The Developing Regulatory Landscape for Hedge Fund Managers

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Many hedge fund managers are dealing with significant regulatory change and uncertainty. As nearly everyone in the hedge fund industry knows, the SEC's new rule requires most hedge fund managers to register as investment advisers with the SEC by February 1, 2006.[1] Other proposed rules and regulatory developments loom. At the same time, some recent SEC examinations and enforcement actions provide cause for caution.

Part I of this article summarizes some recent regulatory developments (both related and unrelated to the new registration rule). Part II discusses what to expect from the inevitable SEC examination when a manager registers. Part III explains the new hedge fund manager registration rule and some of its implications.

PART I
RECENT REGULATORY DEVELOPMENTS

Soft Dollars Releases. On October 19, 2005, the SEC released a proposed interpretation[2] (the "Soft Dollar Release") clarifying the scope of Section 28(e) of the Securities Exchange Act. Under section 28(e), an investment manager does not violate its fiduciary duty by using client commissions to pay for research and brokerage. Without section 28(e), an investment manager would arguably be required always to use the broker with the lowest commission rate. The release will propose a three-part test for determining whether a payment of an expense falls within the so-called "28(e) safe harbor": (1) the expense must be for eligible "brokerage" or "research" products or services, using the revised interpretations of those terms described below; (2) the expense must provide lawful and appropriate assistance to the manager in the performance of its investment decision-making responsibilities; and (3) the investment manager must make a good faith determination that the commission paid is reasonable in relation to the goods and services provided by the broker.

"Research". The Soft Dollar Release proposes to narrow permissible "research" to advice, analyses and reports that reflect the expression of reasoning or knowledge. Permissible "research" could continue to include market data and other financial and economic data, quantitative analytical software and software that provides analyses of securities portfolios, mass-marketed publications and investment seminars (excluding associated travel expenses), so long as the expense met the three part test described above. Some items that would now be outside of the safe harbor include operational overhead expenses,[3] computer hardware,

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[1] The adopting release (Advisers Act Release No. 2333 (December 2, 2004)), including the dissent by two SEC Commissioners, the proposing release (Advisers Act No. 2266 (July 20, 2004)), and public comments on the proposed rules are available at www.sec.gov/rules/final.shtml.

[2] The proposed interpretation (Exchange Act Release No. 52635 (October 19, 2005), is available at www.sec.gov/rules/interp.shtml.)

[3] The Soft Dollar Release lists a number of such expenses, including travel expenses, entertainment, and meals associated with attending seminars, office equipment, office furniture and business supplies, telephone lines, rent, accounting fees and software, website design, e-mail software, internet service, legal expenses, personnel management, marketing, utilities, membership dues, professional licensing fees and software to assist with administrative functions such as managing back-office functions, operating systems and word processing.

telecommunication lines (except those dedicated to trading), IT consultants and the salaries of research staff. Consistent with current practice, payments for mixed-use items (items with research and non-research uses) would need to be allocated between their safe harbor and non-safe harbor uses and that allocation documented. The Soft Dollar Release specifically mentions that the safe harbor would not cover account performance software that is used for marketing purposes.

"Brokerage". The Soft Dollar Release also limits permissible "brokerage" services to those services that the manager uses from communicating with a broker to execute an order through the point at which the funds or securities are delivered to the fund's account. Trading software and communication services related to execution, clearing and settlement, such as dedicated lines to the broker and message services used to transmit orders, would be eligible for the safe harbor. Order management systems and trade analytics, surveillance systems and compliance mechanisms are not permitted "brokerage". Trade analysis programs that are partially used for research and partly to help the adviser satisfy its duty of best execution (for example, by analyzing average commission rates) would be a mixed-use product.

