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A legal update from Dechert's Financial Services Group

US President's Working Group Recommends Best Practices for Hedge Fund Industry

Two private sector committees established by the US President's Working Group on Financial Markets, the Asset Managers' Committee and the Investors' Committee, released separate but complementary reports on 15 April 2008 setting out proposed sets of best practices for hedge fund managers and investors. The committees were tasked to develop best practices for market participants with a view to enhancing investor protection and mitigating systemic risk. These best practices are meant to implement the President's Working Group Principles and Guidelines Regarding Private Pools of Capital issued on 22 February 2007.

In his opening remarks at the release of the best practice recommendations, Treasury Secretary Paulson summarised the goals of the President's Working Group this way: "[W]e want the world's highest investor protection standards; we want to guard against systemic risk and keep the United States the most competitive financial marketplace in the world." It is this background that has shaped the work of the two committees.

The Asset Managers' Committee and the Investors' Committee each acknowledge that both the hedge fund manager and the investor are accountable and must implement appropriate practices to maintain strong controls and infrastructure to support their activities.

The best practice recommendations are not binding and do not have the force of law or regulation. However, as has already proved to be the case in many other instances, best practice recommendations such as these ultimately may serve as the basis for a subsequent legal framework. The Investors' Committee in particular recognises that there is a substantial and ongoing debate among policymakers as to how to address the challenges of the stress that the financial markets currently face, and that these reports have a role to play in influencing that debate.

Consistent with the goal of the President's Working Group to enhance current investor protection standards, the recommendations exceed existing industry standards. Hedge fund managers and investors will need to carefully assess their specific practices against the practices recommended by the committees in deciding whether they wish to follow the recommendations.

The Best Practices Recommended by the Asset Managers' Committee[1]

The report by the Asset Managers' Committee suggests a framework, and related best practices, with respect to five key areas:

- disclosure;
- valuation;
- risk management;
- trading and business operations; and
- compliance, conflicts and business practices.

In particular, the report recommends improvements in protections to minimise conflicts of interest and assess counterparty risk. Some of the most significant recommendations are summarised below.

Disclosure

A core principle is that managers should establish a disclosure framework to provide

1 The Asset Managers' Committee includes 10 representatives from a diverse group of US hedge fund managers, representing many different investment strategies.

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material information to investors with sufficient frequency and detail to allow investors to make informed investment decisions and monitor the risks associated with their investments.

The Asset Managers' Committee recommends that managers adapt the core principles of the US public company disclosure regime in developing their disclosure practices. That disclosure regime is designed to provide investors with material information at the time of making their investment and ongoing updates throughout the life of the investment.

Most of the information that will be material to investors when making their investment decision will be contained in the fund's private placement memorandum ("PPM"). Therefore, managers should review and update as appropriate a fund's PPM on at least an annual basis to make sure that the relevant material information is included. With respect to ongoing information to be provided to investors, managers should provide on a quarterly basis an investor letter, a risk report and certain investment-related financial information, including financial information supplementing FAS 157. These quarterly communications would be in addition to prompt specific event reporting. In addition to considering their disclosure obligations to investors, managers also should address their disclosure obligations to counterparties, such as banks and broker-dealers.

Valuation

To follow the recommendations, a manager should establish a comprehensive and integrated valuation framework, including consistent and documented policies and appropriate controls for segregation of responsibilities between portfolio managers and those responsible for valuations. In particular, a manager should establish a governance function, such as a valuation committee, with ultimate responsibility for establishing and reviewing compliance with the manager's documented valuation policies. Independent personnel should be responsible for the valuation of the fund's investment positions.

A manager's valuation policy should include certain baseline elements which are further detailed in the report along with specific suggestions from the Asset Managers' Committee with respect to valuing investment positions with no readily ascertainable market value. Managers should also follow specific guidance when using side pockets or other similar arrangements.

Risk Management

A manager should establish a comprehensive, integrated risk management framework suited to the size, portfolio management process and investment strategies of its funds. In developing its risk management framework, a manager should identify the material risks inherent in its chosen investment strategies (including liquidity risk, leverage, market risk, counterparty credit risk and operational risk), and measure and monitor its exposure to these risks against its intended risk profile. Furthermore, senior management should not outsource responsibility for risk management but should instead appoint knowledgeable personnel to develop and supervise the risk management program while senior management retains responsibility for the overall risk framework.

Once developed, the manager's risk management framework should be communicated to investors, to enable them to assess whether the fund's risk profile is appropriate for them and how the investment is performing against that profile.

Of the risks identified above, counterparty credit risk in particular should be carefully monitored by a manager. Since hedge funds deal with many counterparties, the manager should take care to monitor a fund's exposure to such counterparty credit risk and understand the impact of potential counterparty loss of liquidity or failure. In order to minimise such risk, the manager should take steps to increase access to liquidity by opening cash and custody accounts at financial institutions other than its prime brokers.

