Best Practices for Hedge Fund Managers and Investors

Two Private Sector Committees Release Best Practices for Hedge Fund Participants

SUMMARY
On April 15, 2008, two private sector committees, established by the President’s Working Group on Financial Markets, released best practice guidelines for hedge fund managers and investors. The Asset Managers’ Committee, comprised of representatives from ten leading U.S. hedge funds, focused its recommendations on five areas: disclosure, valuation, risk management, trading and business operations, and compliance, conflicts and business practices. The Investors’ Committee, comprised of public and private pension funds, endowments, foundations, hedge funds, labor organizations and hedge fund consultants, focused its recommendations on fiduciaries considering hedge fund allocations and individuals executing and administering hedge fund programs. There is a 60-day public comment period for both reports, which are available at: www.amaicmte.org. Sullivan & Cromwell LLP is acting as counsel to the Asset Managers’ Committee, along with Schulte Roth & Zabel LLP, in the development and issuance of its report.

BACKGROUND
In February 2007, the President’s Working Group on Financial Markets released a set of principles to guide financial regulators as they addressed the rapid growth of private pools of capital, including hedge funds. These principles concentrated specifically on investor protection and systemic risk concerns. In September 2007, the President’s Working Group tasked two private sector committees with developing best practices for their respective stakeholder groups, based on these initial principles.
On April 15, 2008, the Asset Managers’ Committee (“AMC”) and Investors’ Committee (“IC”) reports were released for public comment. The reports make recommendations specific to their respective stakeholder groups (i.e., hedge fund managers and investors, respectively), but also encourage use of the reports together as a means to increase the accountability of each stakeholder group to the other. Investors are encouraged to use the AMC report as a basis for due diligence on hedge fund managers, while hedge fund managers are encouraged to use the IC report to guide their interaction with investors.

THE ASSET MANAGERS’ COMMITTEE REPORT

The AMC report makes recommendations in five areas: disclosure, valuation, risk management, trading and business operations, and compliance, conflicts and business practices. In each area, the report outlines an overarching framework to guide the implementation of specific best practices (as appropriate to the particular characteristics of a fund). The frameworks set forth the fundamental principles applicable to each area and recommend the establishment of basic policies and procedures that managers must address and a process for reviewing and updating the manager’s practices, as well as recommending the commitment of resources required to implement the framework.

The frameworks are supplemented by a set of specific best practices that can be used to implement each framework (summarized below). Although the AMC report explicitly acknowledges that the applicability of its best practices will vary according to the particular characteristics of a fund, it asks managers to assess their practices against the report and adopt those applicable to their business. In an effort to increase accountability, the AMC recommends that managers be ready to explain to investors how they have implemented and adopted the practices in the report.

The AMC report makes recommendations in the following five areas:

**Disclosure:** The report recommends that managers provide comprehensive disclosure of material information in the fund’s offering documents, including investment philosophy, strategies, products and terms, significant risks of investing in the fund, the elements of the fund’s valuation framework, and potential conflicts of interest. The report includes recommendations to provide investors regular updates of performance and risk information, including not only quantitative performance information, but also qualitative discussion, and investment-related information consistent with (and exceeding) the requirements of FAS 157. It also states that managers should make more immediate disclosure of material developments relating to the fund and should disclose the material terms of any side letters that may adversely impact the interests of other investors. The report also details considerations for disclosures to counterparties that encourage active cooperation with counterparties in determining the type and frequency of information that will be disclosed.

**Valuation:** The report recommends that managers establish a valuation committee (or similar mechanism) to oversee the fund’s valuation policies and procedures, which in turn should be carried out
by an appropriately independent group of valuation personnel. The fund’s valuation policy should outline the participants (internal and external) in the valuation process, the methodologies for valuing the types of investments made by the fund, use of pricing sources for each type of investment, internal documentation procedures, and procedures for mitigating potential conflicts in the valuation process. The report also recommends that managers have specific policies for valuing hard-to-value investment positions, as well as for the use of side pockets and other similar arrangements. The report specifically recommends that although there should generally be competent and independent review of managers’ final valuations, where hard-to-value investment positions are involved, it may be appropriate to use properly controlled internal valuations, but that in these cases, managers must be particularly vigilant in doing so in light of the more pronounced potential for conflicts of interest.

