NSCP Midwest Regional Meeting
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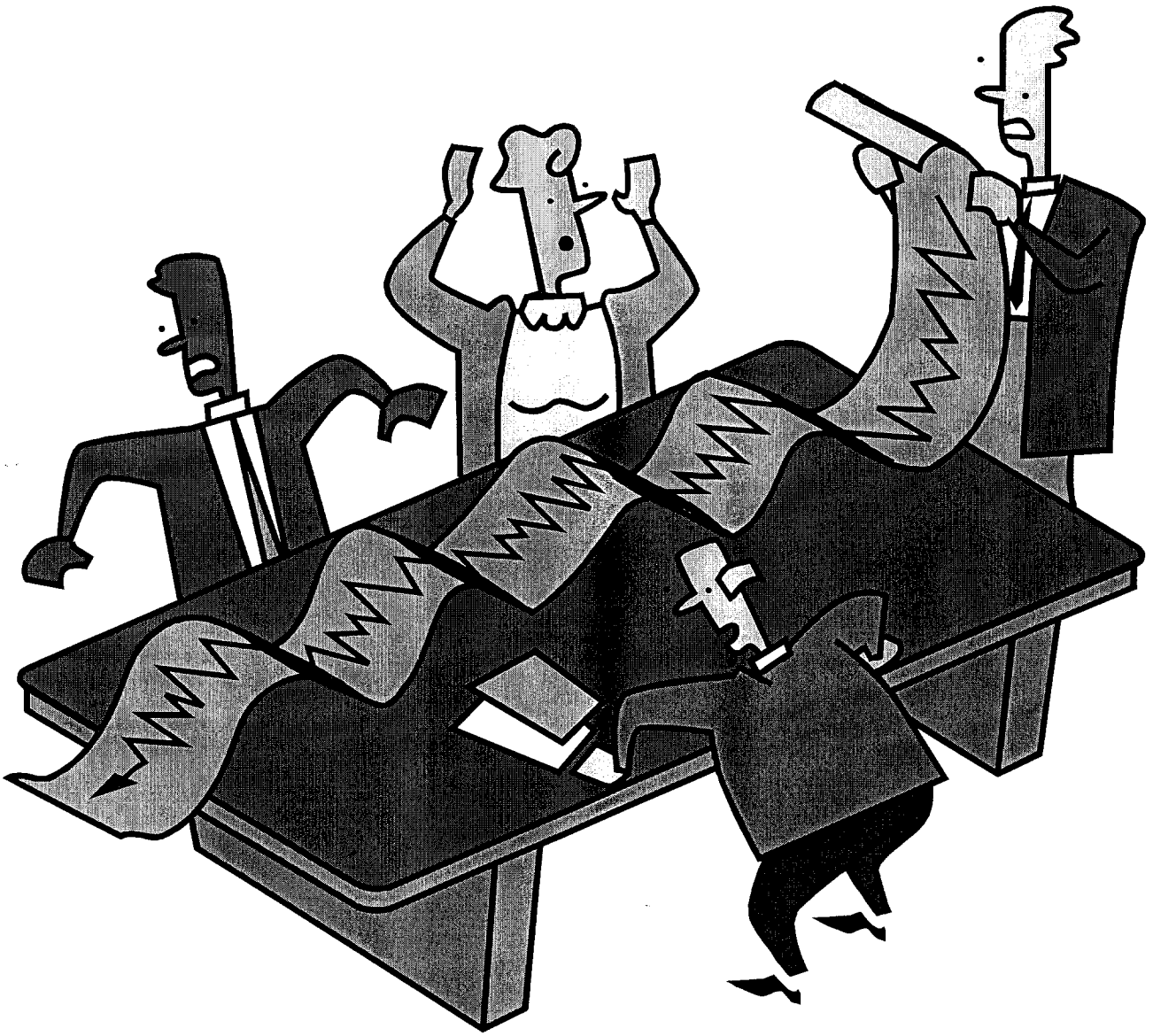

