



Guide to SEC Registration  
of  
Private Fund Investment Advisers

**The guide was prepared by SEC Compliance Consultants, Inc, in response to the July 15th, 2009, U.S. Department of the Treasury proposed Private Fund Investment Advisers Registration Act of 2009. These proposed amendments to the Investment Advisers Act of 1940, as amended (the "Advisers Act") would have significant implications to currently unregistered advisers to private pools of capital such as hedge funds, venture capital funds, private equity funds, and other private pools including both U.S. and non-U.S. domiciled investment vehicles.**

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## Private Fund Investment Advisers Registration Act of 2009

On July 15, 2009, the U.S. Department of the Treasury proposed amendments to the Investment Advisers Act of 1940, as amended (the "Advisers Act") that would have significant implications to advisers to private pools of capital such as hedge funds, venture capital funds, private equity funds, and other private pools including both U.S. and non-U.S. domiciled products. Under the proposal, all advisers with assets under management ("AUM") greater than \$30 million and either domiciled in the U.S. or with greater than 10% of the investors being U.S. persons would be required to register with the Securities and Exchange Commission ("SEC"). Certain exemptions currently available would be eliminated. For example, advisers with fewer than 15 clients with greater than \$30 million AUM including, but not limited to, family offices and Commodities Futures Trading Commission ("CFTC")-registered Commodity Trading Adviser's ("CTA's") which advise private pools would need to register.

### Implications

Registration pursuant to the new proposal would, among other things, require advisers to quickly become familiar with the Advisers Act. Important considerations related to the proposal include, but are not limited to:

- **Compliance** - new registrants would be required to adhere to Rule 206(4)-7 known as the Compliance Rule which requires establishing written Policies and Procedures and appointing a competent Chief Compliance Officer ("CCO"). Key to establishing an adequate compliance program is evaluating existing and potential conflicts of interest. The SEC wants assurance that advisers have a mechanism in place to identify risks, conflicts of interest and have established a system of internal controls to mitigate those risks.
- **Disclosure** - Registrants are subject to the Advisers Act disclosure rules requiring the preparation and filing of Form ADV Part I and Part II. See the Form ADV section for a detailed review of Form ADV.
- **Books and Records** - Registrants, under the proposal, would be required to keep books and records for each private pool managed and those books and records would be considered books and records of the Adviser. The SEC would now have the authority to examine these books and records.

- **Performance Fees** – Registrants must follow Rule 205-3(d)(1) of the Advisers Act which limits the ability to charge performance fees. Performance based compensation can be paid if the adviser's clients are "qualified clients". If you manage a 3c(1) fund and charge a performance fee you will need to determine if your clients meet the "qualified client" threshold.
- **CTA Exemption Eliminated** - CFTC registered CTA's providing advisory services to private pools would no longer be exempt from SEC registration.

### **Compliance Rule - Advisers Act Rule 206(4)-7**

Effective October 5, 2004, SEC Rule 206(4)-7 ("the Compliance Rule") became effective for all SEC-registered advisers. The rule reads as follows:

If you are an investment adviser registered or required to be registered under section 203 of the Investment Advisers Act of 1940, it shall be unlawful within the meaning of section 206 of the Act for you to provide investment advice to clients unless you:

(a) *Policies and procedures.* Adopt and implement written policies and procedures reasonably designed to prevent violation, by you and your supervised persons, of the Act and the rules that the Commission has adopted under the Act;

(b) *Annual review.* Review, no less frequently than annually, the adequacy of the policies and procedures established pursuant to this section and the effectiveness of their implementation; and

(c) *Chief compliance officer.* Designate an individual (who is a supervised person) responsible for administering the policies and procedures that you adopt under paragraph (a) of this section.

Under rule 206(4) -7, it is unlawful for an investment adviser registered with the Commission to provide investment advice unless the adviser has adopted and implemented written policies and procedures reasonably designed to prevent violation of the Advisers Act by the adviser or any of its supervised persons. The rule requires advisers to consider their fiduciary and regulatory obligations under the Advisers Act and to formalize policies and procedures to address them.

Rule 206(4)-7 does not specifically list the elements that advisers must include in their policies and procedures. The SEC acknowledges that advisers are too varied in their operations for the

rules to impose of a single set of universally applicable required elements. Each adviser should therefore adopt policies and procedures that take into consideration the nature of their specific operations. Advisers must therefore have **customized** policies and procedures designed to prevent violations from occurring, detect violations that have occurred, and correct promptly any violations that have occurred.

