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**Hedge Fund Regulation:  
The President's Working Group Committees' Best Practices Reports  
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Raising the Bar but Missing Risks**

John P. Hunt

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# Hedge Fund Regulation: The President's Working Group Committees' Best Practices Reports – Raising the Bar but Missing Risks

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## Summary

Hedge funds – generally defined as private investment funds that are limited to wealthy investors and institutions, base manager compensation at least in part on investment performance, and have limited investor redemption rights – have enjoyed tremendous growth over the past ten years. According to industry estimates cited by GAO, over 9,000 hedge funds managed over \$2 trillion in assets in early 2007.<sup>1</sup> As of mid-2007, hedge funds reportedly accounted for 30% of U.S. fixed-income trading, including 85% of distressed-debt trading and 80% of trading in certain types of credit derivatives.<sup>2</sup>

The past ten years have also seen a continuing debate over hedge-fund regulation, kicked off by the 1998 near-collapse and Fed-orchestrated rescue of one of the then largest hedge funds in the country, Long-Term Capital Management. Various U.S. authorities have fitfully considered a range of regulatory proposals over this period. The current approach, adopted in a February 2007 interagency agreement, establishes broad principles for how regulators, hedge funds, investors, creditors, and counterparties should

conduct themselves, relying heavily on market discipline and adherence to “industry sound practices” to address any challenges posed by hedge funds.<sup>3</sup>

Following the February 2007 agreement and consistent with its emphasis on industry sound practices, the President's Working Group on Financial Markets (“PWG”) empanelled two private-sector committees – one composed of hedge fund managers (the Asset Managers' Committee (“AMC”)) and the other composed of investors (the Investors' Committee (“IC”)) – and asked each committee to produce a report on best practices for the group from which the committee was drawn. The committees released the Reports in draft and opened them for public comment on April 15.<sup>4</sup> The Reports cover a wide range of areas, including position valuation, risk management, disclosure/reporting, and due diligence.

The Reports are written in a hortatory style, with almost all recommendations phrased in terms of what managers or investors “should” (not “must”) do. And the Reports are unclear on what a manager or investor should do about many issues raised by the Reports: They frequently urge investors or managers to “consider” particular issues or courses of action without

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<sup>1</sup> See Government Accountability Office, *Hedge Funds: Regulators & Market Participants Are Taking Steps to Strengthen Market Discipline, But More Attention Is Needed*, GAO 08-200 (January 2008), at 1.

<sup>2</sup> See *id.*; Greenwich Associates, *In U.S. Fixed Income, Hedge Funds Are the Biggest Game in Town* (Aug. 20, 2007) (associated press release available at [http://www.greenwich.com/WMA/greenwich\\_reports/report\\_abstract/1,1622,5943,00.html?rtOrigin=A&vgnvisitor=fKmb16WLnw==](http://www.greenwich.com/WMA/greenwich_reports/report_abstract/1,1622,5943,00.html?rtOrigin=A&vgnvisitor=fKmb16WLnw==)) (last viewed May 19, 2008)

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<sup>3</sup> *Agreement among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital* (Feb. 2007) (available at [http://www.treasury.gov/press/releases/hp272\\_principles.pdf](http://www.treasury.gov/press/releases/hp272_principles.pdf)) (last viewed May 19, 2008)

<sup>4</sup> See *Best Practices for the Hedge Fund Industry: Report of the Asset Managers' Committee to the President's Working Group on Financial Markets* (April 15, 2008) (“AMC Report”); *Best Practices for Hedge Fund Investors: Report of the Investors' Committee to the President's Working Group on Financial Markets* (April 15, 2008) (“IC Report”) (available at [www.amaicmte.org](http://www.amaicmte.org)) (last viewed May 27, 2008)

much detail on what criteria to use or how to weigh them.

The Reports met with a generally blasé reaction, although industry groups gave them a warm welcome.<sup>5</sup> Traditional media coverage was limited, probably reflecting the fact that hedge funds as a group have not been widely blamed for the 2007-08 credit crisis.<sup>6</sup> Meanwhile, blog headlines such as “Hot Air Alert” ran over items claiming that the Reports were nothing more than a rehash of familiar bromides with no real content.<sup>7</sup>

<sup>5</sup> See Managed Funds Ass’n and Alternative Investment Mgmt. Ass’n, *MFA and AIMA Welcome Reports by President’s Working Group on Best Practices for the Hedge Fund Industry* (April 15, 2008), available at <http://www.managedfunds.org/downloads/MFA%20and%20AIMA%20Welcome%20PWG%20Committees%20Reports%20on%20Best%20Practices.pdf> (last viewed May 15, 2008) (“MFA and AIMA welcome [the Reports] and applaud both Committees for the diligence and detail presented in each Report, as well as the thorough and significant contributions by each Committee member.”); U.S. Chamber of Commerce Press Release 08-117 (April 15, 2008), available at <http://www.uschamber.com/press/releases/2008/april/08-117.htm> (last viewed May 15, 2008) (“These reports are a key step in further enhancing industry standards for increasing investor transparency, maintaining healthy markets, and keeping the U.S. globally competitive.”).

<sup>6</sup> Although the collapse of two Bear-Stearns-affiliated hedge funds in late July 2007 was one of the first symptoms of the 2007-08 credit crisis, see, e.g., Kate Kelly, *Lost Opportunities Haunt Final Days of Bear Stearns*, WALL ST. J., May 27, 2008, at A1, a number of official or quasi-official reports have discussed the causes of the crisis – and identified underlying issues in risk management or the financial system more broadly – without describing hedge funds or their regulatory treatment as significant sources of weakness. See Financial Stability Forum, *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience* (April 7, 2008) (report of international group of regulatory experts and regulator representatives housed at the Bank of International Settlements); President’s Working Group on Financial Markets, *Policy Statement on Financial Market Developments* (March 13, 2008) (report of working group of senior U.S. financial regulators); Senior Supervisors Group, *Observations on Risk Management Practices During the Recent Market Turbulence* (March 6, 2008) (group of supervisory agencies from France, Germany, Switzerland, Britain, and the United States).

<sup>7</sup> See <http://nakedshorts.typepad.com/nakedshorts/2008/04/hot-air-alert.html> (last viewed May 14, 2008); <http://seekingalpha.com/article/72616-hedge-funds-disclosure-more-bark-than-bite> (last viewed May 16, 2008). Connecticut Attorney General Richard Blumenthal reportedly commented that “[t]he Treasury Department’s proposals for greater transparency and risk disclosure must be mandatory or they are meaningless.” Frank Schloegel, *President’s Group*

This White Paper takes a slightly less jaded view, especially on the subject of hedge-fund disclosure to investors: The Asset Managers’ Committee Report in particular appears to “raise[] the bar for the industry,”<sup>8</sup> as it claims to do. Its recommendations are considerably more specific than those of the leading compilation of best practices for the U.S. hedge managers, produced by the Managed Funds Association (“MFA”). For example, the recommendation that managers report quarterly on what percentage of assets fall into which of the three tiers of valuation difficulty and what percentage of realized and unrealized profit and loss comes from which tier, combined with the Reports’ recommendations for enhanced reporting of valuation and risk models, seems to go significantly beyond what the MFA recommends.

