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Citi Prime Finance

Dodd-Frank Private Fund Manager Regulation
A New Era of Compliance

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Executive Summary

SEC Registration Under Dodd-Frank

- Dodd-Frank's[1] revisions to the Investment Advisers Act of 1940 ("The Advisers Act") will now **affect the majority** of Private Fund Managers ("Managers") and Registered Investment Advisers ("RIAs") advising U.S.-based funds
- Dodd-Frank lays out a **more defined set of registration requirements** driven primarily by AUM
- In addition to AUM, the business characteristics of a Manager, and their corresponding investment activities, determine whether a Manager qualifies for Family Office, Venture Capital Funds, and Foreign Private Advisers exemptions
- The new registration rules **eliminate** exemptions for Managers with "fewer than 15" clients as the goal of the legislation is **to cast a broader net** for Manager registration
- Parallel to Dodd-Frank, the SEC expands registration requirements and regulatory filings in terms of content and format. These changes apply to **both new registrants and existing registered investment advisers (RIAs)**

This paper outlines the registration criteria and the process to comply with all filing requirements for new registrants and existing RIAs.

Compliance Requirements

- By registering with the SEC a Manager will be **required to introduce and maintain** a formal and process-driven compliance program
- Both RIAs and unregistered Managers will now be required to retain certain records and file certain reports **for each fund that they manage**. This represents a **significant expansion** from prior requirements under the Advisers Act
- Dodd-Frank does not mandate any specific rules on the qualifications of individuals to be a Manager, however this does not alter current state requirements for securities licenses
- Dodd-Frank does not change the existing requirements for a Compliance Program, Chief Compliance Officer, and Annual Review as previously defined under the Advisers Act (SEC Rule 206(4)-7). As well, Dodd Frank does not alter regulatory requirements for Managers to have Anti Money Laundering and Know Your Customer procedures in place

This paper outlines the key aspects of registration and of developing and maintaining a successful Compliance program tailored to satisfy SEC requirements

1. The Dodd-Frank Wall Street Reform and Consumer Protection Act, July 2010

Introduction

Dodd-Frank Title IV requires the majority of U.S.-based or Private Fund Managers to register with either the U.S. Securities & Exchange Commission (SEC) or relevant state securities agencies, and to provide more active monitoring of all "alternative" investment industry participants.[2] This makes Private Fund Managers subject to the same provisions that govern the traditional asset management industry.

The goal of this paper is to provide a detailed explanation as to how the current and pending changes under Dodd-Frank can best be managed, and to share best practices in implementing those changes.

It will lay out the new registration requirements for U.S.-based and some international managers as well as the elements of a robust compliance program. It will also highlight some practical examples of what a successful compliance program must consider.

The paper is targeted towards those responsible for a fund manager's compliance program, typically the Chief Compliance Officer ("CCO").

The paper contains consistent definitions for the following:

- **Private Fund Manager ("Manager")** – Investment managers who advise private funds that are typically defined as legal partnerships managing structured pooled investments that are privately placed and sold to accredited investors
- **Investment Advisor or Registered Investment Advisor (RIA)** – Investment advisors can be registered or unregistered. They manage solely private funds (legal partnerships of accredited investors), or a mix of private funds and separately managed accounts ("SMAs"), or public funds with institutional and/or retail investors

To obtain a deeper understanding of any of the facets of this paper or to discuss how these challenges can be handled within your own organization, please do not hesitate to reach out to Citi Prime Finance Business Advisory Services (prime.advisory@citi.com) and to our co-author, ALaS Consulting (stephen.lipof@alascorp.com).

KEY PLANNING DATE

July 21, 2011: By this date, all Managers registering with the SEC must have their applications processed and approved. Best practice indicates that Managers should try to file at least 45 days prior to the actual registration deadline in order to allow for the processing of the registration forms and affirmation of status.

In order to be ready for June/July, fund managers are beginning the registration process in March/April. Thus we anticipate a significant increase in the amount of focus on registration across the industry in the coming weeks.

2. Dodd-Frank gives authority to regulatory oversight bodies (i.e., CFTC, SEC) to further define and engage in Rule Making to implement its requirements.

Registration Requirements Under Dodd-Frank

The history of the hedge fund industry contains several defining moments where U.S. regulation has set the parameters for Private Fund Managers in terms of SEC registration and public disclosure.

- 1940 - **Investment Advisers Act of 1940** – Recognizes Managers under U.S. law for the first time and introduces exemptions for Private Fund Managers from Registration with the SEC
- 2004 – **SEC "Hedge Fund Rule"** – Requires managers with more than 15 'clients' (re-defined to require the determination at the investor level, rather than the fund level) to register with the SEC
- 2006 – **Goldstein vs. SEC** – Invalidates the Hedge Fund Rule and no longer requires Managers to consider beneficial owners of their funds as clients
- 2010 – **Dodd-Frank Act** – Establishes registration requirements based primarily on AUM, with specific exemptions for Family Offices, Venture Capital Firms, and Foreign Private Advisers

The Dodd-Frank law allows the SEC to focus its attention on larger Managers that potentially pose more risk to the financial system and allows individual states to supervise smaller managers.