**Policies and Procedures:**

The SEC states the policies and procedures, at a minimum, should address the following issues to the extent that they are relevant to that adviser:

- 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;
- Trading practices, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services ("soft dollar arrangements"), and allocates aggregated trades among clients;
- Proprietary trading of the adviser and personal trading activities of supervised persons;
- The accuracy of disclosures made to investors, clients, and regulators, including account statements and advertisements;
- Safeguarding of client assets from conversion or 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;
- The marketing of advisory services, including the use of solicitors;
- Processes to value client holdings and assess fees based on those valuations;
- Safeguards for the privacy protection of client records and information; and
- Business continuity plans.

**Annual Review**

Rule 206(4)-7 requires each Adviser to review their policies and procedures annually to determine their adequacy and the effectiveness of their implementation. 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.

Although the rule requires annual reviews, advisers should also be conducting interim reviews by testing and assessing, on an ongoing basis, how significant compliance events, changes in business arrangements, and regulatory developments affect the adviser's business.

### **Chief Compliance Officer**

Rule 206(4)-7 requires each adviser registered with the SEC to designate a Chief Compliance Officer ("CCO") to administer its compliance policies and procedures. An Adviser's CCO should be competent and knowledgeable regarding the Advisers Act and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm. Thus, the CCO should have a position of sufficient seniority and authority within the organization to compel others to adhere to the compliance policies and procedures.

### **What about Outsourcing the CCO Role?**

Some advisers inquire about outsourcing the CCO position. While not explicitly prohibited, the SEC does not look favorably upon outsourcing the CCO position which would be problematic as the CCO must be an officer of the Adviser. Advisers that attempt to outsource this role are generally perceived negatively by the SEC.

## **Registration Process**

1. Complete Entitlement Forms and submit to FINRA in order to gain access to the IARD system, which is required to begin the registration process. This process takes approximately 10 days.
2. File Form ADV Part 1 electronically through IARD. This process can take up to 45 days before approval is received by the SEC.
3. Complete form ADV Part II and Schedule F in hard copy, which should be complete before beginning operations as a registered adviser.
4. Prepare a customized Compliance Program including written policies and procedures (compliance manual).

## **Form ADV - Disclosure Requirements**

### ***Form ADV is divided into 3 parts:***

Part 1A - Includes information about the adviser, its business practices, the ownership structure, and the client base. Part 1A is mandatory for those advisers registering with the SEC and/or state securities authorities.

Part 1B - Concerns state registration and is only required if an adviser is registering with the state(s).

Part II - Known as an adviser's brochure, Part II, along with its accompanying schedules form the basis of the required adviser disclosures to existing and potential clients. In addition, it is required to be amended whenever material changes occur and affect an adviser's business. Form ADV Part II is also required to be offered at least annually to existing clients and documentation must be retained demonstrating that such offer was made.

**Form ADV Part I**

The Table below highlights the various sections of Part I and is offered to demonstrate what information the SEC is seeking from advisers. When changes occur to many of these sections in ADV Part I, amendments are required to be filed promptly. Although "promptly" is undefined, it is generally interpreted to mean within 30 days of the change.

Part 1A - Item 1	Identifying Information
Part 1A - Item 2	SEC Registration
Part 1A - Item 3	Form of Organization
Part 1A - Item 4	Successions
Part 1A - Item 5	Information About Your Advisory Business
Part 1A - Item 6	Other Business Activities
Part 1A - Item 7	Financial Industry Affiliations
Part 1A - Item 8	Participation or Interest In Client Transactions
Part 1A - Item 9	Custody
Part 1A - Item 10	Control Persons
Part 1A - Item 11	Disclosure Information
Part 1A - Item 12	Small Businesses
Part 1B - Item 1	State Registration
Part 1B - Item 2	Additional Information

Schedule A	Direct Owners and Executive Officers
Schedule B	Indirect Owners
Schedule C	Amendments to Schedule A and B
Schedule D Page 1 to 5	Additional Information to Certain Sections of Part 1

**Form ADV Part II - "Brochure"<sup>1</sup>**

The Table below highlights the various sections of Part II and is offered to demonstrate what information the SEC believes is important to disclose to an adviser's clients.

Item 1	The Adviser's advisory services and fees.
Item 2	The types of clients to whom the Adviser offers or provides services.
Item 3	The types of investments in portfolios managed for clients.
Item 4	The methods of analysis, sources of information and investment strategies.
Item 5	The Adviser's education and business standards.
Item 6	The education and business history of the Adviser's executive officers and advisory personnel .
Item 7	Other business activities of the Adviser.
Item 8	The Adviser's other financial industry activities or affiliations.
Item 9	The participation or interest in transactions of the Adviser's clients.
Item 10	The Adviser's conditions for managing client accounts.
Item 11	The Adviser's procedure for reviewing client accounts.
Item 12	The Adviser's investment or brokerage discretion.
Item 13	Additional compensation received by the Adviser in connection with advice to clients.

<sup>1</sup> In March of 2008, the SEC proposed amending Form ADV Part II. To date, a final rule has not been adopted.