The Soft Dollar Release specifically addresses the role of introducing brokers, which are brokers that do not actually execute a transaction but share the commission with the executing broker and credit a portion of their commission to an adviser's soft dollar balance. The Soft Dollar Release reiterates that managers may direct a broker to pay for an adviser's research and brokerage services only if the broker (1) is financially responsible for those goods or services and (2) actually effects the transaction that generates the soft dollars. Most introducing brokers already meet the first requirement by entering into direct contracts with research firms that obligate the brokers to pay those firms for the services provided to the advisers. The Soft Dollar Release proposes new guidance regarding the level of involvement an introducing broker must have in a securities trade to "effect" that transaction. An introducing broker must (a) be financially responsible to the clearing broker for all customer trades until the clearing broker has received payment or securities, (b) keep required records relating to its customer trades, (c) monitor and respond to customer comments concerning the trading process and (d) generally monitor trades and settlements.

The Soft Dollar Release does not restrict payments for independent research. During the SEC's open meeting approving the Soft Dollar Release, two Commissioners expressed regret that uncertainty about whether the SEC might ban such payments had caused a reported decline in spending on independent research during 2005.

The deadline to submit comments on the Soft Dollar Release is November 25, 2005, so we do not expect a final rule until next year, at the earliest. The SEC specifically requested comments on ten topics, including whether it should provide guidance on other products or services not mentioned (such as proxy voting services) and whether it should reconsider its proposal that mass-marketed publications be included in the safe harbor.

The Soft Dollar Release also mentions that SEC staff is considering whether to propose requirements for disclosure and recordkeeping of client commission arrangements. At the open meeting, SEC staff commented that the release would increase disclosure to investors of the total commissions and commission rates paid to brokers and soft dollar expenditures.

Forthcoming Guidance re Retention of Electronic Communications. Hedge fund managers are uncertain of the extent of their duty to retain e-mail and instant messages and produce those records during inspections. The SEC routinely demands access to all internal and external e-mails in electronic format, although the recordkeeping rules do not clearly require that (1) the firm's internal communications be maintained or (2) all such records be kept in electronic format. Some managers err on the side of caution, retaining all internal and external e-mails and IMs in searchable electronic format and paying for the expensive software needed to do so. Of course, many such communications (in particular informal internal e-mails or IMs among analysts and portfolio managers) can be misconstrued and taken out of context during regulatory proceedings and investor lawsuits. In May 2005, a New York bar association group encouraged the SEC to provide greater guidance on these subjects. According to SEC officials, its staff is in the process of preparing some form of interpretive guidance regarding these responsibilities.

Forthcoming Response to ABA Request for Interpretive Guidance. The SEC has advised the American Bar Association's Section of Business Law that its staff is preparing a response to the ABA's June 2005 letter requesting guidance on a number of interpretive issues relating to hedge fund manager registration, including, among other things, (1) various issues relating to the definition of "private fund", (2) the registration obligation of entities affiliated with a private fund's investment adviser and (3) the treatment of funds composed solely or primarily of family members. The letter also asks that an adviser required to register with the SEC under the new rule be permitted to submit its Form ADV through the IARD system by January 13, 2006, because, under the current system, a newly-registering hedge fund manager does not have control of when the SEC will declare its registration effective, and thus, does not know when it must begin complying with the new rules.

The ABA's letter also asks for guidance regarding a number of other issues unique to hedge fund managers that have additional significance in light of the registration rule, including: (1) the applicability of the principal transaction rules to portfolio rebalancing transactions among an adviser's funds, (2) clarification regarding the term "client" in the Form ADV and guidance as to how to respond to the Form ADV's questions regarding "private funds" and (3) various aspects of the SEC's custody, proxy voting and recordkeeping rules.

New and Proposed Changes to ERISA. The Department of Labor recently promulgated rules that increase the requirements for a hedge fund manager to be treated as a qualified professional asset manager (a "QPAM"). A QPAM is exempt from some of the prohibited transaction rules under ERISA and the Internal Revenue Code. The new rules also modify from what otherwise-prohibited transactions QPAMs are exempt.

