accounts at the same firm should be treated as separate.
- iii) *Changes to Reg SHO.* Effective July 6, 2007, the SEC repealed Rule 10a-1 and amended Regulation SHO to eliminate any price test that prohibits short-selling in a “down” market. The SEC also took additional steps to end instances of “naked shorting” in the market.
- f) *Industry Best Practices.* There were significant efforts in 2007 to articulate hedge fund industry best practices standards:
  - i) In November 2007, the Managed Funds Association published a new edition of its “Sound Practices for Hedge Fund Managers.” It included an updated and expanded section on valuation.
  - ii) The Alternative Investment Management Association (AIMA) updated its 2005 research on hedge fund valuation issues in a March 2007 publication titled “AIMA’s Guide to Sound Practices for Hedge Fund Valuation.”
  - iii) The International Organization of Securities Commissions (“IOSCO”) released a Consultation Report in March 2007 titled “Principles for the Valuation of Hedge Fund Portfolios.”
  - iv) The U.K. Hedge Fund Working Group was launched on June 19, 2007 to review existing standards in the hedge fund industry and make recommendations for strengthening those standards where appropriate. A Consultation Paper was released on October 9, 2007, and the final report is expected mid-January 2008.
  - v) The President’s Working Group (“PWG”) on Financial Markets released a set of principles and guidelines on February 22, 2007, to guide U.S. financial regulators as they address public policy issues associated with the rapid growth of private pools of capital, including hedge funds. The agreement among the PWG and U.S. agency principals will serve as a framework for evaluating market developments and specifically concentrates on investor protection and systemic risk concerns.
  - vi) On September 25, 2007, the PWG announced the formation of two private-sector committees to create and publicly release best practices standards so market participants may enhance investor protection and systemic risk safeguards consistent with the PWG principles and guidelines. One committee is comprised of asset managers and the other of investors.

- g) In Europe, the Markets in Financial Instruments Directive (“MiFID”)<sup>1</sup> came into force on November 1, 2007. While not all European Union Member States have fully implemented MiFID, the U.K. has done so. To a large degree, implementation has been achieved by amending existing rules and the issue of new rules. In particular, the U.K. Financial Services Authority (“FSA”) issued a New Conduct of Business Sourcebook (NEWCOBS), which came into effect on November 1, 2007. Hedge fund managers operating from the United Kingdom are subject to MiFID. Key changes relate to Best Execution, Order Execution Policies and Conflicts of Interest. In practice, however, many U.K.-based hedge fund managers are not that affected given that the FSA (in contrast to other European regulatory authorities) already had equivalent provisions to a number of MiFID requirements.

## 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:<sup>2</sup>
- i) *Cause examinations.* These 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.”<sup>3</sup>
  - ii) *Sweep examinations.* These are special reviews that focus on a single issue.
  - iii) *Routine examinations.* These 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.<sup>4</sup> The staff classifies advisers as belonging to one of 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. Three factors are used to determine an adviser’s risk profile. They are:
- i) The adviser’s assets under management;
  - ii) The adviser’s Form ADV responses; and

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<sup>1</sup> Directive 2004/39/EC on markets in financial instruments.

<sup>2</sup> 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>.

<sup>3</sup> 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>.

<sup>4</sup> *Id.*

iii) The strength or weakness of the compliance environment of the adviser.<sup>5</sup>

- 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.<sup>6</sup>
- d) In the summer of 2007, the examination staff in the SEC's New York Regional Office began a pilot program using a new and expanded form of request letter in connection with its periodic examinations of registered investment advisers (the "Request Letter"). The SEC's New York Regional Office generally provides a copy of the Request Letter to the adviser two weeks prior to the start of the examination, and asks that the adviser have available the requested documents or information to the examination staff at the outset of the examination. The Request Letter used by the New York Regional Office has varied over the past several years. The most recent version requests several new categories of information that are noteworthy, focusing in particular on insider trading, information sharing (between investors, hedge fund managers, brokers, etc.), conflicts of interest and performance marketing.
- e) At a conference on December 7, 2007, OCIE Chief Counsel John Walsh indicated that a new nationwide standard examination request letter is being developed which will differ from the much-discussed 27-page letter being used by the New York Regional Office. Walsh indicated that the new standard OCIE letter will be shorter and will eliminate some of the more controversial items from the 27-page letter. At the same time, he suggested that firms use the 27-page letter as a resource when evaluating how they seek to prevent and detect the misuse of material non-public information.

