
Initiatives To Develop Best Practices for Hedge
Funds in the U.S. and U.K.

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Initiatives To Develop Best Practices for Hedge Funds in the U.S. and U.K.¹

Hedge funds make money through innovation and nimble responses to events in dynamic markets. They now need to apply that same creativity and skill to address the concerns of regulators, investors, creditors, and counterparties globally regarding the role of hedge funds in the financial stability and liquidity of the markets. Although hedge funds have not been the focal point in the current turmoil in the credit markets, they have been a continuing and increasing source of concern and unease. Regulators and market participants believe that there is too little transparency as to hedge fund holdings, leverage, and practices. As a consequence, it is difficult for regulators and third parties who do business with hedge funds to assess or manage risk.

We are on the cusp of potentially dramatic changes in the hedge fund industry. Over the coming months, hedge funds have a unique opportunity to help shape the way business will be done going forward and to influence whether regulatory dictates or market-driven solutions will provide the framework for that business in the future. Several initiatives have begun to develop best practices for hedge funds, and market participants are engaged in an ongoing dialogue concerning the future of the hedge fund industry. In the United States, the President's Working Group recently issued Principles and Guidelines on Private Pools of Capital (the "Principles") which we discuss below. In response, the Managed Funds Association (the "MFA") issued a set of best practices for hedge fund managers. In the U.K., the Hedge Fund Working Group produced a Consultation Paper on which comments must be submitted by December 14, 2007.

A. The United States President's Working Group

Earlier this year, in the United States, the President's Working Group on Financial Markets (composed of four major regulators of financial institutions, the Treasury, the SEC, the CFTC, and the Federal Reserve Board) issued the Principles. These Principles, although developed by regulators, do not favor new regulation. Rather, they urge that market discipline, participant awareness of risk, and prudent risk management be enhanced and that only sophisticated investors be permitted to make direct investments in private pools of capital. The Principles place the onus on all members of the capital markets – investors, fiduciaries, creditors, counterparties, as well as managers of private pools of capital – to protect investors and limit systemic risk. The Principles do not address best practices for hedge funds with any specificity.

In late September 2007, the President's Working Group created two private industry advisory groups to make recommendations by the end of this year as to what information hedge funds should disclose to protect investors and strengthen U.S. markets. It is envisioned that the advi-

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sory groups will propose voluntary best practices relating to valuation, risk management, due diligence and transparency. One group is composed of institutional investors led by Russell Read of CalPERS, the California public employees' retirement system. The other group is composed of asset managers and is led by Eric Mindich of Eton Park Capital Management. That group also includes representatives of Och-Ziff Capital Management.

We have attached the Agreement Among President's Working Group and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital as Appendix A to this white paper. In addition, the Agreement Among President's Working Group and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital can be found on the U.S. Department of Treasury website: http://www.treasury.gov/press/releases/reports/hp272_principles.pdf.

B. The Managed Fund Association's Recently Issued Sound Practices

As a hedge fund industry response to the President's Working Group, in early November the MFA released a revised and expanded publication entitled Sound Practices for Hedge Fund Managers. The Sound Practices contain recommendations for internal policies, practices and perspectives for the hedge fund industry. The MFA continues to work with its members in the implementation of those practices, where suitable, and in publicizing the views of its membership on various issues. The MFA stresses that one size does not fit all, and invites hedge fund managers to tailor and apply the recommended practices as appropriate to particular circumstances. At the same time, it strives to increase efficiency and give market participants the benefit of many experienced market participants' thinking. Going forward, the MFA anticipates that market participants will continue to debate issues raised by the Sound Practices and that the recommended practices will continue to evolve.

The recently published Sound Practices amount to close to 300 pages, and can be downloaded from the MFA website at www.managedfunds.org/downloads/Sound%20Practices%202007.pdf.

C. The U.K. Hedge Fund Working Group

Meanwhile, in the U.K., fourteen hedge funds formed their own Hedge Fund Working Group (the "U.K. Working Group"), which is chaired by Sir Andrew Large, former deputy governor of

the Bank of England and chairman of Marshall Wace's Tops fund, and also includes Och-Ziff Capital Management as a member, to address issues confronting the hedge fund industry. Thus, in contrast to the President's Working Group which was comprised of regulators, the U.K. Working Group is comprised exclusively of industry participants. On October 9, 2007, the U.K. Working Group produced a Consultation Paper that provides a detailed proposal for hedge fund best practices. The Consultation Paper proposes more detailed guidance for hedge funds than do the theoretical Principles created by the President's Working Group.

After receiving comments on the proposed best practices, the U.K. Working Group expects to finalize a set of best practices and proposes a voluntary "comply or explain" approach to those best practices. A hedge fund could conform its conduct to a best practice – comply – or a hedge fund could choose not to do so but set forth the reasons for not conforming to that best practice – explain. As described in the forward to The Consultation Paper itself, "disclosure is at the root of all of our recommendations."

The Consultation Paper sets forth five areas of concern: (1) disclosure, (2) valuation, (3) risk, (4) fund governance, and (5) activism. The Consultation Paper then raises a cluster of issues for comment in connection with each concern. With respect to disclosure, for example, the document addresses investment policy disclosure, commercial terms disclosure, performance measurement disclosure, and the information provided to lenders, dealers and prime brokers. With respect to activism, the document highlights market abuse, proxy voting, disclosure of derivative positions, and voting on borrowed stock.

The U.K. Working Group's voluntary private initiative was undertaken for a number of reasons, but most significantly to enhance confidence in the hedge fund sector and discourage government regulation. Although some European governments are thought to be inclined toward more regulation (most notably, Germany), at the G10 meeting this October, in a joint declaration of Chancellor Merkel of Germany, President Sarkozy of France, and Prime Minister Brown of Great Britain, the U.K. Working Group effort to develop a voluntary code of conduct for hedge funds was welcomed. At the same time, the G10 plans at its Spring Council in 2008 to consider whether regulatory or other action is necessary to provide greater financial market transparency and better risk management.

The U.K. Working Group will accept comments until December 14, 2007, and it intends to issue a final report taking into account those responses in January 2008.

We have attached The U.K. Hedge Fund Working Group's Proposed Best Practices as Appendix B to this memorandum. In addition, the Consultation Paper, with all the issues identified, can be found on the U.K. Working Group's website: www.hfwg.co.uk/files/HFWG%20Paper%20Part%201%20Final.pdf.

D. An Opportunity Exists To Contribute To The Dialogue About Hedge Fund Regulation

Some 65% of hedge fund activity globally is in the United States, while U.K.-based hedge funds account for about 20% of funds managed by hedge funds globally. It is clear that the development of best practices in those two jurisdictions will drive developments throughout the world and will be critical to the strategy of financial regulators in all jurisdictions for managing risk and achieving financial stability.