In addition, a House committee recently approved a bill that would encourage hedge funds to permit increased investments by benefit plan investors. The bill would, among other pro-manager amendments, (1) increase, from 25% to 50%, the percentage of a hedge fund's investors that can be "benefit plan investors" (and would exclude governmental and non-U.S. plans from that definition) before the fund's manager is deemed an ERISA fiduciary (2) eliminate the requirement to compute that percentage separately for each class of the fund's interests, (3) eliminate the ERISA bonding requirement for SEC-registered advisers and (4) reduce some civil penalties for prohibited transactions.

Proposed Anti-Money Laundering Regulations. Though not necessarily a new development, the industry continues to hold its breath for the long-awaited final rules on anti-money laundering that would specifically apply to hedge funds and their managers. In November 2002, the U.S. Treasury Department released proposed regulations that that would require most hedge funds, whether formed within or outside the U.S., to implement anti-money laundering policies and procedures, comply with certain Bank Secrecy Act requirements and provide general information regarding each fund to the Treasury Department. In April 2003, the Treasury released additional proposed regulations that would require many registered and unregistered investment advisers to adopt additional policies and procedures with respect to clients not subject to the November 2002 proposed regulations. Neither of these proposals has yet been finalized, although many investment advisers have incorporated some of the concepts in those proposals into their policies and procedures.

New Part 2 of Form ADV? The SEC has indicated that it will issue a final rule soon regarding the new Part 2 of Form ADV. In 2000, the SEC proposed an overhaul of the current Part II of the Form ADV, which describes various aspects of the adviser's business in a narrative format. The new Part 2 would be designed to be made available on the IARD on-line system, as Part 1 of the Form ADV is today.

PART II
COMPLIANCE AND ENFORCEMENT

The Upcoming Examination Framework. Registered hedge fund managers will be subject to periodic examinations by the Commission's Office of Compliance, Inspections, and Examinations ("OCIE"). OCIE administers the SEC's nationwide examination and inspection program for, among other regulated entities, registered investment advisers. OCIE is the SEC's front-line in understanding and regulating the hedge fund industry and will be the most tangible regulatory presence that most registered hedge fund advisers will face in the near term. On September 29 of this year, Commissioner Paul S. Atkins delivered a speech at the Managed Funds Association that reflected the continuing divide within the SEC over the decision to regulate hedge funds.[4] Among his many continuing concerns about the new regulations, Commissioner Atkins depicted an agency that may be ill-equipped to effectively handle the increased examination workload of an (estimated) additional 1,260 registered hedge fund advisers. Commissioner Atkins expressed his concerns, saying: "Just as some of you are working hard to prepare to deal with us, we at the SEC are struggling to get ready to deal with you. I say 'struggling' because we have neither the resources nor the expertise to oversee all of the potential new registrants . . . . The precious time and attention of our examination staff is being diverted to the oversight of advisers that manage the money of a relatively tiny number of sophisticated investors . . . . Compare that to the more than 90 million mutual fund investors and you would be justified in asking whether we are doing the right thing."

Regardless, the SEC continues to press forward in applying these new regulations. OCIE is not wholly unfamiliar with hedge funds as many large hedge funds have already been registered as investment advisers and thus under OCIE's examination regime for some time.

[4] Commissioners Atkins and Cynthia Glassman were the two dissenting votes against requiring the registration of hedge fund advisers.

Also, as more of its resources are deployed in the hedge fund industry, OCIE is training its staff on hedge fund specific topics, including portfolio and risk management, controls concerning credit and leverage, tax-driven behavior, valuation techniques, and communications with investors. On the other hand, as OCIE prepares for its examinations, registered hedge fund advisers must also ready themselves by, at the very least, understanding the examination process.

Even without the upcoming influx of registered advisers, OCIE's resources have always been limited. In the course of reviewing the efficiencies of its practices, OCIE has developed and continues to change a "risk-based" examination model designed to use its resources in the areas of the most perceived need. The hoped-for result: twenty of the largest advisers will be placed on a two-year examination schedule, which, by most accounts, will continue to be filled by mutual funds. All other investment advisers will be inspected every two to four years, depending on the size of the investment adviser and OCIE's assessment of the investment adviser's risk profile. Criteria that may point to higher risk profiles (and thus more frequent examinations) are investment advisers having custody of client accounts, managing accounts for retail investors, and managing unregistered funds. As part of OCIE's overhaul of its examination processes (prior to the new risk-based model, OCIE attempted to perform examinations every five years), it developed additional processes that focused on an adviser's internal controls and risk management.