Managers Required to Register

In general Title IV sets out two levels of criteria of registration for Managers and Investment Advisors doing business in the U.S.

- U.S. Domiciled Managers with more that $150 million AUM must register with the SEC
- Investment Advisers with AUM in excess of $100 million are **generally** required to register with the **SEC** as Registered Investment Advisers (RIAs)
- Investment Advisers with AUM between $25 million and $100 million are **generally** required to register with the **state** in which they maintain their principal office and place of business as State RIAs. If the state does not offer an examination program or require state registration, the Investment Adviser with AUM between $25 million and $100 million must register with the SEC

To successfully meet the registration deadline, best practice indicates that all eligible Managers should file their registration documents and prepare the main elements of their compliance program at least 45 days prior to the actual deadline. This ensures that paperwork will be fully processed and that the Manager's registration will be **"effective"** by the July 21, 2011 deadline.

RIAs and State RIAs currently registered with the SEC or state are required to amend their current forms in order to re-establish eligibility to remain registered. This is an important mid-year step that may be in addition to regular annual filings. The timing on this mid-year step is detailed in the coming section on Revised Registration Forms.

Managers Exempt from Registration

Dodd-Frank carves out a number of AUM and business activity exemptions from SEC registration. They are as follows:

- Investment advisers with AUM under $25 million are generally not allowed to register with the SEC. If an Investment Adviser had previously registered they must now de-register. Individual state requirements may apply
- **Managers** with assets of less than $150 million **who solely advise one or more qualifying private funds, and do not advise any Separately Managed Accounts (SMAs) or other investor-driven structures, are exempt** and may choose to remain unregistered or drop their SEC registration if they are already registered

Foreign Managers are exempt and may choose to remain unregistered if they meet **all** of the following criteria:

- They have no place of business in the U.S.
- They support fewer than 15 U.S. clients (based on the SEC definition) and investors in private funds
- Their aggregate assets under management attributable to clients and investors in U.S. private funds are less than $25 million
- They do not market themselves generally to the public in the U.S. or act as a manager to a U.S.-based Adviser
- They do not advise registered investment companies or business development companies

Venture Capital Fund Advisers are exempt and may choose to not register if they meet **all** of the following criteria (based on the final SEC definition):

- The venture capital fund invests only in equity securities of private operation companies where they acquired at least 80% of such equities directly from such companies;
- They employ no long-term leverage in excess of 120 calendar days
- They offer substantial managerial assistance to each company in which they invest
- They do not permit investors to redeem their interest except under extraordinary circumstances
- They represent to investors and potential investors that they are a venture capital fund and have done so since their original offering
- They do not advise registered investment companies or business development companies
- The fund does not incur leverage in excess of 15% of the fund's aggregate capital contribution and uncalled capital

Family Offices are exempt and may choose not to register with the SEC. A family office is a company (including its directors, partners, trustees, and employees) that:

- Has no clients other than family clients[3]
- Is wholly owned and controlled (directly or indirectly) by family members
- Does not hold itself out to the public as an investment advisor

One important point to note is that **regardless of registration** status, Dodd-Frank requires that **all unregistered Managers and Investment Advisers retain records for each private fund they advise. Section II of this paper provides more detail on required record retention.**

Managers Able to Choose Their Registration Status

Managers or Investment Advisers who do not qualify for one of the above listed exemptions but who have AUM between $25 million and $100 million may choose to register with the SEC if **any** of the following criteria apply:

- Expects their AUM will be above the $100 million threshold within 120 days of filing
- Is required to register in 15 or more US states
- Is an affiliate of an existing RIA

Registration of Individuals

The Dodd-Frank amendments do not include any specific requirements relating to the qualifications and appropriate licensing of individuals employed by a fund manager. Additionally, the SEC does not oversee individual licenses for RIAs. The SEC defaults to state regulations.

Managers registering with the state should check the requirements for specific roles within the firm (i.e., Marketer, Investment Officer) to determine which securities licenses are required.

Chart 1 on the following page, provides a simplified overview of these registration requirements.

3. For the purposes of registration, a person that is not a family client is deemed to be a family client for four months if that person becomes a client of the family office as a result of the death of a family member or key employee or other involuntary transfer of assets from a family member or key employee;

A QUICK REGISTRATION GUIDE FOR MANAGERS AND INVESTMENT ADVISERS*

MORE THAN $150M

US domiciled Managers with more than $150 million AUM must register with SEC.