### 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.

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<sup>5</sup> "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>.

<sup>6</sup> *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).

- b) Although hedge fund managers 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 toward preventing violations of the federal securities laws by another person if such other person is subject to the adviser's supervision.<sup>7</sup>
  - ii) An important available defense to a claim that an adviser has failed to supervise its personnel is that the adviser has established procedures, and a system for applying those procedures, that reasonably would 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.<sup>8</sup>
- c) Now that Rule 206(4)-7 has been in effect for over three 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 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, including 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) *SEC's CCO Outreach Program.* The SEC's Office of Compliance Inspections and Examinations holds a national seminar annually at SEC headquarters in Washington, DC, to reach out to Investment Adviser CCOs and cover various broad topics applicable to many firms. The seminar consists of panel discussions among SEC staff

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<sup>7</sup> Section 203(e)(6) and Section 203(f) of the Advisers Act.

<sup>8</sup> *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).

and CCOs. SEC participants include staff from the Division of Investment Management and the Office of Compliance Inspections and Examinations, and examiners from various regional offices. Topics include: annual compliance reviews, common examination areas and lessons learned from sweep exams.

- b) *SEC Guide for Newly-Registered Advisers*. On July 24, 2007, the SEC's Division of Investment Management and Office of Compliance Inspections and Examinations came out with a guide for recently registered investment advisers. According to the SEC, approximately 30 percent of all registered investment advisers became registered since January 2005. The guide identifies many of the important compliance areas, including fiduciary duties, Form ADV and other filings, code of ethics, best execution and books and records requirements. Because it provides a general overview of these areas, the guide will likely be the starting point of the analysis of most issues. The guide is available on the SEC's website at <http://www.sec.gov/divisions/investment/advoverview.htm>.
- c) *SEC Compliance Alert*. The SEC's Office of Compliance Inspections and Examinations published its first "Compliance Alert" in June 2007 in the form of a letter to chief compliance officers. The letter describes issues recently reviewed by SEC examination staff—such as performance advertising and disaster recovery plans—and encourages firms to implement improvements in these areas. With respect to performance advertising, the SEC found a lack of policies and procedures governing marketing and performance advertising, or ineffective policies and procedures. With respect to disaster-recovery plans, the experience of advisers in Louisiana and Mississippi after Hurricane Katrina is used as a case study on the effectiveness of such plans. Critical recovery plan components were alternate communication protocols, a pre-arranged remote location for short-term and possible long-term use, and remote access to business records. The Compliance Alert also includes topics of particular interest to mutual funds and broker dealers. The alert is available at <http://www.sec.gov/about/offices/ocie/complialert.htm>.
- d) In a speech before the National Society of Compliance Professionals,<sup>9</sup> 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.<sup>10</sup> Compliance should be incorporated in employee evaluation standards and be a factor that is considered in setting compensation.

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<sup>9</sup> See note 15, *supra*.

<sup>10</sup> 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.

- iv) *Communication, Education and Training*: A firm should ensure that obligations under the firm's compliance policies and procedures are clearly understood by its personnel and particularly by 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 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.
- e) 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."<sup>11</sup>
  - 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."<sup>12</sup>
- f) 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."<sup>13</sup>

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<sup>11</sup> Release No. IA-2204 (December 17, 2003).

<sup>12</sup> *Id.*

<sup>13</sup> 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>.

- 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 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").<sup>14</sup>
- 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 2008

Regulatory developments during 2007 provide helpful guidance in identifying areas that will likely be the focus of (1) SEC staff examinations of hedge fund managers this coming year and (2) SEC enforcement activity with respect to both registered and unregistered hedge fund managers.

