

HIGHLIGHTS OF A WEB SEMINAR FOR SEI CLIENTS

Getting a Grip on Your Compliance Imperatives: Planning and Priorities

For mutual funds and hedge funds alike, compliance priorities keep shifting. Several major regulatory proposals remain in flux. Two key deadlines are looming, and several more issues are on the horizon, with adoption of new requirements expected next year. All the uncertainty makes planning and budgeting for 2006 compliance programs tricky. At a recent SEI Web seminar, compliance experts shed light on the questions of where to focus and what to expect.

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THE SEI KNOWLEDGE PARTNERSHIP

ISSUES ON YOUR DOORSTEP

For Mutual Funds: Compliance Program Review

Rule 38a-1 requires that fund CCOs present an annual compliance program review and update to their fund Boards. The first review is due within 18 months of the initial approval of the compliance program—which, since most funds approved their plans last September or October, could be as early as March, 2006.

That is not so far away, considering what it will take to prepare adequately for the annual review. The timing of your presentation must also be planned. Even though you might be thinking in terms of a March deadline, you may need to present your review sooner, depending on your board's meeting schedule.

Conduct a risk assessment to identify areas of high, medium and low compliance risk. This critical exercise will help you focus on the higher-risk areas first, and then move down the risk scale. The SEC and most boards will want to



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The Partnership is an initiative of SEI's Investment Manager Services unit, which delivers operating solutions including fund accounting and administration, hedge fund services, and separate account services.



see a formal risk assessment, so a good strategy may be to share that assessment with the board in advance, letting board members know which areas you plan to spend the most time on.

Develop and implement compliance program monitoring and testing procedures. Monitoring and testing is a complex area, and one CCOs are grappling with for the first time this year. While the monitoring and testing process will likely become better defined in future years, you need to get the right policies and procedures in place now. Establishing and testing them will take a substantial effort. It's also important to note that this year it will no longer be sufficient to merely discuss the design of your policies and procedures. You will also need to present evidence that they are being followed.

Sit down with your board or board chairperson to assess expectations of the annual review, and identify hot-button issues on which you will want to focus your attention. You don't want your board to feel disappointed by the thrust, substance, or specificity of your review. Nor do you want to spend time on routine items while giving short shrift to an issue of real concern to your board members. You may consider sharing the table of contents of your report. Bottom line: some advance discussion will help you make sure expectations are in sync. Talking with your board's independent counsel in this regard is also important.

Contact service providers to preview the substance and timing of their compliance reports, which you must incorporate into your overall program. You will want to make sure service providers are aware of your timeline and vice versa, so that you receive their reports in time to make good use of them.

Prepare the substance of your review, which, at a minimum, must address the following four required elements:

- The operation of your policies and procedures as well as those of your service providers
- any material changes that have occurred to your compliance program's policies and procedures over the past year. The SEC will want to understand not only

what was changed, but why. Was it to address a deficiency? Have you changed an operational or investment strategy? And do the changes create a need for additional policies?

- any recommendations for changes yet to be implemented. For example, your testing might have identified some deficiencies or anomalies you want to correct.
- all material compliance matters that have occurred since the date of your last annual review, generally last fall when most compliance programs were initially approved and adopted. The rule itself defines a material compliance matter' as (i) one that involves either a violation of federal securities laws, a policy violation, or an identified compliance weakness and (ii) is something the board of directors would reasonably expect to be apprised of.
 - This last criterion is probably the least understood of the four, and the one most likely to cause angst since it will require exercising judgment about what a board reasonably would want to be informed of. Fund counsel can be an important barometer of the board's expectations in this regard. Depending on relationships, you might also discuss matters with the board chair or audit committee chair.
 - Keep in mind that any issue involving a conflict of interest is something that most likely should be reported.
 - Whatever is reported, it's critical to understand that both the board and the SEC will expect a material compliance matter to be explained in plain English, with a clear timeline of events and to have been appropriately addressed in a timely manner.
 - Of course, significant compliance matters should have been promptly reported and addressed as they were identified, so the annual report will be a recap of those items. You don't want to surprise the board with a significant matter in the annual report.



