

PRINCIPLES AND BEST PRACTICES
FOR
HEDGE FUND INVESTORS

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REPORT
OF THE
INVESTORS' COMMITTEE

TO THE PRESIDENT'S WORKING GROUP
ON FINANCIAL MARKETS

January 15, 2009

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I. PREAMBLE

Two major events in particular have roiled global capital markets since the Committee issued its report for public comment in April 2008—the extreme dislocation across all capital markets since September 2008 and the massive fraud allegedly perpetrated by Bernard Madoff. The Investors’ Committee began deliberating in the fall of 2007 and issued a report for public comment in April 2008. During that time, markets were experiencing significant dislocation, particularly in credit-related assets where the disruption was serious and sustained. The Committee was mindful of the developing problems in our capital markets as we prepared the initial report.

Since that time, capital markets have come under even more tremendous stress, particularly following the failure of Lehman Brothers, the rescue of AIG and others, as well as the disappearance, bankruptcy, or reorganization of a number of other major financial institutions, including firms that served as prime brokers for significant numbers of hedge funds. Hedge funds, like almost all investment strategies, have not been immune to these extraordinary events. As a general observation, 2008 was hedge funds’ worst performance year ever and consequently disappointed many investors. However, performance dispersion across hedge funds and hedge fund investment strategies has been wide. Many hedge funds have experienced major losses or, in a few extreme cases, total losses. Others have lost less while yet others have had positive returns. Some hedge funds have demonstrated correlations to other asset classes during this crisis that have been higher than anticipated, even in the context of capital markets characterized by extreme risk aversion which temporarily drives all asset classes to much higher correlations. However, other funds have shown less correlation with the broader markets and performed more in line with investor expectations.

In mid-December 2008, Bernard Madoff was arrested for allegedly running a Ponzi scheme that may have lost more than \$50 billion of clients’ money, including significant assets managed on behalf of hedge funds and funds of hedge funds, as well as many other types of clients. The facts in this extraordinary case continue to emerge but are still not completely known. We are accordingly hesitant to draw strong conclusions at this time.

These two events continue to unfold. The Committee was faced with the choice of releasing this report in the form in which we provided it to Treasury in September, or further delaying its release pending a more in-depth analysis of recent market events. While the Committee is cognizant that no set of best practices provides a complete solution to the complexities of investing in hedge funds, the Committee does firmly believe that this report represents a robust set of best practices for investing in hedge funds that can contribute to a reduction in systemic risk. Because we believe the report will be helpful to investors, the Committee believes it was appropriate to release the report. Recent events have also reinforced two points we make elsewhere in this report. First, this report is a living document and should be treated as such. We do not doubt that many investment and due diligence lessons will be learned as the full impact of the current turmoil becomes known and market participants reflect on what has transpired over the past 18 months. As these lessons are absorbed, we expect that the best practices identified in this report will in the future be refined or changed. Second, hedge fund investments are only for sophisticated investors, are not necessarily suitable for all investors and

require deep, meaningful due diligence in relation to investment strategy and operations both at the outset of an investment and on an ongoing basis. If an investor does not understand the sources of a hedge fund's risk and return and cannot otherwise conduct the due diligence necessary to fully appreciate the risks of an investment, the investor should forego the opportunity.

No matter how sophisticated an investor is, there can be no substitute for comprehensive and ongoing due diligence not only of hedge funds in the investment portfolio but indeed of the full portfolio. There are no easy solutions when it comes to investing. One cannot eliminate investment risk but one should certainly be aware of the risks that are being taken when investing with individual managers and also in the portfolio as a whole. This report is intended as one of many tools to help manage these risks.

II. EXECUTIVE SUMMARY

Hedge funds currently manage over two trillion dollars in assets worldwide, and they are an increasingly prominent feature on the investment landscape. The size of the hedge fund market has grown dramatically in recent years, and issues arising from hedge fund investments and management now have broad implications for the entire financial industry. Hedge funds often involve complex, illiquid or opaque investments and investment strategies. These investments, however, receive little regulatory oversight. Thus, hedge funds are suitable only for sophisticated and prudent investors who are able to identify, analyze, and bear the associated risks and follow appropriate practices to evaluate, select, monitor, and exit these investments.

The Investors' Committee of the President's Working Group on Financial Markets consists of representatives from a broad array of investors and investor advocates. The first assignment under its Mission Statement has been to develop "detailed guidelines defining 'best practices' for hedge fund investors,"¹ which are set forth in the report below. The Committee has designed these guidelines "to enhance market discipline, mitigate systemic risk, augment regulatory safeguards regarding investor protection, and complement regulatory efforts to enhance market integrity."² This report builds on existing industry work and on the Principles and Guidelines Regarding Private Pools of Capital, which the President's Working Group on Financial Markets released in February 2007, particularly Principles 4, 5, and 8.

This report addresses the decision to invest in hedge funds and the management and oversight of hedge fund investments. It contains both a Fiduciary's Guide and an Investor's Guide. The Fiduciary's Guide provides recommendations to individuals charged with evaluating the appropriateness of hedge funds as a component of an investment portfolio. The Investor's Guide provides recommendations to those charged with executing and administering a hedge fund program once a fiduciary has decided to add hedge funds to the investment portfolio. This publication corresponds with guidelines promulgated by the Asset Managers' Committee of the President's Working Group on Financial Markets, which identified best practices for the alternative investment industry with respect to the management and administration of hedge funds, including practices regarding disclosure, valuation, and risk management systems.

Hedge funds invest in a wide variety of financial instruments using a variety of investment techniques. They often profit through exposure to risks that are not typical of, or proportional to, those of traditional investment vehicles. These alternative investments have the potential to offset a portfolio's exposure to traditional market risks, or to add to a portfolio's absolute return, but they also may introduce new dimensions of risk and uncertainty. Therefore, before making a hedge fund investment, investment staff should engage in a due diligence evaluation that is appropriate and effective in light of the risk tolerance of the institution or individual they represent. Once a hedge fund investment is made, staff should continue to monitor the investment to identify any newly introduced risks and to weigh them against the potential impact on overall portfolio risk and the expected effect on portfolio returns.

¹ President's Working Group on Financial Markets, Investor's Committee Mission Statement, available at <http://www.ustreas.gov/press/releases/reports/InvestorsCommMission09252007.pdf> (last accessed on March 31, 2008).

² *Id.*

Many individuals and institutions considering hedge fund allocations will determine that they do not have the resources or the expertise necessary to successfully incorporate hedge funds into their portfolios. This is often the most appropriate decision. No one should feel obligated to invest in hedge funds. Many successful investors never invest in hedge funds, and including hedge funds in a portfolio is not required for effective and responsible portfolio management.

Thousands of institutional and individual investors meet the legal requirements to invest in hedge funds, but it is not always appropriate for them to do so. Prudent evaluation and management of hedge fund investments may require specific knowledge of a range of investment strategies, relevant risks, legal and regulatory constraints, taxation, accounting, valuation, liquidity, and reporting considerations. Fiduciaries must take appropriate steps to determine whether an allocation of assets to hedge funds contributes to an institution's investment objectives, and whether internal staff or agents of the institution have sufficient resources and expertise to effectively manage a hedge fund component of an investment portfolio.

Hedge funds use a broad range of portfolio strategies and are exposed to a similarly broad range of risks. Moreover, because strategies can ebb and flow in terms of popularity within the hedge fund universe, the risks and considerations identified here cannot be considered complete. Further, new (and sometimes severe) market conditions may over time shed new light on the role hedge funds play in investors' portfolios.

III. INTRODUCTION

The Investors' Committee of the President's Working Group on Financial Markets offers the following principles and practices as a guide for responsible investment in hedge funds. These draw upon insights from the President's Working Group on Financial Markets, relevant professional associations, and a wide range of institutional investors and financial services professionals. This report outlines the primary components of a robust process for the evaluation, engagement, monitoring, and disposition of hedge fund investments.

A. Statement of Purpose

The goal of this document is to define a set of practice standards and guidelines for fiduciaries and investors considering or already investing in hedge funds on behalf of qualified individuals and institutions. For the purposes of this document, the term "fiduciary" refers to those with portfolio oversight responsibilities, such as plan trustees, banks, or consultants. The term "investor" narrowly refers to investment professionals charged with implementing a hedge fund program.

Addressing the dissimilar needs of such a broad range of participants is challenging. No single set of best practices applies uniformly to every hedge fund investment, and the burden of applying the practices set forth in this document falls upon the institutions and individuals who are considering or engaged in making such investments. This is a disparate group with different resources and objectives, and the hedge fund arena provides a wide array of investment strategies from which to choose. Thus, individuals 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 investor, its objectives and risk tolerance, and the particular investments under consideration.

The selection and implementation of these best practices must be consistent with the particular obligations and goals of the individual or institution making the investment, and with the particular investment in question. Fiduciaries and investors are in the best position to prioritize these factors, and they must evaluate the specific best practices set forth below in light of their own responsibilities, needs, portfolios, and circumstances.

Likewise, hedge funds do not represent a single asset class but are a type of investment vehicle that provides exposure to a range of investment strategies. Hedge funds come in different sizes and have different management strategies and styles. They follow different administrative, valuation, and disclosure practices. Therefore, management of a hedge fund portfolio must be appropriate for its particular investments. However, because hedge funds all have in common a low level of regulatory protection for their investors, there are minimum levels of diligence required for all hedge fund investors. Beyond this minimum, hedge funds pursuing higher risk strategies—for example, funds making significant use of leverage or funds investing in illiquid assets—will require more extensive investor sophistication and oversight.

The initial responsibility for fiduciaries considering hedge fund investments is to determine what role, if any, a hedge fund allocation might play within the overall investment portfolio. This is a critical decision-making process, but this document does not detail the potential uses of hedge funds within a portfolio. It also does not discuss the risks and potential rewards of specific hedge fund investment strategies. Instead, it outlines the basic factors that one should consider when deciding if a hedge fund investment is appropriate, and it provides a framework for conducting investment evaluation and oversight.

It is not the Committee’s intention to persuade investors that hedge funds are a necessary part of a successful investment program. Nor are we seeking to dissuade investors from gaining exposure to the returns and risk characteristics that hedge funds offer. Our aim is simply to offer both current and prospective investors a practical guide for ascertaining whether there is a role for hedge funds in their portfolios and for managing hedge fund investment programs effectively. Finally, the best practices described below should be read and understood within the context of this entire report. They are not isolated recommendations, but components of an integrated approach to hedge fund investing.

B. Background

The President’s Working Group on Financial Markets (“PWG”) was formed by Executive Order 12631 on March 18, 1988, in order to “[enhance] the integrity, efficiency, orderliness, and competitiveness of our Nation’s financial markets and [maintain] investor confidence.”³ There are four members on the PWG: the Secretary of the Treasury and the chairs of the Board of Governors of the Federal Reserve System, the Securities and Exchange Commission, and the Commodity Futures Trading Commission. On February 22, 2007, the PWG published a set of Principles and Guidelines Regarding Private Pools of Capital, which

³ Working Group on Financial Markets, Executive Order 12631 (March 18, 1988).

includes hedge funds. Later in 2007, the PWG sponsored two private sector committees to build upon the Principles and Guidelines: an Asset Managers' Committee charged with developing best practices specifically for managers of hedge funds, and an Investors' Committee charged with developing best practices specifically for those making hedge fund investments. This document is the product of the Investors' Committee. Most recently, on March 13, 2008, the PWG issued its *Policy Statement on Financial Market Developments*, which underscored that "investors must demand and use better information about investment risk characteristics, when they buy and as they hold."

The Investors' Committee comprises senior representatives from major classes of institutional investors including public and private pension funds, foundations, endowments, organized labor, non-U.S. institutions, funds of hedge funds, and the consulting community. Each of the members has reached out broadly to other institutional investors as well as to professional associations and financial services professionals to gain an informed perspective on the best practices for hedge fund investments. On April 15, 2008, this document was posted for a 60-day public comment period. Input received during this public comment period has been incorporated within this document to the extent deemed appropriate. We greatly appreciate the time and attention that both entities and individuals invested in reviewing and commenting during the public comment period. It is anticipated that the Investors' Committee will meet semiannually and issue clarifications and additions when appropriate.

The Asset Managers' Committee has similarly developed best practices that can promote strong disclosure, valuation, risk management, trading, and compliance practices. The Investors' Committee report and the Asset Managers' Committee report each acknowledge that both the investor and the hedge fund manager are accountable and must implement appropriate practices to maintain strong controls and infrastructure to support their activities. We worked closely with the Asset Managers' Committee and believe that together our reports can result in better educated investors and better managed hedge funds. We are pleased that the Asset Managers' Committee has included in its best practices that hedge fund managers use the Investors' Committee report as a guideline for their interaction with investors. Similarly, investors should use the Asset Managers' report as a guide for their interaction with hedge fund managers and fund of hedge fund managers.

The Asset Managers' report provides managers of all sizes with standards that they can adopt to support and strengthen their businesses and operations. The report encourages managers to carefully assess their specific practices against the practices in the report and adopt the best practices applicable to their business and that managers be able to explain to investors how they have implemented and adopted the practices in the report. We believe that investors can play a very important role in achieving widespread acceptance by managers of the practices in the Managers Report. Indeed, we believe that the PWG, by commissioning two committees, supports the role of investors as an important means in achieving widespread acceptance. Investors should take an active role in seeking to understand how managers have adopted and implemented the report and in seeking explanations if the manager has not done so. Investors should obtain reasonable comfort that managers have conducted a thoughtful assessment of their practices as applicable for their business. We believe the hedge fund community can and should serve as a strong partner for ensuring that investors adopt suitably strong and appropriate practices to support their investments.

C. Notes to the Reader

For the purposes of this document, the term “hedge fund” refers to an investment pool that provides exposure to a set of financial risk factors not typically associated with traditional (equity and fixed income) long-only investments. This may include investments in limited partnerships, limited liability corporations, or other vehicles. These vehicles carry out the investment program under the direction of an investment manager. For purposes of this report, the term hedge fund may also refer to the manager of the investments of a hedge fund.

Historically, hedge funds have focused on publicly traded securities, commodities, currencies, and their derivatives in such a way as to be “hedged,” in large measure, from material changes in stock and bond markets. Increasingly, however, hedge funds have exposure to a broader investment spectrum, including not only traditional markets but also sectors typically associated with other investment vehicles, such as private equity and real estate. We note that the Investor’s Guide targets sophisticated investors, and the Investors’ Committee assumes that those investors are familiar with general investment terms. We have not attempted to define ordinary investment terms, except where there are several possible meanings or our usage is not common among investment professionals.

