Bank of America Merrill Lynch
Hedge Fund Consulting

Updated Overview of Registration, Form ADV, Form PF, and Key Implications
Introduction

To the reader: This document is designed to provide a high level overview of some of the key implications of registration for Hedge Fund managers.

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Given the continuously evolving nature of the new regulation, hedge fund managers should be following the situation closely.

Dodd-Frank has driven sweeping changes to the U.S. financial services industry. In particular, a large number of Hedge Fund managers who formerly were not required to be SEC registered may now be subject to registration. Also, Dodd-Frank specified a number of very specific requirements relating to AUM and exposure to U.S. investments and investors, which determine the need for a non-US investment manager to seek SEC registration.

The SEC registration process may be complex and time consuming. Additionally, being an SEC registered firm brings with it a number of regulatory and filing requirements to be met by the manager on a recurring basis. This document is intended to provide an overview of some of these requirements and some practical suggestions as to how they may be met. Given the complexity of the changes and requirements all managers should be consulting with their legal counsel and developing a comprehensive program tailored for their business.

Fortunately for hedge fund managers, many of the new requirements are already being demanded by investors so that much of the legwork required for registration may be contained in due diligence requests. Given that the information is highly duplicative, managers should look to complete both sets of documents with the same resources to the best extent possible.

While much of the most sensitive hedge fund information is not supposed to be publicly available, we believe that all funds should prepare the information as if it were to be made publicly available.

Newest Changes: On January 18th 2012, the SEC issued a No-Action letter which provided guidance that certain special purpose vehicles created by a registered adviser are not required to separately register as an investment adviser. This is expected to assist large, global firms. Firms should review this newest guidance with their legal counsel to determine it’s relevance.
High Level Overview of Registration

An SEC registered investment manager is subject to the Investment Advisers Act of 1940 ("The Advisers Act"), which has been amended to include the applicable provisions from the Dodd-Frank Act. Key steps and considerations include, but are not limited to:

**Step 1: Understand if Your Investment Management Entity is Required to Register:**

With the elimination of the Private Adviser Exemption (less than 15 clients during the past 12 months and did not hold themselves out to the general public), certain hedge fund advisers may need to register as investment advisers by March 30th 2012. Certain entities may be exempt from registration. Key exemptions:

- Foreign Private Adviser
- Private Fund Adviser with <$150M in AUM – Note that the AUM calculation may be different than expected by many fund managers
- Family Offices
- Venture Capital Advisers

**Step 2: Calculating Your “RAUM”**

Properly calculating AUM for regulatory purposes may be quite a bit different than many managers expect. A new measure of AUM has been introduced that is called “Regulatory AUM” or “RAUM”. RAUM is calculated on a gross basis so leverage/repos must be included—note that when you file your ADV Part 2, you may disclose on a net basis. Examples of included assets that may be missed are:

- All assets – whether compensation is received or not
- Previously optional assets such as assets of non-U.S. clients
- Leverage
- Un-called capital commitments
- Repoed Assets
- Side pockets
- All accounts that the adviser has continuous and regular supervisory or management services (note that sub-advisers do only have to report their portion of a fund)
Step 3. Determine your Filing Level

For managers who advise only Private Funds [e.g. 3(c)(1) or 3(c)(7)]

- Regulatory AUM > $150mm: must register with the SEC by March 30th 2012
- Regulatory AUM < $150mm: do not have to formally register with the SEC; however – still required to file an abbreviated ADV Part I by March 30th 2012. This detail is often overlooked. Potential state registration may be required.

For managers who advise both Private Funds and Separately Managed Accounts:

- Regulatory AUM > $110mm: must register with the SEC
- Regulatory AUM $100-$110mm: may register with the SEC (and probably will want to since approaching the minimum threshold)
- Regulatory AUM $25mm - $100mm: defers to state registration requirements
  - In NY – there is no state examination program, so NY-based managers must register with the SEC
  - In CT and most other states – register with the state
- Regulatory AUM < $25mm – SEC registration not permitted unless NY or WY; state registration may be required.

Step 4: Getting Registered

Getting registered should be thought of as not just a one-time activity, but a true transformation of how the business is required to be run. On an on-going basis, registered investment managers will be required to make certain reporting filings, capture and document conflicts, have a compliance program, manage and test a Disaster Recovery plan, etc.