For Hedge Fund Advisers: Getting Ready to Register

Based on anecdotes and what's been written in the press, it

appears that few hedge managers have decided to register early.

Q&A ON THE ANNUAL COMPLIANCE REVIEW

WHAT IS FORENSIC TESTING, AND WHAT ARE SOME EXAMPLES OF THE KIND OF TESTING I SHOULD CONSIDER?

SEI Knowledge Partnership: While the SEC has not defined "forensic" testing, Gene Gohlke, Associate Director the SEC's Office of Compliance Inspection and Examinations, recently described it in a speech as "periodic testing that is focused on evaluating whether the outcomes of operational and investment activities over time are consistent with expectations." (See <http://www.sec.gov/news/speech/spch111405gag.htm>.)

Take, for example, the prohibition on directed brokerage under Rule 12b-1. In addition to securing the fund sponsor's representation that it hasn't awarded fund brokerage in exchange for the sale of fund shares, you should analyze whether there is a significant statistical correlation between the percentage of trades with a broker/dealer and the percentage of sales with that same broker/dealer. This statistical analysis could allow you to detect a pattern of activity requiring further investigation, rather than simply relying on the fund sponsor's representation that no prohibited arrangement is in place.

Another example of forensic testing would be to compare the performance of similar funds or products managed by the adviser. Material differences in performance may indicate that trades are not being allocated equitably (bearing in mind that performance differentials might be due to other factors such as asset size or investment restrictions).

In a recent speech, Lori Richards, Director of the SEC's Office of Compliance Inspections and Examinations, stated that an acceptable forensic test has three characteristics:

- It is a "real test" that does more than simply repeat a test already being completed.
- It helps answer the question: "what am I missing?" That is, it involves testing of new material to validate the material or data you usually test.
- It "adds current value." That is, it can be used in your everyday program.

(See <http://www.sec.gov/news/speech/spch102605lr.htm>.)

IF I REPORT MATERIAL ISSUES, WON'T IT BE A RED FLAG TO THE SEC?

SEI Knowledge Partnership: While you certainly hope that your fund complex doesn't experience a material compliance matter, that probably isn't realistic given the broad definition under 38a-1. In fact, identifying compliance issues can indicate that your assessment program is working. Moreover, to the SEC, the important question may be how you dealt with those issues. If you're able to document that you're taking compliance seriously, that will be more palatable to the SEC than mentioning no issues at all. A perfectly clean track record in compliance is somewhat suspect because it seems unbelievable.



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Insights for Investment Managers

“The SEC isn’t looking for perfection; it’s more about process. Regulators want to know that you have a systematic process for identifying where compliance has fallen short, analyzing what went wrong, and taking steps to pre-vent those problems from recurring.”

- Tom Harman, Morgan, Lewis & Bockius

There is nothing wrong with waiting to register, so long as you can meet the February deadline. The question is whether you have begun the necessary work behind the scenes to comply with the February 2006 deadline.

Don’t be lulled into complacency by the seemingly straightforward registration form, because filling out Form ADV is the least of it. What takes time is developing the policies and procedures hedge fund advisers must have to operate in a regulated environment. That can be a profound change, and advisers who haven’t already geared up for it may find themselves scrambling.

“Filling out Form ADV is the least of [the hedge fund manager registration process] What takes time is developing the policies and procedures hedge fund managers must have to operate in a regulated environment.”

- SEI Knowledge Partnership

Some of our previous seminars and white papers have gone into detail on this topic. In broad terms, we recommend that you:

- Take care not to underestimate the work it will require to do a thorough job of preparing for registration, no matter how plain vanilla your firm might be.
- Allow adequate lead time to make sure that everyone contributing to completion of Form ADV has the opportunity to review and approve it before filing.
- Remember that a hastily assembled registration application could be a red flag inviting even closer SEC scrutiny.
- Think in terms of what you would do if you had an SEC exam the day after you register. For example, you may have been operating with a sound policy for trade allocation for several years. But that’s not the same thing as being able to provide documentation that you

have been doing so. When the SEC shows up, the examiners will expect to see that you’ve been conducting your business in a manner consistent with SEC requirements and your stated procedures. That means having written policies and procedures, as well as evidence that you have been following them.