**Risk Management:** The report recommends that senior management at the fund determine the fund’s overall risk profile, and then supervise (e.g., through a Chief Risk Officer) the creation of a program to measure, monitor and manage risk at the fund that is consistent with the fund’s risk profile. The recommendations contemplate disclosure of certain risk information to investors, initially and on an ongoing basis, that will enable them to assess whether the fund’s risk profile is appropriate for them and their portfolios and to evaluate how their investment is performing in light of that profile. The report indicates that the principal risks a fund should manage include liquidity, leverage, market, counterparty and operational risk. Liquidity risk management should include the review and monitoring of the fund’s credit and lending agreements. Leverage risk management should take into account inter-related factors such as asset type, overall liquidity at the fund and the effect of concentration among trading strategies. Market risk management should include stress testing and scenario analyses (standardized, historical and unique), as well as forward-looking risk measures. Counterparty risk management should include careful review and monitoring of credit exposure to counterparties, as well as the identities of custodians and sub-custodians used by prime brokers. Operational risk management should include strong internal controls and operational infrastructure commensurate with the fund’s size and complexity.

**Trading and Business Operations:** The report recommends that managers develop policies to manage the fund’s cash, margin and collateral requirements and for the selection of counterparties and key service providers to the fund, and for core infrastructure and operational requirements at the fund (including clearing and settling transactions, wiring funds, reconciling positions and cash accounts across counterparties, and appropriate automation of trading processes). The report also recommends that managers have systems, infrastructure, and automation commensurate with the scale of their business and trading operations. To the extent a manager invests in OTC derivatives or other complex products, the report recommends that specific policies and procedures be developed for each such product. The report also encourages managers to implement appropriate systems, processes and personnel to maintain and produce comprehensive accounting records for their funds, as well as to prepare an appropriate disaster recovery/business continuity plan.
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Compliance, Conflicts and Business Practices: The report recommends that senior management be responsible for creating a “culture of compliance” among fund personnel. This includes developing a written code of ethics addressing issues such as integrity and professionalism, the responsibilities of the manager as fiduciary, protection of confidential information about the fund and its investors, and personal trading by fund personnel. The report also recommends that managers develop a compliance manual (maintained and implemented by a Chief Compliance Officer) addressing topics such as marketing and communication by the fund, anti-money laundering, trading and business practices, market manipulation and insider trading. Notably, the report includes recommendations to identify and mitigate conflicts of interest that may arise in connection with the manager’s business through specific policies and procedures, as well as through the creation of a Conflicts Committee.

THE INVESTORS’ COMMITTEE REPORT
The IC report makes recommendations for individuals considering or already investing in hedge funds. It is divided into two basic sections: a Fiduciary’s Guide and an Investor’s Guide.

Fiduciary’s Guide: The Fiduciary’s Guide is directed towards fiduciaries considering or already investing in a hedge fund on behalf of qualified individuals and institutions and provides recommendations relating to evaluation of the appropriateness of hedge funds as a component of an investment portfolio. This guide emphasizes the responsibility and care those fiduciaries must take not only in assessing the investment, but also in assessing whether they have or can engage investment professionals with sufficient skill and resources to initiate, monitor and manage a hedge fund program successfully. Fiduciaries are encouraged to pay close attention to the characteristics of the hedge fund industry generally, the nature and structure of fees charged by managers, the experience of different managers, the role of a hedge fund investment in the portfolio represented by the fiduciary, and the proper allocation to, and diversification among, hedge fund investments.

Investor’s Guide: The Investor’s Guide is directed towards individuals executing and administering hedge fund programs (i.e., investing in hedge funds). The guide recommends that these individuals conduct adequate due diligence on all hedge fund managers (including the manager’s personnel, management, investment performance track record, style integrity and model use) and establish a risk management process consistent with their desired risk tolerance, and compare that against the hedge fund manager’s risk management program (including in respect of the risks associated with investments, liquidity, leverage, compliance problems, prime brokers and other counterparties, operational and business risks, fraud and other crime and information technology). The guide also recommends that investors understand the legal and regulatory issues involved in a hedge fund investment, including all the terms of any investment, the fund’s valuation policy (including governance mechanisms, methodologies for particular investment positions and control of valuation conflicts), and how the manager intends to measure and report fund performance.
CONCLUSION

The reports each indicate that the respective Committees consulted with many industry stakeholders in developing the recommendations and, as noted above, these reports will be available for public comment during the 60-day period ending June 13, 2008. Sullivan & Cromwell LLP expects to continue to work with the AMC in its consideration of comments and in the finalization of its report, and also to host a seminar on both reports prior to the end of the comment period.

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