$150 MILLION

BETWEEN $100M AND $150M

- Managers with assets **under $150M** and who manage only private funds are exempt and may choose to register, or may choose to remain unregistered, or may drop their SEC registration if they are already registered
- Investment Advisers with assets of **more than $100 m** and **less than $150 m** who advise any SMAs or other investor-driven structures **do not qualify for the exemption** and must register with the SEC

$100 MILLION

BETWEEN $25M AND $100M

- Investment Advisers with $25 to $100 m AUM are generally required to register with their **state** unless the state does not offer an examination program or require registration in which case they'd register with the **SEC**
- Investment Advisers with $25 to $100 m AUM may **choose** to register with the SEC if **any** of the following criteria apply: they expect their AUM to be above $100 m within 120 days; they are required to register in 15 or more states or they are an affiliate of an existing RIA

$25 MILLION

LESS THAN $25M

- Investment Advisers with less than $25 m AUM are **generally not permitted** to register with the SEC. **Individual state requirements may apply**
- Foreign Private Advisers are exempt if they meet **all** of the following requirements: have no place of business in the U.S.; support fewer than 15 clients in private funds; have less than $25 m in U.S. investor AUM; do not market themselves in U.S. nor act as an investment adviser to the public

* Excludes those firms that qualify for the Venture Capital Fund or Family Office exemptions

Revised SEC Registration Forms & Filing Deadlines

Relevant dates for filing are quickly approaching. If RIAs or Managers planning to register have not yet submitted their forms, It is highly recommended that they should begin preparation immediately.

Prior to the Dodd-Frank Act, Managers were required to register with the SEC by submitting **Form ADV Part 1** and separately providing their clients disclosure information in **Form ADV Part 2**.

SEC Rules have modified both the content of the Form ADV and the manner in which new and existing Investment Advisers submit their regulatory filings.

Form ADV Part 1 has an expanded Section 9 has an expanded Section 9 regarding custody. Firms need to pay particular attention to this section as RIAs who are deemed to have "custody" also have an increased compliance and regulatory burden to satisfy. RIAs who maintain their investor assets with a "qualified custodian"[4] (such as a prime broker) and provide at least annual financial statements on their activities maybe deemed to be doing business without "custody" and may thus have a lesser burden.

Chart 2 provides a summary of the filing deadlines for the new ADV form sections.

The **Part 2** "brochure" now comprises two mandatory sections. Part 2A ("Brochure") includes disclosures about the advisory firm while Part 2B ("Brochure Supplement") includes information about each individual working at the firm who provides advice to clients. The SEC directions specify that the brochures must be written in plain English, in the active voice, and use short sentences.

Previously, RIAs were only responsible for retaining copies of completed Form ADV 2 Part A in their files along with documentation that they provided or "offered" the document annually to their advisory clients. Under the new rules, RIAs will now have to annually file the new Form ADV 2 Part A electronically via the SEC Investment Adviser Registration Delivery ("IARD") system.

The new Form ADV 2 Part A will then become readily available online through the SEC Investment Adviser Public Disclosure ("IAPD") website.

The new ADV Forms are available at http://www.sec.gov/about/forms/formadv.pdf.

CHART 2: SEC FORM ADV SECTIONS AND FILING DATES

PART 1	Initial State and SEC Registration	• New firms who are required to register must be registered no later than July 21, 2011. • The process can take up to 45 days. Thus, new managers filing for the first time are encouraged to file at least 45 days prior to the deadline (June 6, 2011). • Existing RIAs need to annually amend their Part 1 filing no later than 90 days from the end of their fiscal year.
PART 2A	The Brochure	• New RIAs must file this component of Form ADV with their SEC submission. • Existing RIAs need to file part 2A along with their Part 1 submission.
PART 2B	The Brochure Supplement	• New Advisors do not have to publicly file on the SEC website, but must maintain a copy in their files. • Existing RIAs are not required to file amendments to their brochure supplements to the SEC, but must maintain a copy in their files.

4. "Qualified custodians" under the amended rule include the types of financial institutions that clients and Advisers customarily turn to for custodial services. These include banks and savings associations and registered broker-dealers. In order to allow Advisers that also offer futures advice to comply with Commodity Futures Trading Commission rules, "qualified custodians" also include registered futures commission merchants. Finally, "qualified custodians" include foreign financial institutions that customarily hold financial assets for their customers, provided that the foreign financial institution keeps advisory clients' assets in customer accounts segregated from its proprietary assets.

Highlights of the New Form

The new ADV Part 2 form represents a *significant* change from traditional regulatory filings.

The SEC requires RIAs to provide The SEC is now requiring RIAs to provide detailed-narrative, plain English responses to each item within Part 2. All disclosures should be succinct and readable. The SEC's instructions are below.

