

HIGHLIGHTS OF A WEB SEMINAR FOR SEI CLIENTS

Looking Ahead: The Top 7 Compliance Issues to Address in 2005

When the SEI Knowledge Partnership was launched in the spring 2004, it was in the midst of the biggest regulatory storm in decades. The first hurdle the SEC put before investment advisors was adoption of a compliance program by October 5, 2004, a challenge SEI addressed with a series of Web seminars.

But more mandates and challenges lie ahead: Implementation of a monitoring and testing program within 18 months of the original deadline, an annual updating and approval process, and a host of new regulations that are either being proposed or are already scheduled to take effect. A recent Web seminar offered guidance on priority issues going forward and how to deal with them.

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1. Implementing your compliance program: What should you consider as possible best practices in monitoring and testing?

Where to Begin

The most practical way to begin addressing this issue is by looking at what your organization is already doing. There will likely be corporate-level activities that overlap with your compliance programs and can be incorporated into a monitoring and testing plan. Why not utilize and take credit for them in your compliance program?

For example:

- **Internal audit and quality assurance.** Your internal audit department may test some compliance-related measures throughout the year. If so, you should discuss this testing with those responsible, find out how the testing was conducted, and determine whether it is reliable enough to be included in your overall compliance testing plan.
- **FAS 70 activities.** Many of the firms that do their accounting in-house, as well as those, such as SEI, who provide outsourced accounting services, have an FAS 70 done. It's worth noting that some of the procedures



The SEI Knowledge Partnership is an ongoing source of action-oriented business intelligence and guidance for SEI's investment manager clients. It helps clients understand the issues that will shape future business conditions, keep abreast of changing best practices, and develop more competitive business strategies.

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.



contemplated by an FAS 70 would actually fall under the category of compliance testing.

- **Activities of service providers.** If you use service providers, it is important that you understand the testing that they are doing and hold them to the same standards you apply to yourself. At the same time, you should consider whether some of the testing they are doing on your behalf can be utilized in your own plan. We here at SEI have an internal quality assurance officer who does some things that can be construed as compliance testing. Our CCO and our compliance plan will certainly take advantage of the work he has done over the past year.

What constitutes an adequate monitoring and testing plan?

It must be a structured, formalized plan that reflects a consistent, ongoing testing strategy. While it is easy to procrastinate, a haphazard or last-minute approach could prove disastrous down the road.

Say, for example, you are nine months into the year, have just started testing, and find a violation that occurred eight months ago. First, you will be hard pressed to explain to your board why you are only now discovering the violation. Secondly, you will have lost all opportunity to respond with a timely sanction or reprimand. If you want to take a risk-based approach, you will begin formulating your monitoring and testing plan immediately, recognizing that it will take some time to complete and fine-tune it.

What is the value of a plan?

Beyond helping you meet the mandate, formulating a good monitoring and testing plan has three benefits you'd be remiss to ignore:

- It forces you to think approach the task strategically, rather than reactively.
- It puts you on record with your board members and internal management, which makes it more likely that you will follow through and deliver on all components of the plan.
- Finally, you will be able to use your inventory of planned monitoring and testing measures as a starting point for measuring results.

Uncovering one or two compliance problems is not necessarily a bad thing if you can demonstrate that you have dealt with those problems in a credible fashion and had the appropriate response in place.

What about dealing with violations and sanctions?

When you do testing, you may come across instances of policy violations. Should this arise, don't miss the opportunity to set an example and carry through the expectations you set when you originally rolled out your plan. Some tips and guidelines to keep in mind:

- All employees must be treated the same, no matter what their level or position.
- Be sure to document your disciplinary history. How you deal with a problem may do more to demonstrate your spirit of compliance than not having any problems at all.
- Work to strike a balance in the rigorousness of your system. Sanctions must be sufficient to deter inappropriate conduct, and it's essential to have a system of escalating sanctions for repeat violators. But be careful not to set up a system where you end up sanctioning people 10 or 20 times a year. That would suggest that your system may be too complicated for people to understand, or that your violation threshold may be too low.
- Clearly inform your employees beforehand the circumstances under which they will be sanctioned and why. Almost every organization will have some people—typically, the assertive, high-achieving personality types—who will not willingly accept sanctions if they do not agree they have done something wrong. In fairness to all, and for your own self-preservation, take the time to spell out your policies in detail up front.



2. Creating a culture of compliance: Which steps to take next?

Every employee must understand that while some of these compliance efforts are just getting underway, they will be part of the way business is conducted from now on.

The SEC has made it clear that its requirements won't be satisfied by mere compilations of policies and checklists. Firms must show what they are doing to embed compliance in their organizational DNA, from the senior management levels on down.