- a) *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) Rule 206(4)-8 gives the SEC authority to bring enforcement actions against registered and unregistered advisers to pooled investment vehicles (e.g., hedge funds and private equity funds) for material misstatements and omissions in offering memoranda, pitch books and other marketing materials.

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<sup>14</sup> *In the Matter of CapitalWorks Investment Partners, LLC*, Release No. IA-2520 (June 6, 2006).

- ii) Performance information included in marketing materials should be carefully reviewed and footnoted, where appropriate, to provide full disclosure of the limitations of such information.
  - 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,<sup>15</sup> the SEC staff may nonetheless scrutinize how a fund's investment performance for periods prior to its manager's registration has been computed.
  - iv) 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.
  - v) 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.<sup>16</sup>
- b) *Insider Trading*: The SEC staff will continue to focus on trading activities of hedge funds and whether there has been trading on material non-public information. The SEC expects compliance officers to analyze where material non-public information may enter into their organization and how it will be addressed (e.g., restricted lists, information barriers). Communications between investors, hedge fund managers and brokers are a particular focus of scrutiny.
- i) During 2007, there were a number of enforcement actions relating to insider trading by hedge funds,<sup>17</sup> and insider trading by hedge funds "remains a substantial concern" and a "significant focus" of the SEC's enforcement efforts.<sup>18</sup>
  - 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.
- c) *Conflicts of Interest*
- i) *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

<sup>15</sup> See, Letter to Subcommittee on Private Investment Entities of the American Bar Association (pub. avail. August 10, 2006).

<sup>16</sup> *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).

<sup>17</sup> 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).

<sup>18</sup> 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/ts120506lct.pdf>.

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. 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.

Similar conflicts could arise in situations where a hedge fund manager may be biased to favor certain hedge funds it manages based on the composition of investors in these funds (e.g., if the principals are invested more heavily in certain of the funds that the firm manages). Managers should consider disclosing this conflict to their investors and address it in their allocation procedures.

- ii) *Proprietary Accounts.* 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.
- iii) *Conflicts in Trading Strategies. Across Advisory Clients.* When managing accounts with different mandates, special attention should be paid to conflicts arising out of the trading activities of the different accounts. Such conflicts may arise in the event that two funds managed by the same adviser trade in opposite directions in the same security (e.g., one is long a security and the other is short the same security) or are invested in different securities of the same issuer (e.g., one fund holds the senior debt and a different fund holds the junior debt of the same issuer).

Advisers managing accounts with different mandates should consider the instances in which their trading activities on behalf of such accounts may put them in a conflict position, how to minimize the occurrence of such conflicts, and how these conflicts should be resolved. Hedge fund managers should also disclose such conflicts to their investors.

- iv) *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.
  - (1) 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.
  - (2) 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.
  - (3) 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.
- v) *“Value Added” Investor.* 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.<sup>19</sup>

- (1) Firms should have policies and procedures that are designed to prevent this type of trading.
  - (2) 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.
  - (3) Consideration should be given as to whether "walls" should be put in place between marketing and investor relations personnel and portfolio managers, analysts and traders.
- vi) *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 provider firms and their personnel as well as policies relating to the receipt of gifts from service providers.
- (1) 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.<sup>20</sup>
  - (2) 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.
  - (3) 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.
- vii) *Employee Service as Directors and on Creditors Committees.* Certain strategies involve adviser personnel serving as directors of portfolio companies or as members of creditors committees. Serving in such roles presents two main challenges from a compliance standpoint. First, serving in such roles is likely to make the employee (and therefore, in most cases, also the adviser) privy to material non-public information, which in turn means that client accounts that do not benefit from the advisory personnel serving in such capacities are likely to be restricted from trading in the securities of same issuer. Second, advisory personnel who serve as directors of portfolio companies or creditors committees will have fiduciary duties in respect of such roles that may conflict with the duties owed to fund investors.