- Use short sentences
- Use definite, concrete, everyday words
- Use active voice
- Use table or bullet lists for complex material, whenever possible
- Avoid legal jargon or highly technical business terms unless you explain them or believe that your clients will understand them
- Avoid multiple negatives

Within the ADV Part 2 form, the RIA provides a number of core descriptions about their business. RIAs who have previously filled out ADV Part 2 form can draw upon that information to fill in the carried forward sections of the new ADV Part 2 form. They must, however, review their previous answers to make sure that they meet the new plain English criteria noted by the SEC. This will allow existing RIAs to focus their effort on filling in the new ADV Part 2 form categories listed below. **Newly registered RIAs must fill in all the information.**

The new Form ADV Part 2A requirements include:

Overview of Advisory Business: The new form has been expanded and now requires RIAs to provide a narrative about their advisory business. The narrative should include information on how long the RIA has been in business, a listing of the principal owners, the types of advisory services offered, and whether the RIA holds itself out as specializing in a particular type of advisory service.

AUM: The new form requires that the RIA detail the amount of client assets they manage, broken out by discretionary and non-discretionary assets. The listing of AUM must be current to within three months of the date of the brochure.

Management Fees and Compensation: RIAs must describe the compensation they receive for their advisory services, provide a fee schedule, and disclose whether such fees are negotiable. The RIA must also describe the types of other fees or expenses, such as brokerage fees, custody fees, and fund expenses, that clients may pay in connection with the services provided.

Performance-Based Fees and Side-by-Side Management Practices: RIAs must provide a description of performance-based fees they receive and (if applicable) how they supervise individuals within their organization who accept such fees for advising external accounts. If an RIA is both accepting performance-based fees and supervising individuals who advise external accounts, they are required to explain conflicts of interest that arise from the simultaneous management of these accounts and describe how they address those conflicts.

Types of Clients: The RIA must describe the types of clients that receive their investment advice and whether there are any requirements for opening or maintaining an account- such as a minimum account size.

Investment Approach and Risks: RIAs must describe their methods of analysis, their investment strategies and explain that investing in securities involves risk of loss which clients should be prepared to bear. RIAs must also disclose if there are any unusual risks associated with their particular method of analysis or strategy or types of securities they utilize.

Disciplinary Disclosure: RIAs must disclose any legal or disciplinary event they have been subject to that is material to a client's evaluation of the RIA's business or to the integrity of its management personnel. RIAs must promptly deliver updated information when there is new disclosure of a disciplinary event or a material change to an existing disciplinary event.

Code of Ethics: RIAs must briefly describe their code of ethics and assure that a copy is available upon request. The RIA must also disclose whether it or an affiliate 1) recommends to clients, or buys or sells for client accounts, securities in which the RIA or an affiliate has a material financial interest; 2) whether it or an affiliate invests (or is allowed to invest) in the same securities that it recommends to clients or in related securities (such as options or derivatives) and 3) whether an RIA trades in recommended securities at or around the same time as the client. If any of these conditions exist, the RIA must explain the conflicts of interest associated with that practice and how it addresses them.

Brokerage Practices: The RIA must describe the factors they considered in selecting or recommending broker-dealers for client transactions and how they assessed the reasonableness of such brokers' compensation. RIAs also must disclose soft dollar services provided in consideration of execution (supplying research or other products); client referrals (using client brokerage to compensate brokers for client referrals); directed brokerage (asking or permitting clients to send trades to a specific broker for execution); and trade aggregation (bundling trades to obtain volume discounts on execution costs). RIAs must explain how they address the various conflicts of interest associated with these practices.

Custody: RIAs must describe any custody arrangements around client funds or securities and explain the reporting they provide around such assets. This would include details of all Prime Brokerage relationships.

Other Financial Industry Activities and Affiliations: RIAs must disclose Broker Dealer, Futures Commission Merchant, Commodity Pool Operation, Commodity Trading Advisor registration or pending applications for both the RIA and key management personnel. The RIA must also describe any material relationship with other industry-related firms or individuals.

Review of Accounts: The RIA must describe their client accounts review process, the frequency and nature of the review and the names of individuals conducting such reviews. As part of this description, the RIA should include the nature and frequency of their written client reports.

The Part 2B Brochure Supplement supplies information about the advisory personnel who are actually providing advice to the clients. Such information includes the educational background, business experience, and disciplinary history (if any) of the supervised persons who provide advisory services to the client.

NOTE: There is some leeway with how this information is presented. For example, the information can be included in an RIAs Marketing Brochure or a firm can have separate Brochure Supplements for each supervised person.

As with the Brochure, an RIA will be required to amend a Brochure Supplement promptly if it becomes materially inaccurate, but unlike the Brochure, the RIA will not be required to update the Brochure Supplement on an annual basis. Neither the Brochure Supplement nor any amendments to the Brochure Supplement will be required to be filed with the SEC, and neither will be publicly available.

