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Investment Management Review
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Assessing Risk





PREPARING FOR

Proposed Hedge Fund Legislation

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Proposed Federal legislation and regulation will have a significant impact on the hedge fund industry. It is clear that due to recent scandals and increasing enforcement action, the industry will be subject to much greater focus and scrutiny regardless of what actual proposals become law. Throughout the industry, there have been calls from investors and regulators to enhance internal controls, compliance and risk management. The focus on improved corporate governance will lead to the development of more robust compliance programs, which should evidence greater transparency. For those hedge fund managers or investment advisers that are already registered with the Securities and Exchange Commission (SEC), there will be a need to enhance existing compliance programs. For those who are currently unregistered, there will be greater expectations to be met regardless of the final decision on any registration requirements. Much of the controls, reporting and transparencies of registered funds would be realized by requiring the registration of investment advisers of hedge funds, and satisfying the requirements of the Investment Advisers Act of 1940 (the “Advisers Act”).

Every investment adviser registered with the SEC must adopt and implement written compliance policies and procedures and develop a compliance program. Specifically, Rule 206(4)-7 under the Advisers Act requires (a) an investment adviser to adopt and implement written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act (and rules thereunder) by the investment adviser or any of its supervised persons, (b) the designation and appointment of a qualified individual

to serve as chief compliance officer (CCO) to administer and implement the compliance program and (c) evidence of an annual review to determine the adequacy of the compliance policies and procedures and the effectiveness of their implementation. The objective of a well-designed compliance program is to prevent violations from occurring, detect violations that have occurred and correct promptly any violations of the Advisers Act that have occurred.



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Major Aspects of Developing and Maintaining a Compliance Program

While Rule 206(4)-7 does not enumerate specific elements that investment advisers must include in their compliance policies and procedures, investment advisers have been instructed to identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm’s particular operations and then design compliance policies and procedures that address those risks. The SEC listed issues an investment adviser’s compliance policies and procedures, at a minimum, should address (to the extent that they are relevant to that investment adviser) in the adopting release for Rule 206(4)-7. Additional guidance has been provided via forums, correspondence and public speeches.

When developing a compliance program, the following steps may be appropriate:

- Develop a checklist of applicable Federal Securities Laws
- Document controls of the investment adviser and its service providers that support compliance with those rules and regulations
- Map the controls to the rules and regulations and determine existing control weaknesses and gaps
- Test and report on the effectiveness of the controls, and update the risk assessment, based on the likelihood and impact of a failure or occurrence, and compliance history
- Perform ongoing reviews to monitor changes to the control environment through internal best practices and regular participation in industry committees
- Develop methods for monitoring new industry developments, rule proposals, final rules and regulatory guidance
- Develop standard review procedures and documentation for procedure changes

The following key areas of compliance oversight have been identified by the SEC for registered investment advisers and may be applicable to investment advisers of unregistered funds:

- Portfolio Management
- Trading Practices
- Accuracy of Disclosures
- Safeguarding of Client Assets
- Creation and Maintenance of Records
- Solicitation Arrangements
- Valuation of Client Holdings
- Privacy Protection
- Business Continuity
- Pricing of Portfolio Securities
- Identification of Affiliated Persons
- Protection of Nonpublic Information
- Fund Governance Standards
- Anti-Money Laundering Policy Development and Oversight
- Personal Trading and Code of Ethics Review and Reporting
- Use of Leverage
- Counterparty Credit Risk
- Performance Calculations
- Regulatory Disclosure and Filings
- Brokerage Allocation
- Investor Transactions and Recordkeeping
- Soft Dollars

During the past year, the SEC has provided guidance and discussed the examination process and focus areas. In order to thoroughly evaluate a compliance program's effectiveness, examiners need to obtain sufficient information about the structure of an investment adviser's organization and operations to (i) understand the risks and conflicts of interest present at the firm and the policies and procedures implemented to address such risks and conflicts, (ii) determine the ability of the compliance program to prevent, detect and correct compliance problems and (iii) evaluate the reasonableness of the firm's compliance monitoring processes and the remedial actions implemented by the firm once problems have been identified.

Examiners also evaluate the frequency, severity and nature of the problems identified by an investment adviser's compliance program. Investment advisers with effective compliance programs will generally have fewer compliance breaches, problems that are not as egregious, fewer repetitive compliance problems, issues identified on a timely basis and problems that are promptly corrected.

Investment advisers are exposed to numerous risks and conflicts of interest that can result in harm to investors and may cause a firm to deviate from regulatory requirements. Many risks and conflicts of interest are common among firms. Examples of such risks and problems include portfolio managers making decisions that are contrary to a client's investment objectives, traders placing orders for clients'

accounts to generate soft-dollar credits rather than seeking best execution and misrepresenting investment performance of a fund to enhance its position in the competitive marketplace. Investment advisers may also have risks and conflicts of interest that are unique as a result of the firm's organizational arrangements, affiliations, business partners, diversity of client base, products and services offered to clients, geographical locations and personnel. To implement a compliance program reasonably designed to prevent violations of the Advisers Act and rules thereunder, each investment adviser should identify the risks and conflicts of interest that are relevant to its business.

Portfolio management covers a broad array of advisory activities. It includes the allocation of investment opportunities among clients, the consistency of portfolios with clients' investment objectives, disclosures to client and consistency of operations with applicable regulatory requirements and the firm's code of ethics. Because of their importance, these areas are typically reviewed during all examinations. Risks in the area of portfolio management are greatly dependent on an investment adviser's operations, services, affiliations and the specificity of guidelines and restrictions clients place on the firm regarding their individualized services. Also relevant is how the firm handles its receipt of nonpublic information, and how the firm maintains the confidentiality of information regarding its clients.

An investment adviser may choose to engage service providers to perform a number of important services for advisory clients, including management or contractual responsibilities. Service providers often serve as administrator, pricing agent, proxy voting agent and/or fund accountant. These service providers may: provide financial reporting, tax and regulatory services; create and maintain required books and records; value portfolio securities and accounts; prepare regulatory filings; calculate client account expenses; vote client proxies; and monitor arrangements with other service providers. However, when a service provider is utilized, the investment adviser still retains its fiduciary responsibilities for the delegated services. As a result, investment advisers should review each service provider's overall compliance program and should ensure that service providers are complying with the applicable compliance policies and procedures of the investment adviser.

In summary, management support at the top fosters a strong compliance environment and sends a strong message when regulators examine an investment adviser. Compliance programs should be approached with a "what-if" mentality, looking for issues that may not have previously occurred, but could in the future. Ideally, a compliance program will be evergreen in nature, and updated and enhanced as needed.

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