MFA reporter
MANAGED FUNDS ASSOCIATION
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MFA and AIMA Announce Plans to Collaborate on Key Industry Initiatives

MFA is pleased to announce that it has entered into an alliance with its European counterpart, The Alternative Investment Management Association (AIMA).

MFA and AIMA, the world's two leading hedge fund associations, issued a joint news release on April 7 establishing a framework for the development of a global voice for the hedge fund industry on issues of common interest such as an international convergence of sound practices and high standards of professional conduct.

This alliance will allow both organizations to work together more closely and to collaborate on key industry initiatives.

Richard H. Baker, MFA President and CEO, and Florence Lombard, AIMA CEO, made the joint announcement saying, "MFA and AIMA will develop a framework for increased cooperation on issues of common interest such as the adoption of a global, principles-based regulatory system which will unify our members across jurisdictions and foster industry-wide compliance with the highest levels of sound business practices and integrity."

Eric Vincent, MFA Chairman, said, "Our members collectively represent the vast majority of alternative investment fund groups worldwide. We seek to establish a unified global industry voice, to avoid duplication of effort on common initiatives and to foster market disciplines and efficiencies for our members, counterparties and investors worldwide."

Christopher Fawcett, AIMA Chairman, said, "AIMA and MFA are seeking closer cooperation on issues of mutual interest and our aim is to facilitate communication among our members that will promote a unified approach to issues that impact our businesses and our ability to meet our investors' needs. The international convergence of sound practices is the right way forward for the industry, and the demand and challenge now is for the industry to bring about convergence between the various standards proposed."

Initially, MFA and AIMA will develop an information exchange, participate on each others' Boards, discuss the development of shared initiatives and collaborate on educational seminars. ◎

REPORTING ON ISSUES FOR INVESTMENT PROFESSIONALS IN HEDGE FUNDS AND OTHER ALTERNATIVE INVESTMENTS.

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U.S. Climate Change Policy Will Drive Significant Investment Opportunities in Traditional and Alternative Energy

BEN MCMAKIN, SENIOR DIRECTOR, GOVERNMENTAL ISSUES, AND JANET ANDERSON, SENIOR TECHNOLOGY AND POLICY ADVISOR, VAN NESS FELDMAN

A new President and the likelihood of more Democrats in the House and Senate may tip the balance of power in energy debates from traditional oil and gas interests to proponents of new energy sources and cleantech goods and services. While we watch the election unfold, and as the rhetorical battles over energy policy continue in Washington, D.C., climate change legislation looms largest of all the energy debates.

As the United States gradually changes the complexion of its energy supply mix towards alternative and renewable sources and implements practices aimed at reducing overall energy demand, a number of sizeable investment opportunities currently exist for asset managers. More will arise in the future. This trend is partly market-based, as companies like GE, Wal-Mart and BP have demonstrated in response to demand from individual and commercial customers (and institutional investors).

However, market developments can carry the trend only so far. U.S. federal (and state) policies are a powerful force in nurturing markets and providing economic incentives for progress in this area. The largest driver of these opportunities over the next few years will be U.S. climate change policy. Given the scope of the climate issue, traditional and alternative energy companies – as well as many companies that have not historically thought of themselves as energy companies or concerned themselves with energy policy matters – are paying close attention. Alternative asset managers should too.

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Recent Developments in Energy Investments

While tightening environmental restrictions (and risk guidelines issued by several major institutional lenders) have cast doubt on the viability of investments in fossil-based (i.e. coal, oil, natural gas) energy generation and production, U.S. energy demand continues to rise. Accordingly, investments in traditional electric generation and vehicle fuels, energy exploration and distribution infrastructure (including petroleum exploration from oil sands and shale formations), new natural gas pipeline infrastructure and liquefied natural gas (LNG) import terminal development, are likely to continue.

In similar fashion, renewable energy generation (*i.e.*, wind, solar, biomass, geothermal, landfill gas) and the current biodiesel and corn ethanol industries continue to experience growth. The U.S. renewable/alternative energy sector depends heavily on renewable energy production tax credits, R&D loan guarantees, direct appropriations and other incentives (for example, mandates that all government buildings use energy efficient lighting and power management technologies) to spur private investment opportunities. Many of these incentives were created or received a significant overhaul in the Energy Policy Act of 2005. The Energy Independence and Security Act of 2007 modified some of the incentives, and the balance of 2008 will see Congress further debate these incentives.

Climate Change Policy Will Drive Significant New Investment Opportunities

However, the current U.S. energy funding vehicles discussed above are just the tip of the iceberg in comparison to the market

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News from Washington

By MFA Government Relations Staff

CFTC Commissioner Jill Sommers

Jill Sommers was sworn in as a CFTC Commissioner on August 8, 2007. Commissioner Sommers has worked in the commodity futures and options industry in a variety of capacities throughout her career. In 2005, she was the policy director and head of government affairs for the International Swaps and Derivatives Association where she worked on a number of over-the-counter derivatives issues. Prior to that, Ms. Sommers worked for the Chicago Mercantile Exchange where she oversaw regulatory and legislative affairs. During that time, she had the opportunity to work closely with Congressional staff in drafting the Commodity Futures Modernization Act of 2000.

CFTC Commissioner Jill Sommers

Commissioner Sommers started her career in Washington, D.C. in 1991 as an intern for Senator Robert J. Dole (R-KS), where she worked in various capacities until 1995. She later worked as a legislative aide for two consulting firms specializing in agricultural issues; Clark & Muldoon, P.C. and Taggart and Assoc.

CFTC Commissioner Bart Chilton

CFTC Commissioner Bart Chilton

Bart Chilton was sworn in as a CFTC Commissioner on August 8, 2007. He was formerly the chief of staff and vice president for government relations at the National Farmers Union.

In 2005, Mr. Chilton was a Schedule C political appointee of President Bush at the U.S. Farm Credit Administration where he served as an executive assistant to the Board. From 2001 to 2005, Mr. Chilton was a senior advisor to Senator Tom Daschle (D-SD), the Democrat Leader of the United States Senate, where he worked on a myriad of issues, including agriculture and transportation policy.