It's a challenge that demands serious thought, because off-the-shelf approaches that are not customized are unlikely to pass muster. Then too, if compliance is not integral to the organizational culture, it makes the CCO's job much more difficult. Here are some issues to think about in considering ways to establish the "culture of compliance," starting with your CCO:

- Does the CCO report to top management?
- Is he or she really viewed as part of the organization's leadership and senior management?
- Is compliance the CCO's primary focus, and understood by others in the firm to be so? Or is it a part-time job squeezed in between handling other responsibilities?
- Does the compliance department have the resources for the job?
- Does the CCO have enough authority to carry out compliance plans?
- Regardless of whom the CCO reports to for administrative purposes, can he or she go directly to the CEO when needed to get something done?
- Is there a board member or someone else who can assist the CCO in cases where it would be inappropriate to bring an issue to the CEO or other senior management (e.g., if there are allegations of CEO misconduct)?
- Has the CCO developed and promulgated a compliance strategy and plan for 2005?

- What are the key objectives and initiatives the firm needs to carry out?
- Who is responsible, and what other roles need to be filled?
- Do all employees understand their roles in the compliance strategy and plan?
- Is everyone in the company well informed about the plan?
- Most important of all, is senior management sufficiently informed and involved?

While it's clearly vital that the CCO be able to give compliance issues the attention they require, that doesn't necessarily mean one hundred percent time. Particularly in smaller organizations, that may not be possible or appropriate. But remember that where a CCO has multiple responsibilities in both compliance and non-compliance areas, you will need to demonstrate to the SEC that the CCO is adequately trained in federal securities laws and regulations.

3. Annual program assessment: How to frame the process for your Board?

Under the SEC rules, the compliance program that fund advisors were to adopt by October 5th of 2004 must be re-assessed and re-ratified by their boards of directors on an annual basis. There may be a tendency to take this annual assessment somewhat less seriously than the initial compliance program requirement, but that would be a mistake.

Remember that in approving initial compliance programs, many board members may have been relatively lenient, recognizing that CCOs were struggling with the most massive set of fund rule changes in 65 years. When it comes time for approval of updated plans, however, boards may not be so forgiving. Our recommendations:

- **Demonstrate credibility by answering questions before they are asked.** Your board will want to know what specific actions you are taking to handle the "hot-button" compliance issues we've discussed previously and how thoroughly you are dealing with the 11 regulations released in the last year. So don't wait for your board to ask; present that data as part of your annual assessment and you will get fewer questions.



- **Make sure to focus enough attention on the items your board will be particularly sensitive to.** It is human nature to gravitate toward the subjects we understand best while avoiding those we feel less comfortable discussing. It's important to pull yourself out of that comfort zone and address the tough questions that are on board members' minds—and the only way to identify those issues and have confidence that you are meeting board expectations is to open a dialogue with your board members early on.
- **Demand performance from your service providers.** The compliance programs of service providers is a key component of what you will need to present to your board. The more your service providers deliver in the way of compliance, the more your own responsibilities will be alleviated because you will be able to rely on what they have done. So it is in your interest to act like a board when dealing with your service providers. Ask the same pointed questions you expect your board to ask—What measures do they have in place? What type of testing have they been doing? What documentation can they provide?—and make sure they have good answers to present to their own boards.

As service providers ourselves, we at SEI will be providing our clients with an updated version of the compliance report we have already issued jointly with our counsel, Morgan, Lewis. Also, we soon will be providing you with a testing plan covering all the policies and procedures outlined in our program.

- **Plan to conduct in-person examinations of service providers.** While the SEC does not specifically call for this; you are only required to ensure that service providers have procedures that are “reasonably designed” to prevent the fund from violating the law. Anecdotal evidence suggests, however, that most CCOs are unwilling to rely on paper or other reports and are anticipating a regular inspection and visitation program.
- **Make sure your compliance program is sufficiently customized and specific.** While some boards may have approved a generic program back in September or October, don't expect that to be adequate the next time around. If you used a pre-packaged set of measures as the basis for your initial compliance program, don't wait until the last minute to begin tailoring it to

your particular circumstances and risk factors. Among other things, your board will want to know how your program has changed it was first adopted, whether you have expanded your compliance staff, how roles and responsibilities are assigned, the status of testing, and so on. If nothing significant has changed, that may be seen as signaling a lack of customization.

- **Give training the emphasis it deserves.** Training is the element that takes words on a page and turns them into compliance practice. It is your opportunity to verse employees not only in the “what” and “how” of compliance, but also the “why.” Thorough, well-presented orientation and training sessions are key to any compliance program, and should be conducted periodically on an ongoing basis.
- **Draw a distinction between industry standards and best practice.** In our industry, it often happens that something one big player has done is immediately held up as best practice. If you are questioned as to why you are not doing the same thing, there is no disgrace in saying that, due to budgetary or other resource constraints, you have not attained best practice yet. If you can show that your program is in line with what many firms are doing, it will give your board some comfort.
- **Document your actions and discussions related to compliance.** The SEC has made it clear that the process your firm uses to plan, test, and approve compliance programs is as important as the results. So keep copies of everything you do.