Delivering the New Form to Clients

RIAs must provide new and prospective clients with narrative brochures that are organized in a consistent, uniform manner and that include plain English disclosures of the RIA's business practices, fees, conflicts of interest, and disciplinary information.

RIAs should give careful thought to the tone and manner in which the ADV Part 2 is written. Typically publicity-shy Private Fund Managers now need to prepare themselves to be reviewed and scrutinized by anyone with Internet access.

Relevant dates for Form ADV Part 2 are detailed on the following page.

Instructions on completion of Form ADV Part 2
may be found on the SEC's website:
http://www.sec.gov/about/forms/formadv-part2.pdf

CHART 3: DELIVERING FORM ADV 2A TO CLIENTS

STATUS	DATE	REQUIRED ACTION
Existing RIAs with a fiscal year ending on 12/31/2010	3/31/2011	Must begin delivering new firm 2A brochures to new and prospective clients.
	5/30/2011	Must have delivered new firm brochures to existing clients.
New RIAs filing after Jan 1 but before April 30	On approval of registration	Must begin delivering brochure to new, prospective and existing clients.
New RIAs filing after April 30	Within 60 Days of filing	Begin delivering brochure to existing clients before or at time of signing advisory contract.

CHART 4: DELIVERING FORM ADV 2B TO CLIENTS

ADVISER	CLIENT TYPE	DATE	REQUIRED ACTION
New RIAs (applying on or after 1/1/11 through 4/30/11)	New and Prospective	July 1, 2011	Begin delivering brochure supplements before or at the time advisory services begin.
	Existing	July 1, 2011	Must have delivered brochure supplements.
Existing RIAs with fiscal year ending 12/31/10-4/30/11	New and Prospective	July 31, 2011	Begin delivering brochure supplements before or at the time advisory services begin.
	Existing	September 30, 2011	Must have delivered brochure supplements.
Existing RIAs with fiscal year ending on or after 5/1/11	New and Prospective	Upon filing annual updating amendment to Form ADV	Begin delivering brochure supplements before or at the time advisory services begin.
	Existing	Within 60 days of filing annual updating amendment	Deliver brochure supplements.

Guidelines are drawn from the Investment Advisers Act of 1940. Dodd-Frank itself only adds guidance around record retention requirements and affirms that all other components of SEC Rule 206(4)-7, which defines a compliance program, are enforced once a Manager or Investment Adviser registers.

Elements of a Robust Compliance Program

SEC Requirements of a Compliance Program

The three essential elements of a compliance program pursuant to Rule 206(4)-7 are:

- **Chief Compliance Officer.** Designate a CCO to be responsible for administering the policies and procedures
- **Compliance Program.** Design a compliance program, including written procedures reasonably designed to detect and prevent violations of the Adviser Act
- **Annual Review.** Review of RIA's written policies and procedures, on an annual basis

The Role of Chief Compliance Officer

"An Adviser's chief compliance officer ("CCO") should be competent and knowledgeable regarding the '40 Act and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm." [5]

The CCO must have a position of sufficient seniority to compel others to adhere to the program. RIAs may need to consider making changes in their reporting lines to give the CCO the organizational clout that the SEC requires. CCOs of RIAs are not required to maintain any securities licenses for FINRA or SEC. For State RIAs, local rules will apply.

The SEC has addressed concerns over potential liability for CCOs. Having the title of CCO does not, in and of itself, carry supervisory responsibilities over individuals responsible for carrying out compliance responsibilities. A CCO appointed in accordance with Rule 206(4)-7 would thus not necessarily be subject to a sanction by the SEC for failure to supervise advisory personnel, provided that:

- The RIA had adopted procedures reasonably designed to prevent and detect violations of the Advisers Act
- The RIA had a system in place for applying the procedures
- The CCO had reasonably discharged his supervisory responsibilities in accordance with the procedures.[6]

It is the responsibility of the business supervisor, and not the CCO, to oversee the business operations of the firm. Within this context a CCO's role is to monitor that the compliance program is reasonably designed and implemented.

The Compliance Program

RIAs are required to develop and implement written policies and procedures "reasonably designed" to prevent and detect violations of the federal securities laws.[7] From the outset, the SEC has clearly stated that the phrase "reasonably designed" means that the Adviser's compliance program must be tailored to its actual or potential operations. Rule 206 (4)-7 was originally intended to ensure that the requirements not be overly burdensome to the Adviser and that its design and implementation coincide with the level and sophistication of the Adviser's operations.

The SEC has identified minimum elements that should be addressed within RIA's written procedures. We have organized the following checklist to correspond with two operational functions: trading and reporting. The compliance officer should review the operations surrounding these activities and identify any risk or conflict that is inherent in the business with a focus on these topics.