This White Paper does find some fault with the Reports’ treatment of what may be the most interesting issue posed by hedge funds: the possibility that they create a material systemic risk. It is far from clear that hedge funds create such a risk. Although hedge funds are highly leveraged and in aggregate make up a significant portion of trading in some markets, they do not occupy the same position in the financial system that banks do and their counterparties have a strong incentive to monitor them. Moreover, although any systemic risk created by a trading relationship can be seen as an externality because systemic failure will impose costs on parties outside the relationship, that may or may not give rise to a market failure, still less one justifying regulatory intervention.

The PWG and Committees apparently believe that hedge funds do pose a systemic risk that should be addressed, as they assert that the recommendations in

*Releases Hedge Fund Best Practices*, CCH Wall Street (April 21, 2008) (available at <http://www1.cchwallstreet.com/ws-portal/content/news/container.jsp?fn=04-21-08>) (last viewed May 15, 2008).

<sup>8</sup> AMC Report, at iii.

the Reports will reduce systemic risk. But the Reports have almost nothing of substance to say about hedge funds’ relationships with their counterparties. Given that whatever systemic risk hedge funds may pose is likely to cause harm through counterparty relationships, one would expect a much fuller discussion of this issue if the Reports reflected a serious effort to reduce systemic risk through best-practices regulation.

Of course, the counterparty recommendations in the Reports may serve as a foundation for more specific and effective future best practices. However, the recommendations may be better understood as an effort to forestall more intrusive regulation than as a serious effort to address a systemic risk problem. The hedge fund industry has demonstrated tremendous innovation and growth, as well as an admirable ability to weather the recent crisis, under light regulation, so a hands-off policy may be justified – at least until greater consensus on this poorly understood issue develops.

This White Paper concludes that in light of the potential importance of systemic risk, further work on the system wide risks faced by networks of leveraged trading counterparties is warranted.

## **Hedge Fund Regulation: The President’s Working Group Committees’ Best Practices Reports – Raising the Bar but Missing Risks**

This White Paper responds to the recently released draft “best practices” reports of committees of private sector representatives of hedge fund asset managers and investors. The committees were convened by the President’s Working Group on Financial Markets (“PWG”). The Reports address topics including position valuation, risk management, disclosure/reporting, and due diligence and propose a series of best practices for operation of several aspects of the hedge fund industry. This White Paper briefly reviews the historic and regulatory context in which hedge funds operate and out of which the Reports emerged. The White Paper then describes ways in which the Reports can be seen as raising the bar for hedge fund managers’ conduct and identifies a significant shortcoming in the Reports’ analysis and recommendations. Appendices to this Paper provide summaries of each of the Reports.

### **The Reports in Context**

The Reports define a hedge fund as follows: “a pooled investment vehicle that generally meets most, if not all, of the following criteria: (i) it is not marketed to the general public (i.e., it is privately offered), (ii) its investors are limited to high net worth individuals and institutions, (iii) it is not registered as an investment company under relevant laws (e.g., U.S. Investment Company Act of 1940), (iv) its assets are managed by a professional investment management firm that is compensated in part based upon investment performance of the vehicle; (v) its primary investment objective is investing in a liquid portfolio of securities

and other investment assets; and (vi) it has periodic but restricted or limited investor redemption rights.”<sup>9</sup>

The question of whether and how hedge-fund regulation should be changed grabbed the spotlight when the Federal Reserve orchestrated the bailout of Long Term Capital Management in 1998.<sup>10</sup> In April 1999, the PWG issued its report *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management*. Among other things, the report recommended that hedge funds be required to make quarterly public disclosures of “meaningful and comprehensive measures of market risk . . . without requiring the disclosure of proprietary information on strategies or positions”<sup>11</sup>— a recommendation that drew criticism from economists as well as industry groups.<sup>12</sup>

The 1999 report recognized that new legislation would have been needed to implement its recommendations, and the Hedge Fund Disclosure Act, introduced in 2000, would have imposed disclosure

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<sup>9</sup> AMC Report, at i n.2. The IC Report adopts the MFA’s definition, which is the same as the AMC Report’s except that it omits element (v). See IC Report, at 8. Apparently the investors do not think that handling a liquid portfolio of securities is a key element of the definition of a hedge fund. This element may have been included in the asset managers’ report to distinguish hedge funds from private equity and venture capital investment vehicles.

<sup>10</sup> See Roger Lowenstein, *When Genius Failed: The Rise and Fall of Long-Term Capital Management* (2001) for an account of the Fed’s actions.

<sup>11</sup> President’s Working Group on Financial Markets, *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management* (April 1999), at 31-33.

<sup>12</sup> See Financial Economists Roundtable, *Financial Economists Roundtable Statement on Capital Management and the Report of the President’s Working Group on Financial Markets* (Oct. 6, 1999) (“The Financial Economists Roundtable sees no overriding government interest in additional hedge fund disclosure.”); Statement of George Crapple, Chairman, Managed Funds Ass’n to House of Representatives, Committee on Banking and Housing Services (May 6, 1999) (available at [http://commdocs.house.gov/committees/bank/hba56675.000/hba56675\\_0.htm](http://commdocs.house.gov/committees/bank/hba56675.000/hba56675_0.htm)) (last viewed May 27, 2008) (“MFA urges this committee and other public policymakers to be skeptical of purported solutions to the LTCM problem that consist of creating yet another Washington information warehouse which is unlikely to advance the important task at hand of improving credit assessment and risk management by lending institutions and financial market counterparties such as those who extended credit to LTCM”).

requirements generally in line with the 1999 report’s recommendations.<sup>13</sup> The Hedge Fund Disclosure Act died in committee,<sup>14</sup> and a parallel rule considered by the CFTC for hedge funds organized as commodity pool operators likewise was not adopted.<sup>15</sup>

In 2004, after the mandatory disclosure proposal was defeated, the SEC adopted a rule requiring hedge-fund managers to register under the Investment Advisers Act of 1940.<sup>16</sup> The rule was challenged under the Administrative Procedure Act, the D.C. Circuit ruled against the SEC in 2006,<sup>17</sup> and the agency – by then under different leadership – did not seek review of the ruling in the Supreme Court. The SEC appears to have abandoned mandatory hedge-fund registration, although many hedge funds are registered on a voluntary basis.<sup>18</sup> More broadly, the agency apparently has ceased efforts to regulate hedge-fund conduct, apart from enacting a narrowly focused antifraud rule governing hedge-fund managers.<sup>19</sup> The agency is considering, but has not adopted, further restrictions of the class of investors

who are permitted to invest in hedge funds and other private investment vehicles.<sup>20</sup>

The current approach to hedge fund regulation is expressed in the February 22, 2007 “Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital,”<sup>21</sup> which articulates broad principles related to investor protection and control of systemic risks and affirms that “market discipline,” supplemented by compliance with “industry sound practice,” is the touchstone of hedge-fund regulatory policy.<sup>22</sup> In its emphasis on broad, flexible principles, the Agreement is consistent with the administration’s interest in “principles-based” regulation of the financial industry, a philosophy endorsed more broadly in Treasury Secretary Paulson’s plan for overhauling the U.S. financial regulation system.<sup>23</sup> Its embrace of “market discipline” signals a strong turn away from prescriptive regulation.