- Pay particular attention to issues the SEC is most likely to focus on. That list starts with potential conflicts of interest such as trade allocation and personal trading. You will also need a comprehensive security-specific valuation policy regardless of what you’re trading, a well-documented and consistently applied trade error correction policy, an e-mail retention policy, and a well-structured code of ethics.

Performance Reporting & Record Keeping

One last notable item related to the hedge fund manager registration rule is its performance reporting component. Effective February 10, 2005, hedge fund advisers that are required to register must have begun to retain whatever records they have supporting the performance they earned prior to their registration if they want to market their performance for periods prior to their registration.

What’s Around the Corner

NSCC’s Mutual Fund Profile Service (MFPS)

Maintained by the National Securities Clearing Corporation (NSCC), the MFPS is an electronic database providing intermediaries with the breakpoint information they need to comply with a fund’s prospectus and applicable NASD Conduct Rules. Because of the risks associated with inaccurate data, it is important that the database be accurate and current at all times.

We, therefore, recommend that product sponsors have procedures to address the monitoring and the updating of the profile service. For example, those responsible for updating prospectuses or Statements of Additional Information (SAI) should make sure to address the question of any impact on NSCC profiles, and breakpoint schedules should periodically be compared with the profile.

Another issue is the lack of common definitions for terms, such as “spouse” and “minor children,” used to link accounts for rights of accumulation (ROA) purposes. The



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NASD Mutual Fund Task Force (NASD Task Force) has recommended that either the SEC require funds to adopt standardized definitions (presumably by amending Form N-1A) or the industry voluntarily adopt uniform standards. We believe the former approach would most effectively create a level playing field.

Given the compliance costs associated with monitoring for breakpoint compliance, omnibus transparency and the eventual point-of-sale disclosure obligations (discussed below), there is some risk that intermediaries will begin limiting the number of fund groups they sell. The good news is that the MFPS, at least, provides intermediaries with a centralized database to obtain breakpoint opportunity information for all mutual funds. In addition, it will give fund sponsors an effective means of evaluating whether they offer competitive breakpoints and ROA.

“Don’t let the nuts and bolts of regulation distract you from considering how new rules will affect your business, or how you must change the ways you operate in order to be in compliance. As with icebergs, the biggest worry is often what lies below the surface.”

- SEI Knowledge Partnership

Point of Sale Disclosure

The mutual fund industry is being singled out for point-of-sale disclosure, a painful and challenging prospect. The SEC’s proposed disclosure requirements would cover the sale of three types of products: mutual funds; variable insurance products, which use a mutual fund as an underlying vehicle; and 529 products, which are municipal securities but have all the trappings of a mutual fund. The SEC also has proposed new trade confirmation disclosure requirements. These proposals are an outgrowth of regulators’ concerns that fund disclosure documents, most notably the prospectus, have not been an effective means of informing investors about areas of conflict or the actual costs of owning shares.

“It is troubling that the disclosure issue has taken on a life of its own and none of us knows where it’s going to come out. There is a concern that this could seriously disrupt the sales process.”

- Geoff Bobroff, Bobroff Consulting

The NASD has also gotten into the game with its own comments and proposals. We can expect some guidance on this issue in 2006.

The pattern could follow what we saw when truth-in-lending reforms were implemented in the auto business. The result was extensive, complicated forms that are non-negotiable on the part of the consumer. After a year or so, everyone simply initialed the pages and moved on. But it is troubling that this issue has taken on a life of its own, and none of us knows where it’s going to come out. There is a concern that this could seriously disrupt the sales process.

There is also a running debate within the industry on the delivery mechanism for disclosure: Does it have to be on paper? Does it have to be delivered in advance and receipt acknowledged in writing? Or are there better ways of communicating with the investor? The investment industry is applying significant pressure to advance a policy of reliance upon electronic delivery. But until broadband is universal, regulators are not likely to mandate electronic delivery, and we likely will still need to operate with paper as well.

Another issue is how we make sure the information gets in the hands of all the right people. That presents a real challenge for the fund industry because so much of our business is maintained by third parties, whether broker/dealer platforms or record-keeping platforms for 401(k) plans.