These events provide an opportunity to participate in a global dialogue about the future of hedge funds. By improving the flow of information among regulators and market participants, and by helping regulators, investors, creditors, and counterparties to better understand hedge fund practices, hedge funds can enhance confidence in the markets and preserve flexibility for the future.

Should you desire to participate in the dialogue regarding hedge fund regulation, we encourage you to provide comments to the U.K. Working Group by December 14, 2007. Comments may be submitted electronically via the U.K. Working Group's website or by hard copy to Thomas Deinet, Hedge Fund Working Group, 13th Floor, The Adelphi, 1/11 John Adam Street, London WC2N 6HT.

We also encourage you to consider the MFA's best practices in light of your own needs and circumstances. The industry advisory groups established by the President's Working Group will be developing their views over the next few months. Broad participation in the ongoing dialogue will better assure that any proposed best practices that are developed are appropriate in the wide variety of contexts in which hedge funds operate.

Appendix A:

Agreement Among President's Working Group and
U.S. Agency Principals on Principles and
Guidelines Regarding Private Pools of Capital

Agreement Among President's Working Group and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital

The President's Working Group on Financial Markets, in the course of our ongoing review of market practices and events, has set forth the following fundamental principles that will inform our approach to private pools of capital. Since we last made a statement on these issues in 1999, the market has matured and expanded considerably, and these fundamental principles have increasingly been reflected in best practices. The current regulatory structure, which is also based on these principles, is working well. As we noted in 1999, "in our market-based economy, market discipline of risk-taking is the rule and government regulation is the exception." We look forward to further progress as these principles continue to inform our actions and strengthen our vibrant capital markets.

OVERARCHING PRINCIPLES

1. Private pools of capital bring significant benefits to the financial markets. However, these pools of capital also present challenges for market participants and policymakers. Investors, creditors, counterparties, pool managers, and supervisors must be aware of these challenges, including those related to some over-the-counter derivatives, and work to address them. Public policies that support market discipline, participant awareness of risk, and prudent risk management are the best means of protecting investors and limiting systemic risk.
2. The vitality, stability and integrity of our capital markets are a shared responsibility between the private and public sectors. Market discipline most effectively addresses systemic risks posed by private pools of capital. Supervisors should use their existing authorities with respect to creditors, counterparties, investors, and fiduciaries to foster market discipline on private pools of capital. Investor protection concerns can be addressed most effectively through a combination of market discipline and regulatory policies that limit direct investment in such pools to more sophisticated investors.

INVESTOR PROTECTION PRINCIPLES

3. Private pools of capital can be an appropriate investment vehicle for more sophisticated investors. Because these pools can involve complex, illiquid or opaque investments and investment strategies that are not fully disclosed, the risks associated with direct investment in these pools are most appropriately borne by investors with the sophistication to identify, analyze and bear these risks.
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3.1 Investors should understand their investments and the corresponding risks, and should not expose themselves to risk levels they cannot tolerate.

3.2 Sophisticated investors that determine to invest in a private pool of capital should ensure that the size of their investment is consistent with their investment objectives and the principle of portfolio diversification.

4. Investors in private pools of capital should obtain accurate and timely historical and ongoing material information necessary to perform due diligence regarding the pool's strategies, terms, conditions, and risk management, thereby enabling such investors to make informed investment decisions.

4.1 As with all investment products and vehicles, clear and meaningful disclosure is essential for investors to evaluate properly their investment decisions.

4.2 Investors should evaluate the investment objectives, strategies, risks, fees, liquidity, performance history, and other relevant characteristics of a private pool.

4.3 Investors should evaluate the pool's managers and personnel, including background, experience, and disciplinary history. Investors also should assess the pool's service providers and evaluate their independence from the pool's managers.

4.4 Investors should consider the private pool's manager's conflicts-of-interest and whether the manager has appropriate controls in place to manage those conflicts.

4.5 Investors should conduct an appropriate analysis regarding the valuation methodology and performance calculation processes and business and operational risk management systems employed by a private pool, including the extent of independent audit evaluation of such processes and systems.

5. Concerns that less sophisticated investors are exposed indirectly to private pools through holdings of pension funds, fund-of-funds, or other similar pooled investment vehicles can best be addressed through sound practices on the part of the fiduciaries that manage such vehicles. These fiduciaries have a duty under applicable law to act in the best interest of the beneficiaries. They have an ongoing responsibility to perform due diligence to ensure that

their investment decisions are prudent and conform to sound practices for fiduciaries. Such pooled investment vehicles should address any special issues relating to investment in private pools of capital, including the availability of relevant, accurate, and timely historical and ongoing material information.

5.1 Fiduciaries should consider the suitability of an investment in a private pool within the context of the overall portfolio and in light of the investment objectives and risk tolerances. Fiduciary evaluation should include the investment objectives, strategies, risks, fees, liquidity, performance history, and other relevant characteristics of a private pool.

5.2 Fiduciaries should evaluate the pool's manager and personnel, including background, experience, and disciplinary history. Fiduciaries also should assess the pool's service providers and evaluate their independence from the pool's managers. Fiduciaries should consider the private pool's manager's conflicts-of-interest and whether the manager has appropriate controls in place to manage those conflicts.

5.3 Fiduciaries should conduct the appropriate due diligence regarding valuation methodology and performance calculation processes and business and operational risk management systems employed by a private pool, including the extent of independent audit evaluation of such processes and systems.

5.4 Fiduciaries that determine to invest in a private pool of capital should ensure that the size of their investment is consistent with their investment objectives and the principle of portfolio diversification.

SYSTEMIC RISK PRINCIPLES

6. Market discipline by creditors, counterparties, and investors is the most effective mechanism for limiting systemic risk from private pools of capital, which is the possibility that losses at one or more entities could threaten the stability of the broader financial system.

6.1 Creditors and counterparties of private pools of capital are generally large, sophisticated financial firms that have the incentives and the expertise to provide effective market discipline. As institutional investors have become an increasingly important source of capital to private pools, the potential for market discipline from investors has increased.

6.2 By limiting their own exposures to losses from a default by a private pool, creditors and counterparties can better protect their own solvency from losses at a private pool. Moreover, the financing terms provided by creditors and counterparties can be an important constraint on leverage employed by private pools of capital.

7. Key creditors and counterparties must commit resources and maintain appropriate policies, procedures, and protocols to define, implement, and continually enhance best risk management practices. Those policies, procedures, and protocols should address how the quality of information from a private pool of capital should affect margin, collateral, and other credit terms and other aspects of counterparty risk management.

