FS Regulatory Briefs*

President's Working Group Asset Managers' Committee Report - "Best Practices for the Hedge Fund Industry"

Kent Knudson, Director
Anjali Kamat, Director

On April 15, 2008, the Asset Managers' Committee (AMC) of the President's Working Group (PWG) on Financial Markets released its report titled "Best Practices for the Hedge Fund Industry." The AMC's report calls on hedge fund managers, both registered and unregistered, to establish a best practice "framework" in the critical areas of (i) disclosure, (ii) valuation, (iii) risk management, (iv) operations and (v) compliance/conflicts.[1] The report publicly acknowledges the huge growth and influence of hedge funds and the accompanying need for robust business practices and accountability.

In adopting and implementing a best practice framework, managers are advised to assess their business as a whole and tailor their controls based on activities and circumstances specific to their operations. The standards encourage Hedge Fund managers to consider the following when designing their controls:

- The desired goals and essential elements of the framework;
- The need for clear and consistent policies and procedures;
- A regular process to review and update the framework; and
- The dedication of adequate resources and knowledgeable personnel to support the framework.

While various controls discussed in the report may be standard industry practice, particularly for registered hedge fund managers, the report provides a comprehensive guide for managers to use in revisiting their control structures. In our view, while the report is based on past industry efforts, it lays-out standards that are more descriptive, specific and actionable than previous guidance. Of particular note are recommendations made in the areas of disclosure and valuation, which will require significant efforts from hedge fund managers beyond current general practices.

[1] The AMC's report is available at http://www.ustreas.gov/press/releases/reports/amcreportapril152008.pdf

Salient points in each of the five areas noted in the report are discussed below.

Disclosure

The goal of hedge fund disclosures should be to help investors (i) make informed investment decisions and (ii) monitor and manage the ongoing risks associated with their investments. Disclosures to counterparties and credit providers are also essential. Key investor disclosures, including conflicts of interest, key personnel changes, changes in operating or valuation procedures, and other material information, should be made in private offering memos, financial reports, performance reports, risk reports, and investor letters.

Key best practices to be considered are:

- Provision of quarterly risk reports to investors disclosing, among other things, portfolio asset types, geography, leverage employed and the basis on which it is calculated, concentration of positions, and material changes in asset allocation.
- Does the firm include a qualitative performance discussion to help investors better understand the factors behind fund's quantitative performance?
- Pursuant to FAS 157, at the end of the 2008 audit year, managers will be required to categorize assets in three levels based on valuation difficulty: Level 1 (i.e., marketable securities), Level 2 (i.e., assets with some observable market price like broker quotes), and Level 3 (i.e., illiquid, hard-to-value

assets). Significantly, the report goes beyond FAS 157's annual disclosure requirement and recommends making this disclosure to hedge fund investors quarterly, including how fund performance is attributed to each category.

- How do managers guard against disclosing key information to one or a select few investors?
- Does the firm have a process in place to annually review its private placement memoranda to assess whether, in light of ongoing developments in the fund, new or additional disclosures are necessary?
- Has the manager determined and agreed on the nature and frequency of communications/reports that must occur with counterparties?

Valuation

The report highlights recent concerns with valuation and related conflicts. It emphasizes that managers should establish a framework to ensure independent and consistent valuation of investment positions. The framework should ensure adequate segregation of the portfolio management and trading function from valuation with oversight from senior management in the form of a Valuation Committee.

Fund managers and investors should ask:

- Does the manager have a Valuation Committee, including senior management, in place, responsible for establishing valuation policies and providing ongoing oversight in the valuation process?
- Is the valuation process sufficiently independent from the portfolio management function, even when portfolio managers and traders have input or can challenge a valuation?
- Are the manager's valuation policies reviewed at least annually by the Valuation Committee to ensure the fairness of the policy and feasibility of consistent application?
- Does the manager back test a sample of its valuations against recent sale prices to help assess the effectiveness of the manager's valuation process, particularly for securities categorized in Levels 2 and 3 of the FAS 157 tiers?
- Does the manager maintain documentation to support the valuation of illiquid securities?
- Does the manager use "side pockets"? Are there established guidelines for when an investment may be transferred into/out of the side pocket other than when the investment is purchased/sold?

