

PWG Committees Release Reports on Best Practices for Hedge Fund Managers and Investors

April 22, 2008

On April 15, 2008, two private sector committees established by the President's Working Group on Financial Markets released their respective reports on best practices relating to hedge funds. The Asset Managers' Committee presented its report, "Best Practices for the Hedge Fund Industry" and the Investors' Committee presented its report, "Principles and Practices for Hedge Fund Investors." These Reports represent recommended "best practices" and may be indicative of future regulation, but they do not currently have the force of law.

The Reports make a wide range of recommendations on issues of disclosure, valuation, due diligence, risk management, operational management and conflicts of interest. Many of these recommendations reflect common industry practices. Several recommendations, however, create, formalize or expand existing obligations for registered and unregistered hedge fund managers and investors, especially in areas relating to disclosure and valuation. While the Reports recognize that not all of the practices they recommend will be applicable to all managers at all times, the Reports contemplate that implementation of their recommendations will be "critical to and consistent with the goal of reducing systemic risk."

Highlights of the Managers' Report

Disclosure: The Managers' Report draws from the public company disclosure regime in making its recommendations regarding fund disclosure practices. Though the Managers' Report does not recommend that managers disclose underlying investment positions of funds, it does recommend a framework for ongoing disclosure of material information, including financial information, risk information and potential conflicts of interest. Further, in addition to quantitative data, managers are to provide investors with periodic qualitative performance analysis. The Managers' Report noted the importance of counterparty and valuation policies and recommended that managers regularly provide investors with explicit valuation and counterparty data.

Valuation: The Managers' Report emphasizes the importance of valuation policies for funds, especially with respect to hard to value assets. The Managers' Report recommends that managers adopt a valuation framework that provides for consistent policies and appropriate controls for the segregation of responsibilities between portfolio managers and those responsible for valuations. Managers are to establish mechanisms for minimizing conflicts by implementing a system of segregation of functions and controls

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with appropriate oversight. Specifically, a hedge fund manager should employ valuation committees which have ultimate responsibility for a fund's valuation policy. Noting the difficulty in valuing certain assets without manager involvement, the Managers' Report rejects any suggestion that third parties be required to value a fund's assets.

Notably, the Managers' Report recommends that managers report to investors what amount of a fund's investments is categorized as Level 1 (marketable securities), Level 2 (assets with some observable market price, like OTC derivatives) and Level 3 (hard to value assets) investments, as determined pursuant to FAS 157. While FAS 157 requires such disclosure annually, the Managers' Report recommends that such reporting occur quarterly.

Risk Management: The Managers' Report recommends that managers adopt a comprehensive framework to measure, monitor and manage risk consistently. The Managers' Report recommends that managers disclose, on a quarterly basis, risk information (including liquidity risk, leverage, market risk, counterparty credit risk and operational risk) including an appropriate qualitative discussion that will help investors understand how the manager views a fund's risk profile. The Managers' Report also recommends that managers pay specific attention to the risk generated by a fund's relationships with certain counterparties.

Trading and Business Operations: The Managers' Report recommends that a manager's compliance framework include the following elements: a member of senior management with responsibility for operations, supported by adequate resources; policies and procedures that address segregation of duties and reconciliation; checks and balances in operations and systems; and infrastructure and automation commensurate with a manager's business. The Managers' Report recommends these steps to ensure a culture of compliance, in direct support of a comprehensive compliance framework.

Compliance, Conflicts and Business Practices: The Managers' Report recommends that managers maintain a comprehensive framework that includes a written code of ethics; a written compliance manual, including a process for handling conflicts of interest and a robust training program to educate personnel regarding the manager's policies; and a compliance function that includes a Chief Compliance Officer, appropriate discipline and sanctions and an annual review of the compliance framework. The Managers' Report notes the particular importance of potential conflicts of interest and suggests that a manager establish a Conflicts Committee as the focal point for reviewing all potential conflicts.