7.1 Creditors and counterparties should undertake appropriate and effective due diligence before extending credit to a private pool of capital and on an ongoing basis thereafter. Due diligence should include a review of the counterparty's ability to measure and manage its exposures to market, credit, liquidity, and operational risks. Due diligence should establish the information flows that will occur during the course of the credit relationship.

7.2 Creditors and counterparties should measure their credit exposures to a private pool of capital frequently, taking into account the availability of collateral to mitigate both current and potential future exposures, and should assess the range of uncertainty around their exposure estimates. Rigorous stress testing should be used to quantify the impact of adverse market events, both at the level of an individual counterparty and aggregated across counterparties. Stress tests should take into account potential adverse market liquidity events in which multiple market participants seek to unwind trades simultaneously.

7.3 The amount of credit exposure to a private pool of capital that creditors or counterparties assume should reflect the level quantity and quality of available information about the pool, the extent to which exposures to the pool can be mitigated through margin and other credit terms, and the amount of capital that the creditors or counterparties have allocated to support the exposure.

7.4 Information that creditors and counterparties should seek to obtain from a private pool includes both quantitative and qualitative indicators of a private pool's net asset value, performance, market and credit risk exposure, and liquidity. The level of detail expected should respect the legitimate interest of the private pool in protecting its proprietary trading strategies.

Where sufficient information is not forthcoming from a particular private pool, creditors and counterparties should tighten margin, collateral, and other credit terms.

7.5 Creditors and counterparties should implement and comply with industry sound practices to strengthen processing, clearing, and settlement arrangements for credit derivatives and other over-the-counter derivatives. These practices include protocols for issuing and completing trade confirmations, obtaining prior written consent for assignments, and using cash-settlement procedures for over-the-counter credit derivatives following a credit event.

7.6 Large exposures to private pools of capital are among the risks that should be reported to senior management periodically. Senior management should ensure that its firm's aggregate exposure to such pools is consistent with approved risk tolerance for bearing losses in adverse markets.

8. Investors in a private pool of capital should carefully evaluate the strategies and risk management capabilities of the private pool to ensure that the pool's risk profile is compatible with their own appetites for risk.

8.1 Such investors should undertake appropriate and effective due diligence before investing in a private pool of capital and on an ongoing basis. Due diligence should include a review of the counterparty's ability to manage its exposures to market, credit, liquidity, and operational risks. Due diligence should establish the information flows that will occur during the course of the relationship.

8.2 Such investors should seek assurances that the private pool in which they invest complies with industry sound practices, including practices for risk management, reporting, and internal controls.

8.3 Such investors should evaluate the extent to which similarities in strategies pursued by multiple private pools in which they invest undermine efforts to limit their risks through diversification.

9. Managers of private pools of capital should have information, valuation, and risk management systems that meet sound industry practices and enable them to provide accurate information to creditors, counterparties, and investors with appropriate frequency, breadth, and

detail.

9.1 Managers must devote sufficient resources to the creation and maintenance of information, valuation, and risk management systems to ensure that high quality, material information can be delivered to creditors, counterparties, and investors in a timely fashion.

9.2 Risk management and valuation policies employed by private pools of capital should comply with the industry sound practices. Such pools also should implement and comply with industry sound practices to strengthen processing, clearing, and settlement arrangements for credit derivatives and other over-the-counter derivatives. These practices include protocols for issuing and completing trade confirmations, obtaining prior written consent for assignments, and using cash-settlement procedures for over-the-counter credit derivatives following a credit event.

9.3 The information provided by managers of private pools to their creditors, counterparties, and investors should adhere to the sound practices articulated in industry guidance. Managers of private pools of capital should provide information frequently enough and with sufficient detail that creditors, counterparties, and investors stay informed of strategies, the amount of risk being taken by the pool, and any material changes.

10. Supervisors should clearly communicate their expectations regarding prudent management of counterparty credit exposures, including those to private pools of capital and other leveraged counterparties, who are increasingly utilizing complex instruments, including certain over-the-counter derivatives and structured securities, such as collateralized debt obligations. Because key creditors and counterparties to pools are organized in various jurisdictions, international policy collaboration and coordination are essential.

10.1 Supervisors' expectations with respect to prudent risk management practices should take into account developments in financial markets and advances in best practices for counterparty credit risk management. Supervisors should actively monitor such developments and revise their policies and associated guidance as appropriate in a timely manner. In turn, supervisors should actively monitor and assess whether policies and procedures measure up to regulatory guidance and industry efforts to identify best practices.

10.2 Supervisors should take full advantage of both formal and informal channels of coordination and cooperation across financial industry sectors and international borders when carrying

out their responsibilities related to internationally active financial institutions' management of exposures to private pools and leveraged counterparties.

Appendix B:
The U.K. Hedge Fund Working Group's
Proposed Best Practices

I. Disclosure to Investors and Counterparties

A. Disclosure of Investment Policy and Risk Disclosure

Managers should carefully consider the appropriate level of disclosure and explanation of its investment policy/strategy and associated risks in the fund's offering documents and marketing materials. When doing so they should take into account the nature (that is, the identity and sophistication) of potential investors.

As a minimum this should include:

- A full description of the investment strategies and techniques employed and prominent disclosure of the risks involved.
- General details of the investments and instruments (including, for example, derivatives) in the portfolio and prominent disclosure of the risks involved.
- Details of any investment restrictions or guidelines and of how breaches will be dealt with.
- A statement of the manager's view of the fund's risk profile relative to other types of funds.
- An explanation of the circumstances in which the fund may use leverage, the source of such leverage and details of any restrictions on the use of leverage (together with a description of the fund's leverage profile as anticipated by the manager).
- Prominent disclosure of the risks involved in employing leverage.
- Details of how the investment policy can be changed, how investors will be notified of any changes and whether investors and/or the fund governing body will be consulted on, or asked to consent to, any such changes.

Managers should carefully consider the appropriate mechanism, given the nature of potential investors, for changing the fund's investment policy/strategy. This may range from prior investor/fund governing body consent to consultation to mere notification..

Managers should ensure that the annual accounts of each fund include a review of adherence to the fund's stated investment policy over the previous year.

B. Disclosure of Commercial Terms

Hedge fund managers should carefully consider, given the nature of potential investors, whether the commercial terms applicable to a particular hedge fund are disclosed in sufficient detail and with sufficient prominence in the fund's offering documents/marketing materials to enable investors to make informed investment decisions.