IA REGULATORY DEVELOPMENTS

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I. REGULATORY DEVELOPMENTS

I) SEC Examination Focus

A) Risk Management Assessment

i) "Tone at the top" – commitment to establish and maintain an effective system of controls and compliance procedures

a) interviews with business heads and senior management

b) evaluations of resources devoted to compliance and supervision

c) existence of written policies and procedures

d) adequate controls in place

ii) Specific risk management, control and compliance processes and procedures employed to address SEC's top ten (10) problematic areas:

a) failure to disclose material facts (particularly in Form ADV, Parts I and II) According to the SEC, 70% of exams reveal disclosure discrepancies

b) failure to have effective internal controls

- failure to adopt effective or relevant compliance policies and procedures
- procedures not followed
- failure to test procedures to determine effectiveness

c) failure to maintain adequate books and records

- failure to produce records promptly
- accounting records cannot be reconciled/untimely financial statements
- failure to maintain required records (e.g., correspondence, backup materials for performance advertising)

d) failure to comply with custody rules

- no "third party" checks and balances to assure client funds are not misappropriated
- no annual surprise audit

e) failure to accurately state performances results

- comparing performance to an inappropriate index
- neglecting to disclose material information concerning how advisors performance results were calculated
- using initial R.I.A. following a person's name on printed materials

f) brokerage problems – soft dollars and best execution

- payment of excessive brokerage commissions for client referrals
- failing to periodically and systematically review brokerage arrangements to ensure best execution

g) improper personal securities transactions

- no procedures to prevent misuse of nonpublic information
- front running client orders/co-opting client opportunities
- purchasing securities for clients in which the adviser has an undisclosed interest.

h) advisory agreement problems

- adviser exceeding its contractual authority
- failing to comply with client mandates – purchasing securities inconsistent with clients risk level

i) failing to compute fees in accordance with contractual terms

- failing to refund pro-rata share of advanced fees when contract terminated
- fees are calculated differently than agreed to in the contract

j) failing to supervise employees and service providers (sub-advisers)

- due-diligence of sub-adviser's qualifications, suitability, compliance controls and performance "track record"

B) Ramifications of SEC's risk assessment of each adviser

i) firms with a strong compliance culture and controls

- lower risk assessment
- shorter exams
- four (4) year exam cycle

ii) firms with a weak compliance culture and controls

- higher risk assessment
- longer and more comprehensive exams
- two (2) year exam cycle

iii) largest firms will likely experience a two (2) year exam cycle

II) Proposed Custody Rule

A) July 2002, SEC Proposed amendments to the Custody Rule, Rule 206(4)-2

B) Currently, SEC registered advisers with custody of client funds and/or securities must do the following:

i) client funds must be deposited in bank accounts that contain only client funds

ii) must segregate and identify client securities and hold them in a reasonably safe place

iii) immediately after accepting custody of client funds or securities, adviser must notify the client of where and how they will be maintained

iv) adviser must send quarterly account statements

v) adviser must have a independent public account conduct an annual surprise examination of all client funds and securities in adviser's custody

C) Definition of "custody" to be incorporated into Rule 206(4)-2

i) Per SEC, an adviser has custody of client assets, when it holds directly or indirectly client funds or securities or has any authority to obtain possession of them

ii) SEC provided three (3) examples to illustrate custody

- any possession or control of client funds or securities even temporarily (e.g., client routes funds or securities to custodian via adviser). **However, rule expressly excludes inadvertent receipt by adviser so long as adviser returns client funds or securities to the sender within one (1) business day of receipt**
- advisor has authority to withdraw funds or securities from a client's account (e.g., adviser has the ability to deduct advisory fees from client's account)
- adviser is the legal owner of the client assets or has assess to those assets (e.g., adviser serves as general partner and investment adviser to a limited partnership)

D) Advisers with custody would be required to maintain *both* funds and securities with a "Qualified Custodian"

i) "Qualified Custodians" include:

- banks
- savings associations
- registered broker-dealers
- registered futures commission merchants

ii) Advisers that are qualified custodians would be permitted to serve as the qualified custodian for the assets of its clients (e.g., broker-dealers and divisions of banks)

iii) Advisers could also maintain client assets with affiliates that are qualified custodians

iv) With respect to securities for which the primary market is in a country other than the United States, the proposed rule would treat financial institutions that customarily hold financial assets in that country and that hold the Client assets in customer accounts segregated from their proprietary assets as qualified custodians