Here is a brief summary of some of the key areas that registration impacts. We will explore some of the more complex areas in further detail later in this document:

Filings

A registered investment manager will be required to file a number of different forms, either as part of a one-time process or on a regular basis, depending on their size. Filings are explained in detail later in this paper:

- Form ADV: A two-part form that comprises public information about the funds and investment adviser, and the registration application itself.
- Form PF: A brand new filing that is periodically required by registered investment managers (exact frequency dependant on AUM). This provides significant information around the exposures of the fund to U.S. institutions, risk data and other exposure information.
Compliance
A registered investment manager is required to introduce and maintain a formal and process-driven compliance program. This should be annually reviewed by a designated CCO, and should be designed to detect and prevent violations of The Adviser’s Act and all other applicable federal and state laws and regulations. Later in this presentation, the detailed aspects of a compliance program are described, but some key aspects of a compliance program include:

- Written policies and procedures – with annual review
- Code of Ethics
- Identification of existing and potential conflicts of interest – and a mechanism to identify and manage on an on-going basis
- A “competent” and “supervised” Chief Compliance Officer in place to manage the overall process

Examination Rights
The SEC has the authority to request and examine an investment managers books and records. In fact, the SEC has the authority to conduct periodic inspections of all records of the private fund that are maintained by a registered adviser. In addition the books and records of private funds advised by the investment adviser are also considered to be books and records of the investment adviser.

Performance Fees, Investment Advisory Contracts and Fund Investors
Performance fees are subject to Rule 205-3 of The Investment Advisers Act. The charging of performance fees under typical hedge fund practices (e.g.”2&20”) cannot be charged to any investors in the fund that are not “qualified clients”.

The Dodd-Frank Act not only changed the AUM standards that define the overall level of registration requirements, but also changed the definition of both “accredited investor” as well as “qualified client”. Note that advisory arrangements are grandfathered.

- The “accredited investor” definition has been updated to exclude the value of the investors primary residence from the $1mm net worth requirement.
- The “qualified client” definition has been updated to $1mm under management of the investment adviser or that the investment adviser “reasonably believes” that the client has a net worth of >=$2mm (ex Primary Residence) at the time the contract is signed. In addition, the requirements are now indexed every five years to inflation.

In addition to changes in the definitions of accredited investor and qualified client, regulators have signaled that additional AML and KYC requirements are on the horizon. Investment managers should be closely looking at their investor bases as well as preparing AML and KYC processes and procedures.
Safeguarding Customer Assets

The Investment Adviser Act is modified by adding Section 223, which requires registered investment advisers “to take such steps to safeguard client assets” “including, without limitation, verification of such assets by an independent public accountant, as the Commission may, by rule, prescribe.”

Representative Registration Process Timeline:

The registration process is highly dependent upon the size of the firm, complexity of the trading strategy / products, current level of preparedness and frankly the level of internal focus. Key steps to get registered (and representative timeframes) include:

- Development and review of the Form ADV: 1-4 weeks
- Gap analysis of existing compliance program: 1-2 weeks
- Address key gaps in compliance program: 4-10 weeks
- Training on new processes, controls, etc.: 1-2 weeks
- SEC review and approval of Registration: 4-6 weeks

Ways to Accelerate

A large number of professional service firms, from the public accounting / consulting firms to specialized hedge fund compliance boutiques have emerged to serve the growing compliance needs of hedge funds. Typically these firms can provide:

- Templates of various manuals
- “best practices” process flows
- Testing of compliance program
- and even software for tracking trading disclosures, etc...

Advisers must ensure however that these various templates are appropriately customized to fit the specifics of their business.
Form ADV Description and Initial Registration

SEC Registration of an Investment Adviser is effectuated by the submission of the Form ADV, which is separated into two parts (Part 1 and 2). Once registered, your firm is now subject to disclosure obligations and the Investment Advisers Act requirements including, but not limited to, requirements relating to operations, controls, etc. **Typically, the Form ADV would be completed with the assistance of a professional adviser, such as a compliance consultant or lawyer.**

- **Part 1:** Registration with the SEC, and state securities authorities - All advisers registering with the SEC or any of the state securities authorities must complete:
  - 1A: Manager information such as ownership and executive officers, among others
    - Publicly available at www.adviserinfo.sec.gov

- **Part 2:** “Brochures” containing narrative, “plain English” information about the advisory firm.
  - 2A: “Brochure” – including but not limited to, information about the advisory firm such as:
    - Fee structure
    - Services offered
    - Disciplinary information
    - Conflicts of interest
  - 2A: Publicly available through the IARD system
  - 2B: “Brochure Supplement” – including information about each “supervised person” who provides advice to clients or has discretionary authority over client assets

These forms (and instructions to assist with their completion) are available at:

http://www.sec.gov/about/forms/formadv.pdf

Parts 1 and 2A must be filed for SEC submission – which should be submitted at least 45 days prior to intended registration date for SEC review and approval.

