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INSIDE...

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FBI reportedly raids hedge funds in alleged insider trading cases

Three hedge funds – including two RIAs – were visited last week in **FBI** raids that the *Wall Street Journal* characterized as culminating a three-year investigation into alleged insider trading. The early reports describe a case of FBI-**SEC** cooperation similar to what **IA Watch** reported last year (**IA Watch**, Sept. 21, 2009).

The three targets reportedly include RIAs **Diamondback Capital Management** ($5.3B in AUM) in Stamford, Conn., and **Loch Capital Management** ($750M in AUM) in Boston. Diamondback's CCO **Ben Anderson** didn't return an **IA Watch** phone call, nor did Loch's attorney **Leonard Pierce** of **WilmerHale** in Boston. The SEC, FBI and the U.S. Attorney's Office in New York declined comment.

IA Watch has learned that the FBI has requested documents of the RIA **Wellington Management Company** ($1.6T in AUM) in Boston as well.

"It's not going to be an easy case to prove," believes **Mark Egert**, a partner with **Crowell & Moring** in New York. "So much of what goes on on Wall Street is people sharing … trading information, looking for the latest rumors …. That's the grease that moves Wall Street." It may be difficult to persuade jurors to understand the fine line between permissible information sharing and illegal insider trading, he says.

Last week the SEC barred and fined **Emil Busse Jr.** $65,000 for cheating clients out of $6 million in a bid to prevent his firm's money market portfolio from

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SEC releases proposed rules affecting RIAs under Dodd-Frank

This is what you've been waiting for – how financial regulatory reform would affect investment advisers. The **SEC** has released the two proposed rules directly targeting advisers in the Dodd-Frank reform law (**IA Watch**, Nov. 19, 2010).

The first proposed rule would broaden Form ADV disclosures – including requiring CCO contact information – outline the transition to state registration for "mid-sized advisers," create a uniform way to calculate AUM and describe what "exempt reporting" advisers would have to submit via the IARD.

The second proposed rule covers who can qualify as "exempt reporting" advisers (see the story on page 3). You'll have 45 days to comment on both rules once they formally appear in the *Federal Register*.

"This is quite an accomplishment" for the SEC to release the two rules so soon after Dodd-Frank was signed

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Continuing series

Your duty #5: Making sure your compliance process fits your firm

A core responsibility of a chief compliance officer's job is to put in place compliance policies and procedures that match the firm's risks. You can see this in the description of a CCO's 5th duty from **Gene Gohlke**, associate director of the **SEC**'s Office of Compliance Inspections and Examinations:

> *Ensures that the steps in the firm's compliance process - risk identification, establishing policies and procedures and implementing those policies and procedures - are appropriate and are undertaken timely by staff of the firm to whom those functions have been assigned.*

This comes from Gohlke's recitation of 24 CCO job duties. This latest installment of our continuing series (**IA Watch**, August 23, 2010) hands you real-world best practices to help you achieve this expectation. Many of your peers recommend you use a compliance calendar to help satisfy this duty.

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New Proposed Rules (Continued from page 1)

in July, says **Michael Sherman**, associate at **Dechert** in Washington.

While Dodd-Frank ordered the SEC to study other issues and gave the agency the choice to develop new rules, Congress specifically directed the Commission to take the actions that produced these two new rules targeting advisers. Another one in the wings would affect the largest advisers. It would mandate systemic risk reporting and "will end up drawing more [of the industry's] ire than either of these will," predicts Sherman.

CCO contact info won't be made public

Among the new Form ADV disclosures for all registered advisers in the first proposal is one calling for "contact information for its chief compliance officer to give us direct access to the person designated to be in charge of its compliance program." Unlike most of the other proposed new disclosures, the public would not be allowed to see this information via the IARD.

Still, the proposal includes many new disclosures that are likely to draw passionate responses from the industry during the comment period. These include public disclosure of :

- Private funds the RIA advises
- Its types of clients, number of employees and advisory activities
- Use of affiliated brokers, soft dollars arrangements and whether the adviser or a related person receives "direct or indirect compensation" for client referrals
- Whether the adviser is a trust company, registered municipal advisor, swap dealer or participant; if it also engages in business development, pension or insurance, works with other investment advisers and whether it does business under a different name
- The identity of the firm's accounting and law firms
- The total number of persons who act as a qualified custodian for its clients
- Whether the adviser had more than $1 billion in AUM at the end of the last fiscal year

This last question would aid the SEC in implementing Dodd-Frank rules about incentive-based compensation provisions within the largest firms. All of the new Form ADV disclosures "will help us identify potential compliance risks and inform our regulatory activities," the SEC writes.