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<sup>19</sup> 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).

<sup>20</sup> *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).

viii) *Relationships with Seed Capital Providers.* Seed-capital relationships may create potential conflicts especially in the event that the seed provider has additional lines of business. The concern in such cases is that the manager would use client assets in order to compensate the seed capital provider for its seed investment by retaining the seed capital provider as a service provider (e.g., prime or executing broker, administrator) or purchase from it assets that it otherwise would not be purchasing (e.g., loan portfolios).

ix) *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).

(1) The staff has said that it will focus on whether appropriate disclosure of these arrangements and the related conflicts are being made to investors.

(2) 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.<sup>21</sup>

(3) 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.

x) *MiFID.* MiFID contains detailed requirements relating to the management of conflicts of interest. The new requirements sit alongside the FSA’s well-established high level Principle that “a firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.”<sup>22</sup> Further, the MiFID provisions do not supercede the general English law governing fiduciaries, which is applicable to investment managers and which broadly requires informed consent to conflicts of interest, rather than just effective management.

(1) The basic MiFID obligations can be summarized as follows:

(a) An investment manager must take all reasonable steps to identify and manage conflicts of interest between itself (including its officers, employees and tied agents and also members of its group) and its clients or between one client and another;<sup>23</sup>

(b) An investment manager must maintain and operate effective organizational and administrative arrangements with a view to taking all reasonable steps to prevent conflicts of interest from adversely affecting clients;<sup>24</sup> and

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<sup>21</sup> 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.

<sup>22</sup> FSA PRIN 2.1.1 R; the full text of the FSA Rules can be found at <http://www.fsa.gov.uk/pages/handbook>. This includes a “time traveler” function whereby it is possible to select a particular date to see what the rules were at that date. This is particularly useful for comparing the position pre and post MiFID.

<sup>23</sup> MiFID Article 18(1).

<sup>24</sup> MiFID Article 13(3).

- (c) Where the organizational or operational measures are insufficient to ensure, with a reasonable degree of confidence, that the conflict is negated, then the investment manager must disclose the conflict to the client.<sup>25</sup>
- (2) In summary, firms must identify and seek to manage conflicts and, if the conflict cannot be negated, disclose the existence. The requirement is just to take “reasonable steps.” What is reasonable will depend upon that nature of the relevant business as well as the size and organization of the firm.
- (3) The MiFID requirements have been implemented in the U.K. in the Senior Management Arrangements, System and Controls section of the FSA Handbook.<sup>26</sup> SYSC 10.1 R requires firms to identify and record conflicts. A firm must then establish, implement and maintain an effective conflicts of interest policy that is set out in writing and is appropriate to the size and organization of the firm and the nature, scale and complexity of its business.<sup>27</sup>
- (4) The conflicts of interest policy must (i) identify by reference to the specific services and activities carried out by the firm the circumstances which constitute or may give rise to a conflict of interest entailing a material risk of damage to the interests of one or more clients, and (ii) specify the procedures to be followed and measures to be adopted in order to manage such conflicts.<sup>28</sup>
- (5) In summary, the policy must:
- (a) Ensure that relevant persons engaged in different business activities involving a conflict of interest do so with an appropriate degree of independence;
  - (b) Prevent or control the exchange of information where such exchange may harm the interests of one or more clients;
  - (c) Where appropriate, ensure there is separate supervision of relevant persons engaged in different business activities involving a conflict of interest;
  - (d) Remove any direct link between the remuneration of relevant persons engaged in one business activity and the remuneration of, or revenues generated by, other relevant persons principally engaged in another activity involving a conflict of interest;
  - (e) Seek to prevent or limit any person from exercising inappropriate influence over the way in which a relevant person carries out services or duties; and
  - (f) Seek to prevent or control the simultaneous or sequential involvement of a relevant person in separate services or activities where such involvement may impair the proper management of conflicts of interest.
- (6) There is no requirement to provide the conflicts of interest policy to professional clients (which include hedge funds; investors in hedge funds are not clients for these purposes and so are not entitled to the policy).

