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Reports on Best Practices for Hedge Fund Managers and Hedge Fund Investors; Recommendations Open for Public Comment

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TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 17-08
SEC RULES COMMITTEE No. 29-08
SMALL FUNDS COMMITTEE No. 14-08 RE: REPORTS ON BEST PRACTICES FOR HEDGE FUND MANAGERS AND HEDGE FUND INVESTORS; RECOMMENDATIONS OPEN FOR PUBLIC COMMENT

Earlier this week, two private-sector committees established by the President's Working Group on Financial Markets issued separate but complementary recommendations for best practices for the hedge fund industry. The report by the Asset Managers' Committee is intended to set new standards for hedge fund managers to reduce systemic risk and foster investor protection. [1] The report by the Investors' Committee is divided into a "Fiduciary's Guide," which seeks to set standards for fiduciaries considering or already investing in hedge funds on behalf of qualified individuals or institutions, and an "Investor's Guide," which focuses on standards relating to the administration and oversight of hedge fund investments. [2] The reports emphasize that both hedge fund managers and investors are accountable, and that together their recommendations should result in better managed hedge funds and better educated investors. The focus of each report is briefly summarized below.

Public comment on the reports will be accepted until Friday, June 13, after which time the committees will review and, as necessary, revise their recommendations. If you have comments or questions about the reports, please contact Rachel Graham at 202/326-5819 or rgraham@ici.org.

Report of the Asset Managers' Committee

The report calls on hedge fund managers to adopt comprehensive best practices in all aspects of their businesses, in recognition of the greater level of responsibility that comes with the industry's increasingly important role in the financial markets. It emphasizes, and discusses in detail, the need for controls and enhanced procedures in five critical areas: disclosure; valuation; risk management; trading and business operations; and compliance and conflicts of interest. The report states that the manner in which each hedge fund manager implements the recommended best practices will differ in light of its size, strategies, products and other salient characteristics of its business. It acknowledges that smaller managers will be unable to adopt all recommended practices, but states that the report will provide these managers with helpful guidance and direction as their businesses develop.

According to the report, some of the recommendations involve innovative and far-reaching practices that exceed existing industry-wide standards. These include the following:

- In fashioning its disclosure recommendations, the Asset Managers' Committee drew from key elements of the public company disclosure regime. Among these recommendations are that hedge fund managers should: (1) provide periodic performance information to investors, including both a qualitative discussion and quantitative data; (2) make timely disclosure of significant events in light of the circumstances; and (3) provide investors with independently audited, GAAP-compliant financial statements.
- The report notes that, under Financial Accounting Standard 157 and GAAP, financial institutions will be required to categorize their assets among three levels based on the degree of valuation difficulty and to report annually (1) the percentage of assets at each level and (2) the profit and loss derived from "Level 3" assets (i.e., the most illiquid and difficult to value). The report recommends that hedge fund managers go beyond these requirements by (1) reporting this information at least quarterly and (2) also disclosing the profit and loss derived from "Level 2" assets (i.e., assets that are hard to value yet about which there is some observable market price information).
- The report identifies potential conflicts of interest relevant to the hedge fund industry, yet also recognizes the impossibility of anticipating all potential conflicts. It accordingly recommends that managers establish a Conflicts Committee as the focal point for reviewing potential conflicts and addressing them as they arise. The report further recommends a segregation of functions as between portfolio managers and non-trading personnel who are responsible for implementing the valuation process.

Report of the Investors' Committee

The report's first section, or Fiduciary's Guide, is intended to assist investment advisers and other fiduciaries in determining whether hedge fund investing would be appropriate and, if so, whether the fiduciary or its agent has sufficient resources and expertise to effectively manage the hedge fund component of an investment portfolio. It suggests several questions and considerations that a fiduciary should take into account, touching on such areas as hedge fund manager selection, the fiduciary's ability to understand the various risks associated with hedge fund investing, and potential conflicts of interest. The Fiduciary's Guide also discusses the factors that a fiduciary should consider in determining what percentage of the overall investment portfolio should be allocated to hedge funds and to what degree that allocation should be diversified among different hedge fund strategies and managers. Finally, it outlines several legal, tax and accounting considerations that impact the decision to invest in hedge funds.

The bulk of the report is comprised of the Investor's Guide, which represents the Investors' Committee's attempt to provide a comprehensive list of best practices and principles applicable to hedge fund investors in a wide array of circumstances. These recommendations are intended to enable investors to verify that hedge fund managers are following best practices; they also include procedures or approaches that the Investors' Committee believes would add significant transparency and increase investors' ability to understand and evaluate a hedge fund's risks and returns. The recommendations address the following areas:

- the due diligence process, including the hedge fund manager's personnel, its historical performance, and its reliance on quantitative models;
- risk management, with regard to both establishing the investor's own risk management framework and evaluating the framework used by the hedge fund manager;
- legal and regulatory, including hedge fund structure and domicile, the terms of hedge fund investments, and the rights of other investors;
- valuation, including a hedge fund's valuation policy, governance of the fund's valuation process, and applicable controls;
- fees and expenses;
- reporting, including frequency, relative transparency, and the reporting of investment performance; and
- taxation, with particular emphasis on issues for tax-exempt investors.

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endnotes

[1] Best Practices for the Hedge Fund Industry, Report of the Asset Managers' Committee to the President's Working Group on Financial Markets (Apr. 15, 2008), available on the Committee's webpage at http://www.amaicmte.org/Public/AMC_Report.pdf. A fact sheet on the report is available on the Treasury Department's website at http://www.treasury.gov/press/releases/reports/amfactsheetfinal.pdf.

[2] Principles and Best Practices for Hedge Fund Investors, Report of the Investors' Committee to the President's Working Group on Financial Markets (Apr. 15, 2008), available on the Committee's webpage at http://www.amaicmte.org/Public/Investors_Committee_Report.pdf. A fact sheet on the report is available on the Treasury Department's website at http://www.treasury.gov/press/releases/reports/icfactsheetfinal.pdf.