Fund Governance Issues

Putting aside the independent chair provision, which really is a lightning rod, most elements of the rule package adopted by the SEC are not controversial. If you work with a mutual fund board, by now you should be thinking seriously about what the board’s self-assessment process is going to look like. If your independent directors haven’t previously had quarterly executive sessions among themselves, with or without counsel, you should be planning how to structure time for them to consider any hot-button or non-



routine

issues in advance of full board meetings. The requirement that 75 percent of directors be independent may be more onerous than some other provisions, but most boards are already reviewing their board composition to determine whether they are in compliance.

As far as CCOs are concerned, we are seeing more boards holding quarterly executive sessions with their CCO to foster that relationship, even though the rule requires only an annual meeting.

When you look at the best practices being put forward by groups such as the Independent Directors Council and Mutual Fund Directors Forum, they are advocating more process and more structure. We are seeing boards create more committees. They are going far beyond the standard audit committee with committees designated to oversee such issues as review of the entire 15(c) process, nomination of directors, director compensation, and so forth. We are also seeing more things reduced to writing. While this creates certain risks and additional work, it also provides additional framework and can increase the board's comfort level regarding the resolution of issues.

Given the challenges being made to the independent chair rule, there is a reasonable possibility that its implementation will be delayed for several months. Regardless, board governance has already changed dramatically. Many boards have already been operating with the independent chair

philosophy. Most, if not all, large fund boards have an independent counsel and now, all have CCOs. So any further changes in the works will be largely cosmetic, because the fundamental shift has already occurred.

E-Mail Retention

We have previously covered this issue in depth. Our only updated advice is to stay tuned, because the SEC is expected to provide more guidance on this issue in the near future. It is not yet known whether that guidance will be in the form of a rule interpretation establishing the SEC's view, or rule proposal inviting industry comment before a rule is finalized. In any case, we don't anticipate that the SEC will soften its stance. Recently there were two more cases of

well-known firms being cited for failure to retain e-mails. The fines assessed were significant, and have been trending upward. Bottom line: this issue is not going away.

Omnibus Transparency Rule

As had long been anticipated, this past spring the SEC adopted a redemption fee rule that permits, but does not require, funds to impose redemption fees of no more than two percent. The compliance date is October 16, 2006. Money market funds and exchange-traded funds are excluded.

"Beyond the logistical challenges of complying with the omnibus transparency rule, the costs may be significant. One consultant has estimated that they will approach \$1 billion industry-wide."

- SEI Knowledge Partnership

Boards must take some action on the matter, either adopting a redemption fee or determining that a fee is not necessary to protect long-term shareholders. If a redemption fee is already in place, the board need not revisit the issue, but it must consider the issue for any new fund launches.

Regardless of whether a redemption fee is imposed, the rule also requires the fund to enter into transparency agreements with its intermediaries, such as broker/dealers, retirement plan administrators and insurance company separate

accounts. These agreements must obligate intermediaries to provide the fund with shareholder trading information, which in turn permits the funds to identify shareholders who have violated the funds' market timing policies and also permit the funds to oversee the assessment of redemption fees.

This transparency requirement presents several logistical challenges. Additionally, the costs of compliance may be significant. One consultant has estimated that they will approach \$1 billion industry-wide. With an eye to reducing those costs, the Investment Company Institute is working with the NSCC to develop standardized information requests, standardized file formats for the transmission of the underlying transactional data from intermediaries, and



standardized intermediary agreements. At the same time, providers of transfer agency and sales reporting services are offering data storage and management solutions to help funds reduce the potentially huge costs of storing and analyzing the data.

Soft Dollars

The SEC recently proposed updated interpretive guidance regarding the soft dollar safe harbor under Section 28(e) of the 1934 Act, further clarifying and narrowing what qualifies as “research” under the safe harbor. The comment period expired November 25, 2005.

In its specifics, the proposed interpretation is largely consistent with the recommendations of the NASD Task Force, which called for limiting the scope of the safe harbor to research with intellectual content. Under the proposed interpretation, a money manager must conclude that the research reflects the expression of reasoning or knowledge and relates to advice concerning:

- the value of securities;
- the advisability of investing in, purchasing, or selling securities;
- the availability of securities or purchasers or sellers of securities;
- analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy; or
- the performance of accounts.

