

Seizing the Opportunity Managing the Business in the Registration Era

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Two months ago we asked, should we register? Now the decision has been made for us, with registration with the Securities and Exchange Commission mandated by Feb. 1, 2006.

So what are the implications of being a registered investment adviser? Will it change your business and your day-to-day life? And will registration create a false sense of security?

One thing we are not hearing U.S. professionals say is, "I cannot operate in this environment—it's ruining my investment strategy." People go out of business for many reasons but not because of SEC registration. Non-U.S. providers whose core business is beyond our shores, may, however, chose to forgo U.S. investors.

The Opportunity

On the bright side, there are compelling reasons to view the registration edict as a launching pad from which to address business realities for infrastructure and internal controls. First, you can open new avenues for capital raising. For institutional investors, registration fulfills an important part of the due diligence process. Complying with the requisite disclosures and disciplines demonstrates a commitment to building and enhancing a sustainable business, subject to audit and oversight. In addition, once a fund is registered, accepting pension fund plan assets in excess of the 25% Erisa ceiling could be less onerous as the incremental cost of becoming a qualified professional asset manager (QPAM) is similar to the cost of operational compliance. Furthermore, your existing clients have a lot at stake. It's good business practice to address operational risk and formalize or develop operational processes and procedures that are designed to prevent and detect errors. Finally, this is an opportunity to revisit your investor communications program. What touches the client is an important topic in today's world, and a lot more can be done with reporting, marketing and client services.

Let's look at some questions that hedge fund officers may have.

How onerous and tedious is the process?

As the business becomes more institutionalized, registration will formalize disciplines in some firms and require others to start from scratch building out the business management side of the business with the right personnel to support it. Starting from scratch and putting in place the appropriate documentation and ensuring disclosures conform to regulatory rules can be a time-consuming task, depending on the firm and its complexities. If the initial hard work is done well, monitoring and maintenance should be less onerous.

So what do I need to think about?

Foremost among the disciplines is actually filing with the SEC and being subject to SEC periodic audit and overriding regulatory requirements. While the actual filing and the provision of updates to the SEC are straightforward tasks, substantial time must be spent addressing process, including written policies and procedures addressing the investment process, trading practices and proprietary trading (including disclosure of conflicts of interest), as well as employee trading controls and disclosure, marketing and disclosure practices (brochure requirement, use of solicitors and the like), safeguarding of assets, document retention policies and business continuity plans.

Special care should be taken crafting a compliance manual and a separate code of ethics that makes sense for your business. One size does not fit all. And you need to do what you say consistently. The SEC audit specifically tracks how you do this.

A strong documentation management system is key to monitoring and maintenance. The written compliance policy must be reviewed annually, and a chief compliance officer with relevant experience should be appointed to administer these policies and procedures. Periodic reporting (transactions and holdings) is also required for "access persons." In addition, other specific reporting requirements can apply and there is no substitute for consulting with a seasoned '40 Act lawyer who has direct experience dealing with the SEC. For example, Special rules apply to RIAs with custody of their clients' assets and to RIAs who exercise voting authority over client proxies. Privacy policy must be prepared and in some cases distributed. And what about written representations under the NASD New Issue Rules?

Note that this is just at the federal level. State securities laws (so called "blue sky laws") also have to be understood and complied with.

New Information Requirements: Record Retention and Business Continuity Planning

Of all the ongoing information requirements, record retention is both costly and cumbersome. For example, every email must be archived and be easily searched and accessible. You may want to rethink all electronic points of entry, especially as records must be kept for five years and are subject to SEC audit. In addition, business continuity planning calls for a duplicate of the entire computer system at a secondary site and an understanding of how employees find their way to this location to conduct the firm's business. Additional resources may have to be spent on technology, outsourcing as well as compliance staffing.

What touches the client?

It's clear the information requirements will affect marketing and disclosure. This is an opportunity to upgrade your investor communication program. For example:

- *Transparency to investors.* Rule of thumb: Transparency should be uniform for all investors. If side letters exist, appropriate disclosures should be made in the private placement memorandum. And what about those one-off emails to the high maintenance client? No way, unless you share with the other investors.
- *Hypothetical performance* is not acceptable. Performance should have some rational basis, and risk disclosures must be carefully drawn.
- *Performance examples.* Specific examples of successful investments should be accompanied by every investment made over the same time frame. Pitch books cannot use testimonials either.

- *Some other pitch books issues where NASD rules apply.*

— Related-performance information is impermissible, and all advertising should stand on its own right and recite all risk disclosures.

—Use of target returns is impermissible if there is no back-up that shows how the target was constructed (investors need to be able to evaluate the reasonableness of these targets).

Managers on the Move and Portability of the Track Record

Registration will also affect the portability of the track record, as performance information must be supported by controlling data in your files. For managers on the move, negotiating upfront the rights to records is critical. In addition, the hedge fund track record must correspond to the team in charge at the old firm and the team in charge at the new firm: a 50/50 key person match is insufficient.

Setting the Tone from the Top and Getting On with It

Setting standards and best practices at the top will set the tone for the firm. Registration itself does not ensure that policies and procedures are followed or that the firm has special expertise in managing money or an investment business. For some it may require a change in etiquette; for others it will be an extension of their established best-practice processes. A cultural change may occur, addressing the business reality for infrastructure and internal controls, and the need for a thoughtful investor communications program. This change, along with new avenues that open for capital raising, can take a firm to the next level of success and institutionalization.

StratConGlobal Inc., based in New York, provides Interim COO services to the alternative investment industry. Joanna Peters and her team address the business management side including upgrading business operations and consolidating infrastructure, maximizing efficiencies, improving operating controls, SEC readiness and operational compliance. See www.stratconglobal.com. Email jpeters@stratconglobal.com or call 212-989-2355.

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