Later in 2007, following on the Agreement’s indication that “industry sound practices” are an important adjunct to market discipline, the PWG created two private-sector committees, the Asset Managers’ Committee (AMC) and the Investors’ Committee (IC), to “define separate sets of best practices that address investor protection, enhance market discipline, and

<sup>13</sup> See Hedge Fund Disclosure Act, H.R. 2924 (106th Congress) (bill text available at <http://www.govtrack.us/congress/billtext.xpd?bill=h106-2924>)

<sup>14</sup> <http://www.govtrack.us/congress/bill.xpd?bill=h106-2924>

<sup>15</sup> See Commodity Futures Trading Commission, Docket No. RIN-AB53, “Public Reporting by Operators of Certain Large Commodity Pools,” 65 Fed. Reg. 20,395 (April 17, 2000).

<sup>16</sup> See *Registration Under the Advisers Act of Certain Hedge Fund Advisers*, 69 Fed. Reg. 72,054 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275, 279); Gary Weiss, *Hedge Funds vs. the SEC*, BUSINESSWEEK ONLINE (March 3, 2003) (available at [http://www.businessweek.com/print/magazine/content/03\\_09/b3822088\\_mz020.htm?chan=mz](http://www.businessweek.com/print/magazine/content/03_09/b3822088_mz020.htm?chan=mz)) (last viewed May 27, 2008) (“The CFTC rule wasn’t revised, withdrawn, or watered down – it simply didn’t happen”).

<sup>17</sup> See *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006). The Investment Advisers Act requires registration only of entities with more than fifteen “clients.” The premise of the SEC rule was that hedge-fund managers’ clients are the investors in the hedge fund, not the fund itself. The court held that the SEC had not “adequately explained how the relationship between hedge fund investors and advisers justifies treating the former as clients of the latter.” *Id.* at 882.

<sup>18</sup> See Houman B. Shadab, *The Challenge of Hedge Fund Regulation*, REGULATION (Spring 2007), at 36 (asserting that in 2006, 86% of hedge funds were registered with the CFTC, SEC, or another government agency).

<sup>19</sup> See *Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles*, Release No. IA-2628, 2007 WL 2239114 (Aug. 3, 2007).

<sup>20</sup> See *Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles*, Release No. 8766, 2006 WL 3814994, at \*10 (Dec. 27, 2006) (proposing definition of “accredited natural person” as someone who meets existing requirements for being an accredited investor and also has \$2.5 million in investments). At the time of this writing, the SEC had not adopted this revised definition.

<sup>21</sup> The members of the President’s Working Group on Financial Markets are the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Securities and Exchange Commission, and the Chairman of the Commodities Futures Trading Commission.

<sup>22</sup> *Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital* (Feb. 22, 2007) [“Interagency Agreement”], at 1.

<sup>23</sup> See Department of the Treasury, *The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure* (March 2008), at 11-12 (proposing merger of SEC and CFTC and adoption by new agency of “overarching regulatory principles focusing on investor protection, market integrity, and overall financial system risk reduction”).

mitigate systemic risk.<sup>24</sup> On April 15, 2008, the Committees released their best-practices Reports and opened them for public comment.<sup>25</sup>

The Reports join several existing private-sector compilations of hedge fund best practices. For U.S. hedge funds, the most pertinent of these is the Managed Funds Association’s (MFA) “Sound Practices for Hedge Fund Managers,” most recently revised in November 2007.<sup>26</sup> The MFA “believes that the 2007 edition directly responds” to the principles and guidelines the PWG adopted in February 2007, so it provides a useful benchmark for the Reports.<sup>27</sup> Other private-sector compilations of best practices and standards have been issued recently by Britain’s Hedge Fund Working Group<sup>28</sup>, by the Alternative Investment Management Association<sup>29</sup> (focusing on European hedge funds), and by the CFA Centre for Financial Market Integrity.<sup>30</sup>

### “Raising the Bar” Relative to Existing Best Practices

The best practices recommended in the Reports are recommendations for voluntary action, not commands. This is the case not just because private-sector committees without regulatory power produced the Reports, but also because almost all the recommendations in the AMC Report are phrased in terms of what actors “should” do, not what they “must” do.<sup>31</sup> The few mandatory instructions the Reports contain are for the most part extremely general.<sup>32</sup> It seems fair to say that the AMC Report in particular would not by its terms impose any meaningful absolute requirements if it were enacted without change into law by Congress (or, more plausibly, adopted without

<sup>24</sup> “Paulson Announces Next Steps to Bolster U.S. Markets’ Global Competitiveness,” Department of the Treasury Press Release HP-476 (June 27, 2007); see also “PWG Announces Private Sector Groups to Address Market Issues for Private Pools of Capital,” Department of the Treasury Press Release HP-575 (Sept. 25, 2007) (“The committees will create and publicly release the best practices so market participants may enhance investor protection and systemic risk safeguards consistent with the PWG principles and guidelines.”).

<sup>25</sup> The Committees describe the reports as their “first task,” AMC Report, at i, and apparently anticipate continuing to meet semiannually and to “issue clarifications and additions if appropriate.” IC Report, at 4; see also Russell Read, “Principles and Practices for Hedge Fund Investors: Highlights of Recommendations,” <http://calpers.ca.gov/eip-docs/about/board-cal-agenda/agendas/invest/200804/item08c-01.pdf>, at 29 (“Both committees will be standing committees[.]” “will continue to address areas of concern to the hedge fund industry and investors as they arise[.]” and “will continue to address broader issues related to investment in private pools of capital”). Mr. Read is Chairman of the Investors’ Committee.

<sup>26</sup> Managed Funds Association, *Sound Practices for Hedge Fund Managers* (November 2007) [MFA Sound Practices]. The 2007 edition follows versions of the compilation published in 2002, 2003, and 2005.

<sup>27</sup> MFA Sound Practices, Introduction at 2.

<sup>28</sup> Hedge Fund Working Group, *Hedge Fund Standards: Final Report* (Jan. 2008) [“UK HFWG Report”].

<sup>29</sup> Alternative Investment Management Association, *Guide to Sound Practices for European Hedge Fund Managers* (May 2007).

<sup>30</sup> CFA Centre for Financial Market Integrity, *Asset Manager Code of Professional Conduct* (2005).

<sup>31</sup> See “President’s Working Group Hedge Fund Report – Interactive Version” (April 15, 2008) <http://allaboutalpha.com/blog/2008/04/15/presidents-working-group-hedge-fund-report-interactive-version/#more-1926>.

Some of the “musts” that do appear are used to eliminate any possibility that the reader will think that the best practices are actually mandatory. See IC Report at 3 (“[I]ndividuals and institutions considering or managing hedge fund allocations must evaluate the best practices described below, determine which apply, and implement the recommendations that are reasonable given the resources available to the investors, its objectives and risk tolerance, and the particular investments under consideration”; AMC Report at iii (“We recognize that not all of the practices in this Report will be applicable to all managers at all times”); IC Report at 16 (“[E]ach best practice may not be applicable to every investment opportunity, and some of the best practices described in this report may be applicable but not possible to achieve.”)