### ***Form ADV Part II - Schedule F***

While ADV Part II is similar to Part I in terms of checking boxes and providing limited answers, Schedule F is the area where advisers are required to provide detailed expanded descriptions in straight forward, easy to understand language. In most cases, Schedule F is a continuation of affirmative answers to Part II questions. It is important to note that the required disclosure in Schedule F often goes beyond the specific questions asked in Part II. It becomes an issue of materiality as the SEC would consider additional items material and therefore necessary to disclose if it would affect a client's decision to invest with the adviser. Being familiar with SEC deficiency letters and understanding SEC disclosure expectations is necessary in order to understand your disclosure responsibilities.

### ***Establishing a Compliance Program***

While the Compliance Rule appears relatively straight forward with regard to establishing policies and procedures, it is more involved than meets the eye. The Compliance Rule specifically lists 10 items which, at a minimum, need to be included. However, it is misleading to expect the SEC to be satisfied if you only develop policies and procedures covering these 10 areas. The regulators certainly expect to see additional items included. For example, a robust compliance manual would also contain additional sections including, but by no means limited to, advisory contracts, proxy voting, payment of fees, supervision, and SEC and State registration.

When assisting clients through the registration process, the bulk of our time is spent on customizing the compliance manual. The manual should be a dynamic document that evolves with the business. The SEC periodically throughout the year provides guidance to firms with regard to expectations. Inevitably, some of these items represent areas of current high interest to the SEC. Consequently, the compliance manual and program is dynamic and needs to be updated periodically as the rules, best practices, and your business changes.

## **Associated Costs**

### ***Cost to Comply***

As private funds consider registration, it is important to remember that implementing an adequate compliance program is a "must-have" that will require time and expense to establish. There will also be on-going costs associated with maintaining and enforcing a properly established compliance program. Regardless of size and complexity, there are certain minimal requirements which must be present in all compliance programs. Moreover, the actual compliance program must be customized to each adviser and fund's unique business risks. The actual costs are therefore very much directly associated with the complexity of the business. At

a minimum, each adviser will have to appoint a competent CCO familiar with the various rules and regulations. However, the CCO should also have the stature and authority within the organization to administer and enforce the compliance program. A tone of compliance from senior management is very important to creating the necessary culture of compliance within an organization.

Each registered investment adviser needs to assess their unique situation and business model when determining how best to allocate resources to compliance. While larger advisers often have dedicated compliance and perhaps, internal audit, they need to consider the adequacy and independence of their internal reviews being performed in-house. Smaller advisers need to assess the cost benefit trade-off of staffing a compliance department with sufficient personnel to ensure suitable and timely monitoring and testing versus outsourcing part of the testing and review of compliance to an independent third party.

#### ***Cost of non-Compliance***

Failure to establish an adequate compliance program has resulted in enforcement actions being brought against CCO's and Adviser's. The actual costs associated with non-compliance may include significant fines and censures as well as employees being barred from working in the industry. In addition to fines, the reputational damage can be staggering. Consequently, CCO's need to ensure they are working for a firm which has the proper compliance culture. CCO's should be prepared to walk away from a position if they are not completely satisfied with their employer's commitment to establishing an effective compliance program

A recent enforcement case involved a CCO being held liable for aiding and abetting his employer's failure to establish, maintain and enforce policies and procedures designed to prevent violations of the regulations. In this particular case, the CCO was not involved with the specific wrong doing. He failed to ensure proper policies and procedures were in place and failed to enforce certain existing procedures. (See A. Carlos Martinez, Exchange Act Release No. 57755, 2008 WL 1913369 - May 1, 2008). In another example, a founding partner and shareholder of a firm was found liable for violating a number of rules under the Advisers Act, including the purchase of "prepackaged" policies and procedures which failed to adequately address the conflicts of interest unique to his firm. (See Consulting Services Group, LLC, Securities Exchange Act Release No. 56612, Investment Advisers Act Release No. 2669, 91 S.E.C. Docket 2079 - Oct 25, 2007). Both cases resulted in censures and fines to both the CCOs and their firms.

## Life after Registration - Our Services

Our firm provides customized deliverables to a diverse client base which is dependent upon each client's unique business model and in-house resources. Our client base is comprised of both large and small clients. Geographically, our clients are predominantly domiciled in the US although we have clients in Australia, the UK and Japan. We are sensitive to the multicultural issues associated with non-US operations. Our clients have included a top 4 accounting firm, a major rating agency, various top national and international banks and numerous hedge funds.