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<sup>25</sup> MiFID Article 18(2).

<sup>26</sup> FSA SYSC 10—Conflicts of Interest.

<sup>27</sup> FSA SYSC 10.1.10 R.

<sup>28</sup> FSA SYSC 10.1.11 R.

- (7) Where actual or potential conflicts cannot be negated, then the general nature or source of the conflict (or both where appropriate) must be disclosed in sufficient detail so as to enable the client to make an informed decision. The disclosure must be made in a “durable medium” (*i.e.*, in writing).
- (8) In addition to the general provisions relating to conflicts of interest, the European Commission has also addressed the issue of inducements. While there is no definition of an inducement, it has been interpreted as meaning any fee or commission or non-monetary benefit paid to or provided to a firm. The regime has primarily been implemented in the UK in the Conduct of Business Sourcebook.<sup>29, 30</sup>
- (9) Firms may only give or receive inducements in three circumstances<sup>31</sup>:
- (a) Where the inducement is paid or provided to, or by, the client or a person on the client’s behalf (such as fees paid by the client, or commissions paid over to the client); or
  - (b) Where three conditions are met:
    - (i) the inducement does not impair compliance with the firm’s duty to act in the best interests of the client; and
    - (ii) the existence, nature and amount (or method of calculation thereof) is clearly disclosed to the client in a manner that is comprehensive, accurate and understandable, before the provision of the service (compliance with this requirement can be achieved by disclosing the essential arrangements in summary form and undertaking to provide additional details on request<sup>32</sup>); and
    - (iii) the inducement is designed to enhance the quality of the service to the client (it does not matter if it does not actually enhance, provided it is expected to at the time the arrangement is entered into); or
  - (c) Where the inducement is the payment of proper fees such as custody costs, exchange fees and the like which, by their nature, cannot give rise to conflicts with the firm’s duties to act honestly, fairly and professionally in accordance with the best interests of clients.
- (10) In May 2007, the Committee of European Securities Regulators (“CESR”), a Committee established, among other things, to facilitate implementation of community legislation, issued five recommendations on inducements.<sup>33</sup> These clarify the scope of the legislation and the aspects to be considered in determining whether or not the relevant conditions have been met. In particular, CESR considered that the following are among the factors that should be considered in determining whether an arrangement may be deemed to be designed to enhance the quality of the service provided to the client and not impair the duty to act in the best interests of the client:

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<sup>29</sup> FSA COBS 2.3

<sup>30</sup> Note that, in addition to the general rule on inducements, the FSA has specific provisions in relation to the use of dealing commissions which builds upon the rule on inducements. This is considered at section (f) below. Investment managers are required to comply with both the rule on inducements and the rule on use of dealing commissions.

<sup>31</sup> FSA COBS 2.3.1 R

<sup>32</sup> FSA COBS 2.3.2 R.

<sup>33</sup> CESR/07-228b – Inducements under MiFID—May 2007.

- (a) The nature of the service provided to the client (including any specific duties under the client agreement);
  - (b) The nature and extent of the expected benefit to the client and any expected benefit to the firm;
  - (c) Whether there will be an incentive for the firm to act other than in the best interests of the client and whether the incentive is likely to change the firm's behavior;
  - (d) The nature of the relationship between the firm and the entity receiving or providing the benefit; and
- xi) The nature of the inducement, the circumstances in which it is paid or provided and whether any conditions attach to it.
- d) *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.<sup>34</sup>
- i) The responsibility for which party (*i.e.*, the investment adviser or the administrator should be clearly delineated). If the administrator is valuing the portfolio holdings, periodic reviews should be made as to the administrator's procedures. Valuation procedures should be reviewed each time a new product or strategy is implemented to ensure that such procedures cover the types of investments in the new product and/or strategy.
  - ii) Consideration should be given as to whether valuation procedures describe when a security should, or would, be subject to fair value pricing. For example, when is a security so thinly traded that a fair value methodology should be employed.
  - iii) 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.<sup>35</sup> For investment advisers managing funds with side pockets, valuation procedures should address when investments would be transferred to a side pocket (*e.g.*, when is an investment so "hard to value" that it belongs in a side pocket) as well as when a side pocket may be "deemed realized" (*i.e.*, there is liquidity and pricing in the market such that the investment is moved out of the side pocket, but the investment has not been sold).
  - iv) For institutional investment advisers, a review should be conducted to ensure that the valuation of securities across advisory and proprietary accounts are consistent. If there are reasons for differences in the way a security is valued among accounts, those differences should be documented in the valuation procedures, or as exceptions to such procedures.
  - v) Many advisers are using outside appraisers to value illiquid investments. Outside appraisers may give positive assurance on the value of an illiquid investment (which means that such appraisers determine the value based on market data and