E) Delivery of Periodic Account Statements

i) Adviser is exempt from the requirements of sending quarterly account statements and undergoing annual surprise examinations if the qualified custodian sends monthly account statements directly to each advisory client and the adviser has a reasonable benefit that the qualified custodian is doing so (adviser should obtain duplicable statements and ensure address is correct)

ii) Adviser who wants to protect the identity of its clients must send quarterly statements and undergo an annual surprise examination to verify the funds and securities of those clients. **However, if that exam reveals any material discrepancies, the accountant is required to notify OCIE**

iii) If adviser also acts as a general partner as has custody of client assets, account statements (whether delivered by the adviser or qualified custodian) must be sent directly to the limited partners or their "independent representative" (investors agent for pooled investment vehicles, who does not control or is controlled by the adviser and who has not had a material business relationship with the adviser in the past two years)

F) Elimination of Delivery of Balance Sheet

i) Rule 206(4)-4 requires advisers to disclose to clients any financial condition that is reasonably likely to impair an adviser ability to meet its contractual commitments to its clients

ii) Audited balance sheet still required if an adviser requires pre-payment of more than $500 in fees per client and more than six months in advance

G) Collateral Issues

i) Numbers of advisers with custody greatly increased

ii) Burden of Custody Rule reduced

iii) Review third-party contractual provisions to ensure responsibilities are accurately described

III) Hedge Fund Regulatory Developments

i) SEC grappling with increasing regulatory requirements for hedge funds

ii) Scope of SEC exams of hedge fund advisers continues to evolve

iii)SEC hedge fund roundtable May 14 and 15 – topics reviewed:

- structure, operation and compliance of hedge funds
- marketing
- investor protection
- current regulatory scheme
- necessity of additional regulation

iv) NASD enforcement action vs. Altegris Investments

- large fine vs. firm - $175,000
- censured and fined Chief Compliance Officer - $20,000
- marketing pieces failed to include important disclosures regarding specific risks of investing in hedge funds and made unbalanced presentations about particular hedge funds that failed to provide investors with a sound basis for evaluating whether to invest in these hedge funds
- action based on NASD's advertising rules (notwithstanding the fact that some or all of the risks were disclosed in the offering documents)

v) NASD Notice to Members 03-07

IV) SEC Proposed Rule Requiring Written Compliance Programs For Advisers

A. Proposed Rule would require the following:

i) the adoption and implementation of policies and procedures designed to prevent violations of the securities law

ii) an annual review of these policies and procedures to determine the adequacy and effectiveness of their implementation

iii) designation of a chief compliance officer responsible for administering the polices and procedures

iv) maintaining copies of the polices and procedures and annual reviews (maintain for 5 years)

B) SEC expects, at a minimum, that the policies and procedures address the following:

i) portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with client guidelines

ii) trading practices including satisfaction of best execution obligations, soft dollar arrangements and allocation of aggregate trades among clients

iii) proprietary trading of the adviser and personal trading activities of supervised persons

iv) accuracy of disclosures to investors, including information in advertisements

v) safeguarding of client assets from conversion or inappropriate use by advisory personnel

vi) 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

vii) process to value client holdings and assess fees based on those valuations

viii) safeguards for the protection of client records and information

ix) business continuity plans

x) prevention of money laundering

C) SEC also sought comment on the following:

i) Periodic third-party compliance reviews of advisers

ii) Formation of one or more self-regulatory organizations

iii) Fidelity bonding requirement for advisers

D) Per the SEC, the chief compliance officer should be competent and knowledgeable regarding applicable federal securities laws and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the adviser

i) According to the SEC, designation of a person by an adviser as its chief compliance officer would not, in and of itself impose upon the person a duty to supervise another person

ii) A chief compliance officer appointed in compliance with the Proposed Rule would not necessarily be subject to sanction by the SEC for failure to supervise, unless the person had supervisory responsibility in which case the person could rely in Section 203(e)(6) as a defense:

a) Adviser adopted policies and procedures reasonably designed to prevent and detect violations

b) Adviser has a system in place to apply the procedures

c) Person reasonably discharged his supervisory responsibilities

E) Proposed Rule falls under the anti-fraud provisions versus the supervisory provisions