Mr. Chilton was a Schedule C political appointee of President Clinton from 1995 to 2001 and rose to deputy chief of staff to the U.S. Secretary of Agriculture Dan Glickman. In this role, Mr. Chilton became a member of the Senior Executive Service (SES): government executives selected for their leadership qualifications to serve in the key positions just below the top Presidential appointees. As an SES member, Mr. Chilton served as a major link between Secretary Glickman and the rest of the Federal work force at USDA.

Earlier in his career, from 1985 to 1995, Mr. Chilton worked in the U.S. House of Representatives as legislative director for three different Members of Congress on Capitol Hill. He also worked in the U.S. House as the executive director of the bipartisan Congressional Rural Caucus.

SEC and CFTC Sign Memorandum of Understanding

Recently, the SEC and the CFTC signed an historic Memorandum of Understanding (MOU) memorializing their agreement to strengthen their relationship and improve collaboration and information sharing between the two agencies. As the SEC and CFTC are stepping up their coordination efforts, the MOU is very timely for MFA members. MFA has recently reached out to both agencies to discuss the duplicative regulation of public commodity pools and ways we can work with them within their legal authorities to simplify regulation.

Chairman Cox and Chairman Lukken agreed to:

- Establish a permanent regulatory liaison between the two agencies;
- Require staff of the two agencies to meet formally every quarter;
- Consult in advance on issues of interest to either agency;
- Establish a framework to improve information sharing (*i.e.*, firms registered with both agencies);
- Ongoing consultation on enforcement and examination matters;
- Consult on mergers of entities that impact their regulatory interest; and

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- Write principles for providing guidance in considering novel financial products with securities and futures characteristics.

Chairman Cox and Chairman Lukken both recognized the importance of the SEC-CFTC MOU for innovation, competition, and growth of the U.S. financial sector. One of the main purposes of the MOU is to establish a framework for the agencies to get new products to the market quickly.

Treasury Releases Its Blueprint to Regulatory Reform

On Monday, March 31, 2008, the Department of Treasury released its *Blueprint for a Modernized Financial Regulatory Structure* (the *Blueprint*), a 218-paged plan for far-reaching U.S. regulatory reform. The *Blueprint* represents the culmination of a year-long effort by Treasury that started back in March 2007 at Treasury's Capital Markets Conference held in Washington, D.C. In a press briefing on the same day as the release, U.S. Treasury Secretary Henry M. Paulson, Jr. answered questions regarding the *Blueprint's* recommendations for the redesign of the U.S. regulatory structure, which calls for the streamlining of federal oversight in respect of financial services providers. Treasury's recommendations would affect all types of financial service providers, including commercial banks and other insured depository institutions, insurance companies, securities firms, futures firms and other financial intermediaries.

Treasury divided its recommendations into "short term," "intermediate term" and an "optimal regulatory framework." Secretary Paulson emphasized that the first priority of the regulators, the Bush Administration and Congress should be to remedy the current market situation and the mortgage crisis, and that the *Blueprint's* recommendations should not be implemented until those issues have been sufficiently addressed.

In October 2007, Treasury published a request for public comment in the *Federal Register*, seeking ideas on the best manner in which to reform the current U.S. regulatory structure. MFA submitted comments in response to Treasury's request. Treasury reviewed hundreds of comment letters submitted by industry participants, state regulators and interested parties. The result of Treasury's review and deliberations is reflected in the recommendations proffered in the *Blueprint*.

MFA issued a press release applauding the *Blueprint*. In the release, MFA President and CEO Richard H. Baker said that MFA believes the *Blueprint* "provides a solid foundation for providing regulatory clarity, reducing duplicative oversight, monitoring and mitigating systemic risk and promoting the highest levels of excellence in sound business practices and commercial honor." MFA plans to consult with its membership and to provide comments and other assistance to Treasury, Congress and others with respect to the recommendations to the extent that they are relevant to the alternative investment industry.

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Complexity, Tight Coupling and Normal Accidents

RICK BOOKSTABER, AUTHOR, "A DEMON OF OUR OWN DESIGN"

In his book, "A Demon of our own Design: Markets, Hedge Funds, and the Perils of Financial Innovation," Richard Bookstaber posits that today's financial crises (i.e. sub-prime mortgage, auction-rate securities) arise not from economic instability or acts of nature, but from the very design of the financial markets themselves. This excerpt identifies three factors – complexity, tight coupling and normal accidents – that serve to exacerbate marketplace distress.

Complexity is a byproduct of today's interrelated markets. It is not always benevolent; it is at times catastrophic and is always helped along by the organizational jumble of firms like Citigroup, as well as by the host of derivative instruments that have come to dominate the financial landscape. These derivatives can be customized to meet specific needs, often with unintended consequences.

The complexity at the heart of many market failures might have been surmountable if it were not combined with another characteristic that we have built into markets; one that is described by the engineering term "tight coupling." Tight coupling means that components of a process are critically interdependent; they are linked with little room for error or time for recalibration or adjustment. A space shuttle launch sequence is a tightly coupled process because each step – the ignition, the liftoff, the clearing of the tower boom – all must proceed at precise intervals and cannot be interrupted without scrubbing the entire operation. A process that is tightly coupled can be prone to accidents even if it is not complex.

The tight coupling in financial markets comes from the nonstop information flow and unquenchable demand for instant liquidity. Information spurs trading, and the trades are entered and executed without a pause. Tight coupling is accentuated by leverage, itself a direct result of liquidity. Leverage and margin are simply loans that use securities as collateral, and the willingness to lend against this collateral is directly related to the lender's ability to quickly sell out the securities if the margin is not posted. The more liquid the securities, the better the leverage terms will be. So tight coupling means higher potential leverage.

For financial markets, the tight coupling born of liquidity feeds right back to the source of complexity. Liquidity is the lifeblood of derivatives; unlike the underlying securities, derivatives are created on the assumption that they can be hedged on an ongoing basis, and so make continuous demands on liquidity. Without liquidity, derivative markets die.