<sup>32</sup> Although AMC Report contains 11 instances of the word “must,” it appears that none of these instances introduces a requirement that is specific enough to be enforceable if the Best Practices were made binding. The IC Report contains 38 instances of word, some of which introduce requirements that be viewed as meaningfully enforceable. For example, the Report states that hedge fund investors “must receive notification from the manager if other investors in the same fund are, or may be, offered different liquidity terms, whether through separate classes of interest or by ‘side letters’,” IC Report at 41, “must retain competent legal advice to aid in the understanding and negotiation of terms,” *id.*, and “must look beyond the PPM to gain a comprehensive understanding of the valuation processes and sources the manager uses,” *id.* at 44. Some of these requirements may simply track existing law, and in any event, investors are expressly instructed to pick and choose which best practices apply to them. The bottom line is that the Report imposes no enforceable requirements, even by its terms.

reservation by a particular hedge fund).<sup>33</sup>

Nevertheless, the Reports do “raise the bar.”<sup>34</sup> They are more specific and more demanding in many respects than the leading existing compilation of best practices for U.S. hedge funds, the MFA’s Sound Practices for Hedge Fund Managers. Differences in four key areas: investor disclosure, counterparty risk, valuation, and risk management are described below. All in all, the AMC Report’s claim that it “raises the bar for the industry”<sup>35</sup> appears to be justified, although one might question just how much the bar has been raised.

One might also question how much the bar ought to be raised. After all, hedge funds are supposed to be offered only to sophisticated investors<sup>36</sup> and typically do business with the highly sophisticated counterparties. It certainly can be argued that these parties should be left to work out their own arrangements. That said, it seems unlikely that even the harshest critics of hedge-fund regulation can object too strenuously to a voluntary regime. Moreover, to the extent that any of the strengthened requirements are unworkable, the Committees can revisit them.

An overview of the key respects in which the Reports “raise the bar” relative to existing standards follows:

#### *Investor Disclosure*

- Reports describe the overall goal of the disclosure regime in more ambitious terms than the MFA Sound Practices, suggesting that managers’ disclosures should enable investors to evaluate the fund,<sup>37</sup> rather than just enhance their ability to do so.<sup>38</sup>
- Recommends disclosures “at least quarterly”<sup>39</sup> segregating percentage of holdings and P&L attributable to assets on each of the three levels of valuation difficulty established by FAS 157.<sup>40</sup> The MFA does not make a corresponding recommendation.<sup>41</sup>

<sup>33</sup> The discussion focuses on the AMC Report. The IC Report is notable in that it reflects a regulatory focus on investors and not just managers, but the institutional investors to which the IC Report directs its recommendations are subject to an established regulatory regime. Given that these entities already are subject to a relatively well-defined set of rights and duties that do not appear likely to be significantly changed with or without the best practices, the AMC Report seems more significant than the IC Report.

<sup>34</sup> See AMC Report, at iii (“We believe this Report raises the bar for the industry”).

<sup>35</sup> AMC Report, at iii.

<sup>36</sup> It has been argued that efforts to restrict hedge-fund investment to sophisticated investors give rise to “black market” in hedge-fund capital (efforts to repackage hedge-fund investments in a form that can be marketed to the general investing public), that these “black-market” vehicles impose unnecessary risks and costs on investors, and that consequently the general public should be permitted to invest directly in hedge funds. See Steven M. Davidoff, *Black Market Capital*, 2008 Colum. Bus. L. Rev. 172.

<sup>37</sup> AMC Report, at 1 (goal is “to disclose material information with sufficient frequency and detail . . . so that investors are able to (i) make informed decisions regarding investments in the fund and (ii) appropriately monitor or manage the risks associated with exposure to the fund.”).

<sup>38</sup> MFA Sound Practices, § 2.2 (disclosures should provide investors with “adequate information to *enhance* the investors’ ability to understand and evaluate their investment in the hedge fund”) (emphasis added).

<sup>39</sup> AMC Report, at 7-8.

<sup>40</sup> As the Report explains it, Financial Accounting Standard 157 establishes a three-level hierarchy of asset valuation difficulty: Level 1 assets, the easiest to value, have observable market prices (stocks that trade on public exchanges fall into this category). Level 2 assets have some observable market price information other than quoted market prices (such as broker quotes for OTC derivatives). Level 3 assets have no observable price information (private equity investments fall into this group). It would appear that the Report in effect requires disclosure of P&L performance by asset level, because the percentage attributable to Level 1 assets could be computed from disclosures about Level 2 and Level 3 assets. According to the Report, changes to GAAP that are scheduled to be implemented by the end of audit year 2008 will require managers to report annually the percentage of assets at each level, and will also require managers to report the percentage of realized and unrealized profit and loss derived from the difficult-to-value Level 3 assets. *Id.* at vii.

<sup>41</sup> The MFA does recommend that managers adopt a standard that incorporates the concept of “fair value.” MFA Sound Practices, § 3.6. If the manager were to adopt U.S. GAAP as its standard, it would be subject to a limited FAS-level disclosure requirement, as explained above.

- Recommends quarterly investor letters and risk reports.<sup>42</sup> MFA’s recommendation is limited to annual audited financial statements.<sup>43</sup>
- Recommends (without qualification) disclosure to investors of fund’s risk profile;<sup>44</sup> MFA recommends disclosure of risk information only “if appropriate.”<sup>45</sup>
- Recommends accelerated disclosure of relevant specific events to investors based on general criteria;<sup>46</sup> MFA recommends only that manager consider consulting with counsel regarding disclosure of a small set of enumerated types of events.<sup>47</sup>

#### Valuation

The AMC Report contains more stringent recommendations than the MFA Sound Practices on manager accountability for valuation and on structural

measures to enhance the integrity of the manager’s valuations.

- The AMC Report appears to differ from the MFA Sound Practices in forbidding delegation of ultimate responsibility for investment valuation to a third party.<sup>48</sup>
- The AMC Report specifically recommends segregation of valuation personnel from portfolio management personnel.<sup>49</sup>
- The AMC Report makes an unqualified recommendation to create a valuation committee or similar body, while MFA emphasizes that this is optional.<sup>50</sup>
- The AMC Report sets a minimum frequency for reviewing the valuation framework and makes an unqualified recommendation that

<sup>42</sup> AMC Report, at 5-6 (recommending quarterly investor letters and risk reports).

<sup>43</sup> MFA Sound Practices, §§ 2.8, 3.6. Although the MFA Sound Practices contemplate the possibility of interim reporting on a “periodic” basis, the MFA does not specifically recommend reporting at a frequency greater than annually. MFA Sound Practices, § 3.14; see also *id.* § 3.10 (“A Hedge Fund Manager should establish policies for the frequency of determining a Hedge Fund’s NAV.”). The MFA does have an unqualified recommendation that managers “report” position-level market risk metrics, *id.* § 4.6, and volatility metrics, *id.* § 4.7, but does not recommend any particular frequency. Moreover, the term “report” in the MFA Sound Practices can be interpreted to refer to internal reporting within the fund, rather than disclosure to investors.

<sup>44</sup> AMC Report, at 22 (recommending that the fund’s risk management framework be “communicated to investors to enable them to assess whether the fund’s risk profile is appropriate for them and how the investment is performing against that profile.”).

<sup>45</sup> MFA Sound Practices, § 2.5.

<sup>46</sup> AMC Report, at 8.