Our focus is two-fold ; we first help clients establish a robust compliance program, and second, we help ensure they stay in compliance and are ultimately prepared for an SEC or investor due diligence visit. SEC3 can walk you through the registration process step by step. In addition to preparing the Form ADVs and working with our clients to customize a written compliance manual, we also help our clients stay in compliance by helping to administer the compliance program. Many of our staff have prior regulatory experience having held positions such as SEC and FINRA examiners, enforcement staff and/or branch chiefs. Once we help you register and prepared your compliance manual, we understand your business in detail. As a result, our consultants are able to partner with the in-house CCO and efficiently, by virtue of having already climbed the learning curve, assist in the ongoing administration of your compliance program. Most clients engage us to work with the CCO in addressing the compliance program by performing periodic testing throughout the year. We are also often asked to provide specialized forensic testing, training, and project specific assistance.

Some of our traditional compliance related services include, but are not limited to:

### *Quarterly Compliance Reviews*

Most advisers prefer to distribute the strain on their operations over the course of the year. Quarterly Compliance Reviews spread all the aspects of the annual review over the course of the year in manageable phases while revisiting critical and changing areas throughout the year. The dynamic scope and disciplined approach of Quarterly Compliance Reviews stimulates the evolution of the compliance program, keeping it continually current and addressing any issues as they emerge. Quarterly Compliance Reviews optimize compliance resources and limit the disruption to your firm. Like the Annual Compliance Review, each Quarterly Compliance Review concludes with a customized, easy to read report and action plan.

Additionally, Quarterly Compliance Reviews address the essential, on-going demands of a compliance program, such as managing disclosure documents, filing requirements, and compliance policies and procedures. Quarterly Compliance Reviews provide the opportunity for

SEC3's professionals to establish a strong working relationship with each adviser and fund and actively participate in the compliance program

### ***Mock SEC Examinations***

Much of the fear surrounding a regulatory examination stems from the "unknown" element. A Mock SEC Examination is an effective process to gauge the types of exposures and concerns that an adviser or fund would face during a real regulatory examination. Our Mock SEC Examinations bring the same SEC focus utilizing proven exam approaches and methodologies, including interviews, reviews of policy and procedures, analysis, testing, and conclude with a customizable summary of assessments, recommendations, and proposed solutions. SEC3's professionals, many with years of experience as senior examiners with the SEC or as compliance professionals, provide expert insight and guidance. Mock SEC Examinations pierce the mystique of a regulatory examination and transform an often stressful experience into a valuable assessment process that allows a Chief Compliance Officer and the compliance staff to face a future regulatory examination with confidence and peace of mind.

### ***Annual Compliance Review***

For registered advisers, the Compliance Rule requires each adviser to review its policies and procedures, at least annually, to determine their adequacy and the effectiveness of their implementation. If advisers are not performing any reviews during the year, the annual review is necessary. During an annual compliance review, SEC3 provides independence and assists Chief Compliance Officers in every phase of the annual review process, from formulating a strategic plan, to conducting thorough assessments and testing of all aspects of the compliance program, to planning for next year's review. SEC3's Annual Compliance Review allows advisers to maximize available resources by fulfilling specific elements or the entire scope of the regulatory obligation. The Annual Compliance Review concludes with a customizable, easy to read report and action plan.

### ***Risk Assessment & Gap Analysis***

The Risk Assessment & Gap Analysis not only fulfills regulatory expectations, it provides valuable insights into your risk profile and your exposure to those risks. SEC3's Risk Assessment & Gap Analysis is based on our experience as ex SEC examiners. Our system considers the likelihood and impact of the compliance risks specific to each advisory firm or fund and assesses how well the existing controls mitigate those risks. The Risk Assessment & Gap Analysis report is a concise, but detailed summary in plain English that prioritizes risks by exposure, arming the Chief Compliance Officer and senior management with the critical information to immediately implement an action plan.

### ***Compliance Testing & Analysis***

Forensic tests are the eyes and ears of the Chief Compliance Officer. Rigorous, consistent forensic testing, provides a Chief Compliance Officer with an early warning system. Various forensic tests are means to identify symptoms of potential compliance problems and can serve as confirmation that the compliance program is functioning properly. SEC3 can assist Chief Compliance Officers in designing and conducting a battery of rigorous and periodic forensic compliance tests as part of the continuous monitoring of the compliance program including, but not limited to, trading and execution, portfolio compliance, code of ethics, account administration, and investment performance

### ***Compliance Training***

Drafting and adopting reasonable policies and procedures is only part of the successful implementation of a compliance program; effective compliance training is also essential. The success of a compliance program is predominately determined by the ability of the adviser's or fund's staff to consistently fulfill the goals and functions of the policies and procedures. SEC3's professionals will assist Chief Compliance Officers in developing and conducting customized training programs to your staff and boards on the various aspects of your compliance program and their responsibilities under that program. Our belief is that training should rejuvenate the staff's awareness and sensitivity of compliance policies while reinforcing the importance of each person's role in the compliance program.

### **Contact Information**

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