Trading and Business Operations

A manager should also develop a comprehensive, integrated framework to manage trading and business operations, taking into account the size and complexity of its activities, the nature of its investments and the requirements of its investment strategies. The integrated framework should include:

- policies and procedures for significant operational and accounting controls;
- adequate management of cash, margin and collateral requirements;
- careful selection of key service providers;
- appropriate segregation of business operations and portfolio management personnel;

- systems, infrastructure and automation;
- plans for disaster recovery/business continuity; and
- the appointment of a member of senior management, such as a chief operating officer, with responsibility for the manager's operations.

Compliance, Conflicts and Business Practices

A comprehensive and integrated framework addressing compliance, conflicts and business practices should also be established. It is critical to the success of the framework that a strong culture of compliance should exist at the manager. The committee expressly recommends that a manager have a chief compliance officer.

The framework should include:

- a written code of ethics that establishes principles governing the conduct of the manager's personnel;
- a written compliance manual covering, to the extent applicable, policies and procedures for complying with laws governing marketing and communications, anti-money laundering activities, and trading and business practices;
- the establishment of a conflicts committee to review conflicts;
- regular training of personnel on the material elements of the compliance programme; and
- a compliance function that includes a chief compliance officer, appropriate discipline and sanctions and an annual review of the compliance framework.

The Best Practices Recommended by the Investors' Committee[2]

The Investors' Committee report recommends best practice standards for investors to use when making a decision to invest in a hedge fund and when managing and overseeing their hedge fund investments. The report includes two guides: a *Fiduciary's Guide,* which defines a set of practice standards and guidelines for fiduciaries considering or already investing in hedge funds, and an *Investor's Guide,* which provides recommendations to those charged with executing and administering a hedge fund programme once a hedge fund has been added to the investment portfolio. The key recommendations of both guides are set out below.

The Fiduciary's Guide

Fiduciaries (i.e., those with portfolio oversight responsibilities, such as plan trustees, banks or consultants) should take appropriate steps to determine whether an allocation of assets to hedge funds contributes to an institution's investment objectives, and whether internal staff or agents of the institution have sufficient resources and expertise to effectively manage the hedge fund component of an investment portfolio. They should also be aware of the difference between risk (where the range of potential outcomes of a situation is understood) and uncertainty (which may arise due to incomplete knowledge about the manner in which events occur) when assessing the risks of investing in hedge funds, and should understand the effort and cost that will be required in relation to the selection and monitoring of hedge fund investments.

Prominently highlighted is the principle that fiduciaries should develop explicit policies that define the key features and objectives of the hedge fund investment programme. Fiduciaries should exercise particular care in due diligence of hedge funds, because of the complex investment strategies they employ, the fact that hedge fund organisations are frequently small and young, their use of leverage and the associated risk, and the generally more lightly regulated nature of these organizations.

The Investor's Guide

In recommending best practices for responsible investment in hedge funds, particular focus should be placed on the areas of:

- due diligence;
- risk management;
- legal and regulatory issues;
- valuation;
- fees and expenses;

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[2] The Investors' Committee comprises senior representatives from major classes of institutional investors including public and private pension funds, foundations, endowments, organised labour, non-U.S. institutions, funds of hedge funds and the consulting community.

- reporting; and
- taxation.

Due Diligence

There are a number of specific recommended best practices and related guidance notes with regard to proper due diligence and monitoring responsibilities:

- *Personnel* – Investors should conduct thorough due diligence in the marketplace on the reputation, experience and background of hedge fund managers and the key principals in the firm. They should also consider the investment risk associated with the loss of a key person or persons.
- *Business Management* – Investors should obtain information from hedge fund managers on their governance and compensation structures. They should also assess the stability of a fund's client base and the manager's overall business.
- *Investment Performance Track Record* – Investors should understand the manager's historical performance and the factors contributing to that performance. They should further assess the manager's ability to operate a fund successfully in varying market environments.
- *Style Integrity* – Investors should employ regular and frequent risk monitoring and actively analyse a hedge fund's risk exposures as a means of evaluating potential style drift. They should also obtain appropriate risk reports, with sufficient frequency, to monitor potential style drift and to confirm that the hedge fund continues to meet the investor's objectives.
- *Model Use* – Investors should assess the hedge fund manager's reliance on models, including assumptions, model inputs and risks associated with the models the manager employs. They should also assess the expected frequency of material and substantive model changes, and whether the manager intends to notify investors when such changes are made.