IV. FIDUCIARY'S GUIDE

Fiduciaries (including plan trustees, banks, consultants, and investment professionals) considering an investment in hedge funds must first determine the suitability and attractiveness of hedge funds for their particular institution and how these investments would promote the client's needs and objectives. Most importantly, no fiduciary should feel obligated to implement a hedge fund investment program. Many sophisticated investors produce strong portfolio returns without investing in hedge funds. As with any investment, fiduciaries must exercise proper care in assessing whether a hedge fund program is appropriate and whether they employ or can engage investment professionals with sufficient skill and resources to initiate, monitor, and manage such a program successfully.

To assess the appropriateness of a hedge fund program, questions prudent fiduciaries should consider include, but are not limited, to the following:

- **Temperament:** Do we, as an organization, have a suitable temperament for investing in innovative strategies? Without the comfort afforded by long-term practice and empirical evidence, do we have the institutional fortitude to stick with our strategic allocation in the face of short-term volatility?
- **Manager Selection:** Do we have qualified staff that can reasonably detect true investment skill and the non-obvious sources of risk inherent in hedge fund strategies? The answer may depend on the particular investment strategy. Can we allocate sufficient resources to manage and monitor new hedge fund investments and existing investments effectively? If the answer to either question is no, do we have the ability to assess, select, and engage appropriate intermediaries to whom we can delegate the evaluation of hedge fund management and its strategies and execution?
- **Portfolio Level Dynamics:** Do we understand the way in which our proposed hedge fund portfolio will generate investment returns? Are our return assumptions reasonable in the context of the market? Do we understand the risks involved in the proposed hedge fund portfolio in the context of our overall portfolio? What part of the total risk comprises systematic risks that are not diversifiable, as opposed to idiosyncratic risks associated with particular investments? In what scenario would the overall hedge fund portfolio likely underperform or outperform its expected returns? Do we understand the types and degrees of leverage embedded in the proposed portfolio? Do we understand more generally issues of counterparty credit risk embedded in the proposed portfolio?
- **Liquidity Match:** Is the liquidity of the hedge fund portfolio consistent with our needs as an organization? To what extent could short-term behavior by other investors undermine our advantage as long-term investors?
- **Conflicts of Interest:** Have we identified and addressed actual, potential, or apparent conflicts of interest arising from our hedge fund program? Have we

taken appropriate steps to eliminate or mitigate adverse consequences arising from these conflicts of interest?

- **Fees:** Are the fees associated with the hedge fund investments generally reasonable in the context of the market? For given levels of realized return, what percent of the gross return would go to the manager versus the investor?
- **Citizenship:** Do we, as an organization, feel comfortable that the hedge funds in our portfolio are good capital market citizens and are not engaged in objectionable practices? Even among high integrity managers, some strategies might be unpopular and subject to characterization in the press that may negatively impact our reputation; do we accept the headline risk that accompanies unconventional investments?

The requirement that hedge fund investments are only for sophisticated investors cannot be over-emphasized. Persons responsible for initiating hedge fund investments must appropriately incorporate the unique risk and reward characteristics of these alternative strategies into their overall portfolios. Thus, fiduciaries considering investments in hedge funds should consider the following fundamental observations when assessing the risks of investing in hedge funds.

- Evaluating the risks of hedge fund investing can be difficult given the broad range of complex, illiquid and sometimes opaque investments and investment strategies.
- Fiduciaries should be aware of the difference between risk and uncertainty. Risk is an element of randomness in situations where the ultimate outcome is undetermined but the range of potential outcomes is understood and quantifiable. Uncertainty arises due to incomplete knowledge about the manner in which events occur, a lack of predictability, and the possibility of unprecedented behavior or events. It is not quantifiable. Because of the complex and highly engineered nature of some hedge fund strategies, these investments often present greater uncertainty than other types of investments. The tolerance for such uncertainty will depend upon the size, strategy, and objectives of the portfolio allocating assets to a hedge fund investment.
- The process of selecting and monitoring hedge fund investments requires additional resources and continuous support from experienced professionals, which may be substantially more expensive than those required to select and monitor traditional investments. Fiduciaries should understand the effort and costs that will be required and should commit these resources prior to investing in hedge funds.

Fiduciaries must be sufficiently sophisticated in their knowledge and experience to evaluate and bear the risks and uncertainties of hedge fund investing, and they must recognize the role of hedge funds within the context of their broader investment preferences and goals.

Fiduciaries and others who choose to engage consultants or funds of hedge funds to augment their capabilities should not expect these third parties to assess all relevant aspects of their hedge fund program or its strategic role within the overall investment portfolio. Even when engaging

such third parties to support a hedge fund investment program, fiduciaries must employ sufficient internal resources to understand and monitor the ongoing capability of these third parties to select and oversee the hedge fund managers and investments and to confirm that the investments remain appropriate for the institution.

A. HEDGE FUND INVESTMENTS AND ALLOCATIONS

Hedge funds are investment vehicles that allow investors to gain exposure to a wide range of investment strategies. They do not represent a single asset class but rather a type of investment vehicle. A hedge fund is a pooled investment vehicle that:

... generally meets the following criteria: (i) it is not marketed to the general public (i.e., it is privately-offered), (ii) it is 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, as amended), (iv) its assets are managed by a professional investment management firm that shares in the gains of the investment vehicle based on investment performance of the vehicle, and (v) it has periodic but restricted or limited investor redemption rights.⁴

Hedge funds offer investors access to a wide variety of investment strategies and risk exposures not typically available through traditional investment classes and investment vehicles. Historically, hedge funds have focused on long and short investments in equities, fixed income securities, currencies, commodities, and their derivatives. These funds are typically leveraged in that the value of the long positions may exceed, in certain circumstances substantially, the investor's capital in the fund. Moreover, unlike traditional funds, which typically are fully exposed to general movements in underlying stock or bond markets, hedge funds are generally managed using a combination of long and short positions to limit exposure to broad market risk, and are, therefore, considered to be largely uncorrelated with fluctuations in major equity and fixed income markets. As a result, hedge funds have exposures to counterparty risks associated with their hedging transactions and to the specific investment risks associated with each individual hedge fund's particular strategy.

Hedge funds are typically distinguished from other private pools of capital (including private equity, venture capital, and real estate) in that private market investments are not generally the central focus of the fund. Hedge funds also typically provide their investors with periodic liquidity (e.g., quarterly) which distinguishes them from other private pools of capital. However, private market investments may be included depending on a manager's strategy. Hedge funds also may impose broad restrictions on the ability to redeem (liquidate) an investment, including lengthy initial lock-up requirements and then infrequent periods when the fund allows redemptions to occur. Finally, because hedge funds may only be lightly regulated in many jurisdictions, persons investing in hedge funds must have a greater understanding of the investment structure and management strategy than would be typical for traditional investment vehicles.

⁴ Managed Funds Association (MFA), *Sound Practices for Hedge Fund Managers*, Washington, 2007.

1. Certain Characteristics of the Hedge Fund Industry

The hedge fund industry differs from the traditional asset management industry in several ways. The hedge fund industry itself is relatively young and has been an important source of new investment management ideas. Managers are often early adopters of investment strategies and new securities, and they frequently use investment vehicles and techniques that are unavailable to more constrained investors. It is important to note that hedge funds are lightly regulated vehicles that usually operate with a broad investment mandate and few limits on the investment authority of the funds.

Defining Features of Hedge Funds⁵

| Hedge funds typically... | Traditional products typically... |
|--|---|
| <ul style="list-style-type: none">• Invest both long and short• Are leveraged• Have a high, performance-based fee structure• Normally require co-investment by fund manager• Are able to use futures and other derivatives• Have a broad investment universe• Can have large cash allocations• Have an absolute return objective• Investor access regulated, but the product itself is lightly regulated | <ul style="list-style-type: none">• Invest long only• Not leveraged• Have a lower, ad valorem fee structure• Do not encourage co-investment• Are restricted in using derivatives• Often have a limited investment universe• Are required to stay fully invested• Have a relative return objective• Are frequently heavily regulated |

2. Fees

Unlike most traditional investment products, hedge fund managers typically charge both a management fee based on assets under management and a performance fee based on the success of the fund. For most successful hedge funds, performance fees typically dwarf the management fees over time. This fee structure typically exceeds the fees of a traditionally managed fund substantially. This higher fee structure implies that an extra standard of care should be undertaken by investors in hedge funds to determine if the higher fee is justified by the risk-adjusted value added potential of the investments.

While the typical management fee ranges from 1 percent to 2 percent annually of the assets managed, the performance fee provides the hedge fund manager with a percentage of the fund's investment returns. The performance fee (or carried interest) is often set at 20 percent (but more generally in a range of 10 percent to 30 percent) of the fund's total return, or, less frequently, the excess performance above a specified benchmark (hurdle). Performance is typically calculated on a cumulative basis (with incentive fees calculated against a "high-water mark"). The result is that performance fees are not paid out (or are reduced) until the losses are recouped. However,

⁵ Oliver Wyman, *Perspectives on Asset Management – Hedge Funds, growth sector or maturing industry?*, New York, June 2005, p. 5.

some hedge funds limit the number of years of loss carry-forward for the purposes of calculating performance fees.

3. Considerations Prior to Investing in Hedge Funds

Before embarking on an examination of the recommended steps to undertake when selecting hedge fund investments, fiduciaries should question the commonly presupposed notion that hedge funds are inherently desirable investments. With their large investment universe and range of strategies, hedge funds certainly have the potential for attractive active returns, but they have distinct risks as well.

A central principle to consider is that hedge funds are not an asset class in the conventional sense. Therefore, one should only pursue a hedge fund investment if:

- the fiduciary believes that the hedge fund manager is particularly skilled in active investing, and that the investment offers investment strategies to which exposure is most effectively (or perhaps only) gained through a hedge fund.
- the benefit of this skill and non-traditional strategy exposure remains after fees, expenses, and due diligence costs.
- the fiduciary, with the assistance of staff and consultants, can differentiate between skill-based managers from those generating profits from generic market exposure.

4. New Hedge Fund Programs and Managers

Hedge fund managers can vary significantly in their levels of sophistication. This is particularly true for managers who are just beginning operations. For example, new hedge fund managers may be able to capture appealing investment opportunities by applying a special expertise, geographic insight, or atypical knowledge of certain securities or commodities. While a newly formed hedge fund may be smaller and thus more nimble than a larger fund, they are generally less sophisticated in their operations and risk management practices. These characteristics increase the degree of risk for fiduciaries that oversee emerging hedge fund programs, as they may have less experience in monitoring and understanding a new hedge fund's operational and market risks. Thus, fiduciaries initiating new hedge fund investment programs may face a significant challenge when assessing the peculiar risks of new hedge fund managers.

5. Roles in the Portfolio

Hedge funds can potentially play a variety of roles in a portfolio. Although it is beyond the scope of this document to provide details on these potential roles, common roles can include the following:

- A program with risks and rewards which *complements* traditional stock and bond investments.
- A program that *integrates* with a traditional asset class as part of a value-added strategy.

- A program that *substitutes* for an allocation to tradition investments.

6. Allocation and Diversification

Before initiating a hedge fund investment program, fiduciaries in general (and investment professionals in particular) must determine the percentage of their total portfolio to allocate to hedge funds and the optimal amount of diversification among hedge fund strategies and managers. Due to the multiple roles that hedge funds may play in an overall portfolio, there is no standard allocation and diversification rule. The fiduciary should consider the same factors used to determine allocations to other investments, including:

- The expected return and risk profiles of the proposed hedge fund investments, including risks not readily measured, such as business risk, operational risk, and the potential outcomes of the investment strategy under particular scenarios.
- The liquidity requirement associated with the hedge fund allocation; in particular, fiduciaries should be cautious about relying on hedge funds to be a source of cash in a stressed market environment since those are the very periods when hedge fund liquidations are most difficult and disadvantageous.
- How the hedge fund allocation benefits the overall portfolio in terms of projected returns and volatility.

Typically, diversification of investments within a specific asset class enhances the return profile of a portfolio by reducing idiosyncratic (non-market) risk while maintaining systematic (market) exposure to a particular asset class. Hedge funds, however, allow exposure to a variety of asset classes and very specific risks not always found in traditional stock and bond investments. Therefore, when making allocation decisions, the fiduciary must consider the amount of an overall portfolio to invest in hedge funds, as well as the diversification among various hedge fund alternatives. Diversification of hedge fund positions serves several purposes, including potential reductions in the exposure to idiosyncratic investment strategy risk, market risks, and manager business risk.

The following guidelines broadly apply to hedge fund allocation decisions:

- The greater the allocation to hedge funds, the more important it is to consider diversification across investments and managers. It may be useful to set limits on the exposure to a single fund, manager, or strategy to an absolute percentage of a portfolio's assets.
- Because hedge funds generally have minimum investment amounts, some investors may be unable to invest across as many managers or strategies as would be optimal. A smaller group of managers, however, will result in a greater risk concentration in the portfolio, while not necessarily reducing the amount of due diligence and oversight. Thus, fiduciaries of organizations that lack sufficient resources or the desire to conduct appropriate due diligence and monitoring over a diverse hedge fund portfolio should consider investing in funds of hedge funds.

In doing so, fiduciaries will have to consider whether the additional fees associated with funds of hedge funds make the overall allocation worthwhile.

- For investments in hedge funds as a stand-alone allocation, diversification across investment strategies may be as important as diversification among managers. Depending on the defined role for hedge fund strategies in the portfolio, a diversified program in a limited number of strategies, or even a single strategy, may be appropriate.

B. HEDGE FUND INVESTMENT POLICY

Fiduciaries considering hedge fund investments should develop explicit policies that define the key features and objectives of the hedge fund investment program. At a minimum, these policies should address the following considerations:

- What is the strategic purpose of investing in hedge funds? What role will hedge funds play in the total investment portfolio?
- Is the hedge fund program consistent with the applicable investment beliefs, objectives, and desired risk profile of the investment program?
- What are the performance and risk objectives of the hedge fund investment program?
- Who will manage the hedge fund investment program and what responsibilities will they have?
- What investment guidelines will apply to the range of funds and strategies that can be utilized, the number of funds to be targeted, and the risk and return targets for those funds?

C. THE DUE DILIGENCE PROCESS

The due diligence process is the set of procedures used to gather information about a particular investment for the purpose of deciding whether the investment opportunity is appropriate. The same information collected in this process is also necessary for the ongoing monitoring of an investment.