As a minimum this should include:

Fees and Expenses

- Fair disclosure of the methodology used to calculate performance fees.
- Details of any other remuneration received by the manager in connection with its management of the fund (this will be relevant, for example, where a hedge fund is a “feeder” fund into another fund managed by the same manager).
- The basis of calculation for any base management fee and details of any expenses which may be payable or reimbursed to the manager in addition to the management fee by the fund.
- To the extent possible, the amount of and/or method of calculating the fees payable to the fund’s other service providers.

Termination Rights

- Details of the circumstances in which the fund is entitled to terminate the manager’s appointment and the terms (for example in relation to termination fees) of such termination.

Exit Terms

For open-ended funds, full and prominent disclosure of:

- The period of notice investors are required to give to redeem their investment in the fund.
- Details of any redemption penalties.
- Any “lock-up” periods during which an investor will be unable to redeem its investment in the fund.
- Any circumstances in which normal redemption mechanics might not apply or may be suspended.

Hedge fund managers should ensure that any changes to commercial terms are disclosed to investors.

The fact that the fees and expenses payable to service providers may change should be clearly disclosed in the fund’s marketing materials. Any such changes should be communicated to investors promptly.

Where a hedge fund or hedge fund manager enters into side-letters conferring preferential commercial terms on certain investors (e.g. preferential liquidity terms or greater transparency), hedge fund managers should ensure that the existence of such side-letters is disclosed to all other investors in the same pool of assets.²

²Hedge fund managers should note, for example, the FSA’s views in relation to side-letters as set out in Feedback Statement 06/2 on Discussion paper 05/4 entitled: “Hedge funds: a discussion of risk and regulatory engagement” and AIMA’s subsequent Industry Guidance Note on Side Letters, <http://www.aima.org/uploads/AIMAIndustryGuidanceNoteSideLettersMembers.pdf>.

Hedge fund managers should seek to ensure that the fund's financial statements are prepared in a way which allows investors to verify the actual fees in the financial statements against the basis of calculation set out in the fund's marketing materials and to assess the impact of such fees on the fund's performance.

For example, the categories and captions in the fund's financial statements should correspond to those used in the fund's marketing materials so they can be easily compared.

On establishing a fund, hedge fund managers should liaise with the fund's administrator to ensure that the methodology for calculating fees (and in particular performance fees) is agreed in advance and accurately described in the fund's offering document/marketing materials and reflected in the annual accounts.

C. Disclosure of Performance Measurement

Wherever performance is disclosed and funds have significant exposure to non-marketable or illiquid securities, reference should be made to factors which may be material to the robustness of the performance calculation, for example:

- The percentage of the portfolio in non-marketable securities.
- Method for valuation of illiquid or non-marketable securities.
- Use of side pockets.

D. Disclosure to Lender/Prime Brokers/Dealers

It is recommended "that credit users and OTC market participants seek a proper balance between preserving proprietary information and providing information that will enable their counterparties to gain an appropriate level of understanding of their management, investment process and philosophy and material risks."³

The information provided to lenders might include risk management processes and measures agreed with the counterparty.

Hedge fund managers should provide the agreed information reports to counterparties in a timely manner.

³Counterparty Risk Management Policy Group II (2005), Towards Greater Financial Stability: A Private Sector Perspective (07/2005), section III (Improving Transparency and Counterparty Credit Assessments), p. 46, <http://www.crmpolicygroup.org>

II. Valuation

A. Governance Relating to Segregation of the Valuation and Portfolio Management Functions

A hedge fund manager should seek to ensure that conflicts of interest over asset valuation are avoided by arranging for the fund to appoint an independent third party valuation agent and/or (where agreed with the fund governing body) by operating a segregated independent in-house valuation function.

The fund's administrator will often be responsible for calculating the fund's net asset value and, based on such calculation, the fees and expenses payable to the manager. Where the fund's administrator is unable to perform this function or where the manager is involved in the valuation process because of its role in assisting the administrator, the manager should ensure that the relevant employees operate independently of the portfolio management team and are not remunerated according to the value of, or increase in the value of, the fund's portfolio.

Hedge fund managers should assist fund governing bodies to satisfy themselves regularly that in-house valuations are handled adequately.

Suggestions for how this could be achieved include:

- Ensuring that valuation staff report periodically to the fund governing body.
- Ensuring that the fund governing body forms a designated "valuation committee" and that no member of such committee is involved in investment decisions.
- Employing the services of an appropriate internal or external party to evaluate the effectiveness and robustness of the valuation procedures in place and report to the fund governing body (or its valuation committee).

Information provided by the portfolio management team for the valuation process should be properly documented and recorded.

B. Disclosure Relating to Segregation of the Valuation and Portfolio Management Functions

Hedge fund managers, in consultation with fund governing bodies, should prepare a document (a "Valuation Policy Document") covering all aspects of the valuation process and valuation

procedures and controls. The Valuation Policy Document (which it is acknowledged will contain information which is proprietary to hedge fund managers) should be reviewed regularly by hedge fund managers, in consultation with fund governing bodies, and be made available to investors upon request on a confidential basis.

As a minimum, the Valuation Policy Document should describe:

- The responsibilities of each of the parties involved in the valuation process.
- The processes and procedures in place to ensure conflicts of interest are managed effectively.
- The provisions of any service level agreements (SLA) entered into with third parties responsible for or involved in the valuation process (excluding details of commercial aspects of the SLA).
- The controls and monitoring processes in place to ensure that the performance of any third party to whom the valuation function is outsourced is satisfactory.

C. Governance Relating to Difficult-To-Value Assets

Hedge fund managers should ensure that the Valuation Policy Document sets out valuation procedures for illiquid and other difficult-to-value assets and investments which are intended to ensure a consistent and dependable approach to determining fair value.

The valuation procedures relating to illiquid and other difficult-to-value assets should be discussed and agreed with the fund governing body (or its valuation committee).

The Valuation Policy Document should include details of the hierarchy of pricing sources and models to be used for each asset type in a fund's portfolio.

When using broker quotes, hedge fund managers should:

- Make reasonable efforts to identify and draw upon multiple price sources (where available).
- Specify in the Valuation Policy Document the acceptable tolerance ranges when multiple pricing sources are used and the approach to handling outliers.
- Ensure consistency and avoid "cherry picking" of favorable price sources by using the same brokers at each valuation point.

When using pricing models hedge fund manager should:

- Have a process for approving pricing models, including back-testing, documentation and approval by the fund governing body or its valuation committee.
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- Have a process for monitoring and verification against observed market prices.
 - Have a process for governing manual overrides of the model inputs or results, including approval, documentation and reporting to the fund governing body or its valuation committee.