<sup>47</sup> MFA Sound Practices, §2.2 (MFA recommends consulting with counsel in the event of changes in fund objectives or strategies, the range of permissible investments, or the terms of investment in a hedge fund). The AMC Report omits the MFA’s specific reservation of the right not to disclose: “After evaluating the circumstances, a Hedge Fund Manager may fairly conclude that it need not make additional disclosure and/or obtain consent from investors to changes in the objectives or strategies of the Hedge Fund.”). *Id.*

<sup>48</sup> MFA Sound Practices, § 3.7 (“A Hedge Fund Manager, in consultation with its governing body, should determine the party who bears ultimate responsibility for the valuation of investments and disclose this information to Hedge Fund investors.”). This suggests that a third party might be the one bearing ultimate responsibility. The AMC Report, by contrast, warns against taking “undue comfort from the independence a third-party administrator brings to the valuation process,” AMC Report, at vii, and specifically recommends that if third parties are involved, the manager “clearly delineate such parties’ roles” and “provide for appropriate oversight and monitoring.” *Id.* at 18.

<sup>49</sup> AMC Report, at 17. The MFA stresses that the decision to create a valuation committee or similar body is optional, while the AMC Report recommends without reservation that the valuation framework include “a governance mechanism, such as a Valuation Committee or other responsible body” AMC Report, at 14, that should be “structured to provide an appropriate measure of independence from the portfolio management function.” *Id.* The MFA suggests no necessary degree of independence in the valuation process, merely recommending that the manager “establish policies and procedures that ensure that NAV is marked at fair value” and that these policies and procedures should “clarify the role of each party in the valuation process.” MFA Sound Practices, §3.9.

<sup>50</sup> MFA Sound Practices, § 3.7 (“A Hedge Fund Manager may deem it necessary to establish a separate committee, such as a valuation or pricing committee, to oversee the determination of fair value in the valuation process.”).

backtesting be part of the review, unlike the MFA Best Practices.<sup>51</sup>

#### *Risk Management*

- The AMC Report calls for the risk management function to be placed under the supervision of a Chief Risk Officer or formal Risk Committee;<sup>52</sup> the MFA Sound Practices merely call for performance of the function by “appropriate personnel.”<sup>53</sup>
- The AMC Report provides that senior management “should not outsource risk monitoring or management and must retain responsibility for the overall risk framework.”<sup>54</sup> No comparable recommendation appears in the MFA Sound Practices.
- The treatment of several specific recognized risk categories (liquidity risk,<sup>55</sup> leverage risk,<sup>56</sup> market risk,<sup>57</sup> counterparty credit risk,<sup>58</sup> and operational risk<sup>59</sup>) is more detailed and prescriptive in the AMC Report than in the MFA Sound Practices.

#### Room for Improvement: The Reports’ Treatment of Systemic Risk and Counterparty Relationships

Although the Reports do appear to make meaningful and possibly helpful recommendations in some areas, their treatment of counterparty relationships is disappointingly vague. A case can be made for mandatory but vague requirements – indeed, that is arguably the heart of principles-based regulation. Likewise, a case can be made for nonmandatory but specific recommendations – best practices that fit this description can educate market participants or potentially persuade them to act better. But it is difficult to see how anything is accomplished by requirements that are both nonbinding and vague. This failing is significant because hedge funds’ counterparty relationships are critical in determining whether hedge funds pose a systemic risk that merits regulatory intervention.

“Systemic risk” can be defined as the risk that problems in the financial sector will spread and impose costs on the real economy, typically through disrupting the provision of credit.<sup>60</sup> Whether hedge funds pose a systemic risk that ought to concern regulators is hotly debated. The pro-concern side points to hedge funds’ large aggregate size and trading volume<sup>61</sup> and argues that channels exist through which distress in the hedge-fund sector could in theory spread to the wider

<sup>51</sup> Compare AMC Report, at 16 with MFA Sound Practices, § 3.9.

<sup>52</sup> AMC Report, at 24.

<sup>53</sup> MFA Sound Practices, § 4.2.

<sup>54</sup> AMC Report, at 24. The AMC Report allows for the possibility that management might rely exclusively on the services of an external provider for risk *measurement*. *Id.* (emphasis added).

<sup>55</sup> AMC Report, at 25-26; MFA Sound Practices, §§ 4.9, 4.11-4.13.

<sup>56</sup> AMC Report, at 26-27; MFA Sound Practices, §4.15.

<sup>57</sup> AMC Report, at 27-30; MFA Sound Practices, §§ 4.8, 4.10.

<sup>58</sup> AMC Report, at 30-31; MFA Sound Practices, §4.14.

<sup>59</sup> AMC Report, at 31-32; MFA Sound Practices, §4.16.

<sup>60</sup> John Kambhu, Til Scheuermann & Kevin Stiroh, *Hedge Funds, Financial Intermediation, and Systemic Risk*, FED. RESERVE BANK OF N.Y. ECON. POL. REV. (forthcoming) (available at <http://www.newyorkfed.org/research/epr/forthcoming/0708kamb.html>) (last viewed May 27, 2008), at 5-6.

<sup>61</sup> *Id.* at 4-5 (hedge funds estimated to have had about \$1.43 trillion under management at end of 2006 and to have accounted in 2005 for 89% of U.S. trading in convertible bonds, 66% of volume in distressed debt, 33% of volume in emerging market bonds and leveraged loans, 20% of speculative bond volume, and 38% of credit derivatives volume); AMC Report, at i (“\$2 trillion” currently under management at 8,000 hedge funds).

economy,<sup>62</sup> and that market failures could cause an unregulated market to produce excessive systemic risk.<sup>63</sup> Arguments advanced on the other side include: regulators’ foresight and skills are not superior to market participants’;<sup>64</sup> fears about hedge funds’ contribution to systemic risk tend to be vague,<sup>65</sup> and any additional measures needed to control systemic risk can be directed at hedge funds’ major trading partners – investment banks – which are regulated already.<sup>66</sup>

Resolving that dispute is beyond the scope of this paper,<sup>67</sup> but the PWG apparently believes that

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<sup>62</sup> *Id.* at 7-10 (identifying hypothetical ways in which hedge-fund sector losses could harm the real economy: (1) reduced bank lending to “real economy” borrowers as a result of direct bank exposure to hedge-funds; (2) capital-market disruptions such as the interest-rate and credit market disruptions that were feared in connection with LTCM’s collapse; and (3) reduced bank provision of liquidity to other hedge funds and banks.). To the extent that hedge-fund demand for securitized assets is part of a “shadow banking” system that is now critical in providing liquidity to the broader economy, as some have asserted, (see, e.g., William H. Gross, *PIMCO Investment Outlook* (Jan. 2008), at 2-3) it seems that hedge-fund losses could have a direct effect on extension of credit to the real economy.

<sup>63</sup> *Id.* at 10-13 (identifying potential market failures with respect to agency (traders’ incentives favor greater risk-taking is optimal for their employers), externalities (the cost of trades that create systemic risk are borne in large part by entities other than the trading parties), moral hazard (perceived regulatory guarantees against failure reduce banks’ incentives to monitor risks, including risks of trading with and financing hedge funds). Kambhu et al. also assert that the possibility that competition for apparent profits in trading with hedge funds may cause banks to relax risk controls, without identifying this effect as a specific market failure.