Generally, best practice objectives for due diligence are applicable across all investment activities and categories. However, particular care should be exercised in due diligence of hedge funds because of the complex investment strategies they employ; the fact that hedge fund organizations are frequently young and small; their use of leverage and the associated risks; the possibilities of concentrated exposure to market and counterparty risks; and the generally more lightly regulated nature of these organizations. In order to understand how a hedge fund may perform in a variety of future scenarios, fiduciaries should review the history of the investment management firm and its professionals, the firm's past and current portfolios, its investment philosophy, its decision processes for implementing the investment strategy, its organizational culture, and its internal economic incentives. The due diligence process should also include an

evaluation of the business infrastructure, investment operations, and controls in place to support the hedge fund's investment strategy.

The Investor's Guide includes detailed sections devoted to due diligence best practices. Fiduciaries should be familiar with these activities, understand the investment professionals' responsibility to follow a systematic due diligence and monitoring process, and receive reports on investment activities on a regular basis.

1. Legal, Tax, and Accounting Considerations

Fiduciaries should recognize that a broad spectrum of legal, tax, and accounting considerations impact the decision to invest in hedge funds. For example, the suitability of a given hedge fund investment for a specific individual or institution may be affected by factors such as:

- the legal structure of the investment vehicle.
- the domicile of the investment vehicle.
- the laws and regulations of the domicile of the vehicle and of the countries where its investments are made.
- the decision of the fund manager to register or not register with the Securities and Exchange Commission or the Commodity Futures Trading Commission.
- the characteristics of the other investors in the fund.
- the hedge fund's overall investment strategy.

Furthermore, ERISA fiduciaries must be familiar with the legal implications of hedge funds' lightly regulated status and be prepared to seek advice from competent attorneys when questions arise. These considerations include, but are not limited to:

- Whether the hedge fund investment is consistent with the plan's investment policies.
- Whether the hedge fund manager is an ERISA fiduciary and, if not, what the implications are for the institution's fiduciary of allocating assets to investment managers that are not governed by ERISA.
- If the hedge fund manager is an ERISA fiduciary, the plan fiduciary must confirm, with respect to the hedge fund manager, that:
 - it is registered as an investment adviser under the Investment Advisers Act of 1940 or under comparable state law;
 - it has acknowledged in writing that it is a fiduciary of the plan;
 - any performance-based compensation that it receives is permitted under ERISA;

- it meets the Department of Labor’s definition of a “qualified professional asset manager” (“QPAM”), which would permit the hedge fund manager to engage in transactions that are common among hedge fund managers but would otherwise be prohibited under ERISA; and
 - it has policies and procedures in place to ensure compliance with restrictions on “soft dollars,” to prevent prohibited transactions and mitigate conflicts of interest.
- Whether the plan fiduciary will be able to fulfill ERISA custody and reporting requirements.⁶

These factors and their possible effects on returns require careful consideration prior to investing in a hedge fund. Much of this information should be contained in a hedge fund’s offering documents, but, if warranted by the circumstances, fiduciaries and investment staff should confirm the relevance and status of these factors through further investigation and inquiry.

2. Ongoing Monitoring

Monitoring a manager and a hedge fund investment is a continuation of the initial due diligence process. While the initial due diligence serves to qualify a hedge fund as a desirable investment, the ongoing monitoring process continually reaffirms that the assumptions used in the initial selection remain valid. Key aspects of the monitoring process should include reviewing the investment strategy and investment performance for consistency, maintaining awareness of factors that could indicate potential style drift, and confirming that there has been no material change to the business operations of the fund manager. Fiduciaries and investment staff should take reasonable steps to identify any events or circumstances that may result in the hedge fund failing to meet the standards and expectations that were originally required to include the hedge fund in an investment portfolio. While a fiduciary can hire qualified investment professionals to fulfill the technical aspects of the monitoring process, the fiduciary must possess sufficient expertise to monitor these professionals.

D. CONCLUSION

Hedge funds may offer opportunities for fiduciaries and investors to improve the likelihood of achieving their investment objectives. Prior to embarking on a hedge fund program, however, fiduciaries should be satisfied that incorporating a hedge fund investment program into a portfolio would improve its risk and reward profile and increase the probability of meeting the applicable investment objectives. The prudent fiduciary should also be able to assess whether its investment staff and agents have the requisite expertise and resources to conduct sufficient due diligence and monitoring that is required to evaluate, retain, monitor, and terminate hedge fund managers as part of an overall hedge fund investment program.

⁶ For example, under ERISA, “Except as authorized by the Secretary by regulation, no fiduciary may maintain the indicia of ownership of any assets of a plan outside the jurisdiction of the district courts of the United States.” *See* 29 USC § 1104(b).

V. INVESTOR'S GUIDE

This Investor's Guide describes best practices and guidelines for investment professionals charged with administering hedge fund investment programs. We use the term "investor" narrowly in this section to refer to the internal and external personnel who are responsible for actually establishing and managing these programs. Some portions of the Investor's Guide elaborate on portions of the Fiduciary's Guide in order to reflect the separate roles and responsibilities of investors, as distinct from those of fiduciaries.

The Investors' Committee seeks to present a comprehensive list of the best practices and principles applicable to hedge fund investors in a wide array of circumstances. Hedge fund investors vary greatly and hedge funds play different roles in different portfolios, so it is not possible to formulate a single process that is optimal for every investor's needs. Thus, each 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.

Investors should decide which best practices are appropriate for their hedge fund investment program and for the individual funds under consideration. They should aspire to implement each applicable best practice fully—understanding that full implementation may not always be possible or practicable. Areas where best practices cannot be implemented call for special scrutiny. Typically, the inability to achieve a best practice would suggest an increased risk associated with the investment. In that case, any investment decision should reflect the appropriate consideration of this risk.

Sophisticated investors will understand the best practices that apply to a specific hedge fund investment program or underlying investment. They will determine the relative importance of the applicable practices, develop an investment policy around these practices, and allocate sufficient resources toward developing a systematic and thoughtful approach to selecting and monitoring the portfolio's hedge fund investments.

Once a fiduciary determines that it has the expertise, resources, and risk appetite to invest in hedge funds and adopts a hedge fund investment policy and strategy appropriate to the overall portfolio, the investor will face numerous challenges related to the selection of appropriate hedge fund investments and the ongoing monitoring of the hedge fund portfolio.

Over the past few years, major groups such as the Managed Funds Association, the Greenwich Roundtable, the Alternative Investment Management Association, and the CFA Institute have published extensive documents related to "best practices" for both investors in and managers of hedge funds (see Appendix). These may be useful resources for investors interested in learning about the best practices that hedge fund industry professionals have recommended to their colleagues and other efforts by investor-oriented groups to provide guidance to investors in hedge funds. The recommendations that follow focus on how investors can apply appropriate due diligence standards to verify that hedge fund managers are following best practices and identify independent controls and processes to further safeguard their assets. Where appropriate,

we have specified certain procedures or approaches that we believe would add significant transparency and increase investors' ability to understand and evaluate funds' risks and returns. We have broadly divided these recommendations into seven categories: the due diligence process; risk management; legal and regulatory considerations; valuation; fees and expenses; reporting; and taxation.

A. THE DUE DILIGENCE PROCESS

Hedge funds are complex investment vehicles that often lack the transparency associated with more conventional investments or investment vehicles. Unlike a publicly traded stock, there is no easily accessible information on a hedge fund's means of producing returns. Unlike mutual funds, hedge funds need not disclose their holdings, and, in the case of some hedge fund strategies, such disclosure would not reveal the types and magnitudes of risks a hedge fund undertakes. Therefore, the unique and complex nature of hedge funds requires a level of due diligence above and beyond what is required for more transparent investments that are strictly regulated.

Due diligence is the process of gathering and evaluating information about a hedge fund manager prior to investing in order to assess whether a specific hedge fund is an appropriate choice for the portfolio. Prior to investing, investors often gather information about managers through due diligence questionnaires, meetings with managers, and interviews with a fund's current investors and business counterparties. Investors should check references, research the hedge fund's key service providers, verify factual information using independent sources, and follow-up with the fund's personnel if the investors have trouble locating data or discover information that poses concerns. Investors should also evaluate the reputation, credit rating, regulatory history, and background of the individuals and entities that are considered important in the management and administration of the hedge fund's investments.

After investing in a hedge fund, the due diligence process continues. Ongoing monitoring of all the hedge funds in a portfolio, and the management of those funds, is an important component in the long-term success of any hedge fund investment program. Similarly, once an applicable lock-up period expires, the decision whether to redeem should be deliberate and scrutinized regularly for as long as the investment remains outstanding.

Proper due diligence needs to be tailored to the circumstances and objectives of each investor and to the particular circumstances of each hedge fund investment. No universal handbook can serve adequately as a guide for due diligence in every circumstance. Instead, a well-tailored due diligence questionnaire ("DDQ") may serve as a useful tool to aid investors in understanding a hedge fund's opportunities and risks and provide structure to the overall due diligence and monitoring process. A DDQ, which should contain probing questions regarding the material aspects of a hedge fund's business and operations, may include, but is not limited to, the following:

- **Process:** What is the manager’s investment process? In what markets does the manager invest? How does the manager have a comparative advantage or “edge” over other managers (or passive investment alternatives)? What instruments does the manager use to carry out investment themes? Under what environments should a fund’s strategy perform particularly well or poorly? What risks is the manager comfortable taking? Why are those risks acceptable?
- **Performance:** How has the fund performed historically? If the fund has had periods of particularly strong or poor returns, is there a reasonable explanation for the unexpected returns? How has the manager performed in running other funds? Have previous efforts to manage a fund failed or succeeded, and if so, why? How has leverage contributed to past fund performance? Will leverage in the future be similar to or different from what the manager has previously employed? If the hedge fund is a new organization and there is no performance record, what is the manager’s prior experience, and how has that experience prepared the manager to run a successful hedge fund?
- **Personnel:** Who will be managing the fund on a day-to-day basis? Who assists the fund’s managers in reaching investment decisions? Who is responsible for back-office functions such as accounting or cash and trade reconciliations? How long have the fund’s personnel worked together, and how much experience do they have individually? Do the fund’s personnel have or do they intend to have a significant portion of their own assets invested in the fund? Are the fund’s key personnel willing to provide references to substantiate their character and skills?
- **Risk Management:** How does the manager assess and manage risks? Risk management extends beyond market risks to liquidity, counterparty, operational, and other risks (discussed below), and these could adversely affect investment returns as well as the fund management firm’s overall business. What contingency and business continuity plans are in place in the event of a disaster or other significant business interruption?
- **Third Parties:** What third-party service providers, such as administrators, prime brokers, auditors, legal counsel, and other vendors, does the fund employ? Who are the fund’s material trading counterparties? Investors should assess the adequacy of the manager’s approach to selecting third parties to determine that they are known, reputable, financially stable, and experienced in the hedge fund industry. Are there structural or contractual relationships between third parties and the fund that may give rise to conflicts (for example, when an executive of a third party serves as a member of the fund’s board or when a fund’s management firm and administrator have the same corporate parent)?

- **Structure:** Is the hedge fund a partnership, corporation, or other entity? Is the entity structured to limit investor or manager liability? Is the fund operated by a large management firm or is it managed by a small team in a “boutique” firm format?
- **Domicile:** Is the fund domiciled onshore or offshore? Are the fund managers familiar with the legal, regulatory, and tax regimes of the jurisdiction where the hedge fund is domiciled? For offshore funds, are the fund managers prepared to fulfill all obligations (e.g., regulatory filings or taxes) that may arise in that jurisdiction? Are assets within the purview of an appropriate judicial system? If an investor needed to pursue legal claims against the fund or its managers, what law would apply and what jurisdiction would provide the appropriate venue for such claims?
- **Legal Matters and Terms:** What are the fund’s fees and other material terms, such as liquidity, limitations on investments, and leverage? Are “side pocket” investments allowed, in which certain illiquid investments are placed in segregated pools? If side pockets are allowed, is participation by investors voluntary or required by all investors? What regulatory regimes is the fund subject to, and with which regulators is the fund (or manager) registered? How might changes in regulation affect the performance of a fund’s strategy? How do taxes impact the fund’s net returns and does the investment strategy, structure, domicile of the fund, or the places where it invests have additional tax implications?
- **Compliance:** How are risk-management and regulatory compliance policies managed and documented to ensure compliance by the fund and its management with applicable regulations and fund documents? How does the fund’s management respond to a breach of compliance or risk-management policies? Is there a chief compliance officer or other individual ultimately responsible for regulatory and risk-management compliance? What is his or her prior experience and regulatory history?

A well-crafted DDQ can provide investors with a systematic approach for assessing the appropriateness of specific hedge funds in their investment portfolios. Yet, no matter how well-crafted, a DDQ is never sufficient on its own to enable a hedge fund investor to make a fully informed investment decision. Investors must also pursue appropriate lines of further inquiry. Moreover, while various industry associations and leading consultants have developed DDQ templates, investors should not use these without modification. DDQs should be adapted to the specific needs and objectives of the investor and to the particular hedge funds and managers under consideration.

1. Personnel

Investors should only invest in hedge funds managed by firms that cultivate an appropriate “tone at the top” with respect to ethics and risk-management policies and that promote a culture of fair dealing toward investors and among management, employees,

and service providers. A manager's reputation likely provides insight into the firm's culture. A number of factors can adversely influence a firm's reputation including poor performance, financial loss, litigation or regulatory difficulties, weak governance, and conflicts of interest.

The background and experience of the key investment, operations, finance, and business management personnel is of paramount importance when selecting a hedge fund. Hedge funds require management with specialized experience in the applicable investment strategies, operations, accounting methodologies, and financial controls. Preferred managers have a strong reputation in the industry, extensive experience trading and investing in a variety of market environments, and are able to demonstrate an in-depth understanding of the specific complexities of the investment strategies and investments they employ.

Best Practice

- Investors should conduct thorough due diligence in the marketplace on the reputation, experience, and background of hedge fund managers and the key principals in the firm. Investors should employ as broad a range of resources as practicable, including industry contacts, references, professional background searches, regulatory registrations, disciplinary history, and other research tools. This due diligence will support investors' efforts to place capital with reputable, experienced managers and mitigate the risk of investing with managers with poor reputations or a lack of experience.

