COMPLIANCE 101
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I. INTRODUCTION – INVESTMENT ADVISERS ARE FIDUCIARIES

The relationship between a registered investment adviser and its clients, and the obligations of the adviser in that relationship, is a fundamental consideration for the compliance function of the investment adviser. Thus, your challenge is to understand your firm's relationship with clients and identify those areas of your firm's business that present potential conflicts of interest between the firm, its principals, and employees on the one hand, and the firm's clients on the other. This requires an assessment of the risks facing the firm so that compliance policies, procedures and programs may be designed to avoid, or at least mitigate conflicts of interest and disclose such risks to clients. Your role as compliance officers is of paramount importance to your firm and protection of its investors. To perform your role, compliance officers must understand the fundamentals of the Investment Adviser Act of 1940 ("Advisers Act").

II. INVESTMENT ADVISER COMPLIANCE PROGRAMS

To assist in developing effective compliance programs, the Securities Exchange Commission ("SEC") adopted Rule 206(4)-7 of the Advisers Act, which requires investment advisers registered with the Commission to:

- Adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws;
- Review those policies and procedures annually for their adequacy and effectiveness of their implementation; and
- Designate a Chief Compliance Officer ("CCO") to be responsible for administering the policies and procedures.

A. Written Policies and Procedures

Firm policies and procedures provide the hallmark to a compliance program. They should be reasonably designed to prevent violations of the Advisers Act and the various SEC rules thereunder. In fulfilling this responsibility, the firm must implement a compliance system to which both management and all associates are committed fully and which has the effect of fostering a compliance oriented environment within the firm.

B. Testing Policies and Procedures: The Annual Review Program

The annual review of your firm's compliance policies and procedures is the best method to survey the compliance program and identify areas in which to improve. The SEC gives particular attention to risk-based approaches and seeks evidence of thorough reviews which identify gaps and corrects issues that are identified.

C. Role of the Chief Compliance Officer

Within an adviser's organizational framework, the CCO is responsible for:

- Identifying and resolving significant compliance issues that arise;
- Ensuring that the compliance policies and procedures are comprehensive and appropriate for the business model;
- Formulating control procedures to gauge the effectiveness of existing internal operational processes;
- Reviewing books and records to make certain that they are maintained for the requisite number of years;
- Identifying material weaknesses in policies and procedures and reporting significant compliance issues to senior management; and
- Conducting an annual review of compliance procedures and recommending policy changes as appropriate.

III. THE FUNDAMENTALS OF COMPLIANCE

For a Compliance Officer, understanding the fundamental processes of your business is crucial for proper compliance management. To advance your knowledge and achieve such comprehension:

- Learn About Your Firm;
- Understand Your Compliance Program; and
- Conduct an In-Depth Annual Review.

A. Learn About Your Firm

Begin by reviewing your firm's registration and business documents to gain a clear understanding of the products and service offerings available to your clients as well as any associated fees that are assessed. Next, ensure that these offerings are disclosed on the firm's registration and client documents. Focus on marketing materials, Forms ADV, and client agreements for details concerning material information regarding your organization, including any conflicts of interest.

Form ADV: Most typically, in accordance with the Advisers Act , an investment adviser is required to register with the Commission if the adviser has assets under management of $100 million or more in regulatory assets under management as reported under Item 5.F(2) of its Form ADV, or if it acts as an adviser to a registered investment company (among other considerations). Form ADV Part 1 is electronically submitted to the SEC, with annual updates thereafter, through the Investment Adviser Registration Depository

("IARD"). These filings are designed to provide the SEC and your clients with the most current information about your firm. Therefore, be sure that the firm maintains complete and current filings at all times.

Part 2 of Form ADV must be furnished to prospective clients prior to, or contemporaneously with, the signing of the Agreement with Adviser for advisory services. In addition, Form ADV Part 2 (the client's disclosure brochure), contains specific information about the adviser and its officers and associates who are engaged in the business of providing investment advice to clients, and must be offered to existing clients at least annually, with a record of the offer maintained by Adviser's CCO.

Advisory Client Agreements: Rule 205 of the Advisers Act does not require that agreements between an adviser and its clients be in writing. However, it should be the policy of Adviser that none of its advisory services will be performed unless a written agreement has been executed by the client and a principal of Adviser. If the adviser does enter into a written agreement with its clients, specific disclosures must be made: (1) whether compensation to the adviser is based on capital gains or appreciation in client's account; (2) The adviser's expressed prohibition against assignment of the contract for advisory services without consent of the client; and (3) Notification to the adviser's clients should any change occur in adviser's partnership structure.