The interplay of complexity and tight coupling that comes from combining liquidity with its derivative and leverage offspring is a formula for disaster. If all the eventualities cannot be anticipated (which is the case for complex systems) and if there is no time to rework the process before the problem is propagated down the line (which is the implication of tight coupling), then when things go wrong a crisis will be unavoidable. Things will go bad, and when they do, they will quickly move from bad to worse before the cascade can be stopped.

Tight coupling means that components of a process are critically interdependent; they are linked with little room for error or time for recalibration or adjustment. The tight coupling in financial markets comes from the nonstop information flow and unquenchable demand for instant liquidity.

The cascade of failure that occurs in systems that share tight coupling and complexity gives rise to what are called "normal accidents." As ironic as the term sounds, normal accidents are accidents that are to be expected; they are an unavoidable result of the structure of the process. The more complex and tightly coupled the system, the greater the frequency of normal accidents. The only way to reduce the number of accidents is to reduce the complexity or add some slack to the process. And it can be done in financial markets, but only by pulling back from the quest to create a real-world analog to the academic model of what the markets should be.

The Regulation Trap

The natural reaction to market breakdown is to add layers of protection and regulation. But trying to regulate a market

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entangled by complexity can lead to unintended consequences, compounding crises rather than extinguishing them because the safeguards add even more complexity, which in turn feeds more failure.

For example, the first line of defense for regulators to prevent banks from failing is placing limits on the amount of risk they can take relative to their capital base. The idea is to create a self-dampening reaction to crisis: if a bank loses capital because of a bad investment, or if a bank finds increased risk in its loans, it will have to offload risk by selling off assets or recalling loans. This will reduce exposure to further losses.

The problem is that selling assets or recalling loans doesn't occur in a vacuum. If the bank's actions take place in the region under pressure, it adds fuel to the fire. Its forced sales will drop prices further, reducing the capital base, which in turn requires further liquidation. At the same time, the increased selling will raise the volatility of the market, implying greater risk for the bank's positions and signaling greater demand to liquidate. Trying to control risk ends up creating a liquidity crisis.

In the idealized market, the starting assumption is that the market should run cleanly and transparently. We are faced with more pernicious problems, however, in attaining these goals. When the market ideals collide with the real world, with individuals who are not in control of full information, with institutions that do not act quickly or necessarily in anyone's best interest, the result is like taking a race car for a spin off-road.

You Can't Play It Safe

Layer one safety system on top of another and you will finally doze off into a world of unjustified complacency. You never end up as safe as you think because there are inevitably points of interaction that can hide failures. And the more layers there are, the more obscured those points become. The point is this: risk controls, putting on layers of regulation and oversight, cannot always fix the problems that arise from the complexity and tight coupling that we have designed into the markets. Indeed, it might just make matters worse. This is not to say we should throw all regulation out the window. But a better approach for regulation is to reduce the complexity in the first place, rather than try to control it after the fact.

Risk controls, putting on layers of regulation and oversight, cannot always fix the problems that arise from the complexity and tight coupling that we have designed into the markets; a better approach for regulation is to reduce the complexity in the first place, rather than try to control it after the fact.

Just because you can turn some cash flow into a tradable asset doesn't mean you should; just because you can create a swap or forward contract to trade on some stated variable doesn't mean it makes sense to do so. In the efficient market paradigm it does, because there nirvana is attained when a position can be taken against every possible state of nature. But in the world of normal accidents and primal risk, limitless trading possibilities might cause more harm than good. Each innovation adds layers of increasing complexity and tight coupling. And these cannot be easily disarmed through oversight or regulation. Rather than adding complexity and then trying to manage its consequences with regulation, we should rein in the sources of complexity at the outset. ◎

In addition to authoring four books, Rick Bookstaber worked at FrontPoint Partners running the FrontPoint Quantitative Fund and Moore Capital Management overseeing risk management. Mr. Bookstaber also served as the managing director in charge of firm-wide risk at Salomon Brothers and was Morgan Stanley's first market risk manager.

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Navigating the Regulation of Hedge Fund Marketing

JAMES R. HEDGES, IV, PARTNER, AND CHARLOTTE LUER, PARTNER, LJH FINANCIAL MARKETING STRATEGIES, AND LUCINDA O. MCCONATHY, PARTNER, AND PATRICIA C. O'PREY, PARTNER, RICHARDS KIBBE & ORBE LLP

Marketing a hedge fund involves a myriad of considerations, including compliance not only with the regulatory requirements and restrictions of the jurisdiction in which the hedge fund is domiciled, but also the requirements and restrictions of each jurisdiction in which the fund's target investors live. Here, we address the status of hedge fund regulation in the United States, with a particular focus on its implication for hedge fund marketing efforts.

Regulation of Hedge Fund Marketing

In order to avoid the requirement to register their securities under the Securities Act of 1933, hedge funds must be sold *via* a private placement. In most instances, as stated in SEC Rule 502(c), such privately placed funds may not be offered or sold "by any form of 'general solicitation' or 'general advertising,'" including, but not limited to, the following:

- Any advertisement, article, notice, or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; or
- Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.

Limited by these restrictions, hedge funds may wonder how to market their funds. Below, we offer some suggestions based on prior SEC statements and based on guidance provided by the NASD (now FINRA, the Financial Industry Regulatory Authority) to its members in setting forth guidelines for marketing hedge funds.

Limited Audience for Solicitations

First and foremost, although the SEC has not defined the terms "general solicitation" and "general advertising," it is clear that solicitations provided to a general audience will run afoul of Rule 502(c). Indeed, the SEC has indicated that it believes the following actions violate Rule 502(c):

- Mass mailings;
- Speaking to the media referencing an investment currently offered or contemplated, particularly where the discussion is an attempt to "condition the market" by making reference to the success or attractive return of previous investments; and
- Print, radio and television advertisements or solicitations regarding funding or investment matters.

Accordingly, hedge funds should limit the audience from which they solicit investments, preferably to individuals or entities with which they have a pre-existing relationship. Even in the potentially fruitful situation of participating in an investment forum, hedge fund advisers should take care that the attendees are limited to accredited investors and, preferably, to investors with whom the advisers have a pre-existing relationship.