Some hedge funds rely significantly on the skills of one or more individuals. The risk of losing such valuable team members is referred to as "key man" or "key person" risk. Such individuals contribute substantially to the success of the enterprise, and fund performance may be highly dependent on these key investment personnel. In recognition of this risk, some hedge funds include a redemption feature that mitigates key person risk by allowing investors to redeem their interests if specific individuals cease to be involved in managing the fund.

Best Practice

- Investors should consider the investment risk associated with the loss of a key person or persons. If this risk is material, investors should assess whether a fund's redemption provisions adequately mitigate the risk.

2. Business Management

The strength of a hedge fund manager's business model, including ownership, governance, management, and clients, is important to judge the manager's ability to focus on investing fund assets without instability and other distractions.

Best Practice

- Investors should obtain information from hedge fund managers on their governance and compensation structures, nature and breadth of ownership of the manager, degree of client concentration, and stability of client base. Investors should assess the stability of the manager's overall business.

3. Investment Performance Track Record

Hedge funds are subject to uncertainty in the distribution of their returns. For example, a fund's track record may exhibit low risk that masks a negative skew or risk asymmetry that is unobservable from the historical return series. Alternatively, a fund with a short track record may experience a random event, causing its distribution to be skewed and unrepresentative of expected distributions over a longer period of time. There may also be discontinuity in the distribution of returns due to changes in the market environment or investment strategy, causing past returns to be an especially poor indicator of future performance.

Best Practices

- Investors should evaluate carefully and understand the manager's historical performance and the factors contributing to that performance.
- Investors should assess the manager's ability to operate a fund successfully in varying market environments.

4. Style Integrity

Style integrity refers to a hedge fund's ability to maintain the investment style or styles upon which the investor originally evaluated and selected it as part of a hedge fund portfolio. Style drift may include changes in the types of hedge fund strategies employed or in the characteristics of the fund and its investments, including the types of instruments employed, the geographic location of investments, and the fund's targeted correlation with market factors. Style drift away from investment strategies in which the manager has proven expertise can diminish return prospects and introduce new risks. Style drift potentially puts a hedge fund manager at a competitive disadvantage in a new, unfamiliar strategy and it may also cause unintended exposures in an investor's portfolio. Given

that a hallmark of hedge funds is their ability to adapt to market conditions, fund managers often seek broad discretion to alter their investment approach—this must be evaluated in terms of the manager’s core competencies.

Investors can use risk analyses to confirm that managers are staying true to the strategies for which they were selected. Investors seeking to analyze style drift typically evaluate current exposures or holdings, or they may employ returns-based risk metrics. Regular discussions with fund managers can also help investors to detect deviations from the manager’s investment style.

Best Practices

- Investors should employ regular and frequent risk monitoring and actively analyze a hedge fund’s risk exposures as a means of evaluating potential style drift.
- Investors should obtain appropriate risk reports, with sufficient frequency, to monitor potential style drift and to confirm that the hedge fund continues to meet the investor’s objectives.

5. Model Use

Some hedge funds employ quantitative models extensively and in a variety of ways. Fund management may use models to predict potential investment performance, to make investment decisions, or to manage risks. Some firms use models to determine a quantitative strategy that directs the fund’s investment process. Other firms use models solely as decision support tools.

Models have inherent imperfections and occasionally provide the illusion of false precision. They can fail to capture the dynamic nature of management’s decisions. Models can rely upon false or incomplete assumptions or incorrect data, and their application can be inappropriate. Moreover, fund managers can materially alter models, causing unintended exposures in an investor’s portfolio.

Robust models should reflect the relevant factors for the investment strategy over a wide range of potential market conditions and use the best available data. A model’s assumptions should be consistent with the relevant market risk and incorporate a reasonably comprehensive set of probabilistic scenarios.

Best Practices

- The scope of risk from model use will depend on the nature of the strategy, complexity of the mandate, and types of models used.
- Investors should assess the hedge fund manager’s reliance on models, including

Best Practices

assumptions, model inputs, and risks associated with the models the manager employs.

- Investors should assess the expected frequency of material and substantive model changes, and whether the manager intends to notify investors when such changes are made.

B. RISK MANAGEMENT

Effective risk management practices help investors protect their assets, manage their expectations in selecting hedge funds, mitigate exposure to unanticipated risks, and support informed, disciplined investment decisions.

This overview proposes best practices for establishing the investor's own risk management framework and best practices for evaluating the risk management framework employed by a hedge fund manager. It also discusses various categories of risk that a hedge fund investment program should address, including investment strategy risk (the risk that the investment thesis is wrong), liquidity and leverage, market risk, operational risk, business continuity, and conflicts of interest. The sections describing these different categories offer related best practices to monitor and manage these risks.

1. Investors' Risk Management Programs

An investor's risk management practice should incorporate controls to protect the integrity of the information used in their hedge fund evaluation and monitoring processes.

Best Practices

- Investors should develop risk management programs appropriate to their size, complexity, and portfolio structure, including appropriate quantitative and qualitative criteria for the reasonable measurement, monitoring, and oversight of risk.
- Investors should establish formal written policies and supervisory procedures designed to meet the risk management objectives of a hedge fund investment program. These policies and procedures should be reviewed and updated no less frequently than annually, and within a reasonable time after any material change in investment objective, strategy, market conditions, or applicable regulations.
- Wherever appropriate and practical, investors should consider the development of comprehensive and professional internal and/or external risk management, measurement, and compliance functions. Risk management should typically reside within the investor's investment function while risk compliance should typically reside separately. Risk measurement would ideally reside in both,

Best Practices

although a duplication of resources may sometimes be unnecessary and too burdensome. In such instances, risk measurement is best aligned within the investor's investment operations.

- Investors' risk management programs should be independent of the manager selection process and the process for monitoring investment performance. Internal or independent compliance related controls, generally residing outside the investment function itself should periodically verify the effectiveness of risk management programs, particularly with regard to risk policy constraints and limits. This should be done in a manner that minimizes conflicts of interest.
- Investors who are not satisfied that they have adequate knowledge, systems, and resources to implement and administer risk management programs should engage outside consultants with appropriate expertise to do so for them.

2. Hedge Fund Risk Management Programs

An investor should expect a hedge fund manager to employ a risk management framework with the following key features:

- An oversight function that defines the processes by which risk management personnel measure and monitor the types of risk that are relevant to the hedge fund's investment style and operations and make timely adjustments to risk exposures when necessary.
- Policies that address the determination and adjustment of risk parameters, the methodology and frequency for periodic testing and verification of effectiveness, including stress testing, along with reporting and communication procedures, and specific protocols to address situations when risk parameters are breached.
- Risk management models that should be based on historical data and hypothesis stresses that are robust enough to capture the real range of possible stresses on the fund's portfolio.
- Risk management personnel should conduct regular testing of risk measurement systems to assess whether they capture all material risk exposures, and whether the results they generate are in line with appropriate assumptions and expectations.
- Risk managers should have the expertise to understand the hedge fund's trading strategies and related risks. The senior risk management executive should report directly to senior management.

- Risk management personnel should have responsibility for reviewing risk data, metrics, performance, current risk position, sources of risk, and exposures to relevant markets both quantitatively and qualitatively. With respect to the latter, there is no substitute for the application of experience and common sense in managing portfolio risk.
- Personnel responsible for a hedge fund's investment portfolio should identify, analyze, and address portfolio risks on an ongoing basis.

In a large hedge fund, a separate group, independent of the investment process, should oversee portfolio risk management. The independence of this risk management function reduces conflicts of interest and allows for effective monitoring for compliance with applicable risk parameters. Compensation of risk management personnel should not depend materially upon the performance of a particular investment strategy. Where independent risk management is not practically feasible, as may be the case for a smaller hedge fund manager, the investor should undertake due diligence to be satisfied that the hedge fund has adequate risk management policies, procedures, and staff in light of the level of investment risk the hedge fund is taking. As with risk management personnel, compensation of independent risk compliance personnel should not depend materially upon the performance of the particular investment strategy.

Best Practices

- Investors should understand the hedge fund manager's risk management philosophy and processes and be familiar with the relevant markets and trading strategies employed.
- Investors should determine that the manager has an independent risk compliance function whose compensation is not directly tied to portfolio performance and that reports directly to senior management of the fund. In the absence of such a structure, investors should determine that the risk compliance structure that is in place provides meaningful risk oversight to the fund. Investors should determine the manager's risk management function is adequately resourced and staffed by qualified personnel in all cases.
- Investors should review and understand the manager's risk management policies and risk compliance procedures, both formal and informal, to determine if they effectively address market risks, including the risk of extreme events.
- Investors should obtain information from the manager about internal risk measurement practices and understand which are most critical, what metrics are reported to investors, and the frequency with which the calculation and reporting of risk occurs.
- Prior to making an investment decision, investors should review samples of the reporting provided by managers and determine if the reports adequately address the disclosure needs and risk parameters of the investor.

3. Investment Risks

Investment risks fall into two broad categories: systematic risks, which are market-related, and idiosyncratic risks, which are not. Pure market risk is the exposure of an investment to movements in particular markets, which generally include the equity markets, interest rate markets, commodities markets, and currency markets. Other market-related risk factors include credit, volatility, and liquidity risks. Non-market-related investment risks include portfolio specific risk factors such as correlation risk, basis risk, and counterparty risks. These risk factors are further described below.

The greater an investment's exposure to a risk factor, the more the value of the investment is likely to fluctuate with changes in the level of that risk. Risks can be embedded in investment strategies—for example, a long position in a particular stock can have embedded interest rate risk and commodities risk as well as idiosyncratic risks related to the specific company's management and business activities.

Investors should assess a hedge fund's key investment risks in light of the fund's investment objectives and strategies. Investors should also be comfortable that the manager adequately monitors investment risks and maintains the portfolio within prescribed risk parameters. As discussed above, hedge fund managers should mitigate potential conflicts by segregating the risk management function from portfolio management in terms of supervision, responsibility, reporting, and compensation.

Investors must evaluate each component of risk in a hedge fund investment and determine their willingness to accept the related risks. There is extensive literature on this subject that is beyond the scope of this report, but the significant risk categories are summarized below. Investors should be sufficiently familiar with these forms of risk to recognize their impact upon a particular hedge fund and its trading strategies.

Market and Market-Related Risks

- **Equity risk** is the risk that a portfolio will change in value due to fluctuations in equity prices. Hedge fund managers can manage equity risk through hedging strategies that utilize equity derivatives such as options and futures contracts or by employing market-neutral investment strategies that generally do not correlate with broad market movements and, thus, carry limited broad market risk.
- **Interest rate risk** is the risk to portfolio value due to changes in interest rates. Interest rate risk can be hedged with a variety of techniques and financial instruments, including futures contracts and swap agreements. It is quite possible that the hedging of interest rate risk of certain investments, with instruments that have different proportions of risk exposures, can result in exposure to forms of basis risk.

- **Currency risk** is the risk of changes in the relative value of a foreign currency in which investments are denominated. This risk directly affects the value of such investments. Currency risk can be offset using forward or futures contracts as hedges against foreign exchange rate fluctuations.
- **Credit risk** is the risk of default of an underlying borrower. Depending on the nature of the borrower, there can be **consumer credit risk** or **corporate credit risk**. Consumer credit risk is particularly relevant to the origination market where, for example, investors holding structured pools of mortgages have credit exposure to the underlying borrowers. Corporate credit exposure arises, for example, when an investor owns fixed-income securities issued by a corporation. The expected cash flows from these securities are dependent on the financial condition of the issuer. Additionally, relying solely on third-party credit rating providers can expose a portfolio to rating agency risk.
- **Commodity risk** refers to the risk of rising or falling commodity prices that may result from supply and demand imbalances, changing spending patterns, or changing input costs. Commodity risk can be contained through futures and forward commodity contracts.
- **Volatility risk** arises from increased market price fluctuations. Managing volatility risk in normal environments can be accomplished through portfolio diversification by market sector and strategy. Volatility risk emerges on a different level under extreme market conditions in which correlations between asset classes and strategies tend to change and often converge. Managers may hedge volatility risk through financial derivatives.
- **Correlation risk** is the risk of changes in the way prices of different investments in a portfolio relate to each other. Increasing correlations can attenuate the expected benefits of diversification.
- **Liquidity risk**, in its “market” form, is the risk of being unable to unwind investment positions at previously prevailing market prices. In a sudden market downturn, margin calls can force the liquidation of portfolio positions. When combined with contracting liquidity arising from hedge fund redemptions, this environment leads to large cash outflows and greater portfolio losses. Because of its tendency to compound market, credit, and other risks, it is difficult to isolate liquidity risk. Market liquidity can suddenly and severely contract, making it difficult to transact at “observed” market prices. For example, bid-ask spreads may be so wide that fund NAVs may not be realistic if a fund actually seeks to sell positions. Where appropriate, liquidity risk measurement should reflect the potential discounts in value that would effectively incorporate the potential impacts of severe market changes. Liquidity risk has additional bearing in the hedge fund context for fund strategies that involve the

purchase of less liquid assets coupled with hedging short positions in more liquid instruments. Hedge funds following this strategy get compensated for acting as liquidity providers to the markets.

Other Investment Risks

- **Basis risk** refers to the risk remaining after hedging has been implemented. Certain investment opportunities may not allow for effective hedging, and hedge funds may be able to hedge some components of risk but not others. Theoretically, perfect hedging should result in a return equal to the risk-free rate, minus transaction costs. Generally speaking, there will always be some basis risk in hedged investments.
- **Common holder risk** results where many investors holding the same asset need to exit it at the same time, resulting in significant downward price pressure.
- **Event risks** are those unusual circumstances in which large-scale swings occur in capital markets. These may arise from unpredictable events such as terrorist attacks, natural disasters, unusual weather patterns, or oil supply shocks. To analyze extreme event risk, a hedge fund manager should employ a series of hypothetical scenarios that are relevant to the particular portfolio. Examples of market stress events may include rapid equity declines and credit-spread widening or a period of rapid equity advances and credit tightening. Managers should conduct appropriate stress testing based on the current portfolio exposures and specifics.
- **Counterparty risk** arises from transacting with parties that are unable to meet their obligations. It is particularly important when investing in derivatives, in which either party's credit exposure to the other will change, perhaps significantly, over the term of a derivative contract. Managers can generally mitigate or diversify counterparty risk on two levels. First, they should choose counterparties with strong balance sheets and consistent cash flow streams. Second, they may be able to use security interests in collateral, covenants, and credit derivatives, such as credit default swaps or other types of protection, to support the timely and orderly repayment of financial obligations. Investors should understand the manager's policies for selecting and monitoring counterparties.
- **Asset/liability matching risk**, sometimes referred to as funding liquidity risk, is the risk of loss when the amount of capital available to a hedge fund falls due to redemptions or the loss of other financing sources and the hedge fund cannot fund its redemptions, investments, payments to creditors, or expenses. Investors assessing this risk must consider the investment strategies employed, the nature of the fund's investor base, the

rights of investors to redeem their interests, asset liquidity, and counterparty funding arrangements.