Highlights of the Investors' Report

Due Diligence: The Investors' Report makes several recommendations regarding an investor's due diligence and on-going monitoring responsibilities including:

- Personnel -- The Investors' Report recommends that investors conduct thorough due diligence regarding the experience and background of the principals of a manager and consider the risks associated with the loss of specific key persons;
- Business Management -- Investors should obtain information from hedge fund managers on the governance and compensation structures, nature and breadth of ownership of the manager, degree of client concentration and the stability of the client base;
- Investment Performance Track Record -- Investors should understand a manager's historical performance and the factors contributing to that performance and a manager's ability to operate in varying market environments;
- Style Integrity -- Investors should obtain appropriate risk reports, with sufficient frequency, to monitor potential style drift and to confirm that a fund continues to meet the investor's objectives; and
- Model Use -- Investors should understand a manager's use of models, including the complexity, assumptions, model inputs, any changes and risks associated with the models a manager employs.

Risk Management: The Investors' Report recommends that investors develop their own formal written risk management programs and supervisory procedures. These programs should be independent of the manager selection process. In addition, investors should understand and review a manager's risk management policies, including reviewing samples of the reporting provided by managers. Investors should understand and consider all types of risks (market risks, liquidity risks, leverage risks) to which a fund is exposed and how a manager intends to address, monitor and comply with its internal risk policy regarding such risks.

Legal and Regulatory: The Investors' Report recommends that investors endeavor to understand the nature and the implications of the structure and domicile of any potential fund. Specifically, investors should understand and examine the legal terms of a fund, with an eye to determining whether their interests are adequately protected. Investors should obtain legal advice to review material legal terms and applicable regulations.

Valuation: The Investors' Report recommends that investors verify a manager's written statement of valuation policies and procedures to assure that a fund's portfolio is consistently valued under GAAP, including those provisions requiring fair value valuation. Further, investors should confirm that the valuation committee or other

government structure of a fund provides sufficient oversight of the valuation methodology. Contrary to the Managers' Report, the Investors' Report recommends that investors should seek independent valuation semi-annually for funds that hold significant assets for which there is not a liquid market.

Fees and Expenses: The Investors' Report recommends that investors seek to negotiate fees and expenses as investors have an obligation not to overpay for investment management services. When the period of audited valuations does not coincide with the fee calculation period, investors should familiarize themselves with the manager's process for calculating the fee.

Reporting and Transparency: The Investors' Report recommends that investors obtain comprehensive performance reporting and fees reporting.

Taxation: The Investors' Report recommends that investors review the tax implications of their investment and consult with tax attorneys to understand the full tax implications of their investment.

Initial Responses and Analysis

While, as indicated above, the Reports are not legally binding, fund managers should consider carefully whether or not to incorporate their "best practice" suggestions into their compliance frameworks and business practices. In an environment of increased government scrutiny, adopting recommended best practices (and thoughtful decisions not to adopt them) may show that a manager's compliance and supervisory practices and procedures are reasonable, appropriate and well-tailored to its business.

The Reports are unlikely to be the final word on the subject of hedge fund regulation. Public officials have indicated that Congress will consider legislation suggesting that they do not consider the Reports' best practices approach by itself to be a sufficient substitute for regulation in this area. Senator Charles Schumer stated that the Reports are a good interim measure while Congress considers what to do in the wake of the credit crisis. Representative Barney Frank says that he expects Congress to revamp financial regulations to better keep pace with, among other things, hedge funds. In addition, an SEC spokesman said the SEC supports the Reports "but recognizes that they are no substitute for the rigorous enforcement of the securities law exercised by the SEC."

Finally, we note that there is a 60 day comment period for the Reports. At the end of the comment period, the committees will meet to consider the comments and as necessary revise the comments.

This Client Alert is a publication of Dewey & LeBoeuf LLP and is not intended as legal advice regarding specific transactions or matters. If you would like to discuss the Reports, please contact one of the attorneys below or your D&L relationship partner.

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