

# LOWENSTEIN SANDLER PC CLIENT ALERT INVESTMENT MANAGEMENT

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## PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS RELEASES FINAL REPORTS CONCERNING BEST PRACTICES FOR THE HEDGE FUND INDUSTRY

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**On January 15, 2009, two private sector committees (i.e., the Asset Managers' committee and the Investors' committee) established by the President's Working Group on Financial Markets, released final reports concerning recommendations for best practices for the hedge fund industry (together, the "Reports"). The Reports were issued following a review of public comments on initial drafts of the Reports released in April, 2008. The Reports address areas of concern to the hedge fund industry and propose a set of best practices for fund managers and investors.**

### **Report of the Asset Managers' Committee (the "Managers' Report")**

In its final report, the Asset Managers' committee notes that the Reports are being released at a time of tremendous uncertainty in the global financial markets. The Reports, however, also emphasize that such uncertainty highlights the need for hedge funds to "evaluate and implement strong practices to manage

their businesses." Consequently, the Managers' Report seeks to "raise the bar" for the hedge fund industry by providing fund managers with clear guidance for "strengthening their practices in ways that investors demand and the markets require." The Managers' Report is careful to acknowledge that not all of its recommendations will be applicable to all fund managers at all times (due in part to structural differences such as fund size and investment objectives).

The Managers' Report identifies certain key areas "where best practices would most effectively enhance investor protection and reduce systemic risk" including, but not limited to: (i) investor disclosures, (ii) valuation policies and procedures, (iii) risk management, and (iv) compliance. The foregoing key areas are discussed in more detail below.

**Disclosure.** The Managers' Report discusses certain disclosure items intended to provide investors with information needed to make and monitor their investments with a hedge fund. Specifically, the Managers' Report focuses on the provision of: (i) a private placement memorandum that would include broad descriptions of a fund's investment philosophy, strategies and significant risks of an investment in

the fund; (ii) annual audited financial statements; (iii) periodic performance information; (iv) disclosures regarding the existence of side letters with terms that may have an adverse impact on other investors; and (v) other types of investor communications. While the Managers' Report specifies that each fund manager should determine the manner and frequency of most disclosures to investors, the Managers' Report recommends that fund managers: (a) communicate risk information on a monthly basis; (b) provide estimated fund performance at least on a monthly basis; and (c) provide investor letters conveying important developments relating to the fund at least on a quarterly basis. The recommendations in items (a)-(c) above differ from the recommendations provided in the April 2008 draft of the Managers' Report, where such disclosures were recommended to be on a (x) quarterly, (y) quarterly, and (z) monthly basis, respectively.

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**Valuation.** The Managers' Report recommends that fund managers adopt consistent and documented valuation policies and procedures while recognizing that the level of detail of such policies will depend in large part on the nature of the hedge fund's investments. In addition, the Managers' Report recommends that fund managers establish a governance mechanism, such as a valuation committee, to establish and monitor compliance with a hedge fund's valuation policies and procedures. In what is likely a response to a June 13, 2008 letter from the Managed Funds Association<sup>1</sup> commenting on the April 2008 draft report, the Managers' committee has clarified in the Managers' Report that there should be some level of segregation between a hedge fund's portfolio management functions and its valuation functions. This differs from the April 2008 draft report, which recommended a segregation of portfolio management personnel and valuation personnel. Finally, the Managers' Report recommends that fund managers adopt procedures for testing valuation policies and conduct a review of valuation policies no less frequently than annually.

**Risk Management.** The Managers' Report recommends that fund managers adopt a comprehensive set of risk management policies and procedures that should focus on managing the various categories of risk such as market risk, liquidity risk, counterparty credit risk and operational risk. Such policies and procedures should be tailored to the hedge fund's overall risk profile, which will in turn depend upon the hedge fund's size, investment strategy and portfolio management process. While the April 2008 draft of the report included recommendations on managing a

hedge fund's counterparty credit risk, the Managers' Report contains enhanced recommendations on this topic. Specifically, the Managers' Report states that (i) a fund manager should understand that a counterparty's insolvency could impact a hedge fund's ability to access its trading positions, and (ii) a fund manager should have an understanding of the way a prime broker or other counterparty finances the hedge fund's positions, whether such third-party uses U.S. and/or non-U.S. broker-dealers or banks in transactions relating to the hedge fund, and whether it segregates the hedge fund's assets.

**Compliance.** Recognizing that the hedge fund industry should be committed to the "highest standards of integrity and professionalism," the Managers' Report recommends that a fund manager maintain a set of compliance policies and procedures that would include: (i) a code of ethics; (ii) a written compliance manual; (iii) a Chief Compliance Officer; (iv) appropriate discipline and sanctions for compliance violations; (v) a process for handling conflicts of interest; and (vi) a robust compliance training program for all personnel. The Managers' Report recommends that a hedge fund's compliance program be reviewed, and, if needed, updated annually. Finally, the Managers' Report notes that the Chief Compliance Officer cannot implement a hedge fund's compliance program alone, but rather, that a fund's compliance program is the responsibility of the entire organization, including senior management.