FINRA's is review identified four general areas of concern in hedge fund advertising: *(i)* risk disclosure; *(ii)* misleading and exaggerated language; *(iii)* performance; and *(iv)* general solicitations.

FINRA Guidelines Regarding the Content of Solicitations

In 2003, FINRA studied hedge fund marketing materials and then issued guidance for member firms in the form of a member update regarding the marketing of hedge funds by its members. FINRA maintains this general guidance today. Although this guidance does not apply directly to hedge funds, it provides a useful framework for hedge fund marketing materials. In reviewing member marketing of hedge funds, FINRA found that some examples of hedge fund sales literature included "unbalanced presentations about the particular hedge funds being offered" and, therefore, failed "to provide investors with a sound basis for evaluating whether to invest in the funds." *NASD Member Update October 9, 2003, NASD Review of Hedge Fund Advertising Results in Formal Action*. FINRA's review identified four general areas of concern in hedge fund

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advertising: *(i)* risk disclosure; *(ii)* misleading and exaggerated language; *(iii)* performance; and *(iv)* general solicitations. We address these areas below.

Risk Disclosure

According to the guidance, hedge fund promotional materials must be a balanced, fair presentation of the risks and potential disadvantages of hedge fund investing. Communications regarding hedge funds and funds of hedge funds must adequately disclose the risks associated with these products. Presentations must address the risks associated with hedge funds in general, as well as the specific risks associated with the fund being offered including, but not limited to, the risks associated with a fund's structure, investment strategies, portfolio securities, tax treatment, *etc*. For example, members must balance sales material or oral presentations that promote the advantages of hedge fund investing with full disclosure of the risks that hedge funds present, including the fact that hedge funds:

- Often engage in leverage and other speculative investment practices that may increase the risk of investment loss;
- Can be highly illiquid;
- Are not required to provide periodic pricing or valuation information to investors;
- May involve complex tax structures and delays in distributing important tax information;
- Are not subject to the same regulatory requirements as mutual funds; and
- Often charge high fees.

NASD Notice to Members 03-07, NASD Reminds Members of Obligations When Selling Hedge Funds. In addition, it may also be advisable to highlight to potential investors the fact that a hedge fund investment may not be suitable for all investors and, in particular, to suggest that it is suitable only for the most sophisticated investors. Indeed, some FINRA comments have called for disclosure of accredited investor requirements in hedge fund marketing materials.

Performance

Hedge fund managers should restrict discussions of performance results to actual performance of the fund being promoted. FINRA has noted that some marketing materials contain language that states or implies that an investor can expect a specific rate of return from investing in a fund. Such projections or predictions of investment results are prohibited. Generally, funds should be very cautious about forward-looking statements with respect to securities investments. Moreover, where a fund has experienced a period of extraordinary performance, disclosure of the reasons for extraordinary market performance, and the fact that such performance may not be repeated in the future, is advisable.

In hedge fund marketing, exaggerated, unwarranted or misleading statements or claims are prohibited. Typically, the use of superlatives in the description of the fund or its performance is not advisable. The use of objective language to describe the fund's performance is advised.

New funds need to be particularly cautious regarding their marketing materials because any attempts to attribute the performance of another product to a new fund that has either a limited operating history or no operating history may be misleading.

Misleading or Exaggerated Language

In its first Compliance Alert letter to the chief compliance officers of registered firms, the SEC staff stated the most common deficiency in adviser advertising was that "many" advisory firms did not include in the advertisements of their performance returns the disclosures necessary to prevent their advertising from being misleading. For example, firms did not:

- Deduct advisory fees from performance results;
- Disclose whether results reflected dividends; or
- Disclose differences with the particular index being used to benchmark performance claims.

FINRA's Member Conduct Rule inherited from the NASD provides that no material fact or qualification may be omitted from marketing materials if the omission would cause the communication to be misleading. In the context of hedge funds, FINRA generally considers the disclosure of the inherent and particular risks of an investment, investment strategy or underlying assets, liquidity restrictions, withdrawal rights and fees and performance fees and charges to be material. Thus, performance calculations should be presented net of the fees charged. If the performance description is not calculated net of fees charged, the fees to be deducted must be disclosed, along with a disclosure

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that the funds' performance would be lower if the fees were deducted. Performance presentations should also illustrate downside volatility and should not highlight only successful investments or reporting periods with positive results. Note that providing a prospectus does not satisfy the duty to provide balanced sales materials and oral presentations.

Exaggerated, unwarranted or misleading statements or claims are prohibited. Typically, the use of superlatives in the description of the fund or its performance is not advisable. The use of objective language to describe the fund's performance is advised.

FINRA noted particular deficiencies where marketing materials:

- Make unbalanced presentations about the particular hedge funds being offered;
- Contain exaggerated, unwarranted or misleading statements or claims, unwarranted forecasts or projections of future performance;
- Refer to a hedge fund as an "ideal fund for conservative investors" when the fund had a limited operating history, was speculative and involved a high degree of risk; indicate that hedge funds are subject to regulatory oversight;
- Present hypothetical results for specific hedge funds that had limited operating history or no operating history;
- State that a fund's objective is to produce a steady or predictable return when, in fact, the fund's prospectus did not disclose such an objective;
- Use language that states or implies that hedge funds or funds of funds are appropriate for all investors or should be part of all investors' portfolios; and
- State or imply that an investor can expect a specific rate of return from investing in a fund.

Best Practices Noted by the SEC

Recently, the SEC's Office of Compliance Inspections and Examinations (OCIE) offered examples of policies and procedures in place at the firms with fewer performance advertising deficiencies. Such policies include:

- A multi-level review process among an adviser's performance group, portfolio managers, and marketing group for the accuracy of marketing materials prior to their use;
- The creation of "tolerance reports" on a monthly basis to compare all composite accounts to their respective benchmarks, with any material discrepancies being investigated;
- A composite committee review of all accounts on at least a quarterly basis to ensure proper composite construction and maintenance; and
- The use of a second independent pricing service to periodically verify the accuracy of prices supplied by the primary pricing service, with any material discrepancies in prices being investigated.