5 - 6. Final Rule: Compliance Programs of Investment Companies and Investment Adviser, Investment Adviser Act Release No. 2,204, Investment Company Act Release No. 26,299, 68 Fed. Reg. 74,714, 74,720 n.73 (Dec. 24,2003).

7. Though not specifically defined under the Rule, the SEC relies on the common law objective standard of "reasonable" care, whereby each person owes a duty to behave as a reasonable person would under the same or similar circumstances.

Trading practices

- Portfolio management processes
- Personal trading of the RIAs employees
- Processes to value client holdings and assess fees based on those valuations

Reporting & Administration

- The accuracy of disclosures made to investors, and regulators, including account statements and advertisements
- Safeguarding investor assets from inappropriate use by advisory personnel
- The accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction
- Marketing advisory services, including the use of solicitors
- Safeguards for the privacy protection of client records and information; and
- Business continuity plans

It will be critical for RIAs to be able to articulate the logic behind their compliance program, particularly these elements defined the adopting release of Rule 206(4)-7. Even if an Adviser never engages in an underlying violation of the Act or Rules, the SEC can charge it with violating Rule 206(4)-7 if the SEC feels that the Adviser's compliance program is not "reasonably designed." In addition, because the Rule was adopted under the Act's antifraud section, a violation of the rule constitutes fraud.

General Record Retention

As highlighted earlier in the paper, regardless of registration status, SEC Rule proposals would require that all fund managers retain records for each private fund they advise.

Dodd-Frank authorizes the SEC to require all managers of private funds (registered or not registered) to retain general records that could be called upon to help assess the Manager's or Investment Adviser's contribution to systemic risk, including:

- AUM
- Type of assets held
- Counterparty risk & use of leverage
- Trading & investment positions
- Valuation policies & practices
- Side arrangements or side letters providing certain investors more favorable rights or entitlements
- Trading practices

In addition, RIAs will be subject to the following additional record retention requirements pursuant to Rule 204-2 of the Investment Advisors Act:

- Advisory business **financial and accounting records**, including cash receipts and disbursements journals, income and expense account ledgers, checkbooks, bank account statements, advisory business bills, and financial statements
- Records pertaining to the provision of investment **advice and transactions in client accounts**, including orders to trade in client accounts; trade confirmation statements; documentation of proxy vote decisions; written requests for withdrawals or documentation of deposits received from clients; and written correspondence sent to or received from clients or potential clients discussing recommendations or suggestions
- Records that document authority to conduct business in client accounts, including a list of accounts over which the RIA has discretionary authority; documentation granting discretionary authority; and written agreements with clients, such as advisory contracts
- **Advertising and performance records**, including newsletters, articles, and computational worksheets demonstrating performance returns
- Records related to the **Code of Ethics**, including those addressing personal securities transaction reporting by access persons
- Records regarding the maintenance and delivery of written **disclosure documents** and disclosure documents provided by solicitors who seek clients on the manager's behalf
- **Policies and procedures** including any documentation prepared for the RIAs annual compliance program review

Additional requirements may apply such as for those RIAs who maintain custody and possession of client funds (Rule 204-2(b)) and for those who provide investment supervisory or management services (Rule 204-2(c)).

Systemic Risk

Additionally, Dodd-Frank also gives authority to the SEC to require Managers, Investment Advisers and RIAs to file reports containing information it deems necessary for the **assessment of systemic risk**.

At this time, the implications of such a rule are not entirely clear, and it is uncertain as to the type of reporting the SEC will request. Regardless, one area of focus will most likely be the leverage, credit, and liquidity of the larger Managers, Investment Advisors and RIAs whose business activities have potential to impact the market. The RIAs should develop the necessary risk measurement and reporting tools and associated procedures to ensure that the risks inherent in their strategies are understood and documented.

The Annual Review

The RIA's written policies and procedures should be reviewed annually for adequacy and effectiveness. This review should consider any compliance matters, changes in business activities or regulatory requirements that arose during the previous year and identify steps in which these issues or changes have been or will be addressed.[8]

To ensure minimum issues at the time of the annual review, it is important for the RIAs to manage any issues or change to their business or regulatory environment in a timely and pro-active manner throughout the year.

NOTE: Although 206(4)-7 requires only annual reviews, RIAs should consider the need for interim reviews in response to significant compliance events, changes in business arrangements, and regulatory developments.

Example Compliance Guidelines

While much of this paper has focused on registration and on understanding the elements of an SEC-defined robust compliance program, the actual amounts of information and processes that must be put into place to successfully deliver the compliance program are hard to understand without some example compliance guidelines. To that end, we have identified some critical areas each RIA must consider, and highlighted the scope of what regulators would be interested in understanding in case of an audit.