4. Portfolio trading: Where are soft dollar and best execution regs headed?

Indications are that this could be the regulatory issue for 2005. It is being driven by the report of the NASD mutual fund task force, which was submitted to the SEC to provide guidance on general proposals concerning soft dollars and transparency of portfolio execution costs. The NASD committee was composed of senior executives from broker/dealers and mutual funds, and the report is oriented to a mutual fund perspective. Much of what it covers, however, will apply to any advisor, whether you manage mutual funds or not.



Reining in use of soft dollars

The best news in the NASD's report was its expression of the task force's unanimous agreement that the Safe Harbor for soft dollars should be preserved, including their use for third-party research. But the big question is whether the market itself will eliminate the use of third-party research. There are certainly signs of a trend in that direction. We have seen a number of large fund groups announce that they are giving up the practice voluntarily or as a required part of a settlement with regulators. We are also seeing a steady stream of fund boards, and some separately managed clients, telling advisors not to use fund commissions for third-party research.

Key recommendations of the NASD report call for:

- A narrowing of the definition of research, so that soft-dollar eligibility is focused on intellectual content that helps managers pick stocks rather than on the mechanisms used to deliver that intellectual content. The SEC is expected to respond with a proposal in the first quarter of 2005. If it follows the NASD recommendations, you will be unable to use soft dollars for computer hardware or software, telephone and transmission lines, publications, or news services. Proxy voting services and research-related travel will also be ineligible.
- Boards to get more information about funds' use of soft dollars. We recommend that you protect yourself by implementing this measure now, regardless of the SEC's actions.
- Enhance disclosure of soft-dollar practices to investors.
- The SEC to apply the same soft-dollar rules to everyone. Currently, mutual fund and ERISA account managers are held to stricter standards than other types of accounts, such as hedge funds. This is clearly shaping up to be a political battle whereby the regulated parts of the industry are seeking to level the playing field. This is one to keep on eye on.

If the SEC propose a new soft dollar system in the first quarter of 2005, we could see a rule adopted by the end of 2005. That means that if you are now using soft dollars for expenses that will be ineligible, you need to start budgeting for the change now. The press is portraying the SEC's pro-

posal as being of relatively minor importance, but for smaller advisors, in particular, the cost impact could be significant.

Reining in use of soft dollars

The NASD did not recommend that advisors be required to unbundle execution and research costs in their reports to shareholders or fund boards. The report does, however, incorporate a minority view of some advisors who believe this unbundling is not only possible, but ought to be required. The question is whether the SEC will seize on the minority view and push it through, despite a feeling on the part of many advisors that unbundling will be difficult to accomplish with any degree of specificity.

In any case, expect the SEC to continue seeking ways to provide greater transparency in commissions. The result could have a major impact on how you do business.

5. Hedge fund registration: where do things stand?

The SEC has finally issued its hedge fund registration rule, which was adopted generally as proposed. The rule is 160 pages in length, with most of the meat in its 500 or so painstakingly detailed footnotes. While it does not take effect until February 1, 2006, don't delay in your planning and preparations; it will take time to get all the needed systems in place.

Who is subject?

All but the smallest private funds are required to register. The rule applies to any private fund with 14 or more clients, with a "look-through" provision requiring counting of all investors, including those in underlying funds if you're a fund of funds, and U.S. investors if you're an offshore fund. Any fund that allows redemptions within a two-year window is considered a private fund. Venture capital and private equity funds are specifically excluded.

Determining asset and client thresholds is complex. If you meet the 14-client threshold (with look-through) and have at least \$25 million in assets, you are eligible to register; if you have at least \$30 million in assets you must



register. In determining whether you hit the threshold, several issues come into play.

- Borrowings cannot be used to reduce the total asset value of funds and remove the registration requirement; these are included in the valuation. However, proprietary investments can be deducted from the valuation.
- When it comes to counting owners, you don't have to count the advisor itself, or the advisor's knowledgeable employees. Should it occur to you to get creative and think about turning clients into employees—don't. The SEC is clear in prohibiting that move if it's made solely to avoid counting clients toward the limit.
- For offshore funds, the SEC will look to the domicile of investors – whether individuals or business entities. Duplicity of jurisdiction is avoided by exemption (i.e., if the fund is already regulated by a foreign jurisdiction).

Looks to principal fund advisor. Funds marketed under the published expertise and management of a manager/advisor will require registration by that advisor. Use of sub-advisors and other consultants will not relieve the principal advertised source of expertise – the major advisor – from that requirement.

Will the rule be challenged?

