

WHERE NO (Hedge Fund) MAN (ager) HAS GONE BEFORE

A/k/a SEC Registration for Investment Advisers

By Paul Brook, CPA, MBA, Partner, Compliance Solutions Associates

It does not appear that any amount of pleading by Captain Kirk to “beam me up, Scotty” will prevent private fund managers from entering the Final Frontier: Registration with the SEC. The deadline to register has been extended to March 2012: if you have \$100 million or more of assets under management, you must register with the SEC. If you act solely as an adviser to private funds, the magic number is \$150 million. Keep in mind the SEC wants 45 days to review the registration filing so reality is an early February deadline. Warp speed may soon be required.

Registration Process

The Final Frontier is simple in concept yet requires a significant investment of time and resources. An adviser that is required to register with the SEC must:

- Prepare and file Form ADV with the SEC (including notice filings with applicable states) and;
- Create a compliance function.

Following is a summary of the steps required for both of the above along with a timeline. Obviously, the timeline has broad ranges that will be determined by the size and complexity of the adviser’s operations. Advisers can get a preliminary idea of where they might fall in the range based on an assessment of their operations.

Preparation of Form ADV

Form ADV contains four parts as follows:

- Part 1A-requires certain information about the adviser, its control and ownership, and its advisory business.
- Part 1B-asks for certain information required by state securities authorities and is not required if the adviser is only registering with the SEC.
- Part 2A-requires a narrative brochure with detailed information describing the adviser’s business.
- Part 2B-requires information about the adviser’s portfolio managers and other supervised persons as defined.

Form ADV must be filled out online through the Investment Adviser Registration Depository (“IARD”). The IARD web site can be found at www.iard.com. Instructions for the preparation of Form ADV can be found at:

- www.sec.gov/about/forms/formadv-instructions.pdf for Part 1 and;
- www.sec.gov/about/forms/formadv-part2.pdf for Part 2

The instructions and the Form itself can also be found at the IARD web site.

Preparation of Form ADV is a time consuming process that will require the input of several of an adviser's executives. Utilizing pre-existing documents such as a private placement memorandum, subscription documents and marketing materials will prove useful. A summary of the estimated time required is included below and summarized in the next section. Such time range will depend heavily on the complexity of the adviser's operations.

Part 1A requires corporate information, information about the adviser's business including employees, clients, assets, other business activities, affiliates, conflicts, custody and disciplinary history. If the other business activities, affiliates, conflicts and disciplinary history are minor, the completion of Part 1A should take approximately one day.

Part 2A requires a narrative response to 19 different items that describe the adviser's business and operations. An estimate of the time it will take to complete Part 2A is one to two weeks. This includes initial meetings to discuss responsibilities, actual writing of the responses, review of responses by all necessary parties and filing through IARD. Allow two to three times that for the entire timeline for preparation given other daily responsibilities of the parties involved.

Part 2B requires that a "brochure supplement" be prepared for any supervised person who:

- Formulates investment advice for clients and has direct client contact and;
- Has discretionary authority over a client's assets even if there is no direct client contact.

The supplements must be in narrative form and include information on the education and business background, and activities of each supervised person. The time involved for Part 2B will obviously be dependent on the number of persons for whom a brochure is required. Unless there are significant disciplinary events or other business activities to disclose, each supplement should not take more than one to two hours to complete.

Creation of a Compliance Function

The next step a registered adviser must take is the creation of a compliance function. This includes creation of a compliance program, an annual review of the program and designation of a Chief Compliance Officer ("CCO"). Rule 206(4)-7 of the Investment Advisers Act of 1940 ("Act") governs the creation and execution of the compliance function.

The Rule is generally broad and permits a wide range of execution options. Industry standards have created areas of focus from which most advisers will create a compliance function. However, the first step, and a step the SEC will be looking for, is a risk analysis. This risk analysis should identify the significant corporate, investment, client and regulatory risks of the adviser. The compliance manual should then be tailored to concentrate on mitigating those risks. There are many "off the shelf" generic compliance manuals available (many for a fee) and care

should be taken in using them. The efficiency of using a generic manual properly cannot be argued with, however, it must be tailored to the adviser’s specific operations and risks.

With this in mind, the following guide can be used in creating a compliance manual:

- Create a risk analysis by brainstorming with all key executives. While it would be best to do this from scratch, practicality may dictate the use of a table of contents from a generic compliance manual. This table would identify the most common sections of a compliance manual and could be used as a guide to identify the risk areas on which to focus.
- Once the risk analysis is prepared (it should be documented and maintained, as well as periodically updated), the compliance manual should be prepared. The risk analysis will focus the effort and time on the areas of most importance to the adviser.
- In addition to the compliance manual sections, policies and procedures to supplement the compliance manual will require creation. Also, certifications/forms to be completed by management, employees, etc. may be required.
- A compliance calendar should be created noting all regulatory filing requirements, tax deadlines, etc.
- A compliance checklist should be created detailing the actual testing to be performed to execute the program. The compliance manual itself will serve as a checklist for the most part, however, to the extent that detailed testing is required (the SEC is looking for “forensic” testing for many compliance areas), the program should be supplemented with a compliance checklist.