Commission Sharing Arrangements / 28(e) Safe Harbor

RIAs should ensure that they have processes in place to review and capture information related to Commission Sharing Arrangements ("CSAs"). These arrangements allow a portion of trading commissions to pay for certain trading-related expenses, such as research. Eligible commissions will accrue in CSA accounts at soft dollar brokers, and invoices can be paid directly from these accounts. Historically, Managers have used these so-called "soft dollars" to pay for multiple fund-related expenses, based on parameters that were laid out in their offering memorandums. Increasingly, Managers, Investment Advisers and RIAs use of soft dollars has come to conform more closely to the guidelines laid out by the SEC with regard to Section 28(e) of the Securities Exchange Act of 1934, even in advance of SEC Registration.

Pre & Post-Trade Order Compliance

RIAs must be able to demonstrate their compliance around order and trade handling. Many funds have pre-trade compliance rules. Such rules can include composition restrictions based on guidelines of the fund documents, or they can alert the firm to potential regulatory filing implications if percentage-of-ownership thresholds are breached. The amount of pre-trade compliance sought by a fund will be directly related to the underlying strategy of the manager. Post-trade compliance entails testing against composition restrictions, as market valuations may cause positions to move beyond pre-defined thresholds.

Employee Trading

RIAs should be able to demonstrate the same rigor as an institutional asset management firm in terms of their monitoring of employee trading. The Adviser should publish and update restricted lists, and should follow a process whereby employees must submit proposed personal trades to the compliance function for pre approval. A common strategy for simplifying this process is to enforce the opening of employee brokerage accounts at pre-specified institutions. The compliance officer can be copied on all such statements, and trading activity can be compared against a list of pre-approved trades.

8. Final Rule: Compliance Programs of Investment Companies and Investment Advisers. Securities and Exchange Commission. 17 CRF Parts 270 and 275. http://www.sec.gov/rules/final/ia-2204.htm#P182_61941

Communication Records Retention

RIAs should be prepared to monitor messaging from a compliance standpoint. Not only does a firm need to capture and archive email, instant messages, and all Bloomberg/Thomson Reuters communications, the firm needs the ability to effectively search through and retrieve this data. Various software solutions are available to facilitate this process, including those that automate the random sampling of communications, and the scheduling of searches around pre-defined keywords. Futhermore, the convergence of the institutional and alternative asset managers can be found in terms of information controls. Managers and RIAs are increasingly adopting the web browsing policies of larger asset management institutions and sellside brokerage firms; access to personal email accounts and social media sites via the corporate network should be limited, if not prohibited.

Valuations

RIAs must be able to evidence their adherence to the policies set forth within their pricing policy. The less liquid and more diverse the instruments traded, the more complex the valuation policy. RIAs should be able to document the various sources of their valuations, have an ability to test and identify inordinate price swings that require further investigation and demonstrate the rules they use to enforce their pricing hierarchy.

AML

As a best practice newly registered and existing RIAs should have in place at a minimum an AML Compliance Program tailored to their specific structure which can identify their investors, monitor the inflows and outflows of monies and provide annual training to employees.

Marketing and the Quarterly Letter

All client correspondence and regulatory filings fall within the purview of the anti-fraud requirements. While Managers have always been responsible for the provisions of the anti-fraud rules, it is essential for RIAs to have robust marketing review processes around the review and distribution of quarterly letters and other marketing materials.

Some key steps in this process are as follows:

- **Have a review process:** Draft marketing and client materials need to be reviewed for accuracy and consistency with the offering documents and comply with general anti-fraud provisions. This includes:
  - No predictions of future events
  - No security or investment recommendations
  - Accurate disclosure about performance calculation; and
  - Accurate disclosure on any relevant exception to facts
- **Maintain a marketing log documenting**:
  - Date reviewed
  - Unique code number for each marketing piece reviewed
  - Use for which marketing piece was designed; and
  - Expiration date
  - Maintain records of all materials reviewed and changes made

Meeting these criteria entails coordination among multiple functions: marketing, accounting, and compliance. The accounting function will either generate monthly performance numbers or they'll work with their Administrator or Accountant to produce the same. Once these numbers are finalized, the marketing group will incorporate this data into the fund's investment letter. The compliance function and CCO will then have oversight of this content, and will make revisions accordingly.

The ability to evidence this process is critical. As such, each function should have checklists indicating when each step has been performed. Then, multiple versions of the investment letter should be on file, with indications of edits clearly marked. These versions can be tracked either through hard or soft copy, but should be organized in a manner that would facilitate quick retrieval during an audit.

Hard copies should contain visible edits that can then be found in subsequent versions, with a sign-off on the final version by the CCO. Soft copies should also be versioned and recorded on a secure file management system, with new versions created in a secure format (e.g., PDF).

