

MFA Releases Sound Practices for Hedge Fund Managers

On August 2, 2005, the Managed Funds Association ("MFA") released the *MFA's 2005 Sound Practices for Hedge Fund Managers* (the "2005 Sound Practices").¹ An updated and expanded version of the 2003 release, the 2005 Sound Practices is intended to provide a framework of internal policies, practices, and controls.

In this latest edition, the MFA includes updated chapters on internal trading controls, responsibilities to investors, valuation, risk controls, regulatory controls, transactional practices, and business continuity and disaster recovery. Furthermore, the MFA added two appendices to provide a checklist of items that a hedge fund manager may wish to consider in developing its own compliance policies and procedures and code of ethics.²

¹ The 2005 Sound Practices is available at http://www.mfainfo.org/images/PDF/MFAs_2005_Sound_Practices_Final.pdf.

The 2005 Sound Practices is not the only best practices guideline drafted for the hedge fund industry. A number of other financial trade groups, such as the Alternative Investment Management Association ("AIMA"), the CFA Institute, and the Investment Company Institute ("ICI"), have released their own best practices guidelines. See e.g. AIMA's *Guide to Sound Practices for Asian Hedge Fund Managers* (December 2004), AIMA's *Guide to Sound Practices for European Hedge Fund Managers* (August 2002); the CFA Institute's *Revised Code of Ethics and Standards of Professional Conduct* (June 2005); and the ICI's *Side-by-Side Management of Registered Investment Companies and Investment Accounts* (March 2004).

² Hedge fund managers that are registered as investment advisers with the Securities and Exchange Commission ("SEC") are required to

adopt a written compliance program pursuant to Rule 206(4)-7 under the Investment Advisers Act of 1940, as amended (the "Advisers Act") and a code of ethics pursuant to Rule 204A-1 under the Advisers Act. See Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Release No. 2204 (Dec. 17, 2003) ("Release No. 2204") and Investment Adviser Code of Ethics, Advisers Act Release No. 2256 (July 2, 2004).

Topics Addressed

The 2005 Sound Practices is divided into seven sections:

- "Management and Internal Trading Controls" addresses key management policies and internal trading controls to be established by a hedge fund manager
- "Responsibilities to Investors" addresses responsibilities to investors and proposes practices intended to assist hedge funds in fulfilling these responsibilities
- "Valuation Policies and Procedures" proposes practices designed to promote sound valuation practices

- “Risk Monitoring” proposes practices for risk measurements and monitoring to ensure that the risk policies of a hedge fund manager are observed
- “Regulatory Controls” addresses regulatory controls and compliance issues
- “Transactional Practices” discusses recommendations for documentation policies, best execution practices, and soft dollar arrangements³
- “Business Continuity and Disaster Recovery” proposes recommendations to improve a hedge fund manager’s business continuity and disaster recovery planning⁴

The 2005 Sound Practices also contains six appendices to the MFA’s recommendations:

- “Risk Monitoring Practices for Hedge Fund Managers” discusses in greater detail concepts relating to risk management techniques, and to developing sound risk management procedures and measurement methodologies
- “U.S. Regulatory Filings by Hedge Fund Managers” lists U.S. regulatory filings that may be applicable to a hedge fund manager
- “MFA Preliminary Guidance for Hedge Funds and Hedge Fund Managers on Developing Anti-Money Laundering Programs” is a copy of the *MFA’s Preliminary Guidance for Hedge Funds and Hedge Fund Managers on Developing Anti-Money Laundering Programs* that was released in 2002
- “Checklist for Hedge Fund Managers to Consider in Developing a Compliance Manual” provides a list of items that a hedge fund manager may

³ The written compliance program of registered investment advisers should address trading practices, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services (“soft dollar arrangements”), and allocates aggregated trades among clients. See Release No. 2204, *supra* note 2.

⁴ The written compliance programs of registered investment advisers should address business continuity plans. See Release No. 2204, *supra* note 2.

wish to consider in developing compliance policies and procedures

- “Checklist for Hedge Fund Managers to Consider in Developing a Code of Ethics” provides a list of items that a hedge fund manager may wish to consider in developing a code of ethics
- “Glossary” is a glossary of terms used in 2005 Sound Practices

Key Recommendations by the MFA

The MFA makes a number of recommendations that hedge fund managers may want to consider when drafting their policies and procedures manual. Key recommendations include:

- Establishing management policies and practices that address trading activities, valuation, risk analysis, and compliance
- Reviewing operations and relationships for potential conflicts of interests and disclosing such conflicts;⁵ possible conflicts that may need to be disclosed include relationships with brokers or other service providers, conflicts generated by fee structures, use of soft dollar arrangements, and “side-by-side” management of multiple accounts
- Establishing valuation policies and procedures that are fair, consistent, and verifiable⁶
- Developing practices and/or systems for capturing pricing data for their positions from independent sources on a daily basis where practicable

⁵ The written compliance program of registered investment advisers should address conflicts of interest. See Release No. 2204, *supra* note 2. In Release No. 2204, the SEC states that the compliance program should address portfolio management processes, including the allocation of investment opportunities among clients and consistency of portfolios with clients’ investment objectives, disclosures by the adviser, and applicable regulatory restrictions.