<sup>64</sup> See Peter J. Wallison, *Bear Facts: The Flawed Case for Tighter Regulation of Securities Firms* (April 2008).

<sup>65</sup> See Houman B. Shadab, *The Challenge of Hedge Fund Regulation*, REGULATION (Spring 2007), at 39 (“Worries about market failure from contagion are mostly hypothetical.”).

<sup>66</sup> See *The Financial Economists Roundtable Statement on Long-Term Capital Management and the Report of the President’s Working Group on Financial Markets* (Oct. 6, 1999) (“hedge fund creditors are typically large financial institutions which are already highly regulated”). A related point is made in Dwight Jaffee & Mark Perlow, *Investment Bank Regulation after the Bear Rescue* (April 2008) (arguing for regulatory changes in the wake of the Bear Stearns rescue to strengthen SEC oversight of major investment banks, including structural separation of investment and counterparty activities and empowering the SEC to order “prompt corrective action” to raise capital).

<sup>67</sup> The difficulty of the problem is illustrated by the qualified conclusion drawn by the Financial Economists Roundtable, a group of senior financial economists: “The FER believes that

hedge-fund related systemic risk is at least a potential issue, because it asserted that mitigating systemic risk is a key part of the Committees’ mission.<sup>68</sup> The Committees likewise asserted that their efforts will reduce systemic risk.<sup>69</sup>

If hedge funds do contribute significantly to systemic risk, it seems they do so primarily through their relationships with trading counterparties, not through their relationships with investors.<sup>70</sup> If, for example, hedge-fund difficulties were to cause bank failures, reduce banks’ ability to extend credit to other borrowers, cause particular financial markets to seize up, or disrupt the provision of capital by reducing demand for securitized products, the problems would spread primarily via counterparties, not investors.

Nevertheless, the Reports focus heavily on the investor-manager relationship, not the relationship between hedge funds and trading counterparties.<sup>71</sup> The two Committees (which worked together on the Reports),<sup>72</sup> represented managers and investors, not hedge-fund counterparties. The AMC Report devotes about 5 of its 50 pages to counterparty relationships.

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systemic risk [from hedge fund failures] of a cascading nature that would jeopardize financial institutions is now small, but we recognize the inherent difficulty in drawing any firm conclusion in this regard.” *Statement of the Financial Economists Roundtable on Hedge Funds* (Nov. 3, 2005).

<sup>68</sup> See sources cited, *supra* note 24.

<sup>69</sup> AMC Report, at ii (“the promotion of robust industry practices, such as those set forth in the Report, will be critical to and consistent with the goal of reducing systemic risk”); *id.* at iii (“[o]ur mandate was to develop best practices to address systemic risk and foster investor protection”).

<sup>70</sup> See Ben S. Bernanke, *Hedge Funds & Systemic Risk* (speech given May 16, 2006) (“Effective market discipline requires that counterparties and creditors obtain sufficient information to reliably assess clients’ risk profiles . . . .”); Counterparty Risk Management Policy Group II, *Toward Greater Financial Stability: A Private Sector Perspective: The Report of the Counterparty Risk Management Policy Group II* [“CRM II Report”] (July 27, 2005), at 7 (“credit risk, and in particular counterparty credit risk, is probably the single most important variable in determining whether and with what speed financial *disturbances* become financial *shocks* with potential systemic traits”) (emphasis in original).

<sup>71</sup> See, e.g., AMC Report, at iii-iv (“What is critical is that managers are able to explain to investors how they have implemented and adopted the practices in the Report.”).

<sup>72</sup> AMC Report, at ii.

The key recommendation of the AMC Report regarding hedge funds’ disclosures to counterparties is that managers should “foster positive and cooperative relationships” with counterparties, and that managers and counterparties should “agree at the beginning of their relationship” about information disclosures, and that appropriate information to disclose “may include” disclosures of the fund’s strategies and allocations among strategies, the manager’s risk management framework, and the fund’s performance.<sup>73</sup>

With respect to counterparty credit risk, the Report recommends that managers monitor exposure to credit risk, assess the creditworthiness of potential and actual counterparties, and “consider taking steps to increase . . . access to liquidity in the event of market stress.”<sup>74</sup> The Investors’ Committee report has even less to say about counterparty credit risk; in effect it merely notes that potential hedge fund investors should be aware that hedge funds take on counterparty credit risk<sup>75</sup> and that they should “assess the manager’s approach to counterparty credit risk and its mitigation, including the amount of exposure a manager has to any counterparty, how it assesses counterparty creditworthiness, whether it imposes limits on counterparty credit risk (and if not, why not), and how it monitors that risk on an ongoing basis.”<sup>76</sup>

Although these recommendations are somewhat more concrete than the recommendations in

the MFA Best Practices, particularly in the areas of counterparty risk disclosure,<sup>77</sup> and counterparty selection,<sup>78</sup> it is hard to believe that any risks that hedge funds may pose to the financial system are going to significantly mitigated by telling managers that they “may” wish to make certain disclosures to their counterparties and that they should monitor their exposure to credit risk and assess counterparties’ creditworthiness.<sup>79</sup> Indeed, the recommendations in the

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<sup>77</sup> The MFA suggests only that managers “maintain an open dialogue with credit providers with respect to credit terms and conditions, including the extent of financial and risk information to be provided to such parties.” MFA Sound Practices, §4.13. Although the AMC Report does not make unqualified recommendations of any particular disclosures, it suggests that managers consider “quantitative and qualitative disclosures regarding the strategies employed by the fund,” “disclosure of the Manager’s risk management framework (including its approach to market and liquidity risk), and “quantitative and qualitative disclosures of the fund’s performance and NAV.” AMC Report, at 12. The AMC Report also recommends that managers “be willing to assist counterparties in understanding and interpreting disclosures” and that they “consider whether it is appropriate for the level of communication with its counterparties to increase under certain circumstances (e.g., during times of market stress that may affect the fund’s strategies).” *Id.*

<sup>78</sup> The AMC Report contains more detailed recommendations regarding the hedge fund’s exposure to counterparty credit risk. The MFA recommends that managers “identify acceptable counterparties based on a counterparty’s creditworthiness and set appropriate risk limits based on such analysis” and “ensure that the counterparty’s creditworthiness is appropriately monitored.” MFA Sound Practices, § 4.14. Both the MFA Sound Practices and the AMC Report address the related issue of collateral agreements with counterparties. See MFA Sound Practices, §§ 6.3, 6.4. AMC Report, at 26, 34-35. The AMC Report goes into more detail on this point, calling attention to the fact that a counterparty’s subsidiaries and affiliates may have different creditworthiness, recommending that managers “weigh the desirability of diversifying counterparty credit risk by using multiple prime brokers” against “any increases in the complexity of settlement, reconciliation processes, and daily collateral management,” *id.* at 30-31, and recommending that the manager “consider taking steps to increase its access to liquidity” in the event of market stress, “such as opening cash and custody accounts at financial institutions other than its prime brokers.” *Id.* at 31.