B. Understand Your Compliance Program

Every investment adviser registered with the SEC is required to adopt written policies and procedures reasonably designed to prevent violation of federal securities laws. Below are the required policies and procedures that every SEC registrant must maintain as appropriate.

1. Codes of Ethics

Codes of Ethics: Rule 204A-1 of the Investment Adviser's Act of 1940 requires investment advisers to adopt Codes of Ethics ("Code"). The rule requires an adviser's Code to set forth standards of conduct, which should include personal trading rules, how to protect against use of material inside information, insider trading prohibitions, gift policies and escalation procedures for Code violations. Each Code also should set forth a standard of business conduct that the adviser requires of all supervised persons, such as an acknowledgement of compliance with federal securities laws.

2. Proxy Voting

Proxy Voting: In January 2003, the SEC adopted Rule 206(4)-6 that requires SEC registered investment advisers that exercise voting authority over client proxies to disclose their proxy voting policies and procedures to clients. Such Advisers are required to adopt policies and procedures reasonably designed to ensure that the adviser votes proxies in the best interest of their clients and to disclose to clients information about those policies and procedures. In addition, the adviser must disclose how clients may obtain information on how the adviser voted their proxies.

3. Portfolio Management Processes, Including Allocation of Investment Opportunities Among Clients and Consistency of Portfolios with Clients' Investment Objectives, Disclosures by the Adviser and Applicable Regulatory Restrictions

Portfolio Management: In establishing client accounts, the adviser should obtain and document basic investment information about the prospective client in order to assure that portfolio recommendations are suitable. Such information includes:

- Client investment objective
- Level of client's risk tolerance
- Client's time horizon for investing
- Client's income and net worth
- Assessment of suitable portfolio assets
- Analysis of the advisory services appropriate for client investment needs
- Reallocation strategy based on market shifts
- Sector and market allocations
- Client restrictions and guidelines for investments

Each portfolio manager should use the above information to monitor the ongoing activity in the client's account and ensure that such activities are in accordance with the financial requirements and investment objectives obtained from documented client interviews.

4. Trading Practices, Including Procedures by which the Adviser Satisfies its Best Execution Obligation, Uses Client Brokerage to Obtain Research and Other Services ("Soft Dollar Arrangements") and Allocates Aggregated Trades Among Clients

Best Execution: By definition, "best execution" refers to a well-designed trade execution process made with the intention of maximizing the value of client portfolios under particular circumstances at a given time. In selecting a broker to execute client securities trades, an adviser must consider the full range and quality of broker services, including execution capability, commission rate, value of the research provided and responsiveness to the adviser. An adviser is not obligated to merely get the lowest possible commission cost, but rather is required to determine whether the transaction represents the best qualitative execution for a client's accounts.

Soft Dollars: Soft Dollars refer to an arrangement under which a money manager pays for certain brokerage and/or research products or services through commission revenue rather than through direct payments (hard dollars). Typically, issues involve the actual or potential self-interest of the investment manager. These conflicts of interest must be disclosed or consented to in advisory contracts, disclosure documents (such as in prospectuses or Form ADV Part 2), and comply with the safeharbor provisions provided for in Section 28(e) of the Securities Exchange Act of 1934.

As a general principle, investment managers should seek best net price, whether or not they actually achieve it. Although transaction costs are important, seeking best net price will help to minimize the total transaction cost and security price. However, the amount of required time and resources the adviser can devote to its execution capabilities depend on several factors, including: (1) the nature of client accounts; (2) its portfolio management turnover, trading strategies, and size of trade relative to volume; (3) practices of similarly situated money managers; and (4) the current regulatory environment.

5. Accuracy of Disclosures Made to Investors, Clients, and Regulators, Including Account Statements and Advertisements

Marketing Materials and Promoter Arrangements: In accordance with Rule 206(4)-1 as amended, there are two prongs to the definition of advertisement. Prong one includes any direct or indirect communication an investment adviser makes that (i) offers the investment adviser's advisory services with regards to securities to prospective clients or private fund investors, or (ii) offers new investment advisory services with regard to securities to current clients or private fund investors. Prong two generally includes any endorsement or testimonial for which an adviser provides cash and non-cash compensation directly or indirectly (including awards, prizes, reduced advisory fees and directed brokerage).

Notably, the marketing rule prohibits the use of testimonials and endorsements in advertisements, unless the adviser satisfies certain disclosure, oversight and disqualification provisions.

- Disclosure must prominently disclose the person giving the testimonial and endorsement, along with the relationship of that person with the adviser (including conflicts of interest) and whether the promoter is compensated.
- There must a a written agreement between the promoter and adviser unless the compensation is de minimis (i.e., $1,000 or less annually).
- "Bad Actors" are disqualified from acting as a promoter.