When using side pockets, hedge fund managers should:

- Describe the side pocketing process in the Valuation Policy Document and in the fund's marketing materials.
- Ensure that the fund governing body has been consulted about, and consented to, the use of side pockets.
- Ensure that side-pocketing occurs at the time of purchase of the relevant asset(s) with the initial valuation at cost.⁴
- Ensure that the total amount of assets to be side-pocketed should be limited to what has been stated in the fund's marketing materials.
- Ensure that management fees for the side pocketed assets are calculated on the lower of cost or market value.
- Ensure that incentive or performance fees are not charged for side-pocketed assets until a gain or loss is realized.

C. Disclosure Relating to Difficult to Value Assets

Hedge fund managers should disclose (for example, via the fund's annual report or newsletters) the extent to which internal pricing models or assumptions are used (and not drawn from externally available, authoritative sources) to value certain components of a fund's portfolio and, where meaningful and applicable, disclose the percentage of the fund's net asset value which has been determined using pricing models.

Hedge fund managers should disclose (for example, via the fund's annual report or newsletters) the proportion of the portfolio that is hard to value (for example the percentage of the portfolio which consists of unquoted or difficult-to-value securities; other measures might apply when derivatives are used).

Hedge fund managers should ensure periodic reporting of side pockets' value in the fund's audited annual accounts (usually at cost, unless a market price has been observed).⁵

⁴May be subject to regional accounting standards.

⁵May be subject to regional accounting standards.

III. Prudential and Risk Issues

A. Governance⁶ Relating to Risk Framework

Hedge fund managers should put in place a risk framework, which sets out the governance structure for their risk management activities and specifies the respective reporting lines, responsibilities and control mechanisms intended to ensure risks remain within the fund's stated risk appetite.

The framework should cover all relevant categories of risk, such as portfolio, operational and outsourcing risks.

B. Disclosure Relating to Risk Framework

Hedge fund managers should explain their approach to managing risk (risk framework) to investors in the fund's marketing materials.

C. Governance⁷ Relating to Portfolio Risk

Hedge fund managers and the fund governing body should ensure that adequate risk management systems and resources are available and well understood by portfolio managers, traders, risk managers, senior staff and other staff related to the management of the portfolio.

Potential conflicts of interests in the risk monitoring process should be managed by clearly separating the risk monitoring function from portfolio management. Risk monitoring reports should be made to the person or body which has ultimate responsibility for risk management (such as the manager's chief investment officer, chief executive officer or management committee).

Hedge fund managers should put in place a written Risk Policy Document, which is approved by the fund governing body. This document should set out the responsibilities of the risk monitoring function.

⁶MFA's 2005 Sound Practices for Hedge Fund Managers provides further detailing of risk monitoring practices for hedge fund managers. Risk frameworks and the concept of risk appetite are common in the banking industry, as described in 'The new Finance and Risk agenda, What is your risk appetite?' (Oliver Wyman) http://www.oliverwyman.com/ow/pdf_files/the_new_FnR_agenda_FNR_0307.pdf.

⁷Further guidance can be found in AIMA's Guide to Sound Practice for European Hedge Fund Managers, 2007, 2.1.2.

As a minimum, this should include:

- Guidelines for distribution of risk mandates among individual sub-portfolio managers and the setting and changing of risk limits.
- Routines for risk reporting, exceptions reporting and escalation procedures.
- Routines for reviewing and testing the risk measurement framework.
- Guidelines for risk monitoring and risk measurement during stressed periods.
- Routines for communicating the above information to all relevant persons within the fund manager in a clear and understandable manner.

D. Measurement of Liquidity Risk

Hedge fund managers should have a liquidity management framework, the primary role of which is to ensure that the liquidity profile of the fund's investments aligns with the fund's financial obligations.

This should include forecasting the liquidity position of the fund and tracking liquidity measures (for example, ratios such as "available cash/Value-at-Risk") which allow the hedge fund manager to assess the probable development of the liquidity position relative to the portfolio's inherent risk.

Hedge fund managers should frequently conduct stress testing and scenario analysis of the fund's liquidity position.

Potential stress events could include:

- Margin calls due to sudden severe market shocks (for example, significant equity price falls).
- Reduction in liquidity in certain market segments relevant to the fund.
- Sudden increase in collateral requirements for funding positions (thereby reducing assets available for sale to meet liquidity needs).
- Investor redemptions (as per the fund's redemption policies).
- Cancellation of credit lines (as per notice periods agreed between the hedge fund manager and counterparties such as prime brokers).

The stress testing/scenario analyses of the fund's liquidity position should work with similar approaches to market risk (see subsequent section).

It has been widely found that in stress situations unexpected correlation can appear. Hedge

funds have been faced with sudden liquidation challenges due in part or in whole to rapid market movements, for example in currencies, commodities or equities. So reviewing these analytics in parallel is critical to a fund having an effective approach to risk management.

E. Measurement of Market Risk

A hedge fund manager should develop a comprehensive set of measures to identify market risk in the fund's portfolio. To overcome the shortcomings of individual measures, managers should rely on multiple techniques. These could include, amongst others:

- Volatility measures.
- Value-at-Risk type approaches.
- Monte Carlo simulation.⁸
- Stress tests/scenario analyses.⁹
- Leverage.
- Portfolio concentration measures.

Hedge fund managers should conduct stress testing/scenario analyses to assess the impact of extreme market occurrences on the portfolio value.

Extreme financial events may not receive sufficient attention when using classic risk measures such as volatility and Value-at-Risk due to the scarcity of historical observations for extreme financial events. Stress testing/scenario analysis allows managers to overcome this shortcoming by accounting for the increased inter-correlation between different asset classes at times of market turmoil.¹⁰

Stresses could include, among other things, equity price drops, sudden shifts of interest rate curves and abrupt changes in foreign exchange rates. A scenario analysis would combine several of these "stresses" across markets at the same time based on extreme assumptions about correlations which may not occur in normal markets.

The analysis should include scenarios based on historically observed crises (for example, the bursting of the new economy bubble in 2000 or the sub-prime mortgage crisis in 2007) and newly developed ("made-up") scenarios to incorporate emerging correlations and new risks, and their respective impacts on the portfolio.

⁸Monte Carlo simulation: statistical evaluation of risks, where a large number of "scenarios" is generated based on random samples for uncertain underlying variables.

⁹A stress test simulates a significant market move (e.g. 30% equity price drop) and measures the impact on the fund's value. In a scenario analysis, multiple stresses are applied simultaneously (e.g. 30% equity price drop, shift in interest rates, etc).

¹⁰Also sometimes referred to as "fat tails", which means that extreme occurrences are more likely to occur than theoretically expected.