Conclusion

In summary, we recommend:

- Targeting solicitations to individual potential investors or to a discrete group of accredited investors, preferably already known to the hedge fund adviser;
- Disclosing the risks and potential disadvantages of a hedge fund investment, as well as particular risks involved in investing in the particular fund at issue;
- Restricting discussions of performance to actual past performance, net of fees charged; and
- Disclosing statutory investor-eligibility requirements.

These marketing recommendations must be understood against the broader context of accelerating initiatives to regulate the hedge fund industry in the United States. ◎

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The Due Diligence of Cash Management: An Ounce of Prevention, A Pound of Cure

BRIAN X. HURLEY, VP, DIRECTOR OF MARKETING, HORIZON CASH MANAGEMENT

Until the mid-1700's, disease and death were common afflictions of long-distance sailors. A physician's recommendation that British sailors consume an orange or lime daily, reduced the incidence of scurvy to near-zero. In this instance, a small but important breakthrough produced lasting and significant change. Likewise, this article suggests a simple, easy-to-use protocol that can significantly elevate the confidence one has about the overall safety and prudent investment of cash reserves.

In times like these in which volatility is the norm, affecting every asset class, fund managers and investors historically have turned to cash to provide a measure of safety, comfort and dry powder. However, over the past six months even this most staid and conservative of investment realms has generated the kind of notoriety and negative headlines that should never be associated with cash. What's happened here? And, more importantly, what can fund managers do to achieve peace-of-mind that those cash assets are being managed prudently and efficiently?

To Diagnose, One Must Ask the Right Questions

Fund managers and investors tend to focus due diligence efforts on a fund's investment strategies and back-office operations. This, despite the fact that for many funds (*e.g.,* managed futures), cash balances can represent a substantial percentage of the fund's total assets. Even for those funds in which the cash component is smaller, it's essential that fund managers – and their investors – know at all times where the money is being held, the safeguards in place for those cash balances, how the cash is invested and the investment returns those balances are generating.

One need only look at the past half year to see how terribly wrong things can go when due diligence is insufficiently performed.

- *August 2007* – Axa Investment Managers, a French-based asset management group, provides a $1 billion bailout of its U.S.-run bond fund, Axa IM US Libor Plus Strategy, after this fund – marketed as a short-term cash fund (but in reality, 100% invested in asset backed securities) – watches its two sub-funds lose nearly 13% of its value over a two-day period.
- *August 2007* – Sentinel Management Group, a $1.6 billion money manager, ostensibly in the business of providing short-term cash management suspends fund withdrawals when redemptions exceed liquid assets. Within a week, the firm shuts its doors, files for Chapter 11 bankruptcy and subsequently is charged by the SEC for fraud and misappropriation of clients' assets through imprudent use of leverage and reliance on illiquid investments. Client losses – yet to be finalized – are expected to fall somewhere between $350 and $400 million.
- *August 2007* – State Street Global Advisors' Bond Market Fund, marketed as a conservative investment option, announces a one-month 12% loss. Resultant lawsuits against State Street indicate that more than a quarter of the fund's portfolio was invested in asset-backed securities made up of home equity loans.
- *November 2007* – General Electric Asset Management's GEAM Trust Enhanced Cash Trust, a $5 billion enhanced cash fund, "breaks the buck" (*i.e.,* offers investors the option to redeem their holdings for 96 cents on the dollar), owing to the fund's investment losses in mortgage and asset-backed securities.

The consequences in each instance were catastrophic. Cash assets were lost or frozen; monies earmarked for margin calls, redemptions or strategic investments were compromised; liquidity evaporated; traders, fund managers and investors incurred unexpected legal costs. In short, risk displaced trust. But it didn't have to be so.

To avoid these types of unpleasant surprises, it is essential to drill down so that every aspect of how cash is being managed is fully understood. For any diagnosis to be helpful, it must be complete. It is insufficient to look merely at the investment strategy; you have to immerse yourself in the details of the company. A good practice is to draw upon a comprehensive guide that outlines every question to be answered.

The Ounce of Prevention

To capture the information upon which to make a prudent decision, fund managers and investors would benefit from a

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detailed due diligence guide that covers the entirety of the cash management function – not merely the investment process – and provides a comprehensive list of questions to guide the fact-finding.

Over the past several years, in consultation with fund managers, administrators, investors, regulatory advisors and legal counsel, Horizon Cash Management has developed a master list of more then 50 questions that – properly asked and honestly answered – would significantly reduce the likelihood of managers and investors having their cash assets jeopardized. This guide, which serves as a useful companion to the MFA's *Sound Practices for Hedge Fund Managers*, is available at no cost to MFA members (details at bottom of article).

Questions, including but not limited to those below, reveal crucial information not only about the investment process but about the firm's regard for, and approach to, risk management, reporting and disclosure.

- Is the firm invested in any illiquid securities?
- Does the client have 100% daily liquidity?
- What is the duration?
- How transparent are the investment positions?
- Are assets managed in separate portfolios or in a pooled investment vehicle?
- Where are the securities held?
- Is there independent third-party access to information in the custody account?

Even the most detailed guide to due diligence can't guarantee the absence of problems as answers could be less than fully disclosed or untrue. However, it's likely that had just these seven questions been advanced and satisfactorily addressed in the cases noted above, fund managers and their investors would have had sufficient information to avoid investments that eventually blew up, either freezing or diminishing cash reserves.

The Pound of Cure

Using a due diligence guide to ensure that the right questions are being asked and nothing is left unexplored is prudent and smart. Failing to do so can result in cash assets being frozen, diminished or completely gone. Fund managers and investors are wise to be as thorough and comprehensive in their due diligence of cash management as they are in any other investment or operational aspect of their funds. ◎

Brian X. Hurley is vice president, director of marketing at Horizon Cash Management. To obtain a copy of the "Due Diligence Guide to Cash Management", please contact Mr. Hurley at **brian.hurley@horizoncash.com**.