- **Meta risks** are the qualitative risks beyond explicit measurable financial risks. They include human and organizational behavior, moral hazard, excessive reliance on and misuse of quantitative tools, complexity and lack of understanding of market interactions, and the very nature of capital markets in which extreme events happen with far greater regularity than standard models suggest. While these qualitative risks exist and it is useful to be aware of them, it is virtually impossible to plan for and hedge against them.

Best Practices

- Investors should obtain comfort that the type and degree of risk a hedge fund assumes is consistent with its stated risk profile and the investor's risk and return objectives. This can be achieved by understanding and continually monitoring the fund's risk profile, obtaining appropriate and regular disclosure from the fund, and confirming effective risk monitoring and management by the fund manager. Investors should also understand how analyses of market risk translate into actions—for example, what triggers position adjustments and who makes those decisions.
- Investors should seek to understand the material risks in a hedge fund's portfolio through independent analysis of data disclosed by the hedge fund manager.
- The hedge fund manager should articulate its major market risks and should provide a comprehensive overview of the metrics and procedures in place to identify, measure, monitor, and manage those risks.
- Managers should discuss their degree of exposure to imperfect hedges/basis risk. Both investors and managers should incorporate reasonable inherent uncertainty into their risk analyses.
- Investors should consider all material types of risks and their relative impact on the performance of the hedge fund. The manager should explain its approach to managing those risks.
- Investors should evaluate the extent to which a hedge fund is subject to event risk. The hedge fund manager should explain the material event risks associated with the fund and periodically stress test the portfolio to appraise the potential effect of extreme events.
- Investors should assess the manager's approach to counterparty 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. With respect to credit risk, investors should assess the

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adequacy of the manager's approach for evaluating the creditworthiness of any borrower; the nature of any underlying collateral supporting the debt, sector, or borrower limits; and monitoring processes.

- Investors should determine whether and to what extent the manager seeks to account for meta risks in its portfolio. A balance of quantitative and qualitative factors in decision making is vital for an effective risk management system designed to preclude or at least mitigate meta risks.

4. Liquidity and Leverage Risk

Investors should understand the liquidity and leverage of a hedge fund, including the impact of redemptions, the ability to liquidate assets, the impact of leverage on the hedge fund portfolio, the availability of financing, and the potential impact of extreme events.

Investors should consider the risk posed by the behavior of other investors in the same fund, or even in the same fund family, which may adversely affect the stability of the manager's business. In dislocated markets, for example, investors may exhibit herding behavior by simultaneously seeking to redeem from a fund or range of funds. This may require a hedge fund to liquidate assets at an inopportune time, at a significant loss, or to suspend investors' redemption rights.

A hedge fund's liquidity terms should be appropriate to prevent this kind of rush to the exit. Appropriate terms may include "gate" provisions that limit the amount investors can redeem at any given time. The investment terms of most hedge funds allow for the suspension of redemptions in extreme situations. Investors should understand the circumstances in which these restrictions may arise.

Hedge funds can employ a variety of techniques that introduce leverage into their portfolios. Often this involves entering into short positions or borrowing money to purchase securities. These strategies may be used to incorporate exposures that are negatively correlated to the hedge fund's holdings in order to decrease the overall risk of the portfolio. However, the use of leverage introduces new risks, such as counterparty risk. Investors should seek to understand the leveraging techniques used by hedge fund managers.

Leverage increases the potential magnitude of portfolio fluctuations. It magnifies investment risks and can exacerbate liquidity problems in market downturns. As such, leverage is not a true risk factor by itself, but a measure of the rapidity with which other factors affect valuation and the resulting margin of safety a manager has to ride out market volatility. Leverage also complicates a portfolio's structure due to obligations to creditors, counterparties, and investors, and it can increase the risk to a fund due to the actions of these parties. In particular, dependence on leverage creates the risk that the fund will be unable to meet its obligations should access to credit become limited due to

broader credit market conditions. Managers should be aware of the risks of leverage and assess leverage levels continuously. Careful attention should also be given to the amount of leverage employed, including the access to that leverage, the methodologies used to determine the amount of leverage that can be acceptably employed over time, and the variance of leverage relative to the complexion of the actual underlying investment opportunity and its projected liquidity under stress.

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- The investor should understand the manager's definition of leverage as well as which investment strategies and instruments utilized by the hedge fund will generate levered exposure.
- If applicable, investors should clearly understand accounting and economic leverage limits to be utilized in the hedge fund portfolio, based on either absolute capital exposures, value-at-risk, or similar measures.
- Investors should monitor leverage on a regular basis and understand hedge fund managers' plans for reducing leverage if limits are exceeded.
- Investors should clearly understand the source of leverage capital in any investment strategy and understand the restrictions on continued availability of financing and alternatives available to replace existing leverage financing in case of market dislocation or problems with an existing leverage provider.
- Investors should review the liquidity risk implicit in different assets traded by a hedge fund, taking into account factors such as jurisdiction, instrument type, and market depth. For purposes of this analysis, investors should develop familiarity with the nature of the markets in which the fund's instruments are traded.
- Investors should obtain information outlining how frequently managers conduct liquidity stress-testing and scenario analysis and understand its scope. Investors should be satisfied that the regularity, breadth, and depth of such testing is adequate.
- Investors should understand the liquidity terms of their investment in the context of the fund's underlying asset liquidity and redemption policy and be satisfied that those terms are fair and reasonable in light of the investor's objectives. Investors should carefully scrutinize any fund that appears to offer redemption terms inconsistent with asset liquidity.
- Investors should recognize the circumstances in which a fund can suspend redemptions and understand the measures that managers employ to mitigate the risk of such suspensions. Investors must be comfortable with those terms in the context of their objectives in considering investment in a particular hedge fund.

5. Measurement of Market Risks and Controls

Risk measurement assists investors in understanding quantifiable market risks and recognizing when they exceed applicable risk limits. Measurement techniques include stress tests and scenario analysis, value-at-risk (VaR) methods, volatility measures, concentration metrics, and other approaches. No single method of measuring risk is suitable in all circumstances, particularly given the broad range of existing and emerging hedge fund strategies. Managers should employ multiple risk measures that describe risks in several dimensions, but these should not supersede good judgment. Investors should understand these multiple risk measures and how they are applied.

Measurement tools can be complex, and investors should not rely on them exclusively. For instance, some risk measures, like VaR, understate portfolio risk in periods of low market volatility. VaR models, as well as other quantitative risk measurement techniques, often incorporate assumptions of correlations between investment returns and the distribution of asset prices. These simplifying assumptions, by their nature, cannot fully estimate the behavior of all market relationships under all conditions. Investors should be particularly wary of risk measurement using limited time series as inputs in models such as VaR. It is particularly important to employ good judgment when only limited historical data on asset behavior is available.

Stress testing and scenario analysis help assess risk during acute market events such as periods of extreme volatility and high correlations. Managers should use these measures to help better gauge their risk in severe market environments.

Best Practices

- Investors should understand the risk metrics employed by a manager, including the implications and limitations of those measurements, and ascertain whether they are appropriate for the strategies and objectives of the fund.
- Investors should confirm that the manager is not unduly dependent on any single measurement tool to manage portfolio risk.
- Investors should understand the historical data available on risk and be aware of its limitations.
- Investors should confirm that the manager understands and regularly tests its portfolio risks in a comprehensive manner under both normal and extreme market conditions.

6. Management of Risk Limits

Hedge fund managers should have procedures in place for taking appropriate responsive action if hard or soft risk limits or guidelines are exceeded. Risk reporting should be

sufficiently robust to allow senior management to evaluate risk positions as frequently as necessary to prevent breaches and to address them in a timely manner if they do occur.

Best Practices

- Investors should be familiar and comfortable with the hedge fund manager's decision-making policies and procedures for addressing situations in which hard or soft risk limits or guidelines are exceeded.
- Risk limit policies and procedures should state clearly who has the decision-making authority to address the breach of a hard or soft risk limit. Ideally, these decision-makers are independent of the standard investment process.
- Risk limit policies and procedures should provide for timely notification to investors and responsive action in the event that risk limits are materially breached.

7. Compliance

A hedge fund adhering to best practices should have a robust compliance function, including a written compliance manual. Where practicable, the compliance function should be independent of portfolio management in order to mitigate conflicts. Compliance personnel should oversee compliance with applicable laws and regulations and with key offering document representations. The compliance function should monitor all issues relating to legal and regulatory compliance and provide reports to senior management on a regular basis.

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- Investors should review hedge fund managers' written compliance manuals.
- Investors should verify that the compliance function is robust, appropriately independent, and supported with sufficient resources and authority.
- Investors should be comfortable that managers' reporting requirements to investors in the case of serious compliance breaches are sufficient to enable investors to protect their interests.

8. Operational and Business Risks

Operational risk is the possibility of losses from systems, processes, technology, individuals, or events. Hedge fund operational risk is often greater than that of traditional asset managers for a number of reasons, including higher transaction volumes,

complexity, use of leverage, financial incentives, and potentially leaner staffing in start-up operations. No two funds are the same, however, and investors must always evaluate the sufficiency of operational resources in light of the particular investment under consideration. To the extent practicable, hedge fund operational functions, including reporting, compensation, and decision-making authority, should be independent of portfolio management.

Investors should assess the experience and training of a hedge fund's operational staff in the critical areas of expertise—in particular, the strength and independence of its leadership, typically either a chief financial officer or chief operating officer.

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- Investors should understand who has authority over the operational functions of the hedge fund.
- Investors should be comfortable that operational functions are appropriately independent from portfolio management to mitigate potential conflicts of interest. Investors should closely evaluate functions where such conflicts are likely to arise, including valuation, risk management, and compliance. Smaller hedge funds may lack sufficient resources to separate the operational function from portfolio management, in which case investors should ascertain how the manager intends to address potential conflicts.

Like banks and long-only asset managers, hedge funds are also subject to trading risks such as failed trades, confirmation backlogs, and other trading errors. These risks can be particularly important for hedge funds due to the frequent trading that is inherent in some strategies.

A hedge fund manager should have a consistent procedure for creating and documenting buy and sell orders, checking and settling trades by personnel other than the trader, and reconciling positions with prime brokers or their equivalents on a regular (typically daily) basis. A manager also should have a process for monitoring and acting on corporate actions on long and short equity positions and a documented procedure for addressing trade errors caused by the manager's personnel.

Best Practices

- Investors should understand and be comfortable with a manager's processes and controls from initiation through confirmation, reconciliation, and reporting of trades and other transactions. These functions should be segregated to ensure the integrity of these controls.
- The investor should confirm that the manager's back and middle office have

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sufficient resources to manage expected trading and transaction volumes.

- Investors should understand and evaluate the manager's written trade error policy to determine if it assigns financial responsibility for errors appropriately.

9. Prime Broker and Other Counterparties

Prime brokers provide many important services to hedge funds such as brokerage, securities lending, financing, and back office support (including clearing and settling trades). Prime brokers and other trading counterparties should be sufficiently large and sophisticated and have the resources and expertise necessary to handle the fund's investments. Larger hedge funds may have multiple prime brokers, while smaller and newer funds are unlikely to have more than one. Prime brokers present credit risks themselves, which need to be managed by managers.

Some hedge funds trade regularly in over-the-counter markets where participants are not subject to the strict credit evaluation and regulatory oversight of exchange-based markets, and where the trades do not settle through exchanges or clearinghouses that guarantee the settlement of trades. The resulting risk is that a counterparty may not complete a trade (if, for example, it has credit or liquidity problems).

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- Investors should be aware of the prime broker(s) and other material credit or trading counterparties of the hedge fund and understand the manager's process for analyzing and diversifying prime broker and counterparty risk.
- Investors should be comfortable that managers select prime brokers with adequate liquidity, that counterparty credit risk is otherwise managed appropriately, and that prime brokers and other important trading counterparties have the ability to perform their duties effectively.
- Investors should understand how frequently the manager trades over-the-counter and what portion of the hedge fund's portfolio is exposed to the risks of over-the-counter markets.
- Investors should understand with whom the manager trades and how the manager manages credit risk with counterparties.
- Investors should understand the financing arrangements of the fund and what constraints those arrangements place on the fund in terms of leverage, liquidity, operations, or otherwise. Important items to consider in this regard include margin and collateral requirements, negative and positive covenants, and default

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triggers such as negative performance or decreases in assets under management, or both.

- Investors should evaluate whether the fund's counterparty and financing arrangements have been appropriately stress-tested to understand the circumstances in which a trading relationship can be unwound or margin/collateral requirements increased.

10. Fraud and Other Crime

Fraud and financial crime are risks with any investment, and hedge funds are no exception. They can manifest themselves in several ways, with some of the most severe forms including false reporting, intentionally misleading audits, and outright theft of capital.

Best Practices

- The Investor should confirm that the manager maintains appropriate procedures and controls to protect against inappropriate or fraudulent conduct. Such procedures and controls will vary by manager but should include, but not be limited to, the following:
 - maintenance of anti-money laundering procedures.
 - appropriate segregation of duties for functions such as accounting, wiring of funds, and valuation.
 - fund's net asset value statement are sent to the investor directly from the independent administrator or similar service provider.
 - fund assets are held away from the manager (e.g., that capital is held with reputable independent custodians, prime brokers, or other similar third parties).
 - existence of internal controls designed to prevent misuse or theft of client money (e.g., by requiring that cash must move in and out of the fund's account only under written instructions of at least two sufficiently senior, responsible individuals).
 - existence of a robust and reasonably independent compliance function.
- The lack of appropriate procedures and controls should be considered as a potential warning sign and, prior to investing, the investor should consider what

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additional scrutiny should be undertaken to protect itself from the risk that the manager may be engaging in inappropriate or fraudulent conduct or be unable to prevent such conduct.

11. Information Technology and Business Recovery

Hedge funds and their managers rely heavily on technology and require support from technological systems on an uninterrupted basis. To prevent unexpected events from disrupting the operation of a fund, the manager should have robust business recovery and information plans that are appropriate to the particular business. These should be tested periodically, and no less than once per year.