<sup>79</sup> The 2005 report of the Counterparty Risk Management Policy Group II, a group of representatives of investment banks and institutional investors, provides an interesting contrast with the AMC Report. It contains several recommendations for dealing with counterparty risks, including recommendations (1) that credit providers “periodically review” their counterparties’ risk measurement analytics in detail and that they “run their own sensitivities on the institution-specific portfolio, when required;” (2) that credit providers “obtain disclosures of contingencies that may have a material impact on the credit quality of the counterparty.” CRM II Report at 13-

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<sup>73</sup> AMC Report, at 12. The Report also recommends that managers be “willing to assist counterparties in understanding and interpreting disclosures” and “consider whether it is appropriate for the level of communication with its counterparties to increase under certain circumstances (e.g., during times of market stress that may affect the fund’s strategies and performance, including during periods of increased volatility or tightening credit terms.” *Id.*

<sup>74</sup> AMC Report, at 30-31. The Report also recommends that managers fully understand prime-broker relationships and “weigh the desirability of diversifying counterparty credit risk by using multiple prime brokers and counterparties.” *Id.*

<sup>75</sup> IC Report, at 6, 8.

<sup>76</sup> *Id.* at 28. The IC Report also recommends specifically that investors evaluate counterparty risk arising from the firm’s choice of prime broker. *Id.* at 34.

AMC Report are less specific than the general principle adopted in the interagency agreement, namely that hedge-fund managers should “provide information frequently enough and with sufficient detail that creditors, counterparties, and investor stay informed of strategies, the amount of risk being taken by the pool, and any material changes.”<sup>80</sup>

Best practices may in theory be useful by disseminating valuable information to managers who may not have thought through certain issues or by persuading managers to undertake conduct they have thought of but would not otherwise undertake. To succeed in either respect, it seems the recommendations would have to be much more concrete in describing, for example, under what circumstances the various categories of information should be disclosed, how counterparty creditworthiness should be assessed, and what criteria standards should be applied under what circumstances. Although it might be argued that (a) it is fruitless to expect managers to take actions that are materially against their interest because a set of best practices tells them to do so, or (b) that it is impossible to formulate more specific best practices, those objections seem to undermine the “moral suasion” and “disseminating information” rationales for best practices, respectively.

Of course, these Reports are not the end of the road. The Committees apparently are set to continue meeting, and their future labors may result in

more specific and effective guidance relating to counterparty relationships.

But another way of looking at the best practices, at least those relating to counterparty risks, suggests itself: Adopting best practices, meaningful or not, suggests that the industry is doing *something* to address concerns. Best practices may therefore “forestall[] future efforts to impose inappropriate government regulation on the industry,” as the UK Hedge Fund Working Group observed.<sup>81</sup> It seems at least possible that warding off ill-advised regulation is the main purpose, and will be the main effect, of the best practices – at least as far as systemic risk is concerned.

A hands-off policy relating to systemic risk may well be justified. After all, the hedge-fund industry has produced tremendous innovation and growth under light regulation. Hedge funds are not widely perceived to have created the 2007-08 crisis, and the industry in aggregate has weathered the latest period of financial stress well so far, although individual funds have failed. Even so, given the importance of systemic risk and the fact that hedge funds’ contribution to systemic risk is not well understood, further research into the risk that a network of highly leveraged counterparties will fail seems justified. A better understanding of this issue may either point the way to worthwhile and substantial regulatory intervention or increase confidence in the conclusion that no such intervention is needed.

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14. These appear to go beyond what the AMC Report contemplates, although the vagueness of the AMC Report makes it impossible to be sure. The CRM II Report also recommends “that the private sector, in close collaboration with the official sector, convene a high-level discussion group to further consider the feasibility, costs, and desirability or creating an effective framework of large-exposure reporting at regulated financial intermediaries that would extend – directly or indirectly – to hedge funds.”). *Id.* at 150. Although the AMC Report acknowledges the recommendations in the CRM II Report, it does not adopt them or expressly urge managers to cooperate with institutions that attempt to implement the CRM II recommendations. AMC Report, at 12 n.7.

<sup>80</sup> Interagency Agreement § 9.3, at 5.

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<sup>81</sup> UK HFWG Report, at 101.

## **Appendix: Summary of Key Committee Recommendations**

The specific recommendations have been summarized in detail elsewhere.<sup>82</sup> This summary addresses only the points that seem most significant.

### **Asset Managers’ Committee Report**

#### Disclosure:

- Seeks to take “core principles” of the public company reporting regime and adapt them to hedge funds.
- Discusses private placement memorandum, periodic performance information and other investor communications.
- Recommends that all hedge funds provide annual audited GAAP-compliant financial statements to investors.
- Recommends that hedge funds and counterparties agree at initiation of the relationship on the information the hedge fund will make available, adding that such information should be subject to appropriate protection of confidentiality.

#### Valuation:

- Recommends adoption and consistent application of an asset valuation framework
- Recommends segregation of functions between portfolio managers and those responsible for valuing positions to mitigate potential issues created by the facts that valuation of assets affects manager compensation and that assets in which hedge funds invest often do not have readily ascertainable market values. Notes that this approach is generally similar to that adopted by other financial institutions that invest in hard-to-value instruments.
- Emphasizes that where a third-party administrator is used to value assets, investors and managers should not take undue comfort from this arrangement, and that the manager may have to be involved with valuation and must take ultimate responsibility for valuation decisions.
- Recommends that managers report what percentage of fund assets are at each level of the FAS 157 hierarchy of valuation difficulty (Level 1 assets have observable market prices; Level 2 assets have some observable market price information other than quoted market prices; Level 3 assets have no observable market price information).
- Recommends procedures for use in “side pocket” funds.

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<sup>82</sup> See, e.g., WilmerHale, “PWG Hedge Fund Committees Announce Best Practices,” available at <http://www.wilmerhale.com/files/Publication/929607b2-d535-48de-876b-4bf2624c2fd0/Presentation/PublicationAttachment/d216908c-fb4a-4347-9fda-c9d5a7e88574/Hedge%20Fund%20Committees%20Release%20Industry%20Best%20Practices%20Part%201.pdf>.

Risk management:

- Recommends that managers determine an overall risk profile for the fund and adopt a comprehensive framework to measure, monitor, and manage risk.
- Recommends that managers “regularly disclose risk information” to investors but notes that because “confidentiality remains important,” “it is not expected that investors will be provided with all information used to monitor risk.
- Recommends that managers “assess the creditworthiness of counterparties and make sure that they understand the often complex legal relationships between funds on the one hand and prime brokers or other counterparties on the other.

Trading and business operations:

- Recommends appointment of a member of senior management with responsibility for operations, segregation of duties and checks and balances in operations and systems, and infrastructure and automation commensurate with a manager’s business.

Compliance, conflicts, and business practices:

- Recommends adoption of a written code of ethics, written compliance manual, a process for handling conflicts of interest, a “robust” training program to educate personnel, and a compliance function that includes a Chief Compliance Officer, appropriate discipline and sanctions and an annual review of the compliance framework.