Risk Management

In general, investors should establish their own risk management framework and best practices, with regard to evaluating the risk management framework employed by a hedge fund manager. There are various recommended best practices for the monitoring and management of various risks. For example, investors should establish formal written policies and supervisory procedures designed to meet the risk management objectives of a hedge fund investment programme. Such investors' risk management programmes should be independent of the manager selection process and the process for monitoring investment performance. Investors should understand the hedge fund manager's risk management philosophy and processes and should determine that the manager has an independent risk management function whose compensation is not directly tied to portfolio performance.

Investors should understand the principles underlying liquidity and leverage in a hedge fund, including the risk posed by the behaviour of other investors. Investors should also be comfortable that the manager selects prime brokers with adequate liquidity, that counterparty credit risk is otherwise managed appropriately, and that prime brokers and other important trading counterparties have the ability to perform their duties effectively.

Legal and Regulatory

Investors should confirm that the hedge funds in which they invest prepare audited financial statements in accordance with acceptable accounting standards, such as US generally accepted accounting principles (US GAAP) or international financial reporting standards (IFRS). Investors should understand the nature, depth, maturity and stability of the legal system in the jurisdiction where the hedge fund is domiciled, and be comfortable with their ability to vindicate their legal rights as an investor in the fund.

Potential for disputes regarding the appropriate jurisdiction in which fund-related claims would or could be brought should also be considered by investors. Investors should seek to understand the risk a fund faces from potential tax, legal or other regulatory changes, and the fund's strategy for mitigating those risks when possible.

Valuation

Investors should verify that a fund's manager has established a written valuation policy and procedures to assure that the fund's portfolio is consistently valued under US GAAP (or other relevant accounting standards), including those provisions regarding the fair valuation of assets.

They should also determine whether proper oversight of the entire valuation process exists, especially the pricing of illiquid investments and other investments that are difficult to price.

Investors should further understand the functioning of the valuation committee or other governance structure of the hedge fund, and evaluate whether there is sufficient oversight of the valuation process, including a mechanism to resolve conflicts relative to pricing on difficult-to-price investments.

Investors should confirm that the manager uses secondary sources whenever possible to enhance the reasonableness of pricing and valuation estimates. Investors should also confirm that the manager uses multiple sources for dealer quotes (to the extent available). Any models the manager uses to determine position prices should be independently tested and verified. Investors should also confirm that the manager applies a consistent approach to valuing “side-pocket” or illiquid and hard-to-value positions.

Fees and Expenses

Investors should determine the overall percentage of total and excess return they are willing to pay to their respective investment managers. They should seek to actively negotiate fees and performance targets to avoid overpayment for investment management services.

There are also numerous detailed recommendations as to how investors should consider fees and expenses relative to the returns sought and risks taken in an investment strategy. The liquidity offered by the investment manager, and the appropriate sharing ratio of alpha generated by the investment manager, are also guided by detailed best practices.

Reporting

Investors are advised to seek sufficient reporting and transparency regarding a fund’s performance. In particular, they should periodically seek confirmation from the manager as to the percentage of the hedge fund portfolio that the manager considers “illiquid”.

In relation to funds of hedge funds, investors should be informed of the fees and expenses charged by such funds of hedge funds managers as well as the fees charged by the managers of the underlying hedge funds.

Taxation

In relation to taxation, investors should consult with their tax advisors and carefully review the tax-related disclosures provided by a hedge fund prior to investing. Investors should seek an explanation in the disclosure document of all tax considerations that may impact a hedge fund’s returns. There are detailed best practices in relation to the content of the tax disclosure. This should include disclosure on taxation resulting from foreign investment or from status as a passive foreign investment company, or any tax loss carry-forward to which the hedge fund may be entitled. Tax disclosures should also discuss the effect of phase-outs of certain exemptions, deductions, and credits utilised by the hedge fund.

Global Impact and Applicability to Non-US Investment Managers and Investors

Although both the Asset Managers’ Committee and the Investors’ Committee most directly address US market participants, there is no clear geographical limitation as to the application of the best practices they propose. The proposed best practices have the potential (and arguably are intended) to influence the behaviour of the global hedge fund industry by influencing investor behaviour. In this regard, the proposed best practices appear to favour the framework existing for US-registered investment advisers, and have the potential to effectively impose that regulatory framework on non-US investment advisers and other investment advisers that are not subject to registration in the United States.

Given the global nature of financial markets, the best practices have also been designed to be consistent with the work done in the United Kingdom by the Hedge Fund Working Group to improve hedge fund oversight. However, the best practices proposed by both the Asset Managers’ Committee and the Investors’ Committee allow for voluntary conformity in contrast to the standards established by the UK Hedge Fund Working Group, which follow a “comply or explain” approach for managers who become signatories to such standards.

Consultation Period

The recommendations will be open to public comment until Friday, 13 June 2008. The committees will consider any comments and

submissions made before this date with a view to revising the recommendations, if necessary.

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