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opportunities anticipated to arise from pending U.S. climate change legislation. Estimates of this market's size, not including emissions trading transactions or arbitrage opportunities, range from the tens of billions of dollars to well over 100 billion dollars (for an overview of emissions markets, see January/February *MFA Reporter* article "Have Emissions Markets Arrived?"). What is the composition of this market, and where are the opportunities for alternative asset managers?

Necessary Research and Development to Commercialize New Energy Technologies

U.S. emissions of greenhouse gases are mostly (82%) comprised of the carbon dioxide (CO2) released when fossil fuels (coal, oil, natural gas) are burned to create energy for electricity, transportation and heat. Reducing emissions of CO2 will require advanced energy technologies, for not only the more efficient use of electric energy and fuels, but also the creation of electricity and fuels.

For the United States to substantially increase the penetration of advanced energy technologies (efficiency, renewables, coal, and nuclear for the electric sector and renewable fuels and more efficient vehicles for the transportation sector), more funding must be directed to the research, development and deployment (RD&D) needed to enable commercialization. A number of groups concerned with electricity and RD&D needs (such as the International Energy Agency, Coal Utilization Research Council,

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MIT Center for Energy and Environmental Policy Research and Electric Power Research Institute) have called for increased funding for this purpose. These recommendations for investment in energy technologies related to electricity alone aggregate to just under $2 billion per year, which is a substantial sum, but one that would be roughly double what is spent today.

Energy Technology Deployment Funds

Contrast this amount with the funding for advanced technology deployment contemplated in the legislation to create a greenhouse gas regulatory program. Senate bill S. 2191, the Lieberman-Warner Climate Security Act of 2007, may be considered on the Senate floor before summer 2008. This bill creates a financial incentive for the development of new energy technologies that enable carbon dioxide emission reductions. S. 2191 proposes the use of a substantial portion (52%) of the proceeds of the auction of emission allowances (defined as the right to emit one metric ton of carbon dioxide equivalent (mtCO_2e) in a cap-and-trade program to create five Energy Technology Deployment funds:

- Zero- or Low-Carbon Energy Technology Program;
- Advanced Coal and Sequestration Technologies Program;
- Sustainable Energy Program;
- Fuel from Cellulosic Biomass Program; and
- Advanced Technology Vehicles Manufacturing Incentive Program.

Adopting as a nominal figure for this analysis an allowance price of $10/mt$CO_2$e (a conservative figure and one that allows for ease of multiplying to a range of likely allowance prices – $15 to $50 by most estimates), the value of these funds over the first five years of a 40-year regulatory program totals $34 billion. Indeed, the first year of funding alone will provide $5.1 billion. This is a substantial allocation of funds to create demand for advanced technologies across a broad range of applications. Another mechanism to generate this funding stream could come from the imposition of a carbon tax.

Zero- or Low-Carbon Energy Technology Program: This program would award the bulk of its funds based on a reverse auction for manufacturers of high-efficiency consumer products and generation of electricity from new zero- or low- carbon technologies. As most observers believe that the lowest cost reductions of CO_2 in the economy will come from increased energy efficiency, high-efficiency consumer products should receive much of the funds from this program ($10.5 billion in the first five years). Funds can also be awarded to manufacturers of zero- or low-carbon electric generation technology and components.

> Given that the pool of funds created under climate change legislation is substantial – $51 billion over the first five years – U.S. climate policy should create a host of investment options for alternative asset managers including traditional long/short equity options, potential carbon markets long/short, arbitrage or derivatives opportunities and direct investments in the energy and technology sectors. In addition "next generation," socially-responsible investment vehicles and fund of funds may hold appeal for certain asset managers.

Advanced Coal and Sequestration Technologies Program: This program awards funds to projects that capture and sequester the CO_2 emissions associated with burning coal for electricity generation. The projects would have to meet increasingly stringent performance requirements over time. The funds available to the program in the first five years are $8.2 billion.

Sustainable Energy Program: Another $8.2 billion over the first five years is directed to the Sustainable Energy Program. Sustainable energy is defined to include wind, ocean waves, biomass, solar, landfill gas, incremental hydro and geothermal energy sources. This is a substantial increase in funding, as the current renewable energy production tax credits cost the U.S. Treasury about $400 million per year. These funds will provide additional incentives to deploy advanced renewable technologies in the United States.

Fuel from Cellulosic Biomass Program: The fund to provide deployment incentives for fuel from cellulosic biomass will total $2 billion over the first five years. The fund will be awarded to a variety of projects relying on different feedstocks that domestically produce transportation fuels from cellulosic biomass. This fund's awards will be divided among producers of different classes of transportation fuels, as well as projects to construct associated distribution and delivery infrastructure (*e.g.*, pipelines).

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Understanding Financial Highlights in the Financial Statements of Hedge Funds

By Ross Ellberg, CPA, Arthur Bell Certified Public Accountants

Background

Since 2003, nonregistered investment partnerships (hedge funds) have been required by accounting principles generally accepted in the United States (U.S. GAAP or GAAP) to present financial highlights in their financial statements. Prior to 2003, there was not a requirement for hedge funds to present financial highlights in their financial statements. In contrast, registered investment companies (mutual funds) have historically had a requirement to present financial highlights in their financial statements in order to be in compliance with GAAP. The primary objective of financial highlights is to provide the financial statement user with: *(i)* objective data regarding the results of the hedge fund's operations and significant financial statement ratios, and *(ii)* a measure by which to compare such financial data among hedge funds (the "comparability" objective). As with all data or statistics, financial or otherwise, caution must be used when drawing conclusions or making decisions based on the data presented. Among other factors, the user of such data must understand how the data was derived, the statistical validity of the data and any data bias that may exist. Such is also the case with financial highlights of hedge funds. The goal of this article is provide a basic understanding of: *(i)* the presentation and disclosure requirements of financial highlights; *(ii)* how financial highlights are calculated; and *(iii)* the benefits and limitations of financial highlights in the financial statements of hedge funds. As the focus of this article is financial highlights of hedge funds, financial highlights of private equity funds are excluded from this article's scope.

