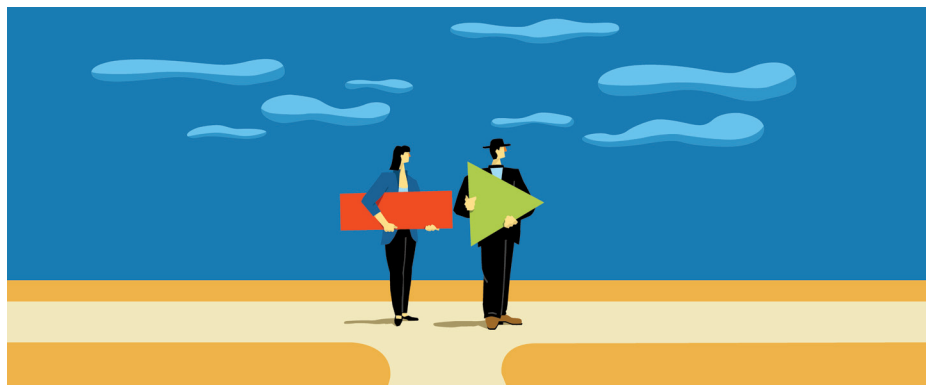


# Seven Key Steps to Help Private Fund Advisers Prepare for Regulatory Change

With the passage of the financial reform, private fund advisers who have previously enjoyed exemption from registration should be making preparations for what will be, at a minimum, a requirement to register under the Investment Advisers Act of 1940.

Registration under the Advisers Act means significant changes for how advisers structure their organization, how they make and retain documentation supporting their business activities, and being subject to regular examination by the Securities and Exchange Commission (SEC). The following are some key considerations for advisers.

- I. **Develop a comprehensive compliance program** that includes written policies, procedures and control activities addressing at a minimum:
  - a. 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;
  - b. 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;
  - c. Proprietary trading of the adviser and personal trading activities of supervised persons;
  - d. The accuracy of disclosures made to investors, clients and regulators, including account statements and advertisements;
  - e. Safeguarding of client assets from conversion or inappropriate use by advisory personnel;
  - f. 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;
  - g. Marketing advisory services, including the use of solicitors;
  - h. Processes to value client holdings and assess fees based on those valuations;
  - i. Safeguards for the privacy protection of client records and information; and
  - j. Business continuity plans.



Advisers should first identify conflicts of interest and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design its policies and procedures to address those risks.

- II. **Appoint a Chief Compliance Officer** with responsibility for the administration of the compliance program. The CCO should be of sufficient seniority, be appropriately credentialed and qualified and have a 'seat at the table' to effectively influence firm conduct with respect to its compliance with applicable regulations. Firms must likewise ensure adequate compliance resources are in place to monitor the adviser's risks and conflicts adequately. The SEC may come to the conclusion that a firm is not fully committed to developing and maintaining a robust compliance program and protecting investors' interests if a firm has inadequate compliance resources.
- III. **Create a written risk assessment and inventory of compliance and other operational risks** that may put client assets at risk, with an emphasis on controls for monitoring the uses of material non-public information (MNPI), management and treatment of potential conflicts of interest and the risks of misappropriating client assets (i.e., adequate segregation of duties). It should also provide a valuation of client assets, performance disclosures and consistency of investment and pooled/managed account related activities with client disclosures (i.e., pitch-books and offering documents).
- IV. **Establish a documented process** to monitor the adviser's compliance with its policies and applicable regulations (i.e., daily, periodic and forensic testing procedures).
- V. **Develop a training program** that addresses the adviser's key business risks, conflicts of interest and high risk policies to better evidence the firm's culture of business ethics and compliance.
- VI. Advisers must **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.
- VII. Advisers who hire sub-advisers or invest in underlying funds must **develop a comprehensive due diligence program** that addresses the awarding of initial mandates, the ongoing evaluation of each sub adviser and fund, and the termination process. The due diligence program should consist of: (1) written policies and procedures-including any 'disqualifiers' to awarding mandates, risk based monitoring program and risk assessment tools; and (2) an oversight function, such as an Investment Committee or Risk Management Committee to ensure the policies are enforced.
  - a. Additionally, advisers who outsource middle and back-office activities and other administrative activities, including outsource/in-source arrangements with affiliates, must develop and implement a service provider/vendor management/oversight program that should include: (1) written due diligence procedures and documentation, (2) formal contracting process oversight,

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and (3) service level monitoring processes and reporting (i.e., metrics, compliance attestations, scorecards, etc.). The oversight program should clearly evidence the 'arm's length' nature of the arrangements and provide sufficient transparency into fees and any other financial arrangements so the CCO can monitor the arrangements for any potential conflicts of interest adequately.

## Final Note

Advisers should not buy compliance manuals "off of the shelf." Compliance policies and procedures must be tailored to the activities of each adviser, addressing the adviser's organizational structure, including affiliates, investment process (frequent use of MNPI indicates a need for firewalls), product suite (including potential competing products), client profiles, distribution channels and any inherent or potential conflicts of interest.

