

May 15, 2008

Memorandum to Our Investment Management Clients and Friends

President's Working Group on Financial Markets Releases Best Practices for the Hedge Fund Industry and Hedge Fund Investors

(I) Introduction

Two private-sector committees established by the President's Working Group on Financial Markets have issued complementary sets of best practices for the hedge fund industry and hedge fund investors in an effort to increase accountability for participants in the hedge fund industry.¹

(II) Best Practices for the Hedge Fund Industry

On April 23, 2008, the Asset Management Committee formed by the President's Working Group on Financial Markets released a report entitled "Best Practices for the Hedge Fund Industry," (the "AMC Report"), which has as its stated goals the reduction of systemic risk and the fostering of investor protection. Representatives from a diverse group of investment advisory firms served as members of the Asset Management Committee.

The AMC Report calls on hedge fund managers to adopt comprehensive best practices in all aspects of their business, and elaborates on the recommendations contained in the Managed Funds Association's "Sound Practices for Hedge Fund Managers", currently often used as a guide to best practices in the industry. The AMC Report recommends enhanced controls and procedures in five critical areas of the investment advisory business, as set forth below:

1. **Disclosure:** The AMC Report sets forth the basic elements of disclosure that managers should make available to all investors, drawing from key elements of the public company disclosure regime. The suggested disclosure framework includes a private placement memorandum, annual GAAP-compliant audited financial statements, quarterly performance information including risk reports, as well as timely disclosure of significant events in light of the circumstances. In addition, the AMC Report suggests that hedge funds and their counterparties, such as banks and broker dealers, should agree on the types of information that will be made available by the hedge fund to such counterparties. The AMC Report also discusses enhanced disclosures to investors in the context of valuation and risk management as outlined below.

¹ For a copy of the reports, please go to <http://www.ustreas.gov/press/releases/hp927.htm>.

2. **Valuation:** The AMC Report recommends that managers adopt a valuation framework with consistent and documented policies, and segregation of responsibilities between portfolio managers and those responsible for valuations. The AMC Report notes the potential conflict of interest that results when hedge funds invest in assets which do not have readily available market prices, since valuation has a direct impact on the compensation received by managers. The AMC Report recommends the establishment of a valuation committee, which will have ultimate responsibility for establishing and monitoring compliance with the manager's valuation policies. In addition, the AMC Report suggests enhanced disclosures to investors in connection with valuation, including the percentage of their assets that (i) have observable market prices (Level 1 assets as defined by Financial Accounting Standard 157 (FAS 157)), (ii) have some observable market price information other than quoted market prices (Level 2 assets as defined by FAS 157), and (iii) have no observable market price information (Level 3 assets as defined by FAS 157), and provide realized and unrealized profit and loss information for Level 2 and Level 3 assets, at least quarterly. Finally, the AMC Report provides guidance on the appropriate use of side pockets, including factors managers should consider in (i) deciding whether to move an investment in or out of side pockets, (ii) valuing assets in the side pocket, and (iii) determining fees, investment restrictions and redemption restrictions connected to the use of side pockets.
3. **Risk Management:** The AMC Report maintains that the first and most important aspect of risk management is that a manager needs to determine the overall risk profile for the funds it manages. Therefore, it recommends that managers adopt a comprehensive framework to measure, monitor and manage risk consistently with the intended risk profile, and that qualitative risk disclosure be made to investors. Common elements of a risk management framework would be that managers (i) identify risks to the portfolio, (ii) measure the principal categories of risk, and (iii) adopt policies and procedures that establish monitoring and measurement criteria, maintain a regular and rigorous process of risk monitoring, and retain knowledgeable personnel to measure and monitor risk. The AMC Report also recommends that managers assess the creditworthiness of counterparties and fully understand the complex legal relationships they may have with prime brokers or lending or derivative counterparties and their affiliates.
4. **Trading and Business Operations:** The AMC Report recommends a comprehensive framework for a manager's trading and business operations, including (i) a member of senior management with responsibility for operations, supported by adequate resources, (ii) policies and procedures that address segregation of duties and reconciliation, (iii) checks and balances in operations and systems, and (iv) infrastructure and automation.
5. **Compliance, Conflicts and Business Practices:** The AMC Report stresses the importance of a continued commitment to the highest standards of integrity and professionalism within the industry. In this regard, the AMC Report recommends (i) a written code of ethics, (ii) a written compliance manual, including a process for handling conflicts of interest and a robust training program to educate personnel regarding the manager's policies, and (iii) a compliance function that includes a Chief Compliance Officer, appropriate discipline and sanctions, and an annual review of the compliance framework. The compliance framework should be supported by a culture of compliance