Business recovery plans should address the security and integrity of systems and data; provide for contingency office space and infrastructure, as well as off-site data storage and other back-up facilities; and include alternate communications procedures. They should provide for the recovery of technology and systems and address other necessary contingencies.

Best Practice

- Investors should take reasonable steps to verify that a fund has robust business recovery and information technology plans and that the fund has comprehensive policies and procedures to ensure that unexpected events do not interfere with the fund's operation. Such plans should be appropriate for the size, complexity, and trading volume of the fund and address weather and geologic events that may be predictable in the locations where the fund has offices.

12. Conflicts of Interest

Conflicts of interest are common in the management of hedge funds and there are few legal protections for investors against such conflicts of interest other than what is provided for in investment agreements. Managers may manage multiple funds or accounts that compete for investment opportunities. They also may have interests in entities that provide services to the funds or incentives to favor some accounts over others. Conflicts also arise in the valuation process, when managers are paid performance fees that depend on the value of those investments. Consequently, investors must largely protect themselves against conflicts of interest through their investment agreements with hedge fund managers. Effective protections must include both disclosure obligations and clear policies and procedures reducing the impact of conflicts of interest on manager decision makers.

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- In order to assess the nature and extent of the manager's potential conflicts of interest, investors should understand the full scope of the advisor's activities, including types of funds and accounts advised by the hedge fund manager and whether they share in allocations or investment opportunities. Investors should also understand the manager's outside business activities, if any.
- Investors should confirm that managers have appropriate conflict-of-interest procedures and controls in place to provide for the fair and equitable allocation of investment opportunities across different accounts, so that none is favored over another.

13. Other Service Providers

In addition to prime brokers, discussed above, hedge funds often rely on other service providers, including administrators, custodians (in certain cases), and auditors, who assist the fund by safeguarding investors' assets and ensuring the accuracy of financial reporting.

Fund auditors should be experienced (specifically in auditing hedge funds), reputable, and independent. Investors should be comfortable that the outside audit firm is capable in the field of hedge fund auditing, has adequate resources, and is independent of the manager. Investors should examine the historical financial statements, if any, of a prospective fund to assess past performance and reporting and, as a matter of due diligence, to ascertain if they disclose unusual qualifications or other significant information about the audits.

Fund administrators should have the capacity, resources, technology, and expertise to handle fund accounting and transfer agency services. The administrator should provide independent mark-to-market pricing, except in special circumstances where input from the manager or another third party is needed to establish the value of illiquid assets for which the administrator does not have sufficient information.

Custodians for hedge funds (usually the prime broker) should be independent and able to provide appropriate security and services to safeguard the assets of the fund.

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- Investors should obtain information from managers explaining the process used to select and monitor the fund's service providers.
- Investors should assess whether the fund's service providers have sufficient experience and independence to perform their roles effectively, are not exposed to undue influence from the manager, and that the compensation and other terms

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of service provider engagements do not give rise to potential conflicts of interest.

- Investors should independently confirm material service provider relationships.

14. Fund Governance

The governing body of a hedge fund varies depending on, among other things, the type of business entity used and the jurisdiction in which the fund is organized. Not all hedge funds are set up in the same way and legal structure is often a significant driver of a fund's governance arrangements. For example, funds marketed mainly to U.S. taxable investors are frequently organized in the U.S. ("onshore"). Onshore funds are typically set up as limited partnerships or limited liability companies, mainly because of the beneficial tax consequences for U.S. taxable investors that are discussed in more detail below. The investment manager acts as the general partner, or equivalent, with investors granting the manager exclusive decision-making power. There is no separate board of directors of the fund.

Funds marketed to non-U.S. investors and U.S. tax-exempt investors are generally domiciled in low tax jurisdictions outside the U.S. "Offshore" funds are frequently structured as corporations and formal control resides with a board of directors, often including representatives of the hedge fund manager and independent directors. While independent board oversight may provide some benefit to investors, the level of investor protection provided by hedge funds' boards of directors often falls short of the protections provided by similar governing bodies, such as U.S. public company boards of directors.

Independent directors with suitable qualifications and the experience and ability to effectively oversee a hedge fund manager may contribute to a more robust governance process; however, their ability to act is sometimes constrained by managers. Regardless of legal form, hedge fund managers play a pivotal role in determining governance arrangements at the outset of a fund's establishment and on an ongoing basis.

While legal structures and relationships are important, investors should not focus on form over substance. Regardless of structure or domicile, investors should pay close attention to the governance mechanisms employed by a hedge fund manager and seek out managers that have established comprehensive approaches to address conflicts of interest and ensure investors' interests are appropriately protected.

In our view, all best practices described in this report should be capable of implementation irrespective of the fund's legal form and where formal responsibility lies.

Best Practices

- Investors should understand the hedge fund’s governance structure, irrespective of its domicile.
- If a fund has a board of directors or similar governing body, investors should inquire as to the scope of its responsibilities and decision-making authority, in particular whether it approves the fund’s financial statements, and how frequently it meets to discharge its duties.
- Investors should be comfortable that a hedge fund’s governance structure is capable of handling potential conflicts of interest and its other responsibilities. Where there is a separate fund governing body such as a board of directors, investors ought to ensure that its members have the skills and experience required to effectively undertake its responsibilities.

C. LEGAL AND REGULATORY

1. Investment Structures

The Investment Company Act of 1940, as amended, generally requires any issuer that holds itself out to the public as being in the business of buying and selling securities or meets certain asset and income tests to register with the SEC as an investment company. Registered investment companies are required to fulfill corporate governance requirements intended to address conflicts of interest, limit their debt, comply with strict rules in determining the fair value of their assets, permit shareholder voting on key issues, ensure that management fees are reasonable, and provide regular disclosures to investors and reports to the SEC. In most cases, a “hedge fund” is a private investment company that is excluded from regulation as an investment company because it is not sold to the general public and has fewer than 100 shareholders, or because it is not sold to the general public and its shareholders meet certain requirements. In most cases, the securities offered by hedge funds are also exempt from registration and offered as private placements under Regulation D of the Securities Act of 1933. Because neither hedge funds nor the securities they offer are registered, investors in hedge funds do not receive the protections that registration provides.

Hedge funds are most frequently organized as limited liability companies (LLC) or limited partnerships (LP). These structures avoid taxation at the fund level and provide flow-through tax treatment to investors. Fund managers serving U.S. tax-exempt investors (as well as non-U.S. investors) frequently employ an offshore “master-feeder” structure. This combines a “master fund,” often an investment company exempt from the Investment Company Act, domiciled in a low tax or no tax jurisdiction such as the Cayman Islands, with an offshore “feeder fund,” another exempted company domiciled in the same jurisdiction as the master fund, and an onshore LLC or LP, which is also a “feeder fund.” Investors subscribe to the feeder funds, which “feed” or “upstream” their

assets to the master fund, and the combined pool of assets is managed at the master-fund level. By investing in the offshore feeder, non-U.S. investors usually avoid being subject to U.S. taxes and the reporting requirements that arise when non-U.S. investors generate taxable income that is “effectively connected to the conduct of a trade or business within the United States.”⁷ For U.S. tax-exempt investors, the offshore feeder fund acts as a “blocker company” and may enable these investors to avoid being subject to Unrelated Business Taxable Income (“UBTI”). This structure enables tax exempt investors to participate in investment partnerships that use leverage as part of their investment strategy.

2. Domicile of Hedge Fund and Investments

Many hedge funds are domiciled in “offshore” jurisdictions because of tax, regulatory, and cost considerations. Regulatory oversight in these jurisdictions is often less rigorous than even the light regulatory oversight that domestic hedge funds receive in the U.S. Partnership, corporate, or other applicable law may be less well developed, and courts less transparent and accessible than in the United States. While investors and hedge funds can contract to have disputes resolved in U.S. courts, hedge fund managers may or may not be willing to agree to such language.

Offshore jurisdictions may not require funds to comply with the same accounting, auditing, and financial reporting standards as found in the U.S. Financial statements for hedge funds, however, regardless of the jurisdiction where they are organized, are typically prepared under U.S. Generally Accepted Accounting Principles (U.S. GAAP) or International Financial Reporting Standards (IFRS) and audited by reputable accounting firms specializing in hedge funds. Offshore jurisdictions often offer less uniformity in standards and practices and less supervision and oversight. This may mean that hedge funds are required to disclose less information to investors, or that they disclose it less frequently or in a different format than would be expected in jurisdictions with more extensive regulatory regimes.

The investments that hedge funds make in non-U.S. markets can be subject to changes in tax and regulatory regimes, confiscatory taxes or laws, political instability, exchange controls, restrictions on capital flows, or other investment controls. Investors in hedge funds domiciled in (or operating in) unfamiliar jurisdictions may find their returns diminished or their capital unavailable for repatriation in the event of a significant change to a jurisdiction’s regulatory, political, or tax regime.

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- Investors should confirm that the hedge funds in which they invest prepare financial statements in accordance with acceptable accounting standards, such as U.S. GAAP or IFRS, and that those financial statements are audited by a reputable auditing firm.

⁷ Internal Revenue Code §§ 871(b), 882. *See also* Internal Revenue Code § 897.

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- Investors should consider the lack of audited financial statements to present an extreme degree of risk and uncertainty with respect to a hedge fund investment.
- Investors should understand the nature, depth, maturity, and stability of the legal system in the jurisdiction where the hedge fund is domiciled and be comfortable with their ability to vindicate their legal rights as an investor in the fund.
- Investors should consider the potential for disputes regarding the appropriate jurisdiction in which fund-related claims would or could be brought.
- Investors should ascertain the manager's level of expertise in the jurisdictions in which the fund is domiciled and in which it invests.
- Investors should seek to understand the degree of risk a fund faces from potential tax, legal, or other regulatory changes, either in its registered domicile or in the jurisdictions in which it invests, and the fund's strategy for mitigating those risks when possible.

3. Terms of Hedge Fund Investments

A hedge fund's governing documents describe the legal and business terms of an investment in that fund. The terms are typically set out in an offering memorandum or prospectus, a subscription agreement, a fund's constitutional document such as a limited partnership agreement or articles of incorporation, and the investment advisory contracts between the fund and its manager. Other contracts may also be important, depending on the fund.

Note, however, that an offering memorandum may not by itself be legally binding on the fund or its manager, and care should be taken in distinguishing between rights and obligations of the fund, its manager, the investor, and any other party. For reasons related to the historical intent of hedge funds to invest with minimal constraints, a focus on liability concerns, and supply and demand considerations in the investment marketplace, the investment terms of a hedge fund typically favor the fund and the manager. This state of affairs is not unique to hedge funds, but should be taken seriously when considering the terms of a hedge fund investment. For example, the governing documents of most hedge funds give managers broad, sometimes almost unlimited, freedom to make investments. As a result, hedge fund managers can often change their objectives, style, policies, or restrictions without notice to or approval from investors. Some investors seek to improve such terms through negotiations. All investors should then determine whether the terms of any given hedge fund investment are acceptable in light of these risks.

The fund's governing documents should disclose the fund's intended investment strategies and policies, and the associated risks. Investors should understand the conditions, if any, in which they would receive notice of a material change to the fund's investment strategies and policies, and whether they would receive a right to redeem their interests if a change in investment strategy rendered a hedge fund unsuitable for the investor's portfolio. Hedge funds, however, generally impose significant restrictions on the right to redeem investments. For example, initial investments may be subject to a lock-up period of one year or more and, following such lock-up period, redemptions may be permitted only quarterly or annually. In addition, funds may have the ability to impose redemption "gates" to limit the outflow of funds at any one time to a certain percentage of the fund's total assets. These help funds avoid excessive redemptions, and provide managers additional time to sell assets to meet redemption requests.

The governing documents also specify the manager's compensation, which typically consists of a management fee calculated as a percentage of the net asset value of the fund, plus a performance fee calculated as a percentage of appreciation in the net asset value of the fund. Performance fees are typically subject to a "high-water mark," whereby performance fees are not paid (either in whole or in part) on gains in the current year until losses from prior years have been recouped. Different high-water mark requirements will specify different periods from which losses must be recouped before a performance fee is paid. Some funds may also offer a "hurdle rate," pursuant to which the manager must achieve a certain return before the performance fee begins to accrue.

In the "master feeder" structure, the fees are typically charged against each investor's capital account at the feeder fund level, and each feeder pays its pro rata portion of the expenses of the master fund. Investors should pay particular attention to terms delineating expenses charged to the fund and expenses charged to the manager. They should understand what portion of the fund's operating expenses, or "overhead," is charged to investors, what expenses are included in the management fee, and which are fund-specific expenses.

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- Investors should examine, with an eye to determining whether their interests are adequately protected, among other terms:
 - the degree of investment freedom afforded to the fund's manager.
 - the management and performance fees charged and how they are calculated.
 - the terms under which an investment can be redeemed, including "lock-ups" and notice periods.
 - the manager's power to suspend or "gate" redemptions.
 - the expenses paid by the fund.
 - extent of the use of "side-pockets," if any.

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- the risk factors associated with the investment.
- the policies regarding the calculation of NAV.
- the scope of the manager's liability to the fund.
- tax implications of the fund's investments.
- indemnification provisions among the fund, the manager, and investors.
- Investors should also understand the circumstances under which the fund or its manager can modify terms of the governing documents and be comfortable with the potential ensuing risks.
- Investors in funds that offer varying liquidity terms to other investors should assess the risks and benefits attendant to such terms. If the fund retains the option to impose a "gate" on redemptions, investors should determine the appropriateness of the gate in light of the fund's investment strategy and instruments.
- 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." In instances where other investors have preferential liquidity terms, the investor should determine whether the investor's interests are adequately protected.
- Investors must retain competent legal advice to aid in the understanding and negotiation of terms.

4. Fiduciary Duties (including ERISA)

The trustee or other fiduciary of a plan subject to ERISA should determine whether the hedge fund manager is an ERISA fiduciary. If so, the plan fiduciary should determine whether the hedge fund manager complies with the requirements for an ERISA fiduciary, including, where applicable, the QPAM requirements and registration as an investment adviser under the Investment Advisors Act of 1940 or comparable state law. If the hedge fund manager is not an ERISA fiduciary, it nevertheless might be prudent for the plan fiduciary to require the hedge fund manager by contract comply with the duties of loyalty and care similar to those provided by ERISA, as well as prohibitions against self-dealing, and if not, whether the fund is an appropriate investment. ERISA fiduciaries must obtain sufficient access to information to enable them to comply with their duties under ERISA to oversee hedge fund investments.