Other material considerations for the IA Marekting Rule include:

1. Third Party Ratings - The adviser must provide disclosures to satisfy certain criteria pertaining to the preparaiton of the rating.
2. Performance - must provide net of fee performance, in addition to other material disclosures related to the type of performance presented (including subset of investmetns, hypothetical performance and predecessor performance). Prohibited from stating that the Commission has approved or reviewed any calculation or presentation of performance results.
3. General Prohibitions - Cannot make an untrue statement of material fact, or a material omission; cannot make a statement unless the adviser has a reasonable basis for believing it will be able to substantiate the statement; cannot provide information that would be materially misleading to a reasonable investor; cannot discuss investment benefits that are not "fair and balanced"; cannot include reference to specific investment advice that are not fair and balanced; may not include or exclude performance results in a manner that is not fair and balanced; and cannot produce an adverstisement that is materially misleading.

- Any graph, chart, formula or other device being offered to assist deciding which securities to buy or sell, or when, without prominently disclosing the limitations with respect to its use; or
- Any report, analysis, or other service that will be furnished free or without charge, unless such report, analysis or other service actually is or will be furnished entirely free and without any condition or obligation; or
- Any statement which contains an untrue material fact, or which is otherwise false or misleading.

6. Safeguarding of Client Assets from Conversion or Inappropriate Use by Advisory Personnel

Custody of Client Assets: Should an investment adviser have custody of client assets, Rule 206(4)-2(c)(1) sets forth specific provisions for advisers to follow to protect client assets from loss or theft. Such protections include the requirement that client funds be maintained at a "qualified custodian," such as a bank or an SEC-registered broker-dealer, and the adviser must have reason to believe his or her client receives periodic reports from the custodian regarding the securities held. If the adviser, rather than the custodian, provides these accounting reports, the adviser is required to seek verification of the reports by independent accountants. These measures safeguard client assets and protect against misappropriation by advisory personnel.

7. Accurate Creation of Required Records and Their Maintenance in a Manner that Secures them from Unauthorized Alteration or Use and Protects them From Untimely Destruction

Recordkeeping: Pursuant to Rule 204-2, investment advisers must create and maintain honest, accurate, and updated books and records relating to the adviser's business. This Rule provides guidance for advisory recordkeeping practices, including, among other things:

- Compilation of all business and accounting records;
- Client correspondence pertaining to portfolio transactions and advisory services rendered;
- Delivery of documents; and
- Polices and procedures implemented for the firm's compliance program.

All records should be updated when necessary and kept for five years with the previous two years readily accessible. Additionally, electronic data should be duplicated and backed up frequently to ensure protection from damage or destruction.

8. Obligation to Conduct Reasonable Due Diligence

Investment advisers have a duty to perform adequate due diligence of the selection of investments and of third-party vendors.

In accordance therewith, advisers have a fiduciary duty to satisfy several requirements, including:

- Developing a written due diligence policy, including the collection and maintenance of critical information;
- Having experienced team members conduct the due diligence and assess the information; and
- Structuring a process for positive and negative result outcomes that result in the adviser's decision to proceed or not.

9. Processes to Value Client Holdings and Access Fees Based on Those Valuations

Fair Valuation: Securities for which market quotations are "readily available" must be valued at market value, and all other securities and other assets must be valued at "fair value" as determined in good faith by the firm's management or trustees. Although "the legal framework is simple, the valuation process has many subjective elements and can be complex."[1]

10. Safeguards for the Privacy Protection of Client Records and Information

Privacy Notice: An investment adviser should not disclose personal financial information about any client to non-affiliated third parties except as necessary to establish and manage the client's account(s) or as required by law. For example, a client's personal financial information may be provided to a broker-dealer or custodian providing services to and/or maintaining the client's account(s).

To safeguard the privacy of confidential information, Regulation S-P requires Advisers to adopt policies and procedures reasonably designed to:

- Ensure the confidentiality of customer records and information;
- Protect against any anticipated threats or hazards to the security of customer records and information; and
- Protect against unauthorized access or use of customer records or information that could result in "substantial harm or inconvenience" to any consumer.

11. Business Continuity Plans, Disaster Recovery, and Succession Plan

A firm's critical systems must operate during disaster or significant business interruptions so that clients can have access to their funds. Accordingly, advisers need to make advanced preparations and formulate procedures to provide an efficient means for minimizing down time in the face of a disaster or outage so that the organization may meet its existing customer obligations.

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[1] An Introduction to Fair Valuation, 2005 Investment Company Institute, http://www.ici.org/issues/dir/05_fair_valuation_intro.pdf , at page 5.