Somewhat surprisingly, the proposed interpretation states that market or economic data satisfying the above criteria could fall within the safe harbor. The cost of seminars, but not travel expenses, would be within the safe harbor.

The proposed interpretation establishes a new “temporal standard” and provide examples to distinguish between “brokerage services” that are eligible under Section 28(e) and those products and services, such as overhead, that are not eligible. It also states that for purposes of the safe harbor, “brokerage begins when the money manager communicates with the broker-dealer for the purpose of transmitting an order for execution and ends when funds or securities are delivered or credited to the advised account

or the account holder’s agent.” In contrast, its definition of “research services” includes those provided before the communication of an order.

As a general matter, the SEC

- reiterated its current standard regarding mixed-use items (i.e. reasonable, good faith allocation and associated record keeping to establish the finding).
- preserved third-party research arrangements, provided that the broker-dealer has the direct legal obligation to pay for the research

In light of the proposal, advisers should anticipate continuing margin pressure. To the extent soft dollar providers seek to re-characterize current products and services, advisers should ensure that such re-characterizations are legitimate and reasonable.

SEC Examinations

The SEC is doing its best to keep to its exam schedule, so mutual fund sponsors shouldn’t assume that the wave of hedge fund adviser registrations means you won’t be examined.

Note, also, that the SEC conducts several different types of exams:

- the “for cause” exam, where the SEC has gotten wind of something it doesn’t like and visits you to investigate.
- the “routine” exam, whereby you are examined every few years as part of the SEC’s normal cycle.
- the seemingly ubiquitous “sweep” exam, whereby the SEC seeks to gather intelligence on a particular topic by making inquiries of many firms at the same time.

The important point is that, while these exams differ, you should approach each of them with the same level of diligence and seriousness. With sweep exams, for example, you may feel there’s safety in numbers. But remember that whatever the SEC finds in a sweep exam can lead to an extended exam or enforcement action, so don’t fall into the trap of being complacent.



Our advice to hedge fund managers is to assume that you will be audited in the first year. Whether or not that actually happens, you need to be prepared, which means being proactive in assessing whether your policies and procedures would hold up under SEC scrutiny. By the same

token, smaller firms shouldn't assume that they will be off the SEC's radar. While the SEC has begun doing some profiling, which will probably be geared toward large advisers, this will undoubtedly include some smaller advisers to make its sample sufficiently random.

APPENDIX

BACKGROUND ON SEC POINT OF SALE AND TRADE CONFIRMATION PROPOSALS

The SEC has proposed (i) amendments to trade confirmations with respect to mutual fund transactions and (ii) point of sale disclosure requirements regarding mutual fund transactions. These proposals are not finalized so there currently is no proposed compliance date.

More specifically, the SEC has proposed new Rule 15c2-2 to replace Rule 10b-10, which currently governs the confirmation of transactions in mutual fund shares. Generally speaking, proposed Rule 15c2-2 would require the disclosure of certain general information (e.g. date of the transaction, class of shares, number of shares, etc.), transaction costs associated with purchases and conflicts of interest disclosures with respect to purchases (including dealer concessions, revenue sharing, brokerage commissions received from portfolio transactions with the fund complex and differential compensation, including different commission rates based on share classes available for purchase). Importantly, the proposed rule would preserve quarterly statements for periodic investment plan and money market fund investments.

In conjunction with the proposed confirmation rule, the SEC proposed a point of sale (POS) disclosure obligation with respect to purchases of mutual fund shares. In particular, proposed Rule 15c2-3 would require conflicts of interest disclosure (including disclosure regarding dealer concessions, revenue sharing and differential compensation). There are proposed exceptions to the POS disclosure obligation (e.g. shares purchased with reinvested dividends and purchases made by mail subject to certain conditions).

In the spring of this year, the ICI submitted a important comment letter to the SEC, noting the risk that the proposed rules will discourage brokers from selling mutual funds and making several recommendations.



ISSUES FOR 2006

- Legal and regulatory change
- Business operations and outsourcing
- Marketing, sales, distribution
- Client service
- Business strategy

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