Best Practices

- Investors and fiduciaries responsible for assets governed by ERISA should:
 - Consult with legal counsel familiar with ERISA before making hedge fund investments.
 - Confirm that they will receive disclosures from the hedge fund that are sufficient to enable them to comply with their duties under ERISA to oversee hedge fund investments.
 - Determine if the hedge fund manager is an ERISA fiduciary and complies with the requirements for an ERISA fiduciary, including the QPAM requirements, where applicable.
 - Assess whether the hedge fund manager provides assurances that it will assume fiduciary duties including loyalty and due care provided by ERISA, and if not, whether the investment is appropriate.

5. Registration with SEC, CFTC, and Other Regulators

Hedge fund managers operating in the United States generally may register as investment advisors with the Securities and Exchange Commission. Such voluntary registration provides investors with a number of protections, including well established fiduciary duties enforceable in U.S. federal courts, which may not be available when investing with unregistered managers. Hedge fund managers may also voluntarily register as a broker-dealer with FINRA, or as a commodities dealer with the Commodity Futures Trading Commission.

In some non-U.S. jurisdictions, investment managers are required to be registered with the relevant authorities. Such requirements may provide additional information or protection to investors. Investors, however, should be cautious in their reliance on registration by a hedge fund manager in any jurisdiction and should not substitute regulator oversight for their own due diligence in any circumstances.

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- Investors should determine whether a hedge fund manager is registered as an investment advisor with the SEC. If the manager is not registered, investors should obtain an explanation from the manager of the decision not to register.
- Investors should understand under what circumstances and in which domiciles registration is required (as opposed to voluntary) with the relevant body. Where registration is required, investors should confirm that such registration (for example with the FSA) indeed exists. Where it is not required, and a manager or fund has elected not to register, investors should determine why and what the consequence are for the investor.
- To the extent a manager is registered or licensed with a regulatory body, investors should avail themselves of all information available by virtue of such registration or licensing (such as Form ADV with the SEC), obtain additional information from the manager or regulator concerning the nature of the registrations and their attendant obligations, and investigate any regulatory disciplinary history.

6. Rights of Other Investors / Side Letters

Hedge fund managers should disclose material terms available to some investors that are not offered to all investors. Investors should inquire about such special terms and request copies of any side letters embodying them. At a minimum, the manager should disclose the existence of the material terms of any side letters to all investors. If the manager offers the investor less favorable terms than available to other (e.g., larger) investors, the investor should consider the extent to which it would be disadvantaged by such special rights, especially preferred or differential liquidity rights, when evaluating the appropriateness of the investment.

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- Investors should, both prior to investment and on a regular basis following investment, request and receive from a fund's manager all pertinent information on material terms which differ from those of other investors who have invested in the fund.
- The investor should obtain sufficient information about variations in terms to determine the consequent impact of such terms on the fund's risks (including liquidity) and expected returns.

D. VALUATION

Valuation is ultimately at the core of any investment. It is the key to deciding whether to make an investment and to calculate returns from that investment over time. The increasing complexity and diversity of hedge fund portfolios and the increasing allocation to complex investments has resulted in a significant increase in efforts to formulate tools and processes for accurately valuing them. These efforts have been evident within the operations of alternative investment managers over the past several years. Auditors and institutional investors are striving currently to improve valuation techniques in the context of hedge funds increasingly investing in less liquid assets and harder to value assets.

The issues surrounding hedge fund valuation arise from the types of underlying investments and the corresponding procedures required to establish accurate, fair net asset values. The complexity of security types can range from U.S.-listed, actively traded equities (easiest to value) to non-U.S. privately placed securities (which entail foreign currency conversion as well as securities valuation issues) and complex derivative instruments that are traded over-the-counter. U.S.-listed securities are typically valued at the last sale price (or offer price for longs, bid price for shorts, or the bid/ask spread midpoint) on the primary exchange on which the security is traded. Their valuation is readily available and easily verifiable through a number of publicly available sources. From this baseline, there is a spectrum of securities and valuation methodologies with decreasing objectivity and increasing complexity. Valuation methodologies include dealer quotes (either direct or through aggregators), valuation services, models, and finally good faith estimates by the fund manager.

Valuation can become a particular problem in the context of unstable markets. Assets that are valued based on a mark-to-model approach may not be saleable at anywhere near the valuation in a market liquidity crisis. On the other hand, mark-to-market valuations in such a crisis may dramatically underestimate the value of performing assets if looked at from a cash generation perspective. The accuracy and appropriateness of valuation often has a profound impact on the ultimate portfolio returns reported to investors, as well as the fees paid to the manager. Therefore, it is critical that an investor understand the processes and controls related to deriving valuation, and that the investor evaluates and monitors these on an ongoing basis. Effectively assessing the valuation of an investment requires an understanding of the various activities involved with developing that valuation.

A hedge fund's private placement memorandum ("PPM") should describe the fund's investment valuation policies and procedures, as well as the frequency with which the fund's managers will notify investors of changes to the process and sources employed. The PPM will frequently provide the manager significant latitude in valuation methods. Also, the manager may begin investing in new types of investments without notifying investors of the new investments. Therefore, investors must look beyond the PPM to gain a comprehensive understanding of the valuation processes and sources the manager uses.

1. Valuation Policy

A fund should maintain a written valuation policy separate from the PPM and other fund documents to describe in detail the actual valuation process that the fund will follow for each

type of security in which it invests. At a minimum, this should identify the securities and instruments that the fund is expected to hold and the valuation source for each. This document should be available to all investors, and it should be updated at least annually or whenever a new instrument or security type is added.

The valuation policy should include, on an instrument-type-by-instrument-type basis, how the valuation for each instrument type is determined. The policy should also describe the control activities that occur within the organization to confirm that valuations are correct and appropriate. Investors should obtain reasonable assurances from the fund that the valuation policy is consistently applied and that it covers all of the fund's investments. In the absence of a written valuation policy, an investor should determine if sufficient valuation information is otherwise available to assess appropriately the fund's valuation-related risks. Whether or not the investor receives a formal valuation policy from the fund, the investor should confirm that the fund's valuation approach is consistent with industry standards, including Financial Accounting Standards Board Statement No. 157 ("FAS 157"), which defines fair value accounting measurements.

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- Investors should verify that a fund's manager has established a written statement of valuation policies and procedures to assure that the fund's portfolio is consistently valued under GAAP (or other relevant standards), including those provisions requiring fair value valuation. These policies and procedures may include, but are not limited to:
 - use of independent, reliable and recognized pricing sources.
 - regular reviewing and updating of the valuation policy as necessary.
 - creation of an effective governance mechanism, such as a valuation committee.
 - established practices and/or systems for capturing traded investment instrument prices daily.
 - established processes and models for pricing non-liquid securities consistently that are reviewed frequently for effectiveness.
- Investors should review the valuation policy document and understand the applicable valuation procedures and controls.
- Investors should understand the roles of each party involved in the valuation process.
- Investors should determine whether proper oversight of the entire valuation process exists, especially the pricing of illiquid and other investments that are difficult to price.
- Investors should confirm that valuation professionals employed by the fund apply the valuation policy on a consistent basis and that investors are notified of any material exceptions.

2. Governance of the Valuation Process

A valuation committee or similar governance mechanism can serve as an additional control to provide consistent and appropriate application of valuation methodologies. The necessity and level of formality of a valuation committee or similar mechanism is typically a function of a fund's investment strategy and the composition of the fund's investments. For example, a U.S. domestic long/short equity portfolio should have very little need for an active valuation committee. On the other hand, a multi-strategy global fund, with significant private investments, should have an active valuation committee that meets regularly.

A valuation committee's mandate should be appropriate for the complexity and liquidity of the fund's investments. It should have the authority to approve the fund's valuation policy and it should verify and validate valuations on a periodic basis (no less than quarterly). A valuation committee should include the manager's senior staff members responsible for accounting, risk, and compliance. A valuation committee may also benefit from the inclusion of independent committee members with valuation expertise who are not employed by the fund's manager. In any case, the committee's composition and decision-making process should be designed to provide competent oversight of the valuation process that is independent of the manager's investment and trading functions.

The valuation committee should meet regularly and review both the fund's valuation policy and the valuation of any securities that are illiquid or otherwise difficult to value. Decisions made by the valuation committee should be documented in writing and available to investors.

The manager's senior investment and trading personnel should be made available, where appropriate, to consult with the committee and support its assessment and comprehension of the valuation of assets, particularly those that are hard to value.

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- Investors should understand the functioning of the valuation committee or other governance structure of the hedge fund and evaluate whether there is sufficient oversight of the valuation process, including a mechanism to resolve conflicts relative to pricing on difficult to price investments.
- Investors should confirm that adequate segregation of valuation duties exists and that valuation functions are performed by suitably independent, competent, and experienced professionals.

3. Valuation Methodologies

Depending on the particular security, hedge funds employ different valuation methodologies. The valuation of illiquid securities and those that are otherwise difficult to price are more difficult to verify.

- **Last Sale/Primary Exchange:** This method, applicable to all listed securities, is the most readily available, widely used, and easily verifiable valuation method. In the case of a listed security that does not trade on a given day, the mean of the bid/ask spread is usually used. Securities valued using this method include equities, futures, listed options, and exchange traded funds (ETFs).
- **Dealer Quotes:** For securities that are not exchange-traded but are actively traded over the counter, dealer quotes are the most common and accepted pricing source. These can be quotes directly from dealers that make a market in a particular security or quotes from pricing aggregators who gather quotes from various dealers on various securities daily. When a fund is using dealer quotes, it generally is preferable to consider multiple quotes for each security. Securities priced using dealer quotes include corporate bonds, preferred stock, sovereign bonds, convertible bonds, and commonly traded swaps such as credit default swaps.
- **Valuation Services:** In the case of less liquid securities, such as loans or private placements, valuation services may be utilized. Due to the expense and complexity of these valuations, they may be performed less frequently.
- **Models:** Models include industry-accepted models, such as those used to price currency forwards, or models created by the investment manager and used as part of the initial investment evaluation. In the latter case, the valuation model should be reviewed by an independent third party who may be, but need not necessarily be, the firm's independent auditor. In the case of such "manager models," auditors typically review whether the manager has consistently used the model as part of the annual audit. Examples of securities priced by manager models could include level two and level three investments, as defined by FAS 157, such as infrequently traded corporate bonds, swaps that are not commonly traded, and certain private equity investments.
- **Other Third-Party Sources:** There are other possible sources of independent prices. For example, administrators may have their own models to price derivatives or to verify the pricing of the securities in portfolios they administer. Administrators may have the capability to compare values assigned to a particular security by funds managed by different managers to determine if a security is being consistently valued and to determine if a manager's valuation approach tends to be conservative or aggressive.
- **Manager Priced:** In those situations where none of the above methods is available, the manager often has the authority to determine a "fair value" for the

security. It is the responsibility of the fund’s general partner or board of directors to ascertain that the process used to arrive at the valuation is independent, transparent, and consistently applied.

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- Investors should confirm that the manager uses secondary sources whenever possible to enhance the reasonableness of pricing and valuation estimates.
- Investors should confirm that the manager uses multiple sources for dealer quotes where they are available.
- Investors should confirm that any models the manager uses to determine position prices are independently tested and verified.
- Investors should confirm that the manager applies a consistent approach to valuing “side-pocket” or illiquid/hard-to-value positions.

4. Valuation Controls

Controls over valuations can include the annual audit, a valuation committee, the use of third party administrators, and internal procedures and controls. A third party administrator responsible for independently getting quotes and producing the NAV can provide a level of independence that may give an investor additional comfort. Also, if an independent administrator is used in conjunction with an internal valuation process, there is a process of dual control that may also provide greater comfort to an investor.

One concern raised by investors is the elapsed time between independent valuations of a fund’s entire portfolio, including less-liquid investments. Experienced hedge fund investors generally expect an independent third party to provide valuations on at least a semi-annual basis, such as at the midpoint between the annual audited financial statements. Therefore, a fund with a fiscal year ending on December 31 might have an independent valuation on June 30 in addition to its annual audited financial statements.

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- Investors should seek an independent valuation semi-annually in funds that hold significant assets for which there is not a liquid market, where practicable. Independent valuation should, to the extent practicable, mirror the liquidity of the fund.
- Investors should confirm that credible supporting information is provided to valuation personnel on any investments requiring pricing by the manager.
- Investors should confirm that hedge fund managers use separate and distinct resources for portfolio valuation and portfolio management responsibilities in order to avoid

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conflicts of interest between managing and pricing a portfolio.

- Investors should understand any material involvement by the fund manager in pricing activities.
- Investors should be familiar with the manager's policy with respect to illiquid investments and side pockets. Many managers utilize side pockets for illiquid investments and accrue incentive compensation on private investments only when they are realized. However, if the manager does not use side pockets, investors should carefully review the manager's valuation of illiquid investments.
- Investors should assess a fund's valuation methodology in the context of the fund's liquidity profile and fee structure.
- Investors should obtain NAV reports directly from an administrator if an external, independent administrator is used.

E. FEES AND EXPENSES

Hedge fund managers receive a management fee (typically ranging from 1 percent to 2 percent annually) plus a percentage of the fund's performance (often set at 20 percent). Performance is typically calculated on a cumulative basis (with incentive fees calculated against a ceiling or "high-water mark") so that any losses experienced by a hedge fund in one or more prior years must first be recouped (in whole or in part) by compensating gains before further (or full) incentive fees are paid. (An example would be a \$15 million loss in one year followed by a \$20 million gain in the next year for which an incentive fee would be assessed only on the net \$5 million gain.) In addition, hedge fund managers allocate expenses to their funds and the investors in those funds.

Each investor should develop a comprehensive philosophy regarding the payment of fees and expenses for all investment management services contracted. This philosophy should consider fees and expenses relative to the returns sought and risks taken by an investment strategy, the liquidity offered by the investment manager, and the appropriate sharing ratio acceptable to the investor of alpha generated by the investment manager.

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- Investors should determine the overall percentage of total and excess return they are willing to pay to their respective investment managers. The percentage should be based on an investment strategy's returns, risks, liquidity, and lock-up period.
- Investors should seek to actively negotiate fees and performance targets. Investors, particularly fiduciaries for others, have a responsibility not to overpay for investment

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management services and also have a duty to obtain high quality investment management services when available for a reasonable price in light of market conditions.