⁶ The written compliance program of registered investment advisers should address the valuation of client holdings. See *id.*

- Drafting policies and procedures that explicitly authorize that, in circumstances where a hedge fund manager believes that the application of its normal policies and procedures would not produce an accurate or fair price for a given financial instrument, senior management may use alternative procedures to price such instrument
 - Determining the methods to be used in obtaining values from alternative sources where market prices for an instrument are not readily available from organized market exchanges or a recognized data vendor; for example, hedge fund managers should seek to obtain reliable quotes from well-established, recognized pricing services, or use appropriate valuation models developed by third-party pricing services, or recognized industry standard models using third-party inputs
 - Applying “side-pocket” methodology in instances when a hedge fund manager invests in illiquid, or otherwise hard-to-value, securities or other investment instruments
 - Performing “stress tests” to determine how potential changes in market conditions could impact the value of a hedge fund’s portfolio; in particular, hedge fund managers should consider assessing the impact of extreme events
 - “Backtesting” one’s market risk models
 - Conducting a funding liquidity analysis to determine whether such manager can continue its trading strategy without being forced to liquidate assets when market losses occur by taking into account the investment strategies employed, the liquidity of the assets, the redemption terms of the fund, and the funding arrangements negotiated with counterparties
 - Hedge fund managers (especially those that enter into swaps or derivatives contracts) should understand and manage their exposure to potential defaults by trading counterparties
 - Establishing documentation requirements for all trading (including confirmation requirements
- and documentation of master agreements as appropriate)⁷
- Evaluating the types of products and services that are the subject of soft dollar arrangements, including the extent to which products or services are used in the research process (if applicable)⁸
 - Developing policies with respect to soft dollar arrangements that address *inter alia* the proper allocation of products or services with “mixed uses” so that non-research services are paid for out of the manager’s own funds and the proper allocation of “step-out” arrangements (if applicable)
 - Adopting policies with respect to soft dollar arrangements that also address the retention of correspondence, including e-mails related to directed brokerage and “step-out” arrangements, and records of the value, quantity, purpose, and ratios of each product and service (if applicable)

Drafting a Compliance Policies and Procedures Manual

The MFA notes in the introduction that the 2005 Sound Practices is not a substitute for legal or professional advice. Rather, the 2005 Sound Practices is specifically intended to provide hedge fund managers with a general description of aspirational management and business practices to consider. It consists primarily of recommendations to take into account and does not provide explicit step-

⁷ The written compliance program of registered investment advisers should address the establishment, maintenance, and retention of certain books and required as set forth in Rule 204-2 under the Advisers Act. *See id.* Moreover, in an audit of an investment adviser conducted by the Office of Compliance Inspections and Examinations of the SEC, the SEC typically requests a copy of the adviser’s trade blotter, which lists transactions in securities and other financial instruments for investment advisory clients. Furthermore, the SEC requests the following data: trade date; buy or sell; number of shares or principal amount; security name; ticker; CUSIP/SEDOL number; price; total commission; commission in cents per share; fees; accrued interest; net amount to/from client; client name; client account number; broker/dealer name; and country/exchange rate.

⁸ *See supra* note 3.

by-step procedures on how to comply with various legal and regulatory requirements. The 2005 Sound Practices also does not address issues specific to managers of fund-of-funds. As such, hedge fund managers—both single-fund managers and fund-of-funds managers—should consult with legal counsel when drafting their own compliance policies and procedures manual to ensure that all pertinent legal and regulatory issues are addressed.

A U.S.-based hedge fund manager that is currently unregistered will have to register as an investment adviser with the SEC by February 1, 2006, if the adviser satisfies the following three conditions:

- The adviser advises a fund that is a “private fund”
- The adviser has 15 or more clients
- The adviser has \$30 million U.S. or more of assets under management⁹

By this date, hedge fund managers required to register must also have implemented policies and procedures required under the Advisers Act (e.g., a written compliance program or a code of ethics).

Dechert’s financial services group is available to assist in investment adviser registration and in drafting and implementing a written compliance policies and procedures manual. If you have any questions regarding the information in this client alert, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed.

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⁹ A fund is a “private fund” if it satisfies three conditions: (i) the fund is an unregistered investment fund in reliance on the exceptions provided in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended; (ii) investors are permitted to withdraw their investment within two years of the date of investment; and (iii) the fund’s interests are offered based on the investment advisory skills, ability or expertise of the investment adviser. See Registration Under the Advisers Act of Certain Hedge Fund Advisers, Advisers Act Release No. 2333 (December 2, 2004) (“Release No. 2333”). Non-U.S. based advisers that advise offshore funds that are “private funds” and have 15 or more U.S. persons that are clients are also required to register as investment advisers with the SEC and are subject to only certain provisions under the Advisers Act. See Release No. 2333.

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