On October 19, 2005, Mary Ann Gadziala, an OCIE Associate Director, elaborated on OCIE's risk- based approach applicable to registered hedge fund managers in her remarks before the SIA Compliance and Legal Division Regional Seminar. According to Ms. Gadziala, OCIE has established a formal risk assessment team that will, in conjunction with OCIE's examination staff, centralize the risk assessment function. OCIE's establishment of such a team may reflect an internal perception that OCIE's risk-based examination approach continues to be successful in deploying OCIE's limited resources to areas of perceived need. OCIE also continues to conduct "mini-sweeps" in examinations will be conducted with an eye towards certain identified compliance weaknesses on an accelerated basis. Finally, OCIE appears to have installed certain technologies that facilitate information sharing and coordination throughout the examination process.

For minor infractions or non-compliance, OCIE will issue a deficiency letter, which allows the adviser to pursue remedial action without more formal regulatory action. Should OCIE's examination result in findings of a more serious nature, OCIE will refer these violations to the Commission's Division of Enforcement.

For the most part, adviser deficiencies will be dealt with through the deficiency letter process. If OCIE makes a referral to the Division of Enforcement, it typically conducts an investigation. According to the available statistics, 78% of OCIE's referrals resulted in the opening of an investigation. Once an investigation is opened, the adviser should expect that the Division will deploy its full arsenal of investigative powers, including the issuance of subpoenas for documents and testimony.

The Regulatory View of the Hedge Fund Industry Starts Now. As OCIE initiates its first cycle of newly registered hedge fund adviser examinations, the SEC's practical knowledge of the inner workings of the hedge fund industry will begin to take shape. Hedge fund advisers will positively affect this view by effectively assessing and controlling their risk profile. On September 14 of this year, Commissioner Roel C. Campos, during his remarks before the SIA-Hedge Fund Conference, identified "commonalities" of high-risk behavior by hedge funds, singling out the recent Enforcement action against Bayou Group in his comments. In that case, the SEC alleged that the Bayou Group made numerous misstatements concerning its funds returns in attracting over $450 million in investments. In fact, the funds never made a profit. Commissioner Campos, in drawing an analogy from this case, identified hedge funds' affiliations with broker dealers, lack of independence by auditors, and "painting the tape" at the end of the month to boost performance figures as risk enhancing characteristics.

OCIE has also identified certain criteria centered on a hedge fund adviser's internal controls and procedures that form the basis its risk-profile assessment. An adviser that addresses OCIE's criteria in formulating and implementing its internal controls and procedures and effectively communicates its efforts to the staff will put itself in the best position for a positive risk assessment outcome. Some of the more important areas are:

Insider Trading. Hedge fund advisers differentiate themselves competitively by their ability to identify and analyze relevant market shifting information to make investment decisions. The pursuit of this goal has resulted in increased exposure to allegations of insider trading. For example, regulators have been concerned recently that hedge funds, in addition to other market participants, have been receiving illegal tips from doctors participating in pharmaceutical clinical trials, brokers selling PIPES, and trading on that information. These developments may resonate throughout the hedge fund industry as serious consequences await those trading based on this misappropriated information. Hedge funds should re-examine their policies and procedures with a critical eye towards misappropriating information in violation of confidentiality obligations, whether by agreement or regulation.

Conflicts of Interest. The Commission has identified an adviser's duty to disclose all material conflicts of interests to clients as a critical area of concern. Recent Enforcement actions involving an adviser favoring one set of clients over another, allowing employee or proprietary trading over client trades, and improperly allocating expenses to clients provide concrete examples of the Commission's desire to pursue charges against advisers who fail to live up to this obligation. Also, Commissioner Campos identified potential risk enhancement resulting from possible disclosure requirements for affiliated hedge fund consultants or other individuals and entities receiving marketing fees from hedge funds.