Specifically:

- Section 2A (“Brochures”) are required to be uploaded to the Form ADV Part 1 submission and these forms will be publicly accessible through the SEC IAPD (“Investment Adviser Public Disclosure”) system (http://www.adviserinfo.sec.gov). Within 90 days of a registered investment adviser’s fiscal year end, the adviser is required to file an annual updated Form ADV.

- Section 2B (“Brochure Supplements”) Must be delivered to clients and maintained in the managers files, but does not have to be filed with the SEC.
Form ADV Filing Timing

Initial Filing: Must be completed by March 30th 2012 for most funds that were previously unregistered (accordingly, should submit Form ADV no later than February 14th to allow SEC 45 day review period).

Ongoing Yearly Updates

- Annual Updating Amendments must be completed 90 days after the end of your fiscal year.
- Other Amendments: if your information becomes materially inaccurate, you must “promptly” amend your ADV filings.

Filings – Form PF

Form PF represents a key new compliance requirement for Hedge Fund managers that are registered with the SEC, and that have private fund clients with at least $150mm in AUM. While much of the information required for the form can often be found with your fund’s Fund Administrator, it is critical that you review the form and prepare a detailed action plan to file. For complex funds with multiple fund administrators, a variety of vendors have emerged to help consolidate information.

The SEC believes this form provides two key benefits:

- Information collected through Form PF is expected to facilitate FSOC’s (Financial Stability Oversight Council) monitoring of the systemic risks that private funds may pose and to assist FSOC in carrying out its other duties under the Dodd-Frank Act with respect to hedge funds and other nonbank financial companies.
- Information may enhance the ability of the SEC to evaluate and form regulatory policies and improve the efficiency and effectiveness of the Commission’s monitoring of markets for investor protection and market vitality.

The details on this form will not be accessible to the public, however, we believe that whether through information sharing within the government or by mischance, managers should be prepared for this information to be made public at any time.
Report Content

The form itself comprises 4 main sections:

- **Section 1:** Basic information to be completed by all registered investment advisers that have private fund clients with at least $150mm in AUM.
  - 1a: Information about the private funds managed by the adviser (AUM, asset distribution to private funds)
  - 1b: Completed for each private fund (gross/net assets, breakdown of derivative positions, borrowings, U.S. creditors, information about investor concentration, monthly and quarterly performance information)
  - 1c: Completed for each private fund (% of assets managed systematically, significant counterparty exposures, clearing practices)

- **Section 2:** Applies to larger registered investment advisers.
  - 2a: Information at an aggregate level for all funds (exposure/market value of assets held, duration of fixed income holdings, interest rate sensitivity, turnover rate of portfolio, geographical breakdown).
  - 2b: Information for each fund advised by the large hedge fund adviser >$500m AUM (exposure/market value of assets held, portfolio liquidity, position concentration, collateral practices, details of relationships with clearing counterparties, risk metrics, investor information, financing information).

- **Section 3:** Applies to advisers advising liquidity funds and registered money market funds with a combined AUM of at least $1b, (pricing method for NAV, information relating to funds portfolio, asset class exposure, secured or unsecured borrowing breakdown, investor concentration, gating and redemption policies).

- **Section 4:** Applies to advisers advising private equity funds with at least $2b in combined AUM (borrowings and guarantees, leverage of portfolio companies, debt-to-equity ratio of controlled companies, maturity profile of portfolio companies’ debt, bridge financing details, investment breakdown).

Information reported on Form PF would not be available to the public, but Form PF information may be used by the SEC in an enforcement action or by FSOC as a basis for ordering further investigation by the Office of Financial Research.

**Thresholds for reporting**

Form PF is filed periodically, the period being determined by the size of the management company submitting the report. The size of the manager also directly determines the version of the report to be submitted, with a significantly larger report being required for larger managers.