The investor should understand the fees and expenses to be paid by the investor prior to the undertaking of any investment. This should be clearly reflected in the offering materials and legal documents for the fund, including a description of the fee schedule; the exact formula used to calculate fees owed, including, where appropriate, example calculations; the time period for fee calculations; and the source of information to be used to calculate the fee payments.

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- Hedge fund fees should be calculated based on audited portfolio valuations.
- Where the period of audited financial valuations does not coincide with the fee calculation period, investors should familiarize themselves with the hedge fund manager's portfolio valuation methodologies and the processes used to prepare the fee calculation. Once audited financials become available, the fee calculations should be reviewed and adjusted for any valuation differences.
- Performance fees should be calculated based on dollars of value added, not percentage returns or average capital invested for the calculation period.
- Performance fees computed as carried interest should be calculated on net value added as opposed to gross value added. The hedge fund's offering documents should adequately define "net value added," upon which performance fees are calculated (gross value added less any other expenses charged to the hedge fund).
- The hedge fund's offering documents should adequately delineate all types of potential expenses and other charges that potentially could be deducted from fund assets. These expenses may include, but are not limited to, legal expenses, accounting expenses, trustee fees, administrative fees, marketing and sales fees, custodial fees, and general investment management charges.
- The hedge fund's offering documents should adequately describe all fee sharing arrangements, soft dollar arrangements, and any compensation or benefits that the hedge fund manager may receive from fund assets or as the result of the fund's investment activity.
- Performance fees should be calculated over a period of time that is appropriate given the volatility of the hedge fund strategy's returns and any lock-up period required by the hedge fund manager. Generally, the more volatile the investment strategy, the longer the period included for calculating the performance fee.

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- Investors should determine whether performance fees are subject to a “high-water mark,” whereby the fund must recoup losses from prior years before the manager receives performance fees based on current gains. Investors should determine the period of time to which the “high-water mark” limitations apply and confirm that it is consistent with their redemption rights and investment objectives. High water marks are widely used and are considered a market standard best practice. Further, since investors may join a hedge fund investment at different times, investors should confirm that high water marks are specific for each investor and separately tracked.
- Investors using a fund of hedge funds manager should clearly distinguish all fees and expenses payable to the fund of hedge fund manager separately from fees and expenses payable to the underlying hedge fund managers.
- Investors should use the same best practices in evaluating fees paid to a fund of hedge funds manager as they do for evaluating the fees and expenses paid to a hedge fund manager directly, including payment of carried interest on net alpha, high-water marks, the use of audited financials to calculate fees, and the like.

F. REPORTING

1. Reporting and Transparency

A key concern for investors is that hedge funds’ lack of transparency may lead to unexpected risk exposures. Given the broad range of strategies that hedge funds can employ, it is difficult and impractical to prescribe precise disclosure standards. Hedge fund managers typically cite commercial reasons for providing little transparency. There are sometimes legitimate competitive reasons for keeping information confidential, but often there are not.

Investors should seek sufficient transparency and disclosure to assess and monitor the material risks of a hedge fund investment. Disclosure must be timely and frequent enough to allow investors to make informed investment decisions. Appropriate portfolio transparency levels and risk metrics vary by fund and strategy. For example, it may be appropriate for funds with a small number of concentrated investments to provide position-level transparency, while meaningful portfolio metrics may be more useful to investors in hedge funds with large portfolios that trade with high frequency.

Investors should receive reports and letters, no less frequently than quarterly, while performance reports should be provided on a monthly basis, from a manager that allow the reader to discern the fundamental portfolio characteristics and drivers of performance at the end of a reporting period and determine if these factors might be changing over time. Where funds provide less frequent reporting, investors should consider the extent to which this limits their ability to adequately monitor their investment. Investors with significant analytical and staff resources

may desire real-time information about the hedge fund's trading activity (full transparency) to gain additional insights into the fund's investment strategy.

With hedge funds, like other investments, there are practical limits to transparency dictated by issues associated with competitive secrets and materiality. The prudent investor will need to determine what disclosures are critical in assessing the essential risks and rewards of the investment. A thoughtful presentation of risk exposures and performance attribution should allow the investor to understand the structure and strategy of the manager and to ask intelligent follow-up questions. Ideally a periodic (for example, quarterly) letter would expand upon significant portfolio developments that might include a discussion of contributions to performance, major investment themes, responses to shifts in market conditions (if relevant), and changes in personnel or vendors. If a material event has occurred between quarterly reports, the manager should report that information when it occurs. Quarterly reports should include the following items, when applicable:

- gross and net exposure.
- total portfolio, by geography and industry sector - multi-strategy managers should display the allocation of the portfolio by strategy.
- market capitalization distribution.
- portfolio concentration: top ten long positions and top five short positions as a percentage of the total portfolio.
- portfolio themes and names of top positions once the positions are fully established.
- performance attribution:
 - long and short
 - by geographic regions or strategy, including hedges
 - most significant "winners and losers"
- assets under management (by fund).
- portfolio statistics (i.e., turnover, long positions, short positions).
- a statement of the investor's investment in the hedge fund, a letter discussing performance, and a report of the performance net of fees and expenses.
- tax exposure for the investors.
- a statement of the asset valuations for any period in which the hedge fund manager received performance-based compensation and the percentage allocation to FAS 157 Level 1, 2, and 3 categories.

- a report of the percentage of assets at each level as well as the percentage of realized and unrealized profit and loss that is derived from Level 3 (the most illiquid and difficult-to-value) assets. This information will help investors understand what types of assets are contributing to the fund's performance and, in particular, how much of the fund's performance is coming from more difficult-to-value assets.

Investors should be able to address the following issues if they are receiving high quality manager reports:

- Is the manager following the strategy it outlined to investors? Has there been material style or strategy drift?
- Are assets under management appropriate given the manager's strategy and staffing? Have assets under management changed significantly? Have there been any material withdrawals of or additional contributions of capital made by firm personnel?
- Have there been any personnel, operational or ownership changes at the firm? Investors should be aware of significant hires and departures, new corporate structure or office locations, new prime brokerage or other relationships of this nature, and any changes to operations.
- Investors should take note of exceptional excess performance as well as underperformance, as both outcomes could be the result of an excessively concentrated position or excessive portfolio leverage.
- Investors should confirm that variations in performance do not result in conduct inconsistent with the manager's investment strategy.

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- Investors should employ a process to determine the sufficiency and timeliness of a fund's transparency and disclosure. Prior to investing, investors should review sample reporting, including the risk metrics reported, and confirm that the firm will continue providing these metrics. Satisfactory disclosure will include the information investors need to understand the material risks and assess the investment in the context of their overall portfolios.
- Investors should ensure they receive appropriate information regarding a hedge fund's strategies, terms, conditions, and risk management. At a minimum, investors should receive timely and agreed-upon aggregate metrics that adequately capture material portfolio risks.
- Investors should receive critical disclosures and metrics on a consistent and timely basis

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including general asset classes to which the portfolio is allocated. Disclosures should 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, and geographic region, and exposures related to derivative positions.

- Investors should periodically confirm the percentage of the hedge fund portfolio that the managers classify as “illiquid.”

2. Performance Reporting

Investors should develop a comprehensive approach regarding the measurement of investment performance that addresses: (i) the frequency of performance measurement; (ii) the need to measure total performance; (iii) benchmark performance and alpha (excess return over the benchmark performance); and (iv) the volatility of total return and alpha performance.

An investor's performance measurement approach may be driven in part by their risk profile. Investors with riskier portfolios often require more frequent strategy-specific and aggregate performance reporting.

Investors should measure aggregate fund and investment strategy volatility as well as returns. These volatilities should be viewed at both the total hedge fund portfolio level and at the strategy level within the portfolio. Both normal and semi-variant risk calculations should be considered.

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- Investors should develop a comprehensive approach regarding the measurement of investment performance at the aggregate portfolio level, the investment strategy level, and the manager level. This should address: (i) the frequency of performance measurement; (ii) benchmark performance and alpha (excess return over the benchmark performance); and (iii) volatility of total return and alpha performance.
- When practical and applicable, investors should require that hedge fund managers report their performance according to GIPS reporting standards.
- Performance measurements should be based on audited financial information. Valuation estimates are only acceptable for interim reporting to the extent that audited financial information is not available.
- Investors should require that hedge funds provide 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. This may be particularly important for multi-strategy hedge funds and funds of hedge

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funds investments. These marginal contributions may be calculated for the current performance period and/or for monthly, quarterly, and annual performance periods.

- Investors should require that hedge funds provide total fund volatility and residual risk measures for their investment portfolios. These measures should be based on a performance calculation appropriate to the types of assets the fund owns. The industry standard is to make this calculation on a monthly basis, but it may be more or less frequent depending upon the nature of the fund's assets. Investors should compare this information to the hedge fund manager's expectations of volatility/residual risk for the hedge fund portfolio.
- Investors should require hedge funds, as a part of their performance reporting responsibilities, to report the percentage of the portfolio in illiquid/non-marketable securities and/or the percentage of the portfolio held in "side pocket" arrangements.

3. Funds of Hedge Funds Performance Measurement

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- Investors in funds of hedge funds should require that the manager employ appropriate practices to determine portfolio valuation.
- Investors should be informed of the fees and expenses charged by funds of hedge funds managers as well as the fees charged by the managers of the underlying hedge funds.
- When practical and applicable, investors should require that funds of hedge funds managers report their performance according to GIPS reporting standards.
- Investors should request performance and risk attribution statistics in order to understand better the drivers of risk and returns in the funds of hedge funds portfolio.

4. Aggregate Portfolio Performance Measurement

Best Practice

- Investors should calculate their aggregate portfolio return, risk, and attribution measures in a reasonable manner given their performance measurement philosophy, but no less than monthly.

G. TAXATION

No investment due diligence process is complete without an analysis of the impact of taxation on an investment's return profile. This section raises some, but not all, of the tax issues that investors may face when investing in hedge funds. A comprehensive discussion of all of the tax issues that might affect an investor in hedge funds is beyond the scope of this report. An investor should consult with their tax advisors and carefully review the tax-related disclosures provided by a hedge fund prior to investing.

Hedge fund disclosures should explain all tax considerations that may impact a hedge fund's returns, such as taxation resulting from foreign investment or from status as a passive foreign investment company (PFIC), or any tax loss carry-forward to which the hedge fund may be entitled. Tax disclosures should also discuss the effect of phase-outs of certain exemptions, deductions, and credits utilized by the hedge fund.

1. Unrelated Business Taxable Income (UBTI)

U.S. tax-exempt investors, such as pension funds and endowments, are required to pay taxes on income generated through activities that are unrelated to their typical operations, or "unrelated business taxable income" (UBTI). Despite the fact that investing is generally unrelated to the purpose of the tax-exempt organization, tax-exempt investors are not required to pay taxes on income from passive investments. However, tax-exempt investors are required to pay taxes on income generated from passive investments if the manager borrows money to finance its investment activities.

The use of leverage within a hedge fund creates debt-financed income that is taxable to tax-exempt entities as UBTI. Investors should monitor the use of leverage and other strategies that may generate UBTI, and they should investigate structures intended to mitigate UBTI generation. For example, hedge funds that are structured as offshore corporations effectively "cleanse" the debt-financed income so that tax-exempt investors do not generate UBTI.

Best Practices

- Tax exempt investors and hedge fund managers should agree on the desirability of leverage in a fund's portfolio and expectations of incurring UBTI. If a fund undergoes changes that modify the tax ramifications of investment beyond what was agreed to at the inception of the investment, the investor should receive immediate notice and have the ability to exit the fund without penalty. In addition, investors subject to UBTI should evaluate the use of structures to mitigate the impact of potential UBTI.
- Regardless of the investor's situation, they should seek the advice of competent tax advisors.

2. U.S. and Foreign Tax Withholding

Tax-exempt organizations investing in offshore funds may be subject to withholding on U.S. dividends. These amounts can often be reclaimed if the hedge fund is classified as a partnership for U.S. tax purposes and it complies with certain procedures. Status as a partnership may, however, conflict with UBTI planning, as discussed above. In the case of investments in foreign jurisdictions, dividends and other income may be subject to foreign tax withholding. The ability of a U.S. investor to rely on U.S. tax treaties with such jurisdictions may be impacted by choice of the jurisdiction under which the hedge fund is formed and by the hedge fund's classification (corporation or partnership) for U.S. tax purposes. Some hedge funds claim the inability to monitor withholdings or comply with tax documentation obligations on an investor-by-investor basis, sometimes subjecting tax-exempt and governmental investors to U.S. withholding taxes as well. These hedge funds leave it to the investor to claim any treaty benefits or other rights related to withheld taxes.

Best Practices

- Tax-exempt investors should be familiar with the hedge fund's procedures for foreign and U.S. tax withholding. Investors in offshore funds should understand the fund manager's processes and procedures for monitoring, recording, and reclaiming withheld taxes. Tax-exempt investors who may be subject to withholding taxes should monitor their investments and reclaim withheld taxes or pursue avenues to avoid withholding entirely.
- Investors should seek the advice of competent tax advisors.

3. Changes to Capital Gain Allocations

When an investor withdraws from a hedge fund, partnership agreements may allow the hedge fund manager to reallocate short-term or long-term gains to the withdrawing investor regardless of the investor's proportional share of those gains. If the hedge fund allocates short-term capital gains to the investor instead of long-term capital gains, taxable investors will have to pay the higher short-term capital gains tax rate for more than their proportional share of those gains. As a result, a withdrawing investor may be subject to a higher than expected tax burden and lower than expected net returns.

Best Practice

- Taxable investors should obtain adequate information regarding a fund's allocation of capital gains to redeeming investors, including a fund's policies and procedures for allocations if they are not made on a pro rata basis. Taxable investors should understand the potential effects of capital gain allocations on after-tax returns prior to investing in a fund.

H. CONCLUSION

Hedge funds are a legal construct. They are not an asset class. More than other investment vehicles, hedge funds require in depth and continuous oversight by their investors. The job of the investor is to understand the essential risk and reward prospects of each hedge fund investment and how these investments combine to meet the objectives of the hedge fund program in the context of the investor's overall portfolio. Investors should assess whether their managers' investment strategies are effective and are being executed consistently. Ultimately, investors must determine whether a manager's results are due to luck or skill and, therefore, whether results are repeatable over time. This imperative requires that investors utilize quantitative as well as qualitative information and analysis. Effective reporting by managers will allow thoughtful investors to evaluate the manager's performance, strategy, organization, and decision-making so that the investor may judge the suitability of each manager under consideration for inclusion in the investor's portfolio.

VI. APPENDIX

Sources and Acknowledgements

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