Personal Trading. A subset of an adviser's potential conflicts of interests, personal trading, which is trading by an adviser's employees and access persons, is a potential pitfall that is addressed in the current regulatory scheme. First, advisers are required to collect and review certain types of personal trading by employees and access persons. Second, advisers must implement procedures to minimize or eliminate the potential for conflicts of interest associated with personal trading. Such procedures can include pre-clearance of employee or access persons' personal securities transactions, creating and maintaining a list of issuers the adviser is currently recommending or analyzing (and prohibiting trading in those issuers' securities), and the creation of "blackout periods" that restrict trading when clients' trades are being recommended or initiated.

Record-keeping and Information Presentation. The Commission staff has emphasized the need for advisers to implement procedures designed to ensure accuracy in the pricing of securities and net-asset values, calculation and presentation of performance, and reconciliation of client transactions. Further, an adviser should maintain an independent custodian to provide clients with information about their accounts and regularly square these accounts with fund and adviser records.

High-quality Internal Audits. As part of her comments described above, Ms. Gadziala also emphasized the need for examinees to conduct "high quality" internal audits. Ms. Gadziala continued that to the extent that the examiners gain comfort to the quality and scope of the examinee's internal audit function, OCIE will focus its resources on areas of higher risk. As such, registered investment advisers who conduct such audits will, to some degree, take positive steps that may ultimately lead to a lower risk assessment.

PART III
HEDGE FUND MANAGER REGISTRATION RULE

Registration of Advisers to "Private Funds". The new rule requires most investment advisers that manage more than $30,000,000 and manage "private funds" to register as investment advisers with the SEC by February 1, 2006. The registration requirement applies whether an adviser currently is unregistered or is registered as an investment adviser with a state securities authority or as a commodity trading adviser or commodity pool operator with the Commodity Futures Trading Commission. An adviser with at least $25,000,000 but less than $30,000,000 under management may but is not required to register with the SEC. An investment adviser with less than $25,000,000 of assets under management remains subject to state investment adviser regulation (if applicable in the relevant state), and cannot register with the SEC (subject to exceptions from this prohibition for advisers to mutual funds, pension consultants and certain other types of advisers).

"Look-Through" of Private Funds. Advisers Act section 203(b)(3) generally exempts an investment adviser from investment adviser registration if it (1) has had fewer than fifteen clients during the preceding twelve months and (2) does not hold itself out generally to the public as an investment adviser. To adopt the rule change without amending that statute, the SEC changed the way in which it counts "clients". Advisers Act Rule 203(b)(3)-1 previously counted a hedge fund as a single "client" for purposes of the "fewer than fifteen client" test above. Under the amended rules, however, an adviser to a "private fund" must count each of that fund's investors as a client.

Non-U.S. advisers that manage only non-U.S. private funds are also subject to the look-through provisions (and thus may be required to register as investment advisers with the SEC), except that only U.S. investors count toward the fourteen-client limit. Those advisers are exempt from many of the provisions of the Advisers Act.

Definition of "Private Fund". A "private fund" is an entity that has all three of the following characteristics:

1. The entity would be an "investment company" under the Investment Company Act but for the exception provided from that definition by section 3(c)(1) or 3(c)(7) of that Act. Sections 3(c)(1) and 3(c)(7) both require that a fund not make or propose to make a public offering of its securities. Section 3(c)(1) limits to 100 the number of beneficial owners of the fund's securities. Section 3(c)(7) limits sales of the fund's securities to qualified purchasers.

2. The entity permits redemptions of ownership interests in the fund within two years of purchasing those interests for all new investments on or after February 1, 2006. The SEC adopted this two-year lock-up requirement to exclude private equity and venture capital funds from the "private fund" definition while capturing most hedge funds within it. The SEC has warned that it will monitor whether the two-year lock-up requirement is effective in distinguishing hedge funds from private equity and venture capital funds.