Those exempt from registration would file

Even the three categories of advisers exempt from registration would have to use Form ADV and the IARD to report a "subset of items" and "periodically update" them. The information would be publicly available. The seven items are Item 1 (identifying information, such as name, address, contact data and owner); new Item 2.C. (reporting by exempt reporting advisers), Item 3 (form of organization); Item 6 (other business activities); Item 7 (financial industry affiliations and private fund reporting); Item 10 (control persons), and Item 11 (disclosure information, including disciplinary reports).

These exempt reporting advisers would also have to fill out parts of schedules A, B, C, and D but could skip other Form ADV items and wouldn't have to prepare a Form ADV, Part 2 brochure.

The SEC seeks comments on whether this proposal would result in the public release of proprietary information. It defends the proposal by saying the new data

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would allow it to spot red flags and "identify firms for examination. For instance, it would be relevant to us to know that a private fund is using a service provider that we are separately investigating for alleged misconduct."

The proposed reporting of private fund activity could be controversial. The SEC would want to know where the fund is organized, the identity of its general partner, directors and others, whether it's a master or a feeder fund, the "regulatory status" of the fund and the adviser, gross and net assets, the type of strategy (e.g., hedge, liquidity, private equity, real estate, securitized asset, venture capital or other private fund), the number and types of investors, any minimum investment amounts, fund characteristics that could present conflicts of interest that could "implicate the adviser's fiduciary obligations to the fund and, in some cases, create risks for the fund investors" and the names and locations of its "gatekeepers" (auditors, prime brokers, custodians, administrators and marketers) and whether they're affiliated with the adviser.

Transition to state registration

Among the new Advisers Act rules suggested by the proposal is one that would give those mid-sized advisers plenty of time to make the transition. Of course, those advisers can make the switch at any time – provided they have "a reasonable belief" that their state subjects investment advisers to exams. You may recall Dodd-Frank permits advisers with between $25 million and $100 million in AUM to remain with the SEC if their state doesn't have a registration program and doesn't do exams.

For instance, Wyoming has neither. So the 36 RIAs in that state can stay with the SEC. The agency will rely upon the word of the state securities commissioner as to whether it conducts exams. "The Commission does not intend either to review or evaluate each state's investment adviser examination program," the proposal reads.

The transition will affect all RIAs in one respect. Beginning on the one-year anniversary of the Dodd-Frank law – July 21, 2011 – every RIA would have 30 days (or until Aug. 20, 2011) to report their most recent AUM via the IARD. This first step would permit the SEC "to identify those advisers required to transition to state registration and to understand the reason for the transition or basis for continued Commission registration."

Those firms with under $100 million in AUM would have until Oct. 19, 2011 to file Form ADV-W, withdrawing their SEC registration. Those that fail to do so will have their registrations cancelled. These dates can be pushed back if **FINRA** doesn't update the IARD in time.

The SEC hopes to make the transition process seamless via the IARD. The registrant would be able to "satisfy both state and Commission requirements with a single electronic filing." The state form would be pre-populated thanks to the past information shared with the SEC. Each year, these mid-sized advisers would have to affirm that they need not return to SEC registration – meaning they haven't topped $100 million in AUM.

Calculation of assets under management

Given that so much of Dodd-Frank's changes play off of a firm's AUM, the SEC proposes a uniformed approach to calculating it. For example, the fair value of private funds would be included (using a cost basis could inflate the values, the SEC states), plus uncalled capital commitments, proprietary assets, assets managed without compensation and foreign clients' funds.

Advisers would no longer be able to "subtract outstanding indebtedness and other accrued but unpaid liabilities." These changes are necessary "to preclude some advisers from excluding certain assets from their calculation and thus remaining below the new assets threshold for registration with the Commission," the rule reads. ■

This story first appeared as breaking news at www.iawatch.com on Nov. 22. ■

Second SEC proposal addresses venture capital, other exempt advisers

The Dodd-Frank law exempts three types of advisers from registration under the Advisers Act – venture capital funds, private funds with under $150 million in AUM and foreign advisers. The **SEC**'s second new proposal suggests the rules for these three entities (see related story on page 1).

The proposal would formally appeal the private fund exemption under the Advisers Act that Congress ordered scuttled. The SEC notes any of the three types of "exempt reporting" advisers are free to register with the SEC, if they wish, provided they manage more than $100 million in assets.

Should they remain exempt, each would have to report for the first time data about their businesses using Form ADV and the IARD. As with the SEC's first new proposal, you'll have 45 days to comment once the

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Second New Rule (Continued from page 3)

proposed rule is published in the **Federal Register**.

