

# A report from J.P. Morgan's Alternative Investment Services Forum



**J.P.Morgan**

## To Our Clients and Friends,

J.P. Morgan recently hosted a conference in New York City to focus on helping alternative fund executives respond to increasingly complex investor and regulatory demands. With many hedge fund and private equity fund managers working to enhance their processes to meet new obligations, we received a very strong turnout.

In his opening address, Governor George Pataki welcomed more than 100 attendees, stressing the importance of working together to preserve a vibrant alternatives investment industry. His remarks were followed by a lively panel discussion, where a diverse team of experts spoke to a broad range of investor risk assessment and regulatory issues. In post conference surveys, the panel received high marks from attendees for their knowledge, as well as the breadth and relevance of the content they covered.

To assist you in your own efforts navigating industry demands, we are pleased to share below some of the best practices put forth by our panelists.

### Maximizing Your Operational Success and Efficiency When Working With Investors and Regulators Post SEC Registration

#### **WELCOME REMARKS:**

**Governor George Pataki**, Counsel, Chadbourne & Parke

#### **MODERATOR:**

**Georges Archibald**, Head Strategist,  
J.P. Morgan, Alternative Investment Services

#### **PANELISTS:**

**Ted Eichenlaub**, Founding Partner, ACA Compliance Group

**John Phinney**, Chief Operating Officer, Apollo Funds,  
Apollo Capital Management

**Dan Ronnen**, Managing Director & Senior Private Equity Counsel,  
BlackRock

**Daniel Bender**, Managing Director, Risk Consulting, KPMG

**Kenneth McDonald**, Managing Director, Bus. & Oper.  
Due Diligence, SkyBridge Capital

## Marketing in the New Regulatory Climate

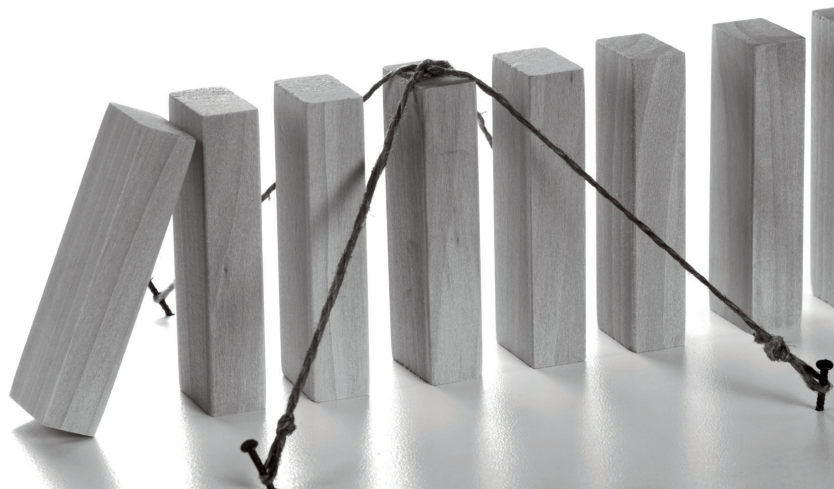
Registered Investment Advisors need a thoughtful process for screening all marketing materials, with involvement from compliance, finance and administration. More specifically:

- Review all new marketing materials against your original investing documents and reconcile any discrepancies
- Make sure information is consistent across all documents
- Be careful with specific claims (e.g., If you say you review 10,000 investments, you must be able to prove that you have counted them)
- Make sure you include all requisite disclosures
- Have an audit trail that follows your process

### Table of Contents

Marketing in the New Regulatory Climate	1
Understanding Your Risk Factors	2
A Positive Approach to Due Diligence	2
The When, What and How of SEC examinations	3
Stay Current with your Regulatory Filing Obligations	3
Conclusion	3

## Understand Your Risk Factors



Preparing your firm for the rigors of a regulatory review and due diligence process begins with a strong set of internal controls focused on the specific risk factors inherent in your business model. Effective risk management requires constant vigilance and a deep commitment to continual improvement. Among the specific recommendations:

- **Valuations should be a primary focus of your annual review.** Understand when and how all positions are being priced, what pricing sources you are using and how many. Responsible fund manager personnel should review whether or not all prices are in before the NAV is set. Furthermore, as a fund manager you should consider whether your role in pricing constitutes a conflict of interest.
- **Perform more proactive asset substantiations and verifications.** Include more independent price verifications and ongoing spot checks of valuations in your processes.
- **Back testing as one mechanism to help in the risk assessment process.** Showing the SEC what you have tested, the results, what conclusions you drew from those results, how you fixed the problems you

identified and how you are viewed by investors and regulators will be accretive. Regulators look for a strong process, not perfect results.

- **Pay to Play rules.** Registered advisors who exceed limits on political contributions face a ban on handling government business for two years. Make sure you are aware of the tools you have to monitor political contributions made by your employees. The SEC will look for both preventative measures and defective controls.

“You have to be able to look your client in the eye and say these charges are fair and reasonable.”

- **Be fair and reasonable in charging back expenses.** While there is some disagreement about what these should be, the experts agree that all charges should be fully disclosed and documented in the PPM, particularly when going outside the bounds of administrative and investment expenses.

## A Positive Approach to Due Diligence

Being the subject of a due diligence process gives you a chance to get an external perspective on your risk management efforts and can serve as a great learning opportunity.

Expect to focus on issues related to monitoring, escalation and remediation including:

- Segregation of duties
- Controls on cash movement
- Access to systems
- Reconciliation procedures
- Valuations

“The level of commitment to a due diligence process is a measure of a funds commitment to transparency.”

A robust process may also address business risks such as the tenure of management; any legal proceedings against the firm; staffing adequacy; front, middle and back office systems; the strength of fund administrators, auditors, prime brokers and compliance partners; and more.

## The When, What and How of SEC examinations

Despite the enormous number of newly registered funds, the SEC intends to “touch” the industry more frequently.

Many of these “touches” will come in the form of Desk Exams, where the SEC will request a dozen or so documents and conduct phone interviews with key managers, while looking for good disclosures and operational infrastructure. Further, the SEC is moving toward more risk-based examinations, focusing on areas such as insider trading, how side pockets work, fund expenses, conflicts of interest, and custody and safekeeping of client assets.

Where the SEC sees a need for a more robust examination, they will come on site, request hundreds of documents and conduct an extensive series of interviews well down

the organizational chart. Make sure your chief counsel and/or compliance officer is present for all interviews. You should also assemble a formal presentation detailing your internal controls. It will show that you are serious about compliance and help frame the conversation.

“One of the few things you can control is how you present your firm. Create a presentation that demonstrates the strength of your risk management processes.”

## Stay Current with your Regulatory Filing Obligations

Make sure you have a clear understanding of your regulatory filing obligations, both domestically and internationally, and have the staff and process in place to address them. If you need outside legal counsel or other help, get it early in the process.

### For the particularly daunting task of filing Form PF:

- Establish a common set of definitions. Adopt a data strategy with a common taxonomy across multi-strategy funds
- Conduct an in-depth gap-analysis and retain outside help early if you need it
- Think ahead: If values change between future filings, you will have to explain why
- Make sure you have the systems in place to accomplish that

## Conclusion

The expert panel at the well-attended J.P. Morgan Conference dispensed an exceptional variety of useful information and advice. The better part of it falls under three broader themes:

**1. Be proactive:** Do not wait until the last minute to address your obligations.

**2. Understand the risks inherent in your business model:** All risks are not created equal for all firms. By understanding the conflicts that are most likely to arise, you will be in a better position to manage them.

**3. Train early and often:** Education is the best preventative fraud measure. From Pay to Play rules to the misuse of material non-public information, the best preventative measure is a clear understanding of the rules.

## Join us next time

As regulation evolves, we'll continue to reach out to our clients with the intelligence they need to make informed decisions. We look forward to seeing all of you at our next event.