### Investors’ Committee Report – Fiduciaries

- States that “no fiduciary should feel obligated to implement a hedge fund investment program” and that “[t]he requirement that hedge fund investments are only for sophisticated investors cannot be overemphasized.”
- Emphasizes the importance of the fiduciary’s determination that its investment staff and agents “have the requisite expertise and resources to conduct sufficient due diligence and monitoring”

#### Hedge fund investments and allocations:

- Recommends that fiduciaries consider hedge fund investments only if:
  - The manager is skilled and the benefit of this skill remains after fees
  - The fiduciary can distinguish between skill-based managers and managers generating profit from generic market exposure
  - The fiduciary will have the opportunity to invest in hedge funds that are identified as suitable investments.
- Recommends that fiduciaries consider hedge-fund returns and risk (including difficult-to-measure risks like liquidity and business risk) in the context of the entire portfolio.
- Recommends that fiduciaries consider diversification across hedge-fund strategies, potentially through funds of hedge funds.

#### Hedge fund investment policy:

- Recommends that fiduciaries “develop explicit policies that define the key features and objectives of the hedge fund investment program,” addressing at a minimum:
  - The strategic purpose of investing in hedge funds
  - Whether the hedge fund program is consistent with the investment beliefs, objectives, and risk profile of the investment program
  - The performance and risk objectives of the hedge fund investment program
  - Who will manage the hedge fund investment program
  - What investment guidelines will apply to the range of funds and strategies that can be used, the number of funds to be targeted, and the risk and return targets for those funds

#### Due diligence process:

- Asserts that “best practices objectives for due diligence are applicable across all investment activities and categories” but that “particular care should be exercised in due diligence of hedge funds” because such funds
  - Are frequently young and small
  - Use leverage
  - Present the possibility of concentrated exposure to market and counterparty risks
  - Are more lightly regulated
- Points out specific legal, tax, and accounting considerations for hedge fund investors (such as the investment vehicle’s legal structure and domicile), and points out special considerations applicable to ERISA fiduciaries.

- Describes areas for ongoing monitoring of investments, such as style drift.

### Investors’ Committee Report– Investors

This portion of the Report is directed at “the internal and external personnel who are responsible for actually implementing and executing” hedge fund investment programs

#### Due diligence process:

- States that because of the limited transparency of hedge funds, they require “a level of due diligence above and beyond what is required for more transparent investments that are strictly regulated.”
- Recommends use of a due diligence questionnaire (DDQ) that covers the manager’s investment process, historical performance and reasons for historical performance, personnel, risk management, third-party service providers, as well as the hedge fund’s structure, domicile, and compliance policies and procedures, as well as the fund’s material terms, such as fees, liquidity restrictions, investment limitations, and leverage.
- Recommends specific issues to consider, including:
  - The risk associated with loss of key persons, compensation and governance structure
  - The manager’s ability to operate a fund successfully in varying market environments
  - Obtaining appropriate risk reporting to monitor potential style drift,
  - The manager’s reliance on models, including assumptions, model inputs, risks associated with the models the manager employs and the expected frequency of material and substantive model changes, and whether the manager intends to notify investors when such changes are made.

#### Risk management:

- Recommends that investors adopt a risk management program that is independent of the management selection process and the process for monitoring investment performance.
- Recommends that investors demand that hedge-fund managers have an independent risk management function with compensation not tied to portfolio performance that reports directly to senior management, or that whatever risk management structure is in place provides “meaningful risk management” to the fund.
- Recommend that investors review fund’s risk reporting before investing to determine whether the reports adequately address the disclosure needs and risk parameters of the investor.
- Enumerates specific considerations applicable to investment risk (including market risk, event risk, counterparty risk, and “meta risk”) and liquidity and leverage risk.
- Recommends that investors understand the manager’s compliance function and review separation of operational and portfolio management functions.
- Recommends that investors be aware of the fund’s prime broker and other material credit or trading counterparties and financial arrangements of the fund with those parties, such as margin and collateral requirements, negative and positive covenants, and default triggers.
- Recommends a checklist of items to consider relating to fraud and other crime, IT and business recovery, conflicts of interest, and service providers.

Legal and regulatory:

- Recommends that investors ensure that hedge funds prepare audited financial statements that follow “acceptable” accounting standards such as US GAAP or IFRS , and that they understand the legal ramifications for dispute resolution and tax purposes of the locations of the hedge fund’s domicile and investments.
- Instructs that investors “must” receive notification from the manager if other investors in the same fund are, or may be, offered different liquidity terms and “must retain competent legal advice” to negotiate terms.
- Recommends that investors “request and receive from the fund manager all pertinent information on material terms which differ from those of other investors who have invested in the fund.”
- Prescribes items to consider in reviewing the fund’s legal documents, such as the manager’s discretion and fees, limits on redemption of investments, and the use of “side-pockets.”
- Enumerates special considerations for ERISA fiduciaries. Recommends that investors determine if the fund manager is registered with or licensed by any regulatory body and, if so, review all information available by virtue of such registration or licensing.

Valuation:

- Recommends that investors verify that the manager has established a written statement of valuation policies and procedures, that the policy is consistently applied, and that the valuations are consistent with GAAP or other relevant standards.
- Specifically recommends that investors “understand the functioning of the valuation committee or other governance structure” and “confirm that adequate segregation of valuation duties exists.”
- Recommends that investor confirm that manager uses secondary sources wherever possible, uses multiple sources for dealer quotes, uses only valuation models that are independently tested and verified, and uses a consistent approach for valuing side-pocket or illiquid/hard-to-value positions.
- Recommends practices for valuation control, including a recommendation that investors “seek an independent valuation semi-annually in funds that hold significant assets for which there is not a liquid market, where practicable.”

Fees and expenses:

- Recommends that investors determine the overall percentage of total and excess return they are willing to pay each investment manager and actively negotiate fees and performance targets.
- Recommends that performance fees be calculated based on audited portfolio valuations or “trued up” to such valuations, that they be calculated based on dollars of total value added, not percentage returns or average capital invested.
- Recommends that performance fees be calculated over a period of time that is appropriate given the volatility of the hedge fund strategy’s returns.

Reporting:

- Notes that “[g]iven the broad range of strategies that hedge funds can employ, it is difficult and impractical to prescribe precise disclosure standards”

- Recommends that investors “employ a process” to assess reporting adequacy, review sample reporting, and confirm that firm will continue providing those metrics.”
- Recommends that investors receive “appropriate” information regarding a hedge fund’s strategies, terms, conditions, and risk management” and “[a]t a minimum, investors should receive timely and agreed-upon aggregate metrics that adequately capture material portfolio risks.”
- Recommends that disclosure provide “sufficient details about the hedge fund’s individual holdings to allow the investor to evaluate the associated risk exposures, such as the types of securities the fund holds, broken down by sector, duration, credit quality, geographic region, and exposures related to derivatives positions.”
- Recommends that investor develop a comprehensive approach regarding measurement of investment performance at the portfolio level, the investment strategy level, and the manager level.
- Recommends that investors demand “a marginal contribution to return and marginal contribution to risk analysis of their hedge fund strategies to the extent that it is crucial for the investor’s assessment of the proper role of the hedge fund strategy” and that they “require that hedge funds provide total fund volatility and residual risk measures for their investment portfolios.”
- Contains recommendations for performance measurement for funds of funds.

Taxation:

- Recommends that investors seek competent advice on tax issues including unrelated business taxable income and U.S. and non-U.S. withholding taxes.
- Recommends that investors “obtain adequate information regarding a fund’s allocation of capital gains to redeeming investors.”