Risk Management

The manager's risk framework should allow the measurement and monitoring of risk in relation to the fund's pre-determined risk profile. In addition to disclosing the fund's risk profile, there should be clear and consistent risk reporting to investors. The principal categories of risk detailed in the report include, liquidity risk, leverage, market risk, counterparty credit risk and operational risk. Key Risk Management issues to consider include:

- Has a risk profile been determined for each fund? Has senior management been involved in determining such risk profile?
- Does the manager have a Chief Risk Officer responsible for the risk framework established?
- Does the Chief Risk Officer have regular dialogue with portfolio managers and senior management to clearly understand each fund's positions and strategies?
- Does the manager have measurement and monitoring processes in place to review principal categories of risk including, liquidity risk, leverage, market risk, counterparty credit risk and operational risk?
- If risk measurement processes are outsourced to an external provider, do the Chief Risk Officer and senior management continue to hold responsibility for the outsourced processes, as recommended in the report?

Trading and Business Operations

The report's discussion of trading and business operations emphasizes developing an integrated framework suitable for the size and complexity of the manager's activities and investment strategies. As part of this, the manager should adopt policies and procedures and have checks and balances in place for various operational and accounting functions including:

- Selection and monitoring of its counterparties;
- Management of cash, margin and collateral requirements;
- Selection of key service providers;
- Adequate accounting and operational processes; and
- Disaster recovery plan.

Key issues to consider in the area of trading and business operations include:

- Does the manager have a Chief Operating Officer (or other senior manager) responsible for business operations, and are those operations sufficiently segregated between business operations and portfolio management processes?
- Does the manager have adequate systems and automation to support the size and nature of its business, and are systems and infrastructure reviewed on a regular basis to ensure they are current in light of internal and external changes?
- Does the manager have a robust disaster recovery plan, which is tested on a regular basis? Does the disaster recovery plan cover all aspects of the manager's operations (not just technology based recovery)?

Compliance, Conflicts and Business Practices

The report emphasizes a manager's compliance and conflicts framework can be effective only if the firm has a culture of compliance that emanates from senior management down to all levels through personal example, communication and training. As part of this framework, the report requires that managers adopt a written code of ethics, a written compliance manual and of particular note, a Conflicts Committee to review various conflict of interest issues.

Key Issues to consider in the area of compliance, conflicts and business practice include:

- Does the manager have a committee in place, with representation from senior management (including the Chief Compliance Officer), to review various conflict of interest issues? Conflicts could arise from many issues including proprietary trading, valuation processes, allocation of expenses, gifts and affiliate relationships.
- Once a real or potential conflict is identified, does the manager adopt policies and procedures to address the conflict and ensure its application is consistent, disclosed and controlled?
- Does the manager have a written Code of Ethics, which addresses issues such as personal trading, gifts and entertainment?
- Does the manager have a written Compliance Manual, which includes policies in the areas of trading and business practices, marketing and communications, and anti-money laundering as discussed in the report?
- Does the manager have effective surveillance systems in place to monitor compliance with its policies and procedures, including testing and review of relevant documentation?
- In the event of non-compliance, does the manager have a disciplinary action and sanctions process?
- Is the manager's compliance framework assessed at least annually to ensure effectiveness?

Conclusion

Overall, while the report is not legislation for the hedge fund industry, it certainly sets a higher standard, which if adopted by hedge fund managers, will provide greater comfort to regulators and investors alike. It is an acknowledgement that hedge funds have grown-up as an industry, and that with growing influence and resources comes a responsibility to increase transparency and controls over the management of "other people's money." The framework is very detailed, and together with developing valuation guidance sets forth an ambitious agenda for the industry. The challenge now will be for hedge fund managers to undertake honest self-assessments in measuring their activities and disclosures against these high standards.

Additional Information

If you would like additional information about the topic discussed in this FS Regulatory Brief, please call:

Kent Knudson, Director	703-918-1377
Anjali Kamat, Director	610-933-4340
Daniel Ryan, Principal	646-471-8488
David Sapin, Principal	703-918-1391

If you would like additional information about PwC's Financial Services Regulatory practice, please call:

David Albright, Principal	703-918-1364
John Campbell, Principal	646-471-7120
Roger Coffin, Principal	646-471-2545
Carlo Di Florio, Principal	646-471-2275
Jeff Lavine, Partner	703-918-1379
Ric Pace, Principal	703-918-1385
Bruce Roland, Principal	410-783-7650
Ellen Walsh, Principal	646-471-7274
Harold Schuler, Managing Director	703-918-1392
Gary Welsh, Managing Director	703-918-1432
Dan Weiss, Managing Director	703-918-1431

www.pwcregulatory.com