### **Report of the Investors' Committee (the "Investors' Report")**

Much like the Managers' Report, the Investors' Report notes that the release

of the Reports during a period of economic uncertainty, including allegations of fraudulent activity by some persons in the hedge fund industry, was not undertaken lightly. In fact, the Investors' Report states that the Investors' committee debated delaying the release of the Investors' Report pending a more "in-depth analysis of recent market events." The Investors' committee determined, however, that it was appropriate to release the Investors' Report at this time because it contains many recommendations that may be beneficial to hedge fund investors and to fund managers.

The Investors' Report recommends a set of principles and best practices intended to (i) address the decision to invest in a hedge fund, and (ii) guide the management and oversight of the implementation of a hedge fund investment program. In order to meet its objectives, the Investors' Report contains both a Fiduciary's Guide (providing recommendations to "individuals charged with evaluating the appropriateness of hedge funds as a component of an investment portfolio") and an Investor's Guide (providing recommendations to those "charged with executing and administering a hedge fund program once a fiduciary has decided to add hedge funds to the investment portfolio").

**The Fiduciary's Guide.** The Fiduciary's Guide provides a brief description of the considerations that should be given to any decision to include hedge funds in an investment portfolio, including a recommendation that fiduciaries develop an explicit policy describing the goals of a hedge fund investment program. At a minimum, such policy should include the strategic purpose of including

hedge funds in an investment portfolio, the performance and risk objectives of the hedge fund investment program, and the investment guidelines that will apply to the range of hedge funds that can be used. The most salient feature of the Fiduciary's Guide is the prominence given to the fiduciary's responsibility to maintain a robust due diligence process for any hedge fund investment program. In particular, the Fiduciary's Guide specifies that any viable due diligence process should include ongoing monitoring in order to reaffirm that any assumptions used in the initial due diligence process remain valid.

**The Investor's Guide.** As mentioned above, the Investor's Guide provides a set of recommended principles and best practices for the investment professionals administering a hedge fund investment program. In furtherance thereof, the Investors' Guide provides a framework and collection of best practices for structuring an ongoing due diligence process for choosing and monitoring hedge fund investments. The Investors' Guide develops this framework by focusing on certain key areas of the due diligence process, namely, initial and continuing due diligence on fund managers, risk management, valuation and reporting (i.e., disclosure). Certain highlights of the Investors' Report principles and best practices are as follows:

- The due diligence process should examine items such as a fund manager's investment process, key personnel and their professional experience and disciplinary history, risk management procedures, historical performance, including

market conditions affecting such performance and material terms such as fees, liquidity restrictions and the manager's use of leverage.

- Investors should establish a viable risk management program that is independent of the hedge fund selection process.
- Investors should request and obtain risk reporting from fund managers in order to monitor a fund's level of liquidity, leverage and counterparty risk.
- Investors should request and ensure that fund managers provide disclosure of different investment terms offered to other investors (i.e., side letters).
- Investors should have a thorough understanding of a hedge fund manager's compliance policies and procedures.
- Investors should review a fund manager's valuation policies and procedures and monitor the application of such procedures to ensure compliance with Generally Accepted Accounting Principles or other applicable standards.

## Analysis and Conclusion

The Asset Managers' Report and the Investors' Report each detail a set of principles and recommended best practices that may be useful to fund managers and investors regardless of size, investment objective or risk exposure. While this alert seeks to highlight certain key topics discussed in the Reports, such as disclosure, risk management and due diligence, the Reports go into great detail regarding numerous topics not discussed in detail herein, such as effective trading and business operations, business

continuity, conflicts of interest management and instituting procedures for more effective management of illiquid investments.

The maintenance, strengthening and/or implementation of strong business and compliance practices will likely have a profound positive effect on a hedge fund's business, particularly considering the current economic climate. Although many fund managers may already carry out some of the Reports' best practices recommendations (because of their status as registered investment advisors, or otherwise), fund managers will likely be expected to devote increased attention to such recommendations in order to meet heightened expectations and requirements of investors, market participants and anticipated legislation. Such recommendations are also important considering the increased focus that the Securities and Exchange Commission and other regulators are expected to devote to compliance and transparency issues under existing laws, rules and regulations.<sup>2</sup> Consequently, a robust framework of best practices and compliance procedures by fund managers and hedge funds in general, will be of great importance in maintaining existing operations and attracting future capital infusions.

Lowenstein Sandler's Investment Management Practice Group will continue to monitor and report on developments regarding the issues affecting investment managers, private investment funds and other matters of interest to our clients.

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Please contact any of the attorneys below for further information on the matters discussed herein, including the implementation of any of the Reports' recommendations.<sup>3</sup>

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<sup>1</sup> Letter submitted by the Managed Funds Association on June 13, 2008 and available at <http://www.managedfunds.org/downloads/MFA%20--%20Comment%20Letter%20to%20PWG%20AMC%20--%20FINAL.pdf> (last accessed on February 4, 2009).

<sup>2</sup> See, e.g., An October, 2008 speech given by Lori Richards, Director, Office of Compliance Inspections and Examinations entitled, "Compliance through Crisis: Focus Areas for SEC Examiners and Compliance Professionals." Available at <http://www.sec.gov/news/speech/2008/spch102108lar.htm> (last accessed on February 4, 2009)

<sup>3</sup> The Asset Managers' committee report may be accessed at <http://www.amaicmte.org/Public/AMC%20Report%20-%20Final.pdf> and the Investors' committee report may be accessed at <http://www.amaicmte.org/Public/Investors%20Report%20-%20Final.pdf> (each last accessed on February 4, 2009).

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