The new rules permit redemptions during the lock-up period due to "extraordinary" events, which include, for example, when it becomes impractical or illegal for an investor to continue to hold the interest, when redemption is necessary to avoid materially adverse tax, regulatory or ERISA consequences, when an investor dies or becomes disabled, and when key personnel of the adviser die or become disabled. An adviser may not, however, use side letters to circumvent the two-year lock-up; the SEC has stated that a hedge fund whose documents require a two-year lock-up but that enters into side letters with some investors allowing them to redeem within two years will be treated as a "private fund." The new rules permit redemption during the lock-up period of interests acquired through reinvestment of distributed capital gains or income. The SEC allows an adviser to determine the age of capital contributions to its hedge fund on a first-in, first-out basis.

3. The entity's interests are offered based on the ongoing investment advisory skills, ability or expertise of the investment adviser. The SEC adopted this element to confirm the direct link between the fund manager's advisory services and investors' decisions to invest in the fund. The adopting release does not provide an example of what types of funds would be excluded by this element of the definition of "private fund."

An offshore hedge fund with all three characteristics is also a private fund and each investor in that fund (whether a U.S. or non-U.S. investor) is counted toward a U.S. adviser's fourteen-client limit. Nevertheless, the rule excludes from the definition of "private fund" a fund that (a) has its principal office and place of business outside the U.S. and (b) makes a public offering of its securities in a country other than the U.S. and is regulated as a public investment company by that country.

Other Rule Amendments. The SEC also adopted several related Advisers Act rule amendments with varying compliance dates.

- Rule 204-2 requires an SEC-registered investment adviser to keep records that support its performance advertisements. The rule has been amended to allow an investment adviser that was exempt from SEC registration but is now required to register under the new rule to continue to market its performance if it retains all required records relating to periods after February 10, 2005, and any existing records demonstrating its performance prior to that date.

- Rule 204-2 now clarifies that the books and records of an SEC-registered investment adviser include the books and records of a private fund for which it (or any related person) acts as the general partner, managing member or in a comparable capacity. The records of the private fund will therefore be open to SEC inspection.

- Rule 205-3 allows an SEC-registered investment adviser to charge a performance fee or allocation only to a "qualified client" (generally, an investor with a net worth of $1,500,000, an investor with at least $750,000 under the investment adviser's management, a non-U.S. investor, a qualified purchaser for purposes of Investment Company Act section 3(c)(7) or one of several specified managers or employees of the investment adviser). To avoid requiring investors that are not "qualified clients" in private funds to divest their interests in those funds, Rule 205-3 now allows an investment adviser to continue to charge a performance fee or allocation to any such investor that invested in a private fund before February 10, 2005. Such investors also may make additional investments. Generally, an SEC-registered investment adviser must "look-through" any hedge fund that relies on section 3(c)(1) to determine whether each underlying investor is a qualified client. As noted in Advisers Act Release No. 2333, note 221, however, the SEC will allow an investment adviser to charge a performance fee to an offshore fund, whether or not that fund has U.S. investors.

- Schedule D of Part 1 of Form ADV now incorporates questions regarding the name, minimum investment commitment, current value of assets and other information about each private fund that an investment adviser or its related person manages. Any SEC-registered investment adviser that amends its Form ADV (and any adviser that submits its initial Form ADV in connection with an application for SEC registration) after that date must answer the new questions. Many advisers already disclose most of this information on Schedule D about U.S.-based hedge funds they manage, but an adviser must now also identify offshore private funds to which the adviser acts solely as an investment adviser (and not general partner or manager).

Timing of Registration. Investment advisers that are required to register with the SEC under the new rules should begin that process immediately. It may take at least several months to develop and implement compliance policies and procedures that meet the standards that the Advisers Act imposes on SEC-registered advisers. The SEC has routinely been approving new SEC registrations within one or two weeks, so an adviser should begin complying with all of the SEC rules prior to submitting the Form ADV. If hedge fund managers flood the SEC with registration applications, the SEC's turnaround time may increase, so an adviser should submit its Form ADV online no later than early December 2005, to improve the likelihood that the SEC declares the registration effective by the filing deadline, February 1, 2006.