Code of Ethics

Many of the key elements of the Code of Ethics have been covered in the examples above. These include processes in place to monitor and show compliance around the manager's policy for personal trading and controls to mitigate the potential for insider trading, including the use of restricted lists and tracking the methods used within the fund for receiving information for analysis.

Other elements to consider in the Code of Ethics include documents that employees must fill in that disclose their outside business activities, any political contributions and the publication and demonstration of enforcement of rules limiting monetarty gifts, given or received.

Technology

Vendors focused on the Manager space are actively looking to incorporate functionality to record and monitor business activity in order to help Managers address emerging compliance requirements.

- Order management and other trading systems can assist a fund in tracking commissions, setting up trading rules and creating an audit trail around the execution life cycle
- Valuation databases can clearly indicate the sources of pricing information and workflow tools can apply logic and variance testing to help identify inordinate price swings and enforce pricing hierarchies
- Software solutions can help Managers and RIAs automate the random sampling of email and other communications and offer scheduled searches around pre-defined keywords to identify situations warranting investigation
- Cloud-based solutions can be used to support disaster recovery and business continuity requirements and offer more flexible, lower cost solutions than full architectural build-outs

Disaster Recovery / Business Continuity Planning

RIAs should be able to document their protocols in various business disruption and disaster scenarios. The SEC will look for evidence that this policy has not only been determined, but tested. Such testing includes having employees acknowledge that their remote computing and telephony solutions are in working order. Given technology advances, funds also need to address the ability of their employees to remotely access their virtual desktops. Documenting the frequency and process of data backups will also be viewed favorably during an audit. To that end, replicating fund data to a SAS-70 Level 2 data center adds a level of assurance to both auditors and investors.

For more information on technology options to help support your compliance needs, please do not hesitate to reach out to Citi Prime Finance Business Advisory services.

Summary

Many Managers that used to be exempt from SEC or state registration are no longer going to be able to claim exemptions under the new Dodd-Frank mandated requirements.

All Managers and RIAs must be more cognizant of the areas around which they must maintain records and be prepared to produce documentation to prove that they have a more formal and process-driven compliance program.

The first best step for any Manager, Investment Adviser or RIA to take as we approach the Dodd-Frank registration deadline of July 21, 2011, is to understand whether they need to register or if they are already registered, understand whether their existing registration is adequate or whether they need to change their registration under the new rules.

As part of the registration process, there have been some key changes in the main regulatory filing documents. The first most important change is that managers must now submit their documents using "plain English" and that there is a requirement that responses provided in the documents be "succinct and readable."

There have also been changes in the ADV form used for filing. Part 1 now lays out a new responsibility for managers around defining the role they play in "custody" of their investor assets. Part 2A requires the creation of a "brochure" that includes the disclosure of the RIA's AUM and other information previously seen as highly sensitive. Part 2B creates a "brochure supplement" that provides information on the employees within the RIA. Completing these documents can be time consuming and the filing deadlines are looming. New RIAs must be registered no later than July 21, 2001. For their filing to be effective they should seek to file at least 45 days prior to the deadline in order to allow the SEC time to process the application.

Once their registration status is sorted, RIAs are responsible for ensuring the maintenance of a robust compliance program. Each firm should understand whether their existing compliance program is adequate by reviewing their existing procedures. RIAs should also consider that the Chief Compliance Officer is going to be responsible for overseeing the compliance program and working with those business leads that will bear responsibility if there are compliance breakdowns. The CCO will thus need to be adequately empowered within the organization.

The example compliance requirements discussed at the end of the paper give readers some insight into the depth and breadth of how significant the effort will be to ensure a robust compliance program and offers some suggestions of where technology may be available to help in this effort.

To further discuss the content in this whitepaper, please contact prime.advisory@citi.com or ALaS Consulting at (stephen.lipof@alascorp.com).

SEC Information Links:

Complete new ADV Form Part 2

http://www.sec.gov/about/forms/formadv-part2.pdf

SEC website – Dodd-Frank initiative

http://www.sec.gov/spotlight/dodd-frank.shtml

SEC Interpretive Releases

Rules implementing amendments to the investment Adviser RIAs Act of 1940

www.sec.gov/rules/proposed/2010/ia-3110fr.pdf

Exemption of Venture Capital Private Fund Manager Registration Requirements

www.sec.gov/rules/proposed/2010/ia-3111.pdf

Form ADV – Frequently asked questions & instructions

www.sec.gov/about/forms/formadv-instructions.pdf

Frequently asked questions on Form ADV & IARD

www.sec.gov/divisions/investment/iard/iard-faq.shtml

Amendments to Form ADV (part 2)

www.sec.gov/rules/final/2010/ia-3060.pdf

Investment Adviser Code of Ethics: Final Rule

www.sec.gov/rules/final/ia-2256.pdf

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