The hedge fund release was the subject of scathing dissent within the SEC and some of the bitterest public debate ever seen in that arena. The dissenting commissioners have taken the majority to task, maintaining that options other than registration should have been considered, that there is no evidence of rampant fraud among hedge funds, and that the SEC lacks the resources to expand its authority into this area.

The issue won't be going away, and congressional hearings are already being discussed. We can expect major challenges and, perhaps, some modifications. The SEC appears determined to adopt the rule, however, and for planning purposes, we recommend proceeding with the assumption that the rule will take effect as scheduled.

6. E-mail retention: How to plan for the upcoming rules?

Over the past year, e-mails have been the smoking gun that brought down some fund advisors. That is reason enough for e-mail rules to be of major concern.

Over the last 15 months, the SEC has been routinely asking to see e-mails—in fact, asking for them in electronically searchable format. Some of these requests have been for all e-mails or all e-mails to and from certain individuals. Their very broad nature is raising concerns and a number of questions we will try to shed light upon:

- **Does the SEC have the authority to make such sweeping requests?** It would appear that they do. All the record-keeping rules refer to the SEC's authority to examine "communications," and one would hard-pressed to argue that e-mails do not fall into that category.
- **How much e-mail information should be routinely provided?** Clearly, certain e-mails do not fall under the context of the rules because they deal with topics completely unrelated to the SEC's interests. But how can you segregate e-mails that fall under the rule from those that don't? When the SEC comes calling, you can either sort through e-mails manually, hire some service to do it, or give the SEC a disk it can search. In all three cases, you still end up retaining all e-mails.
- **Is it possible to segregate the e-mails relevant to the SEC's interests?** It is difficult to imagine how such a system would be designed. Even if that were possible, it would be a risky approach, as it would be sure to draw extremely close SEC scrutiny to the particulars of the system. One possible avenue might be to have a very explicit and thorough method of training employees in e-mail retention. But again, if that's the policy, the SEC will give all aspects of your e-mail especially close examination.

The SEC has promised to provide guidance on these specifics in the coming months. The Investment Counsel Association of America has sent the SEC a letter requesting an official position on several key questions:



- Must all e-mails be retained in the computer-searchable form the SEC is requesting? The ICAA is suggesting that the rule simply says the e-mail must be produced, without specifying the format.
- If I have reasonable measures in place to guide my staff in segregating e-mails that are of concern to the SEC, am I in compliance with the spirit of the rule? The industry needs specific guidance.
- If I have a system for culling out e-mails that are not of SEC concern, does the SEC have a right to request those as well? The ICAA would say not, and it is looking for the SEC to confirm that.
- If some firms are manually spot-checking e-mails as part of their CCO diligence, is that a best practice we are encouraged to emulate? Or is it a requirement? We would argue that it is a best practice, but not required.

As a final point, the ICAA is asking the SEC whether it is permissible to divide the term “communications” into two subsets: one being external communications that are subject to the rule, and another being internal communications that aren’t. But we strongly suspect that the ICAA is not going to win on that point.

Practically speaking, the logistics of setting of a system to retain all e-mails would not seem difficult. The key to any e-mail program is training employees not to send things through e-mail that could be misinterpreted, and that takes constant reinforcement. Employees must also recognize that the rule applies to both incoming and outgoing e-mails, and to any work-related e-mails sent or received from home.

One last question concerns how attorney-client privilege fits into this. You must know that if the SEC comes in and asks for your e-mails, they will want to see everything. If you are going to invoke attorney-client privilege, you will have to comply with what is called the privilege law and provide a

basic description of the e-mail content and who sent it. Note, however, that the SEC has been increasingly aggressive in urging people to give up the attorney-client privilege, and that waiver of this privilege has been one factor in the lessening of sanctions. So the attorney-client is not gone, but it would be unwise to invoke it unless it’s absolutely necessary, and it should not be relied upon to protect information that could be problematic.

7. Client relations: How can compliance efforts be turned into a competitive advantage?

Increasingly, investors and intermediaries are asking funds what about their plans and progress on the compliance front. What we recommend is a proactive communication plan that informs clients about your philosophy and approach, and gets you some credit for all the things you’re doing. Specifically, we suggest that you:

- Comply with new regulations well before the deadlines, and use periodic updates to let clients know you are ahead of the game. This also applies to currently unregistered hedge funds. Why delay the inevitable? If you wait until February 2006 to register, you are missing a great opportunity to make points with clients or prospects by embracing registration and having your act together.
- Make sure that all of your client service and sales personnel are knowledgeable about the firm’s compliance strategy and approach.
- Have an action plan in case you inadvertently run afoul of an issue. Decide in advance who needs to know, what you will tell your clients, and what level of transparency you want to provide. In the best case scenario, you will never have to get into the mode of damage control, but at least you will be ready if you do.



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