

IN PRACTICE

SECURITIES LAW

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Laying Out the Welcome Mat for SEC Examiners

What newly registered hedge fund advisors can expect from SEC compliance inspections

The SEC deadline for hedge fund adviser registration has passed without a decision from the U.S. Court of Appeals for the District of Columbia as to whether the SEC exceeded its authority in adopting a rule that requires most hedge fund advisers to register. To date, the SEC has received several hundred new applications for registration from hedge fund advisers. If you are one of these newly registered advisers, you are probably wondering what to expect from the inevitable SEC compliance inspection that all SEC investment advisers must undergo every few years.

For SEC registered investment advisers, the frequency and scope of compliance inspections is for the most part determined by the examiners' perception of the advisers' compliance risk profile. Because a handful of hedge fund fraud cases have received a lot of media attention recently, examiners may perceive hedge fund advisers to present a higher compliance risk than other types of advisers, which may mean more frequent and broader inspections in the foreseeable future.

The underlying theme of routine inspections relates to compliance with Rule 206(4)-7 under the Investment

Advisers Act of 1940, which requires advisers to adopt policies and procedures designed to prevent and detect violations of the securities laws. Examiners test the effectiveness of an adviser's compliance policies and procedures by conducting informal interviews with key employees and reviewing required books and records. Areas typically reviewed by examiners include e-mail, client files, client complaints, financial statements, trade blotters, brokerage and trading practices, personal securities trading, marketing materials, solicitor arrangements, privacy procedures and business continuity plans.

Focus Areas

The SEC's Office of Compliance Inspections and Examinations has been conducting training sessions to educate examiners in more sophisticated trading and hedging strategies. In addition to investment practices, examiners will probably focus on areas where conflicts of interest arise as a result of the business practices used by hedge fund advisers. Some of these areas are discussed below:

Valuation and Illiquid Securities. Performance-based fees may create the incentive to overstate performance by assigning inflated values to investments. Accordingly, advisers should have detailed policies and procedures for the fair valuation of securities for which prices are not readily available. Such procedures should require that prices be obtained from independent parties, and if possible, from more than one source. Hedge fund advisers should consider side-pocket accounting for illiquid securities in order to avoid disadvantaging long-term investors. Advisers should be prepared to demonstrate that valuation procedures have been applied in a consistent manner.

Allocation of Investment Opportunities. Advisers should be vigilant not to allocate a disproportionate number of limited investment opportunities, such as IPOs, to hedge funds or other clients whose advisory fees are based on performance. Advisers should be prepared to explain any real or perceived discrepancies.

Trade Allocation. Best practices require that bunched trades be allocated pro-rata among all qualified clients at the average price. Similarly, advisers who do not bunch trades should have procedures to ensure that all clients are treated fairly by adopting a rotational system for trade execution. Examiners routinely compare price and trade exe-

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cution times among clients to determine whether advisers are favoring certain clients.

Prime Brokerage Arrangements. Advisers should be mindful of their duty to seek best execution for all client transactions. Soft dollar credits should only be used to obtain brokerage and research services. In addition, hedge fund advisers should avoid the appearance that trades are directed to brokers as compensation for capital introduction.

maintain meticulous records documenting calculations of performance-based fees. Examiners routinely recalculate performance-based fees for several periods to determine if the fee has been calculated in compliance with disclosures, taking into account hurdle rates and high water marks.

Business Continuity Planning. All advisers should have plans to respond to contingencies that have the potential to interrupt their ability to provide services to their clients. While it is very

should) refuse to provide any privileged documents.

Managing the Inspection Process

When going through a regulatory inspection, advisers should be prepared to take these steps before, during and after the process:

1) Conduct an entrance interview with the examiners to provide an overview of your advisory practices and operations — what you do and do not do. This will help the examiner and your firm to narrow the scope of the issues to be addressed during the inspection process.

2) To the extent you are able, address and correct issues or deficiencies raised by examiners before the end of the inspection and advise them accordingly. Likewise, know when and how to request clarification, or to disagree or respond to issues that you believe have been misconstrued or cited in error. Consult with legal counsel on how to address issues raised during the examination.

3) Request that examiners discuss their findings with you in an exit interview. The person responsible for interacting with the examiners should already be aware of these issues, and, hopefully, be able to address and remedy them, or at least have begun to do so. If any of the issues cited by the examiners are of substantial concern or could result in referral to the SEC's Enforcement Division, immediately begin to address the issue with legal counsel prior to receipt of a deficiency letter or follow-up informational request.

4) Respond promptly to the deficiency letter or follow-up requests. Do not be afraid to disagree with issues that you believe have been misconstrued or cited in error. Finally, make sure that you take the corrective action promised in your response letter. ■

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Compliance with Private Placement Memoranda. Examiners routinely review all side letter agreements. Hedge fund advisers should not enter into side letter agreements unless in compliance with "most favored nation" clauses included in Private Placement Memoranda or partnership agreements.

Marketing and Suitability. Examiners will inquire about procedures to prevent private offering memoranda from being distributed to non-qualified persons. At a minimum, examiners will expect to see client questionnaires or acknowledgments of the clients' net worth. Advisers should also number and track private offering memoranda to avoid losing the private offering exemption.

Risk Management. Portfolio managers and Risk Managers should be prepared to describe both portfolio and operational risk management processes to examiners. Hedge fund managers should be prepared to explain their due diligence procedures.

Anti-Money Laundering. Hedge fund advisers should have adequate procedures to prevent and detect violations of the U.S. Patriot Act, including procedures for verifying the identity of clients and filing of suspicious activity reports.

Fee Calculations. Advisers should

important to address information and technology issues in contingency plans, firms that rely heavily on the investment expertise of one or two individuals should also include procedures for responding with prolonged absences by key employees.

E-mail Retention. As with other correspondence, advisers should be prepared to produce electronic correspondence during an inspection. SEC examiners have taken the position that any document on the premises, including personal e-mail, is subject to examination even if it is not required by the books and records rules. Accordingly, advisers should have policies and procedures for the archiving of required electronic records and periodic deletion of any personal e-mail. Communications with legal counsel should be maintained in a separate file that is clearly marked as "Privileged Communications." Advisers may (and

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