Business Continuity Plans: The SEC expects that its registered advisers adopt a Business Continuity Plan ("BCP") that addresses procedures by which loss of business may be minimized or avoided in the event of a significant business disruption. In addition, an adviser's BCP should address the firm's succession plan if the CEO, President or other critical management members become unable to oversee the business.

A BCP should address what the adviser should do if:

- The adviser's offices or facilities are destroyed, whether by natural causes or by other means;
- There is a loss of life or major injuries to personnel or equipment in an office location that disables the office's ability to conduct business; and/or
- There is a disruption of service from a critical business constituent.

All BCP critical employees must be familiar with the Plan in its entirety and be able to effectively execute procedures in the subject area assigned to them whenever the plan is triggered.

12. Anti-Money Laundering Program

Anti-Money Laundering Program: Although the Investment Adviser's Act of 1940 does not require investment advisers to establish an Anti-Money Laundering ("AML") program, investment advisers should consider their fiduciary duty and contemplate developing, as banks and broker-dealers have, the following:

- A systemic process for reviewing of all incoming accounts, including a customer identification program, to ensure compliance with AML regulations;
- Designation of an AML Officer who is responsible for daily coordination of AML compliance;
- Mandatory annual training for personnel; and
- Independent annual testing of AML compliance.

C. Conduct an In-Depth Annual Review

In accordance with the Rule 206(4)-7 (the "Compliance Program Rule") advisers registered with the SEC are required to "review, no less than annually, the adequacy of the policies and procedures (to ensure compliance with federal securities laws)….and the effectiveness of their implementation."[2] Consider taking the following steps to conduct the Annual Review.

[2] _See_ Investment Advisers Act of 1940 Rule 206(4)-7.

Step 1: Identify Firm Risks and Question Policies and Procedures

Conduct a comprehensive assessment of the firm's policies and procedures to ensure that they provide sufficient detail. This review should focus on whether the policy is clearly defined, whether the procedure is currently followed and if the procedure articulates roles and responsibilities for personnel to perform. In addition, the CCO should identify changes in the firm's business and consider what, if any potential conflicts of interest might exist as a result of this development. If conflicts are identified, the CCO should deliberate on what checks and balances might be needed to address those conflicts. Finally, the CCOs should consider changes that occurred in applicable regulations that might necessitate the firm to revise its policies or procedures.

Step 2: Prepare for the Annual Review

In preparing for the Annual Review, consider, among other things:

- Establishing an annual review committee;
- Identifying business line owners to evaluate whether any changes in the firm's business had triggered new or different legal or regulatory requirements;
- Reviewing whether the firm's polices and procedures are enforced (if available, internal audit results may assist in these efforts);
- Evaluating customer complaints to help identify potential compliance issues; and
- Reviewing current regulatory hot topics.

Step 3: Perform Periodic and Forensic Tests as Part of the Annual Review

In May 2005, Gene Gohlke provided CCOs with further guidance on how the compliance review process may further identify and document risks. Gohlke suggested conducting and analyzing results from three types of tests: transactional, periodic and forensic tests.[3]

Step 4: Document the Annual Review Results

There are various approaches to take in documenting the results from your Annual Review. All work papers, including GAP analysis of firm processes, exception reports, noted policy exceptions, and periodic and forensic tests results should be maintained to evidence the firm's approach to identify issues and provide resolution for any issues noted.

Most importantly, the annual review should assist CCOs in identifying firm risk-management needs and potential resources necessary for the firm's compliance program. CCOs should develop a written report to senior management that helps identify high-risk compliance areas and define what resources are needed to address these issues.

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[3] Gene Gohlke, speech: "Managed Funds Association Educational Seminar Series 2005: Practical Guidance for Hedge Fund CCOs Under the SEC's New Regulatory Framework," (May 5, 2005).

IV. CONCLUSION

Understanding the fundamentals of investment advisory compliance is fundamental to the integrity of your firm. Good compliance is good business – and compliance is everyone's responsibility. Consider these questions to help assess the effectiveness of your investment advisory compliance system.

- How does the firm go about educating their employees to identify and address conflicts of interest? What is the firm's escalation process when a violation of firm policy occurs?
- What type of training do new employees receive on compliance policies? Are there processes in place to constantly remind all supervised persons to place the client's interests first?
- What is the firm's "culture of compliance?" What is senior management's expectation for creating ethical uniform standards of business conduct across all geographic boundaries and multiple business channels?
- What is the firm's process for updating policies and procedures and testing its compliance program? Who is responsible for reviewing the policies?
- Who is involved in the annual review process? What type of testing is conducted?