Hedge fund managers should also assess basis risk arising from imperfect hedging strategies¹¹ and incorporate resultant uncertainties into their stress testing/scenario analysis approach.

Hedge fund managers should account for valuation sensitivities under stressed conditions in their approach to risk measurement (for example, Value-at-Risk, stress testing/scenario analysis).

In times of abrupt market fluctuations, situations can arise where market liquidity is much lower than is usually observed, making it difficult to trade positions at observed market prices. Under such circumstances, a fund's net asset value may not only be hard to calculate, but be unattainable in the event sales are attempted. At the same time, the manager might be forced to sell positions, for example in order to meet redemption requests and/or margin calls. The risk measurement framework should account for this by applying valuation discounts for modeling purposes to positions that might have to be liquidated under stressed conditions (*see* Section 4.2.4.1 (Funding liquidity risk)).

The results of the analysis of market risks (stress tests/scenario analyses, etc) should be translated into timely management action (for example, adjustment of positions) as part of the control and management process.

F. Measurement of Counterparty Credit Risk

Hedge fund managers should have a formalized process for setting up trading relationships, including assessment of creditworthiness and setting of risk limits.

Creditworthiness of trading counterparties should be monitored continuously and risk limits adjusted if required.

Netting agreements and collateral arrangements (for example, hedge fund managers making collateral calls/two-way collateral posting) should be put in place.

G. Control Process

Hedge fund managers should track a fund's adherence to its stated investment objectives and risk appetite and, subject to override by the manager's chief executive officer, chief investment

¹¹For example, when the price of a future varies from the price of the underlying instrument as expiry approaches. The imperfection of hedging strategies is likely to be higher the more immature the market.

officer, management committee or similar, take corrective action if a breach of any restrictions or limits occurs.

Limits should be set at the outset for the aggregate portfolio and all individual subportfolios. These limits should include general investment restrictions (for example, eligible asset classes, geographic location of risk) and could also encompass individual limits for market risk, funding liquidity risk, counterparty credit risk and other relevant risk factors such as concentrations (for example, in relation to single names, sectors or illiquid assets).

Risk reporting should be put in place so that the investment decision makers have a daily or more frequent view of the risk position of the fund and can prevent breaches of limits. Limit breaches should be immediately reported to the respective fund manager, the manager of the trading activity and the compliance officer, with escalation as needed to the fund manager's chief executive officer, chief investment officer, management committee or similar. Serious breaches should be reported immediately to the fund governing body.

The process should ensure that, if required, the findings of the stress testing/scenario analyses are translated into mitigating portfolio risks.

H. Disclosure (To Investors)

Hedge fund managers need make the necessary effort to disclosing and explaining their investment and risk management approach in the fund's offering documents.

As a minimum this should include all items described in section 2.1 (Investment policy and risk disclosure) together with a summary of the risk framework (processes and risk management techniques employed, and reporting lines). Hedge fund managers should also carefully consider whether it would be appropriate to disclose target ranges or averages as anticipated by the manager for specific risk parameters. This could include:

- Volatility of returns.
- Value-at-risk or equivalent (for example, potential loss arising from a stress event).
- Leverage (the manager would need to clarify how leverage is defined).¹²
- Limits to the percentage of the portfolio which can be invested in non-marketable securities¹³ (or another measure of liquidity).

¹²See Appendix B for leverage definition.

¹³Marketable Securities: Securities, that can be easily liquidated into cash, for example government securities, stock, bonds, notes, commercial paper, and other financial instruments that are regularly listed for sale on recognized public exchanges.

The hedge fund manager should then ensure that the management report submitted with the audited annual accounts of each hedge fund includes disclosures on the risk profile of the fund for the respective period.

As a minimum, this should include:

- The actual risk profile of the fund, where applicable using risk measures such as:
- Realized volatility of returns.
- Value-at-Risk type measures (actual, average, range for observation period and decomposed by, for example, risk type and market).
- Leverage (high, low, average for the respective observation period), if applicable.
- The percentage of the portfolio invested in non-marketable securities (or other measures of liquidity).
- Investment instruments used during the respective period.

IV. Disclosure (To Investors)

A. Governance – People and Governance

In areas where potential conflicts of interest could arise (valuation, risk management, compliance), hedge fund managers should clearly divide these activities from the portfolio management function with separate reporting lines into the managers' chief executive officer or chief investment officer or similar.

The HFWG acknowledges that separation of duties may not always be possible for start-up and smaller hedge fund managers. Hedge fund managers should disclose to investors if they have not adequately separated (or are unable adequately to segregate) activities in areas such as valuation, risk management and compliance and explain how they intend to deal with the issues which may arise as a result.

Staff remuneration should not set false incentives (for example, aligning the compensation of the valuation team with fund performance).

The hedge fund manager should ensure that material aspects of its operational procedures are adequately documented and training is provided to staff. This should include, among others, areas such as compliance procedures, back-up/disaster recovery procedures, personal account dealing policies and client confidentiality. (See Part 1 of the report, Section 6 (*Longer term and*

next steps) for a proposal on developing an educational curriculum dedicated to the hedge fund sector).

B. Trading and Execution

To prevent trading and execution failures, it is considered best practice to have effective trading and counterparty procedures in place, incorporating the following aspects:

Master agreements for trading counterparties.

- Well defined termination and collateral policies.
- Tracking of changes in key provisions.

Robust trade confirmation and reconciliation process.

- Sufficient back- and middle-office capacity to handle trading volumes.
- Daily confirmation of trades and positions.
- Use of electronic matching and confirmation systems.
- Timely reconciliation of complex OTC trades and loans.
- Monitoring of corporate action events (for example, voting, splits, spin-offs) on long and short equity derivative instruments and applying the events to fund accounts.

C. Fraud and Financial Crime Prevention

Hedge fund managers should be confident that they themselves understand the applicable laws and regulations in the markets where they deal and have adequate procedures to prevent financial crimes. This applies to areas such as:

- Anti-money laundering procedures.¹⁴
- Procedures to prevent market abuse offences see Section 6.1 (*Prevention of market abuse*).
- Strict internal controls to prevent misappropriation of client monies.

Hedge fund managers who adhere to best practice will appoint an independent compliance officer, overseeing all issues relating to legal and regulatory compliance, market and professional conduct, with regular reporting to the manager's chief executive officer or management committee or equivalent and the fund governing body.

¹⁴Further guidance on Anti-Money Laundering Regulations can be found in AIMA's Guide to Sound Practices for European Hedge Fund Managers (2007), (section 4.1.5).