Other Implications of SEC Registration. Investment advisers to private funds that currently are not SEC-registered will become subject to a number of significant requirements:

Form ADV. An adviser that currently is not required to file a Form ADV will need to complete the Form and offer to distribute Part II to current and future investors in its hedge funds (and to its separate account clients).

Custody Rule. An SEC-registered adviser must maintain each hedge fund's assets (and the assets of the adviser's other clients) with a qualified custodian and notify the fund's investors where those assets are held. Unless the hedge fund distributes annual financial statements audited in accordance with GAAP within 120 days of the end of the fund's fiscal year, an SEC-registered adviser must also arrange for the fund's account statements to be sent to the fund's investors. The new rule also allows the manager of a fund of hedge funds to distribute those audited financial statements within 180 days of the end of the fiscal year of the fund of hedge funds. State-registered or unregistered advisers that currently follow the *Bennett* and *PIMS* line of SEC no-action letters may no longer rely on those letters to avoid the custody rule if they become SEC-registered. Thus advisers that become registered in 2005 will need to prepare the 2005 audited financial statements of their hedge funds no later than April 30, 2006, to take advantage of this special rule.

Policies and Procedures. The SEC has promulgated numerous rules that require advisers to maintain specific policies and procedures regarding, among other things, prevention of insider trading, privacy, proxy voting, compliance programs and codes of ethics. Every SEC-registered investment adviser must adopt and implement policies and procedures that address, at a minimum, all of the following issues and must have a chief compliance officer who oversees those policies and procedures:

- A code of ethics designed to prevent fraud by firm personnel, which also addresses the firm's standard of business conduct, compliance with federal securities laws (which may include a fairly extensive discussion of the specific laws, rules and regulations applicable to the adviser, its employees and any funds it manages), personal securities reporting, pre-approval of certain transactions and reporting of violations of the code of ethics;

- Prevention of insider trading;

- Proxy voting;

- Portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by the adviser and applicable regulatory restrictions;

- Trading practices, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services and allocates aggregated trades among clients;

- Proprietary trading of the adviser and personal trading activities of supervised persons;

- The accuracy of disclosures made to investors, clients and regulatory authorities, including account statements, advertisements and published prior performance;

- Safeguarding of client assets from conversion or inappropriate use by advisory personnel;

- The accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction;

- Marketing practices, including the use of solicitors;
- Procedures to value client holdings and assess fees based on those valuations;
- Safeguards to protect the privacy of client records and information; and
- Business continuity plans to protect client interests if the adviser becomes unable to provide advisory services (for example, after a natural disaster).

Recordkeeping Requirements. SEC-registered advisers must keep myriad financial, trading, marketing and client relations, policies and procedures and general records, in most cases for at least five years and in some cases indefinitely.

Marketing and Past Performance Disclosure. SEC-registered advisers are subject to several rules and a number of interpretations that regulate their marketing and disclosure of their past performance.

Some Significant Benefits. SEC registration does have significant benefits:

- Unlike an adviser that is not registered with the SEC or a state, an SEC-registered adviser can hold itself out to the public as an investment adviser. Of course, this may be of limited use to a hedge fund manager as public offerings of an adviser's hedge funds are still prohibited, unless the funds themselves are registered as mutual funds with the SEC.

- Some ERISA plans might be more likely to invest in hedge funds managed by SEC-registered or state-registered advisers, because, under certain conditions, trustees of ERISA plans may be exempt from co-fiduciary liability for acts or omissions of such advisers and SEC regulated advisers may have greater protection in avoiding prohibited transactions under ERISA. See Part I – "New and Proposed Changes to ERISA."

- An SEC-registered adviser may be able to exclude assets held in a client account (such as a hedge fund) from its own holdings for purposes of determining whether it has ten percent beneficial ownership of an issuer's class of securities under the reporting and short swing trading provisions of Securities Exchange Act section 16.

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