The completion of the compliance manual should be led by the designated Chief Compliance Officer. The time and timeline for completion of the risk assessment and compliance manual may be estimated to be in a range of the following:

- Risk assessment-one week of actual time over a one month period.
- Compliance manual and related policies and procedures-assuming a generic manual is used as a guide, this should take one to two weeks of actual time likely spread over a one to two month period.
- Compliance calendar and checklist-These should be able to be created in two to three days.

Time required for the execution of the compliance program will be specific to the operations and risks of the adviser and providing an estimate is not practicable without some level of knowledge of the adviser.

Estimated Time and Timeline

The table below summarizes the estimated actual time (range) to register with the SEC and create a compliance function as well as an estimated timeline to expect to accomplish both objectives given the need to run the adviser’s business while adding on this process.

<u>Procedure</u>	<u>Actual Estimated Time</u>	<u>Timeline to Expect</u>
-------------------------	---	----------------------------------

Part 1	1 day	1 day
Part 2A, excluding Appendix 1	1-2 weeks	2-6 weeks
Part 2B	1-2 hours per supplement	1-2 weeks depending on number of supplements
Risk assessment	1 week	1 month
Compliance manual	1-2 weeks	1-2 months
Compliance calendar and checklist	2-3 days	2 weeks
Total (approximately)	4-6 weeks	3-5 months

Portions of the above Actual Estimated Time could be outsourced to lawyers, accountants or consultants to save on the amount of time an adviser’s staff would need to commit. But that comes with a commensurate cost. Adviser personnel would still have to participate in the process and review the information as well. The adviser might be able to save half to two-thirds of the Actual Estimated Time noted above, but not all of it. The other substantive advantage to utilizing outside professionals is the Timeline to Expect can be reduced significantly.

Cost

As with any function, the more the adviser does, the less the total cost will be. There will be relatively minor filing fees (up to \$225 to file with the SEC initially and annually thereafter, plus state notice filing fees). Professional fees to assist and/or review in the registration process and creating the compliance function may be far greater. An adviser is encouraged to consult with its professional advisers to gain an understanding of fees that may be incurred. It will also be helpful to gain perspective on fees that are or should be required and those that are discretionary. Clearly utilizing professional assistance in any of the steps outlined herein is discretionary; however, serious consideration to utilizing some level of professional services to review any filings with the SEC prior to their submission is encouraged.

Consideration also should be given to the cost of ongoing compliance execution. The registered adviser must appoint a Chief Compliance Officer (“CCO”) as noted above. There are no requirements for the CCO in terms of background or education, however, the SEC will expect the CCO to have sufficient knowledge to execute all functions required. While, as noted above, estimating the number of hours required to execute the CCO role is beyond the scope of this document, it is not an insignificant task and should be estimated as part of the creation of the compliance function. An adviser has basically three choices in designating its CCO:

- Hiring a full-time CCO with the experience to execute the job without staff assistance.
- Designating a current employee as the CCO. Since the CCO role will require a significant amount of time to execute, such employee must have the capacity to perform the function effectively. Again, administrative support will be required.
- Outsource the complete function to a professional services firm capable of executing the function. This does not remove responsibility from the adviser for the effective performance of all compliance procedures.

With each choice comes a different level of cost. While cost may be a factor in the ultimate decision, it must be kept in mind that the CCO function is a very significant one in the eyes of the SEC and they will be looking for a robust and effective system to be in place.

Summary

If Spock were Captain instead of the First Officer, his logic might have dictated that this registration process is not necessary. However, no one in Congress has pointy ears and green blood, so many investment advisers who have not previously been required to register with the SEC, will be required to do so by March 2012. Registration includes filing Form ADV with the SEC, creating a compliance function and designating a Chief Compliance Officer. The process to register will require significant time from staff and executives. Once registration is effective, the compliance program will need to be implemented immediately. It will be prudent to combine the compilation of information needed for Form ADV with the building of the compliance program where possible. The registration process and the creation of the compliance program provide opportunities for outside assistance, but come with the cost of professional service providers, which can be significant. The entire process can be expected to take 3-5 months. Finally, the appointment of the Chief Compliance Officer can be made through hiring a dedicated CCO, designating someone internally to provide that service or outsourcing the function entirely. The decision will be based on cost, availability of internal resources and expertise, and culture of the organization.

Paul Brook is a Partner in Compliance Solutions Associates (“CSA”), a consulting firm that serves as Chief Compliance Officer on an outsourced basis for hedge funds, mutual funds and investment advisers. CSA also provides compliance consulting services such as registration assistance with the SEC, creation of compliance manuals and procedures, mock SEC exams and other support for the compliance function. Paul can be contacted at pabrook@csacompliance.com