

March 6, 2006

Memorandum to our Clients and Friends

### **Annual Review of Compliance Policies and Procedures**

Each investment adviser registered with the SEC is required to perform an annual review of the firm's compliance policies and procedures. Registered advisers that adopted their policies and procedures as of October 5, 2004 were granted a special 18-month transition period permitting the first annual review to be completed by April 5, 2006<sup>1</sup>. Rule 206(4)-7 (the "Compliance Rule") under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), specifies that the annual review must assess the adequacy of the investment adviser's compliance policies and procedures and the effectiveness of their implementation. The SEC has not provided any formal guidance regarding the scope of the annual review or the nature of any related report. This memorandum sets forth our suggested approach for the conduct of the annual review.

#### **Who Should Conduct the Annual Review**

The Compliance Rule does not specify how an adviser should conduct its annual compliance review or who should conduct the review. Accordingly, each adviser has the flexibility to design the annual review in the manner that will be appropriate given the nature of its business. We would, expect, however, that the Chief Compliance Officer ("CCO") will have significant involvement in the annual review. The level of the CCO's involvement may vary depending on factors such as the size of an adviser's business or the complexity of its operations. In certain cases, the CCO may be directly involved in all aspects of the annual review. In other cases, the CCO may need to delegate certain aspects of the review to other persons in the firm or to outside service providers. In any event, the CCO should be involved in reviewing results of tests performed by others and the preparation of any written report. Finally, senior management of the adviser should, at a minimum, review the results of the annual review.

#### **Scope of the Annual Compliance Review**

In adopting the Compliance Rule, the SEC indicated that, in conducting its annual review, a registered adviser should consider any compliance matters that arose during the previous year, any changes in the business activities of the adviser or its affiliates, and any changes in the Advisers Act or applicable regulations that may suggest a need to revise the

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<sup>1</sup> Investment Company Act Rule 38a-1 imposes an annual compliance policy review requirement on registered investment companies, and funds were similarly granted an 18-month time period for completion of the first annual review. The chief compliance officer of a registered investment company must provide the first annual report to the fund's board within 60 calendar days of the completion of the annual review.

policies and procedures. Essentially, the annual review should assess whether the adviser's compliance policies and procedures continue to be effective. We believe that the annual review should be focused on an assessment of current conflicts of interest and seek to identify any new conflicts of interest or other compliance risks that may require changes in the firm's compliance policies and procedures.

To determine whether any changes in business activities have occurred or whether any special issues have arisen, we suggest that, at a minimum, the annual review should include an assessment of factors or events such as the following:

- the results of interim reviews conducted under specific policies and procedures (e.g., the quarterly or periodic best execution reviews conducted under best execution policies)
- all compliance violations identified and their resolution and all recommendations for change made during the year but not yet implemented
- new product introductions (e.g., new funds or new managed accounts) presenting novel administrative or compliance issues
- implementation of new investment strategies
- changes in fund or product structure
- new distribution arrangements
- new or revised fee structures or liquidity arrangements
- new agreements with investors, including any side letters
- management or personnel turnover or other material changes in the adviser
- regulatory changes (SEC, NASD, CFTC), regulatory actions (e.g., enforcement actions) within the industry and identification of industry best practices
- SEC or other regulatory examination conducted during the year, any related deficiency letter and the adviser's responses
- unresolved or recurring matters or issues from prior years

### **Written Documentation of the Annual Review**

There is no explicit requirement that written documentation of the annual review be created<sup>2</sup>. However, any written documentation evidencing the review is required to be

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<sup>2</sup> As noted above, however, Rule 38a-1 requires that a written report be submitted to the Board of Directors of a registered investment company by the fund's CCO.

maintained by the adviser in accordance with the recordkeeping rule under the Advisers Act. We recommend, however, that some written documentation of the review be maintained, primarily because we expect that SEC examiners will request copies of such records in connection with SEC registered adviser examinations.

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If you have any questions regarding the foregoing or if you would like us to assist you with the annual compliance review, please contact your primary attorney in the Investment Management Group at Seward & Kissel LLP.

Seward & Kissel LLP

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