D. Disaster Recovery

Hedge fund managers should ensure that the provision of fund management services will remain possible in the event of a disaster. The level of tolerance should be agreed by the executive committee of the hedge fund manager, or, where relevant fund governing body. Depending on the scale of the hedge fund manager's business, this should include:

- A communication plan to contact important parties (such as senior management, prime broker, administrator and supervisor).
- Contingency plans (including succession plan to address key man risk, fall back communications router and capabilities).
- Offsite data back-up facilities .
- Back-up office space/infrastructure.
- Regular testing of procedures/processes.

E. Model Risk

As part of their operational risk management procedures, hedge fund managers should assess their exposure to model risk annually and where model risk is perceived to be material to the performance of the manager, should implement appropriate procedures to ensure that material model risks are identified and mitigated where possible. Such procedures include:

- Evaluation of model risk in the model selection process.
- Frequent review of models, including parameterization, calibration, assumptions and data integrity.
- Stress testing of assumptions.
- Sign-off and documentation of management overrides (overrides can become necessary when models produce unreasonable results so that human intervention becomes necessary. Human overrides need to be governed carefully).
- Documentation of models to avoid key man risk.
- Security of algorithm and source code (back-up).

Hedge fund managers should disclose use of internal models in the valuation process Section 3 (Valuation).

E. IT Security

Hedge fund managers should ensure security and integrity of systems and data. This includes system testing, offsite back-up facilities, disaster recovery procedures and supervision of contract IT resources.

G. Disclosure

To ensure that investors and creditors are confident that hedge fund managers handle operational risks satisfactorily, a summary of management procedures and controls applying to the management of operational risk should be available to investors and creditors undertaking due diligence.

V. Outsourcing Risks

A. Governance

Third party services are normally provided under a contract between the hedge fund and the entity providing the service.

Hedge fund managers should conduct careful due diligence on third party service providers before recommending them to the fund governing body.

Hedge fund managers should assist fund governing bodies to establish policies for selection and regular review of third party providers.

Valuation and administration

Hedge fund managers should seek to ensure that a service level agreement (“SLA”) is put in place (commonly, this will be attached as a schedule to the agreement between the fund and the service provider). The SLA should set out in precise detail the services to be provided along with deadlines for completion of the services.

- The SLA should make clear accountability and responsibilities for the orderly operation of all administration or other functions performed on behalf of investors.
- The SLA should include Key Performance Indicators (“KPIs”) to provide hedge fund managers and fund governing bodies with a means of measuring whether the objectives set out in the SLA are met by the third party service provider.
- Further guidance on the contents of SLA is provided in Appendix C.
- The services provided should be regularly reviewed by the hedge fund manager and the fund governing body against contractual or agreed standards.

Prime Brokers

Although prime brokers often try to provide “one-stop shop” services, it is recommended that large hedge fund managers have more than one prime broker to ensure sufficient diversification of funding and other services.

The HFWG acknowledges that this may not be applicable to smaller hedge funds and new market entrants.

In carrying out due diligence, the hedge fund manager should consider the potential prime broker’s credit rating and general ability to fulfill all process functions accurately and efficiently.

Auditors

Fund governing bodies should appoint reputable auditors.

B. Disclosure

The names of the third party providers used should be disclosed to investors in the due diligence documents or upon request.

Hedge fund managers should provide information on committed funding or financing arrangements with prime brokers/lenders to investors in the due diligence documents or upon request.

The nature of any special commercial terms with third party service providers which result in potential conflicts of interest (for example in-house brokerage or rebates) should be disclosed in the due diligence documents or upon request.

Governance procedures in relation to third party service providers should be disclosed in the due diligence documents or upon request.

VI. Fund Governance

A. Governance

On establishing a fund, hedge fund managers should assess where the fund governance structure should lie on the spectrum (see above). In light of that assessment, the manager should be proactive in ensuring that, regardless of the jurisdiction in which a fund is established, a fund governance structure which is suitable and robust to oversee and handle potential conflicts of interest is in place.

Hedge fund managers should make sufficient resources available to identify and obtain members of fund governing bodies with suitable experience and integrity to enable the fund governing body to be able to discharge effectively its role with the appropriate level of independence.

Hedge fund managers should throughout the life of the fund monitor whether the fund governing body and governance processes continue to be effective and appropriate (given any changes in the nature of the fund and its investors) and advise the fund governing body as to whether it considers changes to be necessary or desirable:

- Managers should consider whether the investment management agreement should contain an obligation on the manager to monitor the fund governance arrangements and advise the fund governing body accordingly.
- Managers should also consider whether the investment management agreement should contain an undertaking by the fund to put any new or replacement fund director proposed by the manager to an investor vote.

Hedge fund managers should carefully consider the extent to which the adoption by the fund governing body of all or parts of established codes of corporate governance is appropriate and encourage fund governing bodies to act accordingly. This includes ensuring that fund governing bodies have adequate resources to comply with any such corporate governance principles.

Whilst the HFWG recognizes that managers cannot legally require independent boards to adopt best practice principles for their governance, they should nevertheless encourage compliance. Naturally, the HFWG is also aware that the best practice standards in no way override legal, technical, contractual and tax realities.

As guidance to managers when considering the corporate governance principles which they

should encourage fund governing bodies to comply with, the HFWG has set out below a selection of those principles contained in the corporate governance codes published by AIC and AIMA which it considers to be of greatest importance. The HFWG recognizes, however, that not all of these principles will be applicable to all types of hedge fund:

- Directors' potential conflicts of interest should be disclosed fully to the fund's investors (through the prospectus) and the board as a whole (at the first available meeting) (AIMA 1.D).
- Fund boards should have sufficient collective expertise, availability and be otherwise qualified to understand the investment policy and strategies of the fund and the attendant risks (AIC 6., AIMA 1.F). Expertise should include areas such as regulatory issues, accounting, administration and technical understanding of the fund's strategies.
- The board should put in place a policy on tenure of directors and disclose it in the fund's marketing materials and its annual report (AIC 4.).
- Directors' remuneration should reflect their duties and responsibilities, and the value of their time spent (AIC 8.).
- Regular face to face board meetings should be held, preferably quarterly (AIMA 1.F.). Typical board agendas include approval of accounts, investment performance review, review of any relevant regulatory breaches and review of the performance of third party service providers such as the administrator and prime broker(s) – There should be regular review of adherence of the manager to investment policy and investment restrictions, review and approval of side letters, compliance and valuation functions and regular review of business continuity. (AIMA 3.E provides further detail).
- The manager, external valuation agent and administrator should be required to report regularly to the fund directors regarding performance, subscriptions, redemptions and adherence to investment policy and restrictions and applicable anti-money laundering requirements (including direct reporting from the compliance officer and any in-house valuation function) (e.g. AIMA 4.B. and 6.B. and 6.E.).
- The fund directors should be made aware of their personal responsibility for the issuance and legality of side letters or discretionary waivers (AIMA 6.I. and 6.K.).
- The fund on behalf of the directors should take out adequate D&O insurance proportional to any liabilities relating to their role with respect to the fund (AIMA 7.).