that includes a commitment from the most senior levels of management and an environment in which each person within the firm regards compliance as his or her own responsibility and feels empowered to raise concerns. The AMC Report identifies potential conflicts relevant to the industry; however, it also recommends the establishment of a Conflict Committee as the focal point for reviewing and addressing potential conflicts as they arise.

The AMC Report states that managers in the industry have found that implementing strong internal controls and business practices have provided a platform for stability and growth, enhanced client relationships, and enabled them to carry out investment activities more effectively and efficiently.

The AMC Report also stresses the importance of flexibility in establishing and implementing frameworks dealing with the five critical areas outlined above. In particular, the Asset Management Committee states that it fully expects that smaller managers will be unable to adopt all of the practices in the AMC Report, especially at inception, but that the AMC Report should provide helpful guidance and direction as they build and develop their businesses.

Comparison with MFA's "Sound Practices for Hedge Fund Managers"

The AMC Report elaborates on many of the recommendations contained in the Managed Funds Association's "Sound Practices for Hedge Fund Managers," which is often used as a guide to best practices in the industry. The AMC Report provides more detailed guidance related to a manager's obligations in connection with compliance, disclosure, collateral management, accounting and risk management. Most notable is the AMC Report's recommendation pertaining to valuation, particularly, the Committee's suggestion that managers separate the functions related to valuation and portfolio management.

(III) Best Practices for Hedge Fund Investors

Concurrent with the release of Best Practices for the Hedge Fund Industry by the Asset Management Committee, the Investor's Committee released a report (the "IC Report") intended to set new standards to help investors with the decision to invest in hedge funds, as well as the management and oversight of hedge fund investments. The IC Report includes both an "Investor's Guide" and a "Fiduciary's Guide."

It will be very useful for hedge fund managers to be aware of the contents of the IC Report, as it is likely that more and more fiduciaries and other investors will adopt many of the recommendations set forth therein in making decisions about hedge fund investments.

1. The Investor's Guide

The Investor's Guide describes best practices and guidelines for investment professionals charged with administering hedge fund investment programs. The IC Report focuses on:

1. **Due Diligence:** The IC Report recommends that proper due diligence be tailored to the circumstances and objectives of each investor and to the particular risk and reward character of each hedge fund investment. The IC Report provides best practices in connection with material aspects of the due diligence process.
2. **Risk Management:** The IC Report recommends best practices for establishing the investor's risk management program, as well as for evaluating, monitoring and managing the risks to which the hedge fund investment may be subject.

In addition, the IC Report gives investors guidelines and recommends best practices with respect to their examination of the legal and regulatory (including taxation) structure, valuation guidelines, and reporting standards of hedge funds.

2. *The Fiduciary's Guide*

In addition to the material in the Investor's Guide, the Fiduciary's Guide makes additional recommendations relevant to plan trustees, banks, consultants and investment professionals charged with evaluating the appropriateness of hedge funds as a component of an investment portfolio.

1. **Suitability of Hedge Fund Investments:** The IC Report provides a set of questions to be considered by fiduciaries in assessing the appropriateness of investing in hedge funds, and recommends the development of explicit policies that define key features and objectives of the hedge fund investment program.
2. **Due Diligence Process:** The IC Report gives additional information with respect to the due diligence process as it applies to fiduciaries.

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If you have any questions regarding this memorandum, please contact your primary attorney in the Investment Management Group at Seward & Kissel LLP.