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<sup>34</sup> 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).

<sup>35</sup> See, *e.g.*, "The SEC Isn't Finished With Hedge Funds," *Business Week*, July 17, 2006.

its own methodology) or negative assurance (which means that the appraiser concurs with the investment adviser that the valuation being used is not an unreasonable one). Disclosure should be made to investors regarding the use of appraisers and the type of assurance given.

- vi) Compliance with Financial Accounting Standards Board Statement 157, *Fair Value Measurements* (“FAS 157”) is now mandatory. FAS 157 sets forth detailed valuation and disclosure requirements for financial statement reporting purposes. Certain key elements of FAS 157 are as follows:
- (1) FAS 157 states that fair value is a market-based measurement, with the value being based on those market participants that would have the highest and best use for the asset or liability.
  - (2) FAS 157 requires that the principal market be used to determine fair value (where a market exists). The principal market is the market with the largest volume and activity.
  - (3) FAS 157 creates a three-tier valuation hierarchy. An investment in tier one has a quoted price on an active market. An investment in tier two has market observable inputs that can be used to price such investment (e.g., by the use of matrix pricing). An investment in tier three has significant unobservable inputs that would need to be used to determine fair value (e.g., proprietary information is used to value such investment). Additional financial statement disclosure would be included for portfolio holdings under tier three.
  - (4) Under FAS 157, discounts can no longer be taken when valuing a large block of securities. The securities in such block must be valued at the quoted price.
  - (5) A single broker quote in a non-liquid security could be categorized in tier two if the broker stands willing to transact at such price. If, in such circumstance, the broker is only providing an indicative price, such security would be categorized in tier three. Investment advisers occasionally “test” valuations of non-liquid securities by selling a small portion of the portfolio position in the market.
  - (6) Under FAS 157, fund-of-funds are required to consider whether the net asset values provided by the underlying funds are “fair value.” If the underlying fund has limited liquidity (e.g., a long lock-up, a gate, side pockets and/or annual liquidity) consideration should be given as to whether a discount from net asset value is required.
- e) *Brokerage*: 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.<sup>36</sup>

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<sup>36</sup> 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 have aided and

- iii) 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.
- f) *Use of Soft Dollar.* 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.<sup>37</sup> 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).
  - iv) On May 31, 2007, SEC Chairman Cox surprised many in the investment community by making a speech in which he argued that the safe harbor for soft dollars should be eliminated. According to Chairman Cox, soft dollars "are as out of date as the Betamax, leisure suits and Welcome Back Kotter," and they encourage conflicts of interest by giving managers a means to cover costs the manager otherwise would pay out of its own pocket. This position was particularly surprising in light of the SEC's unanimously adopted July 2006 guidance on soft dollars which concluded that they were an acceptable use of client assets.

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betted 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).

<sup>37</sup> Release No. 34-54165 (July 18, 2006) (Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Exchange Act).

# Presentation



**SchulteRoth&Zabel**

17th Annual  
Private Investment Funds Seminar

Spotlight on Compliance:  
Key Issues for 2008

Marc Elovitz, Udi Grofman, Christopher Hilditch, Kelli Moll

Tuesday, January 15, 2008

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# **Insider Trading**

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# Conflicts

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