It should be noted that the AUM thresholds referred to below should be measured monthly in the case of Hedge Funds and Liquidity funds, and as of the last day of the prior fiscal year in the case of Private Equity funds.
<table>
<thead>
<tr>
<th>Manager’s Regulatory AUM</th>
<th>Filing Frequency</th>
<th>Initial Filing Requirement</th>
<th>Form Size/Contents</th>
</tr>
</thead>
<tbody>
<tr>
<td>$150mm - $1.5bn, or $1bn in liquidity / money market funds</td>
<td>Annually (no later than 120 days after fiscal year end)</td>
<td>End of first fiscal year to end on or after December 15th, 2012</td>
<td>“Short form” – Only including section one.</td>
</tr>
<tr>
<td>$1.5bn-$5bn</td>
<td>Quarterly (no later than 60 days after each quarter end, (15 days with respect to large liquidity fund advisers))</td>
<td>End of first fiscal year to end on or after December 15th 2012</td>
<td>“Long Form” – Sections 1-4, with sections 2-4 being completed based on the types of assets held within the fund as described above.</td>
</tr>
<tr>
<td>$5bn+</td>
<td></td>
<td>End of first fiscal year / quarter to end on June 15th 2012</td>
<td></td>
</tr>
</tbody>
</table>

**Key Considerations**

While a large amount of the information required within Form PF should be accessible to the adviser, there will need to be procedures in place to be able to extract and provide this information quickly to meet the filing requirements. At present, while a large number of portfolio management platforms may provide a disparate array of reporting functionality, this may not be in the form required for easy population of the required section(s) of the form. As such, it has become clear that the majority of the responsibility for information on the Form PF will be taken on by your fund administrator. It should, however, be noted that in the event where a manager is responsible for multiple funds, which use multiple fund administrators, there will at least be some burden directly on the manager for aggregation of such information, before it can be filed. To fill this gap, multiple vendors have emerged (including many Fund Administrators) who are working on multi-fund data aggregation solutions.

The finalized technical details of this form are not yet quite complete as the exact XML data element formats are still being finalized. This is a critical step as many Fund Administrators are preparing electronic submission forms.

**Taking Action**

Building out a program to address Form PF typically involves the following steps:

- Review the Form sections identify internal and external sources of data
  - Use people who worked on Form ADV to help ensure consistency
- Meet with your fund administrator(s) to review their Form PF program. Key areas to understand include:
- Data provided automatically
- Output quality / match to Form PF template
- Ability to provide risk data or integrate to third-party solutions
- Submission types / user interfaces supported (web, excel, etc.)
- Additional costs (if any, above your existing Fund Admin costs)

- If multiple fund administrators are involved, identify if any provide a multi-administrator solution. If not, look for third-party multi-administrator solutions. Key areas to review around a multi-administrator solution include:
  - Integration with which Fund Administrators and third-party solutions
  - Data security / controls
  - Segregation of Fund Admin from group offering multi-fund solution
  - Costs

- Complete static firm data into Form PF toolset
- Execute preliminary Form PF run
- Review results. Key areas to look at:
  - Consistency with Form ADV filings
  - Review how risk and other metrics are reported
  - Proper alignment of data elements

**Compliance requirements**

Guidelines around the establishment of a robust compliance program are specified in the Investment Advisers Act of 1940, and are defined within Rule 206(4)-7.

These requirements break down into three core elements:

- **Appointment of a Chief Compliance Officer (CCO)** – This individual would be responsible for designing, controlling, administering and monitoring the procedures that make up the compliance program.

- **Compliance Program** – Design and adoption of written policies and procedures that are reasonably designed to prevent violations of The Advisers Act.

- **Annual Review** – A review of the written policies and procedures should take place on an annual basis. You should consider any compliance matters that arose during the year, changes in business activities undertaken, and any changes in regulation that may require updates to the procedures.
Appointment of a Chief Compliance Officer

“An Adviser’s Chief Compliance Officer (“CCO”) should be competent and knowledgeable regarding the ’40 Act and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm”1

CCO’s of RIAs are generally not required to maintain any securities licenses with FINRA or the SEC.

- A CCO appointed in accordance with Rule 206(4)-7 may not necessarily be subject to sanction by the SEC for a failure in supervisory duty provided that:
  - Procedures are designed to prevent and detect Advisers Act violations, and that there is a system in place to implement them.
  - The CCO had reasonably discharged his supervisory responsibility in accordance with said procedures.

The Compliance Program

Advisers are required to develop and implement written policies and procedures designed to prevent and detect violations of federal securities laws. The SEC expects that procedures are formulated such that risks identified through a review of the individual firms operations are properly addressed.

There is an expectation that the following areas are at least given a degree of attention within the compliance procedures:

- Code of Ethics (Rule 204A-1)
- Portfolio management processes - this includes the allocation of investment opportunities among clients and consistency of portfolios with investment objectives.
- Accuracy of investor disclosures.
- Proprietary trading – by you and personal account trading of your approved persons.
- Safeguarding of client assets – from conversion or inappropriate use.
- Accurate creation of required records – this includes the maintenance and storage that prevents them from being altered or destroyed unless authorized.
- Privacy protection safeguards – specifically for protecting client information.
- Trading practices – how best execution obligations are satisfied, soft dollar arrangements.
- Marketing – advisory services including the use of solicitors.