The agency proposes defining a venture capital fund as one that holds itself out as such (e.g., it can't have advertised that it's a hedge fund), it invests in equities of private companies, at least 80% of each company's holdings by the fund came from a firm that's not publicly traded, it faces leverage limits, permits redemptions only in extreme cases, isn't registered as an investment company and doesn't invest in another private fund, a commodity pool or other investment company. The venture capital fund could hold cash and short-term U.S. Treasuries and must provide its portfolio companies with "managerial assistance." The SEC estimates venture capital funds hold $179 billion nationally. A foreign adviser would be able to qualify if all of its clients are venture capital funds.

The agency also proposes a grandfather clause that it believes would protect all existing U.S. venture capital funds from being forced to reorganize under the proposal.

Private funds with under $150 million in AUM

An adviser would be allowed to remain unregistered if it advised numerous private funds permitted they don't in the aggregate top $150 million. Each quarter, the private fund would have to determine its AUM "based on the fair value of the assets" that need not be tabulated according to GAAP. A subadviser would count only those assists for which it holds responsibility.

Should the adviser exceed $150 million in AUM, it would have three months to register with the SEC. This time "would enable the adviser to take steps to register and otherwise come into compliance … including the adoption and implementation of compliance policies and procedures," the agency writes.

It estimates "one-time costs to new registrants to establish a compliance infrastructure" as ranging from $10,000 to $45,000, "while ongoing annual costs of compliance and examination would range from $10,000 to $50,000."

Exempted foreign advisers

This would accommodate those without an office in the U.S., who manage under $25 million in assets and have fewer than 15 clients/investors. The SEC proposes that these advisers could count as a single client an investor and his minor children, spouse or other relative living with him, even a corporation or a single investor who belongs to two or more private funds advised by the same investment adviser. ■

CCO Duties (Continued from page 1)

The annual calendar for risk assessment at **Wells Capital Management** ($251B in AUM) in San Francisco includes items to be checked on a monthly, quarterly, semi-annual and annual basis. Testing for each item should be completed by the deadlines, and then the compliance department gets 45 days to issue a report about it, says CCO **Mai Shiver**. The IT system accepts all these data, as well as remedial actions and cost estimates if the problem weren't addressed.

Match compliance headings to policies

If the department misses a deadline, it simply gets pushed back, she says. Too many delays can frustrate compliance staff and cause them to "wind up not using the calendar," warns **Vicki Hogan**, president of **NorthPoint Compliance** in Red Bank, N.J. Her time-saving tip is to insert headings (e.g., books and records, trading, etc.) in your compliance calendar and list the policies and procedures that tie back to each heading and where they can be found in your compliance manual.

Add into your calendar's spreadsheet when issues were resolved, recommends **Krista Zipfel**, CEO/president of **Advisor Solutions Group** in Newport Beach, Calif. Another approach is to use forms to document exceptions to your policies. The forms also would indicate the dates an issue was discovered and resolved. This technique would demonstrate the timeliness inherent in Gohlke's description. "The CCO should be reviewing that type of documentation to see that things are being addressed in a timely manner by the appropriate people," Zipfel advises.

Exceptions to your policies should be resolved, and be sure to check next year that the issues no longer pose a problem, suggests **Michelle Kennedy** of **Compass Compliance Services** in Greenwood, S.C.

The pros and cons of delegation

Gohlke's comment alludes to delegating compliance tasks. It's smart, especially in a smaller firm, to spread compliance duties around. But if you do, follow up. Too many CCOs tend to "over-delegate and not" check back in a timely manner on completion of the tasks, finds **Nancy Lininger** with **The Consortium** in Camarillo, Calif.

Another risk you can encounter when delegating is being considered a supervisor of the person to whom you're delegating, points out **Ann Oglanian**, president of **ReGroup** in San Francisco. This could technically open you up to a failure to supervise charge, if things go badly. An alternative is to work through the person's supervisor,

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so the delegation winds through that supervisor and not you.

The job often necessitates delegation. **Donna Courtney**, CCO at **Brown Capital Management** ($2.5B in AUM) in Baltimore, relies on the firm's director of administration to perform many back-office compliance tasks, such as reconciling accounts, billing and performance. The director produces a report that Courtney includes in her annual review.

Each month the bookkeeper at **Rembert Pendleton Jackson** ($553M in AUM) in Falls Church, Va., prepares a list of clients by state so Deputy CCO **Knut Rostad** can ensure the firm isn't brushing up against thresholds for state registration. "Just like clockwork on the first of the month" the report arrives, he says.

Administrative staff also can handle transaction reports and the collection of employees' forms, notes Hogan. ■

Lack of regulatory guidance won't stop firms from venturing into social media

The benefits of social media – including reaching new prospects, interacting with clients and increasing your firm's brand awareness – will continue to attract advisers even as they crave clarity on regulatory rules.