B. Disclosure

The hedge fund manager should disclose the outcome of its assessment as to the location of the fund's governance requirements on the "spectrum" and its reasoning in the fund's prospectus.

Where relevant, hedge fund managers should ensure that the existence of any class of shares which are held only by the manager (or an entity connected with the manager) and which carry voting rights affecting fund governance is disclosed in the fund’s prospectus.

Such classes of shares are often known as “founder” or “management” shares and carry rights to, among other things, vote (to the exclusion of any other shareholders) on the appointment or removal of directors and/or the termination of the investment management agreement between the hedge fund and its manager.

Naturally, the HFWG recognizes that in following the best practice standards set out, hedge fund managers will need to take into account any relevant legal, regulatory, accounting or tax considerations.

VII. Market issues and activism

A. Governance Relating to Prevention of Market Abuse

Hedge fund managers should ensure that they have internal compliance arrangements to identify, detect and prevent breaches of market abuse laws and regulations.

A sound approach would include the following components:

- A dedicated compliance officer who is not involved in the investment management process.
- Written compliance document describing all relevant compliance procedures.
- Documentation of all compliance incidents by the compliance officer.
- Training/education of investment management and other staff to ensure that the relevant laws and regulations, the relevant compliance procedures and what constitutes inside information are all understood and adhered to.
- Direct and regular reporting of the compliance function to the fund governing body.
- Seeking legal and regulatory guidance to ensure that compliance arrangements prevent regulatory breaches.
- Disclosure of the name of the compliance officer to investors in the fund’s marketing materials and annual accounts.
- Open relations with the regulator.

The table below provides some examples of procedures which may support the application of best practices:

Illustration: Compliance procedures to identify, detect and prevent market abuse

| Abuse | Procedures |
|---------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Insider dealing | <ul style="list-style-type: none"> • Notification to the compliance officer if an employee believes he/she has received inside information • Compliance officer to determine whether information is material and non-public • If information is material and non-public, the securities of the issuer concerned are to be placed on the restricted list (in which case such stocks cannot be traded) or on a grey list (non-disclosed restricted list, which prevents such information from being shared with the entire firm, such that it might allow personnel to second guess why something was restricted) • Securities (shares, bonds, etc) of companies on the restricted list in which the entire firm would be excluded from dealing (for example, restricted in the order management system) • Chinese walls to prevent, for example, individual portfolio managers who are members of a creditors' committee of a distressed or bankrupt company (and who therefore have access to confidential information) from also trading such company's debt or equity • In instances where inside information is known to employees who have no active involvement in the investment management function, documentation of details of this knowledge should be placed on a separate (non-publicized) register |
| Dissemination of insider information | <ul style="list-style-type: none"> • Managers should have policies to restrict dissemination of material non-public information including, for example, the manager's own intention actively to engage with a company (for example, by initiating a corporate restructuring) |
| Non-disclosure of concert parties when disclosure thresholds have been exceeded | <ul style="list-style-type: none"> • Managers should document which other parties (for example, other managers) are concert parties supporting the same strategy • Relevant disclosures should take place if disclosure thresholds are exceeded, accounting for collective share ownership of all parties involved |
| Prevention of market manipulation | <ul style="list-style-type: none"> • Public relations policies regarding public statements of intent to ensure that no false or misleading impressions are given to the market |

B. Disclosure Relating to Prevention of Market Abuse

Hedge fund manager should disclose to investors in the fund’s offering documents whether the manager has a policy to prevent market abuse (no disclosure of the actual policy is required).

C. Governance Relating to Shareholder Conduct: Proxy Voting of Stock Owned

Hedge fund managers should have a proxy voting policy which allows their investors to evaluate the general approach the manager takes towards proxy voting and to determine whether this approach is consistent with their own objectives. A best practice approach in a proxy voting policy document would include the following elements:

- Guidelines as to the process to be followed to decide how to exercise voting rights, including responsibility to vote and mechanisms to resolve potential conflicts of interest.
- A mechanism to review proposals that are not considered to be in the best overall interests of a company in which the hedge fund is invested.
- Process for deciding when and how to communicate with a company’s management or board of directors and other shareholders.
- Process for determining whether to join the efforts of other concerned investors, with due regard to compliance procedures (see guidance on concert parties in Section 6.1 (*Prevention of market abuse*)) to prevent market abuse.

The HFWG acknowledges that not all firms will be in a position to vote all proxies (for example, “black box” traders¹⁶) and might, for cost benefit considerations, adopt a systematic approach, for example never voting except in exceptional circumstances, rather than evaluating each proxy situation. If a firm decides to take a systematic approach or decides otherwise to deviate from best practice, this process should be disclosed and explained to investors.

D. Disclosure Relating to Shareholder Conduct: Proxy Voting of Stock Owned

The proxy voting policy document should be made available to investors and companies (in which funds managed by the fund manager are invested) upon request. The policy should also be set out in the fund’s annual accounts. The hedge fund manager should also document cases where the voting policy has not been followed and report to the fund governing body.

¹⁶Further guidance on Anti-Money Laundering Regulations can be found in AIMA’s Guide to Sound Practices for European Hedge Fund Managers (2007), (section 4.1.5).

E. Shareholder Conduct: Disclosure of Derivative Positions

The HFWG acknowledges that companies have a right to know who owns them or who has an ability to easily obtain significant voting power. Indeed, members of the HFWG would welcome higher levels of disclosure.

However, the voluntary adoption of enhanced disclosure requirements by hedge fund managers (or any other particular sector of the market) would cause distortions in the market place because they would not apply to all market participants but merely to hedge funds.

Therefore, the HFWG recommends that regulators take action to introduce a regime (similar to that of the Takeover Panel in the United Kingdom applicable during takeover offer periods) requiring notification of “economic” interests in shares held via instruments such as CFDs.

The HFWG members are willing to contribute to consultations with regulators to work out a solution that enhances the current disclosure regime.

F. Shareholder Conduct: Voting of Borrowed Stock

Hedge funds following best practice will not engage in practices such as voting on borrowed stock while not being economically exposed.

- The HFWG would be happy to engage in wider consultation on this issue with regulators and other market participants.
- The HFWG would welcome a regime where the voting party had an economic interest corresponding to the votes it was casting.

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