Presentation and Disclosure Requirements

The presentation and disclosure requirements presented herein are general in nature. The specific presentation and disclosure requirements are contained in American Institute of Certified Public Accountants (AICPA) Statement of Position 95-2, *Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide Audits of Investment Companies and AICPA Statement of Position 95-2, Financial Reporting by Nonpublic Investment Partnerships, as codified in the AICPA Audit and Accounting Guide: Investment Companies* (May 1, 2007 edition).

The presentation and disclosure requirements vary depending on if the hedge fund is a: *(i)* capital based fund; *(ii)* a unit or share based fund; or *(iii)* a private equity fund. The general disclosure requirements for capital based funds and unit or share based funds are as follows:

Capital Based Funds

- Total return, both before and after the incentive allocation or fee for each reporting class taken as a whole (Total Return);
- Ratio of expenses, both before and after the incentive allocation or fee, to average net assets for each reporting class taken as a whole (Expense Ratio);
- Ratio of net investment income (excluding the incentive allocation or fee) to average net assets for each reporting class taken as a whole (Net Investment Income Ratio); and
- Other disclosure information.

Unit or Share Based Funds

- Per unit or share information, which details the change in net asset value per unit or share at the beginning of the period to net asset value per unit or share at the end of the period, for each reporting class taken as a whole;
- Total return for each reporting class taken as a whole (Total Return);
- Ratio of expenses, both before and after the incentive fee, to average net assets for each reporting class taken as a whole (Expense Ratio);

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- Ratio of net investment income (excluding the incentive fee) to average net assets for each reporting class taken as a whole (Net Investment Income Ratio); and
- Other disclosure information.

Method of Calculation

Total Return for capital based hedge funds is calculated by comparing the aggregate ending value of each class of investor with the aggregate beginning value of each such class, adjusted for cash flows related to capital contributions and withdrawals during the period. Total Return for unit or share based hedge funds is calculated by dividing the change in unit or share value for each reporting class during the period by the beginning of period unit or share value for such reporting class.

The Expense Ratio for both capital based and unit or share based hedge funds is calculated by taking the total expenses (both before and after the incentive allocation or fee) attributable to the reporting class and dividing it by the average net assets of the reporting class during the period.

The Net Investment Income Ratio for both capital based and unit or share based hedge funds is calculated as the sum of all interest income, dividend income and other income from miscellaneous sources (*i.e.*, all non-trading or investing related income) minus all expenses (Net Investment Income) and then dividing the Net Investment Income by the average net assets of the reporting class during the period. For both capital based funds and unit or share based funds, the Net Investment Income Ratio excludes the incentive allocation or fee attributable to the applicable reporting class.

The above are the general calculation requirements for Total Return, the Expense Ratio and the Net Investment Income Ratio. GAAP requires adjustments, modifications, specific treatment and/or additional disclosures in certain instances. Several of the more significant items that require adjustment, modification, specific treatment or additional disclosure are as follows:

- The Expense Ratio and the Net Investment Income Ratio must be annualized for reporting periods of less than one year;
- The Total Return is not annualized;
- The effect of certain fee waivers must be disclosed; and
- Fund of Funds, Master Funds and Feeder Funds have certain specific unique requirements.

Benefits and Limitations

Since the 2003 requirement for hedge funds to present financial highlights in their financial statements, financial statement users have been provided with better information regarding the operating performance of hedge funds, primarily presentation of Total Return and the Expense Ratio, and more information to help them compare financial data among hedge funds. For instance, prior to 2003, the financial statement user had no way of determining how net income or net loss translated into a rate of return. In fact, a hedge fund could have had significant net income, but still have produced a negative rate of return (or vice versa). However, the financial statement user would have only known that the fund had significant net income, thus leading such financial statement user to assume that the fund had produced a positive rate of return. The Expense Ratio has also tended to provide more useful information regarding hedge fund expenses and the impact of such expenses on the Total Return.

There are, however, many limitations to financial highlights. Although certain disclosure is required by GAAP regarding certain of these limitations, these limitations are not always apparently obvious.

One significant limitation is that the financial highlight calculations are "aggregate calculations." It is not uncommon for a hedge fund manager to waive or reduce management fees or incentive allocations or fees for certain investors. In calculating the financial highlights, the performance of investors who pay full fees and those that pay reduced or no fees are aggregated together in calculating the various financial highlights. Thus, in this situation, the financial highlights presented will produce blended results that do not match the actual experience of any one investor in the fund. The actual results of both a full fee paying investor and the reduced or non-fee paying investor will differ from the actual results presented in the financial highlights.

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Another limitation is that the Expense Ratio and the Net Investment Income Ratio are annualized. For instance, let's take an example of two absolutely identical hedge funds: Fund A, which commenced operations on January 1, 2007; and Fund B, which commenced operations on October 1, 2007. One would expect that Fund A and Fund B would have very similar Net Investment Income Ratios. However, due to the method of calculation and annualizing the ratio of Fund B, Fund A will have a higher Net Investment Income Ratio. Why? Interest rates on interest bearing deposits were in a declining trend throughout 2007. Fund A, which earned actual interest income all throughout 2007, earned a higher average interest rate than did Fund B, which only earned actual interest income during the last three months of 2007. When Fund B's Net Investment Income Ratio is annualized, it inherently assumes that Fund B earned interest income throughout the year at the same rate it earned during the last three months of 2007. Since interest rates declined during 2007, Fund B will be annualizing a lower average interest rate, thus producing a lower Net Investment Income Ratio than Fund A's Net Investment Income Ratio. The above examples are two very common examples of the limitations of financial highlights.

So what is the conclusion? Are financial highlights accurate and worthy of reliance or not? I would suggest that financial highlights provide a general indicator or approximation of the results of operations and financial ratios. However, the financial highlights should be utilized only with the understanding of their limitations and any fact specific circumstances applicable to the hedge fund for which they are presented. I would also suggest they be used in conjunction with other verifiable information.