While the **SEC** continues to advise the industry to adhere to its advertising rules when it comes to social media usage, **FINRA**'s guidance serves as suggested best practices, said **Janaya Moscony**, president of **SEC Compliance Consultants** in Philadelphia, during **IA Watch**'s Nov. 16th webinar, *Getting The Best Of Social Media*. She noted studies indicate investment advisers are bullish on use of social media (**IA Watch**, April 5, 2010).

Those firms that remain skeptical should remember that it's likely their employees and investors are using social media – defined as a form of interactive communications – such as **Facebook**, **Twitter**, **LinkedIn** and **YouTube**, noted **Mitch Gibbons**, a partner with **Mayer Brown** in Houston.

Online compliance pitfalls

Hazards dot the interactive landscape. For instance, if a sampling of clients responds online to a firm's questions and the firm selectively showcases the answers, could this be seen as a partial client list and thus a form of a forbidden testimonial, wondered Gibbons.

To prevent such a finding, **Stephanie Brown**, CCO at **Merriman** ($1.3B in AUM) in Seattle, says her firm discloses under the social media site's information section that its list of followers is open to the public, may include employees, clients, family members and that the list should in no way be seen as an endorsement or a recommendation of the firm (**IA Watch**, Oct. 11, 2010).

When it comes to compliance and social media, "you do the best you can by adding disclosures and rules and guidelines," added Gibbons.

A social media policy

They also discussed the wisdom of maintaining a firm policy regarding use of social media and 10 items that should be within such a policy [**IA Watch**'s Compliance Toolbox includes an example of a social media policy].

Because e-communications can be sent via social media sites that wouldn't go through your firm's e-mail archiving system, your policy should be to respond to client inquiries via social media only through your server's e-mail system, noted Brown.

Sites like LinkedIn allow users to "recommend" another member. Brown's firm has a rule that such recommendations about former employees can come only from its HR department. Insisting that employees create two profiles – a professional one and a personal one – is another favorite tactic.

Employee certification

You also could have employees certify that they don't engage in any social media networking or, if they do, that they pledge to follow the firm's policies and procedures while doing so, said Moscony. That policy should state a clear company philosophy regarding social media, e.g., that any bio an employee publishes must be factual or stating a strict prohibition against anonymous postings. You also could have a rule that forces any employee who uses Facebook to make the firm's CCO his friend on the site to aid in monitoring of online behavior.

Obviously if you're going to prohibit certain online actions you will have to monitor for it.

It makes sense to have the responsibilities for e-mail marketing and social media usage placed within the same department to promote a consistent message, said Moscony.

Brown says her current recordkeeping of the firm's social media site consists of copying and pasting screen shots. ■

NASAA tries to swerve Commission away from an SRO for advisers

The **SEC** sure is hearing a lot about a subject it hasn't publicly asked the industry to comment on: whether to ask Congress for the authority to name an SRO for investment advisers (**IA Watch**, Nov. 4, 2010). This time **NASAA** sends the Commission a letter critical of the idea and claiming "there is no [regulatory oversight] regime superior" to the government.

NASAA's letter, dated Nov. 22, doesn't name **FINRA** but the tone appears to lob in the SRO's direction. It claims SROs lack transparency, aren't "directly accountable to the investing public" but rather to their members and suffer from "substantial conflicts of interest that governmental regulators do not." It urges the Commission not to outsource oversight of investment advisers "to a private, third-party organization that does not have expertise or experience with investment adviser regulation."

The NASAA letter also reveals that state regulators contributed to another Dodd-Frank triggered SEC study, this one having to do with IA exams. NASAA alerted the Commission that states "employ more than 400 experienced employees dedicated to the licensing and examination" of RIAs. If the figure were meant to impress, the math means that each state has on average fewer than 10 employees dedicated to exams. The letter states that NASAA is "confident" that states will have the resources to examine the estimated 4,100 RIAs coming their way thanks to Dodd-Frank.

Also last week, the **Investment Adviser Association** issued a new letter that refutes some of the claims from recent FINRA correspondence to the SEC about the SRO issue. ■

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breaking the buck. The agency says Busse reallocated loans from the money market fund to a bond fund to save the former's NAV. The attempt failed. Busse was questioned first by a client and later by his firm, **FAF Advisors** ($92B in AUM) in Minneapolis. Compliance staff hired a law firm to investigate, ending with Busse's dismissal.

FAF used software to allocate loans properly. The SEC states Busse "counteracted" the software to perpetrate his escapade.

In another enforcement case, **New Castle Funds** of New York agreed to pay nearly $300,000 for violating Rule 105 of Regulation M's prohibitions on short selling securities during a restricted period and then purchasing the same securities in a public offering. The Commission considered "remedial acts" taken by the firm. CCO **Gerald Cummins** declined to comment to **IA Watch**. The firm has terminated its SEC registration. ■

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