• Valuations and fee calculations - methodology, data sources, etc.
• Business continuity plans – and test plans.

It is important to note that even if an adviser is not involved in a violation of the ’40 act, if their compliance policies are deemed to be not “reasonably designed” by the SEC, they can still be charged with violating the act.

**Key areas to note within the Compliance framework**

1. **Code of ethics/Personal account trading**

An important part of the compliance program is the implementation of a code of ethics which sets the standards of conduct expected of your “supervised persons”, as well as placing structure around personal account trading.

Again, the SEC does not specify the exact content of the code of ethics – it should reflect your fiduciary obligations to your clients and the obligations of the people you supervise. There are, however, several points that must at least be given consideration within any formalized policy;

• “Access persons”, i.e. those individuals with access to non-public information relating to client activity or holdings, or who make securities recommendations to clients, must report all personal securities transactions to the CCO or other designated person at least quarterly.

• “Access persons” must report their personal account holdings upon being appointed, and on a yearly basis after that. The code must also require such persons to obtain approval prior to investment in IPO’s, private placements or limited offerings.

• Your CCO or other designated person must review personal transaction reports.

• Violations of the code of ethics should be reported to the CCO or other designated person promptly, with a record of such violations being maintained.

The code should also establish, maintain and enforce written policies and procedures that are reasonably designed to prevent the misuse of material non-public information, and include references to documents that employees must fill-in to fully disclose any outside business interests.

Fundamentally these processes should mirror those of an institutional-sized asset manager or bank. While the scale on which they are implemented and the resources available to manage them may be smaller, the complexities of the controls that need to be put in place are very much the same.

2. **Record Retention and Books & Records**

As a part of ongoing compliance the SEC mandates that certain records are maintained for all registered advisers (under “the Books and Records Rule” – Rule 204-2). The rule is quite specific in terms of what records need to be maintained, and these include, but are not limited to:
• Advisory business financial and accounting records;
• Records that pertain to providing investment advice and transactions in client accounts;
• Records that document your authority to conduct business in client accounts;
• Advertising and performance records;
• Records related to the code of ethics rule;
• Records regarding the maintenance delivery of the written disclosure documents (Form ADV Part 2); and
• Policies and procedures adopted and implemented as part of an adviser’s compliance program.

Generally, these records should be maintained for five years from the end of the fiscal year in which they were last amended (although there may be requirements to keep certain documents for longer periods). These records must be retained in your place of business for at least the first 2 years.

Retention of records should not only apply to documents relating to the adviser and the funds under management. It is also important that any methods of electronic communication used within the organization, such as Bloomberg messaging, desktop communicator tools and email, are effectively recorded and are also searchable in the event of the SEC requiring access to information contained within them.

3. Pre- and Post-Trade Compliance

While the levels to which specific pre and post-trade compliance checks are employed will be driven predominantly by the strategy of the manager, certain limits are placed upon trading activity as a result of regulatory restrictions, such as the need for filing when a certain ownership threshold in a given issuer is reached. The use of a pre and/or post-trade compliance system or process can help mitigate risks in this area and flag when such limits are breached as a direct result of either trading activity, or market moves.

Under The Advisers Act, an adviser must be able to demonstrate robust controls around trade and order handling.

In addition, Dodd-Frank authorizes the SEC to require all managers of private funds, regardless of registration status, to retain records that could be used to help assess the advisers contribution to systemic risk.

4. Valuations

Advisers must be able to demonstrate adherence to a formalized and documented valuation policy, which is drafted appropriately to the assets being traded. The policy should list the different sources of valuations being used, have the ability to track abnormal price movements that require further investigation and demonstrate the rules they have in place to enforce their pricing hierarchy.
5. Disaster Recovery Planning

Advisers should have a detailed plan in place covering business disruption and/or failure scenarios identified through analysis of their operational structure. The SEC advises that the process should be both clearly defined and tested on a regular basis. This will also include evidence of the presence of remote working facilities.

The Annual Review

The written policies and procedures put in place by the Adviser should be formally reviewed at least annually (although it is highly recommended this review takes place more frequently). The review should take into account any compliance matters, changes in business activities or regulatory requirements occurring during the preceding 12 months, and identify steps in which these occurrences have been (or will be) resolved.

Contact Us

For information relating to the content within this guide, or any other areas for which you require assistance, please contact the Hedge Fund Consulting Team at Bank of America Merrill Lynch. Our contact details are below – we look forward to hearing from you.

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