Arthur Bell Certified Public Accountants is a public accounting firm providing a full range of accounting, audit, tax and consulting services to the hedge fund and managed funds industry. E-mail: ***ross.ellberg@arthurbellcpas.com***
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Advanced Technology Vehicles Manufacturing: The incentive program for advanced technology vehicles manufacturing will be awarded to manufacturers of vehicles (or components designed for such vehicles) that meet a standard of at least 125% of the base year combined fuel economy, as well as new criteria pollutant emission standards. The funding for this program over the first five years is $4.9 billion.

Opportunities for Asset Managers

Given that the pool of funds created under climate change legislation is substantial – $51 billion over the first five years at the generally agreed upon low-end allowance price of $15/mtCO$_2$e – U.S. climate policy should create a host of investment options for alternative asset managers. These might include traditional long/short equity options, potential carbon markets long/short, arbitrage or derivatives opportunities and direct investments in the energy and technology sectors. In addition, "next generation," socially-responsible investment vehicles and fund of funds may hold appeal for certain asset managers. Finally, depending on their strategies, asset managers may be interested in influencing the policy debate with an aim to securing favorable incentives and/or climate policy design features that will foster market growth of certain sectors, attract capital investment, or ensure the availability of carbon market finance options.

Ben McMakin is senior director governmental issues at Van Ness Feldman. Janet Anderson is senior technology and policy advisor at Van Ness Feldman. Based in Washington, D.C., with an office in Seattle, WA, Van Ness Feldman is a law and policy firm focused exclusively on energy and environmental issues. The firm has twice been recognized by Environmental Finance *magazine as a leading law firm in the U.S. carbon markets, and advises a wide range of energy, manufacturing, technology and trade association clients on U.S. climate policy, as well as on energy infrastructure project development. The firm produces a* Weekly Climate Policy Update*, available on its Web site at* ***www.vnf.com****. The authors may be reached at* ***blm@vnf.com*** *and* ***jma@vnf.com****, respectively.*

Phil Duff launched **Duff Capital Advisors** (DCA) with $500 million of equity capital from Lindsay Goldberg, a New York-based private equity firm. Mr. Duff co-founded and was chairman and CEO of FrontPoint Partners. DCA has a team of over 20 professionals including **Eileen Murray**, president, responsible for helping DCA build out its infrastructure, develop new operational lines of business and focus on talent development. Ms. Murray was formerly the head of global finance, operations and technology and a member of the executive committee, the executive board and the management committees at both Morgan Stanley and CSFB. **Jack Zimmermann** is head of the client advisory group, and was a former partner at FrontPoint Partners and president of Van Kampen Funds Distribution Company. **Kevin Becker**, chief investment strategist, will manage all internally developed and partnered investment products. Most recently, he managed his own long/short equity fund, Claiborne Capital Group. **Lisa Polsky**, head of global investment solutions, will focus on risk management, product development and building customized solutions for clients. Ms. Polsky has run derivative and hedge fund businesses at Citigroup and Bankers Trust, and prime brokerage at Merrill Lynch. **Perry Poulos** is the chief operating officer and chief financial officer. Most recently, Mr. Poulos was at Morgan Stanley as a managing director supporting global operations and technology. **Shelley Leibowitz**, chief information officer, had been chief information officer at Morgan Stanley, Greenwich Capital Markets, Greenwich NatWest and Barclays Capital. **Scott Cooper** joins as head of business development. Mr. Cooper was at Morgan Stanley for 20 years in institutional equities and corporate finance. **Peter Kimball** serves as a special advisor, assisting in business strategy and client relationship development. Mr. Kimball will also work closely with clients on macro investment outlooks. Most recently, he started Sagebrush Capital which focuses on alternative energy opportunities.

Bob Alderman joins **Clearbrook Financial, LLC** as managing principal. Clearbrook Financial is an independent financial services firm that provides tailored solutions to high-end investment advisors, institutions, multi-family offices and investment managers. Prior to joining Clearbrook Financial, Mr. Alderman was a managing director at Merrill Lynch, where he was responsible for the global distribution and development of the firm's alternative investment offerings.

Pauline Modjeski has been promoted to president and executive managing partner of **Horizon Cash Management LLC**, a leading cash and liquidity manager for alternative investment funds. Ms. Modjeski was previously Horizon's executive vice president and senior managing partner.

Dennis R. Zarr joins **AlphaMetrix, LLC** as chief operations officer and president of Dekla Financial LLC. **AlphaMetrix, LLC** is an alternative investment research and management company delivering an innovative combination of investment services on a real-time electronic platform for managed accounts. Mr. Zarr was previously senior vice president and director of business development for Rand Financial Services.

James T. Lidbury, **Jonathan M. Grandon** and **Deborah A. Monson** join **Ropes & Gray LLP**, a leading national law firm, in their newly opened Chicago office. Mr. Lidbury, Mr. Grandon and Ms. Monson all join the firm as partners and all three were formerly partners at Mayer Brown in Chicago. Mr. Lidbury and Mr. Grandon focus on mergers and acquisitions, private equity transactions, and corporate and securities matters, and Ms. Monson focuses on investment management, including hedge funds and commodities matters.

Alan Flanagan joins **Bank of New York Mellon**'s European alternative investment services (AIS) as business managing director. Mr. Flanagan was previously with UBS Fund Services (Cayman) Ltd., where he was the head of hedge funds business development for the Americas.

Kevin P. Scanlan joins international law firm **Dechert LLP** as a partner in the financial services group. Mr. Scanlan previously was a partner at Orrick, Herrington & Sutcliffe LLP.

Jane Mendillo has been named CEO of **Harvard Management Company** and will run Harvard University's nearly $35 billion endowment after its former top money manager, Mohamed El-Erian, resigned unexpectedly last fall to rejoin Pacific Investment Management Co. Ms. Mendillo currently manages Wellesley College's endowment and has worked at Harvard's management arm before. She will begin her position on July 1, 2008. ◎

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Thursday, May 8, 2008
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3:30 p.m. – Registration
3:45 p.m. – Program
6:15 p.m. – Reception

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