

**BEST PRACTICES  
FOR THE  
HEDGE FUND INDUSTRY**

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**REPORT  
OF THE  
ASSET MANAGERS' COMMITTEE**

**TO THE PRESIDENT'S WORKING GROUP  
ON FINANCIAL MARKETS**

*January 15, 2009*

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## EXECUTIVE SUMMARY

The Asset Managers' Committee ("AMC") issues this comprehensive Report that sets a new standard of best practices to answer the call of the President's Working Group on Financial Markets ("PWG") to reduce systemic risk and foster investor protection. The AMC, which comprises institutional alternative asset managers representing diverse strategies and perspectives, was formed as a private sector committee by the PWG in September 2007.<sup>1</sup> Its first task was to develop guidelines that define best practices for the hedge fund industry.<sup>2</sup>

This call to develop best practices comes at an important time in the hedge fund industry.<sup>3</sup> Over the past three decades, the hedge fund industry has evolved from a niche business consisting primarily of single-strategy, single-geography firms serving high net worth individuals into an important participant in global markets, consisting primarily of global multi-strategy firms serving a wide variety of institutional investors.

With this growth comes increased responsibility. This Report represents our acceptance of this responsibility by promoting strong practices that are commensurate with the increasingly important role of hedge funds in the financial markets. The AMC Report:

- Calls on hedge funds to adopt comprehensive best practices in all aspects of their business including the critical areas of disclosure, valuation of assets, risk management, business operations, and compliance and conflicts of interest;

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<sup>1</sup> *PWG Announces Private Sector Groups to Address Market Issues for Private Pools of Capital*, September 25, 2007, available at <http://www.ustreas.gov/press/releases/hp575.htm>.

<sup>2</sup> This is the final Report, which incorporates comments received after the initial draft of the Report (published in April 2008).

<sup>3</sup> By "hedge fund" we mean a pooled investment vehicle that generally meets most, if not all, of the following criteria: (i) it is not marketed to the general public (*i.e.*, it is privately offered), (ii) its investors are limited to high net worth individuals and institutions, (iii) it is not registered as an investment company under relevant laws (*e.g.*, U.S. Investment Company Act of 1940), (iv) its assets are managed by a professional investment management firm that is compensated in part based upon investment performance of the vehicle, (v) its primary investment objective is investing in a liquid portfolio of securities and other investment assets, and (vi) it has periodic but restricted or limited investor redemption rights. (This description is based in part on the definition in the Managed Funds Association's 2007 *Sound Practices for Hedge Fund Managers*.) Although hedge funds may invest in private equity and real estate, this Report is not addressed to the specific considerations of private equity or real estate funds. We use the terms "alternative asset manager" and "manager" to refer to the entity that establishes the investment profile and strategies for the hedge fund and makes the investment decisions on its behalf.

- Recommends innovative and far-reaching practices that exceed existing industry-wide standards; and
- Increases accountability for hedge fund Managers. This is the first time a best practices Report is being released together with a separate Investors' Report. This will promote accountability, and together these Reports will result in better managed hedge funds and better educated investors.

Over the last several months, global markets have been experiencing a period of tremendous stress. While we do not yet know the full impact of this stress on the financial system, we recognize that it has been and will continue to be significant in many ways for all market participants, including hedge funds. It is clear that substantial discussion and debate by policymakers on how to address these challenges is underway. No set of best practices can resolve the complex issues facing the financial industry today. However, we believe that these events underscore the need for hedge funds, along with other market participants, to evaluate and implement strong practices to manage their businesses. Regardless of the results of that debate, the promotion of robust industry practices, such as those set forth in the Report, is an important step and will be critical to and consistent with the goal of reducing systemic risk and fostering investor protection.

The AMC believes that even in light of all of the change and turmoil that is affecting all market participants, hedge funds will continue to play an important role and be an important source of capital and liquidity in world markets, by providing financing to new companies, industries and markets, as well as by committing capital in times of both market stress and market stability. Hedge funds' role in helping to provide efficiencies in pricing of securities and other financial assets throughout the markets as a result of their extensive research and willingness to make investments in all market conditions will continue to be significant. As hedge funds have evolved and continue to be integral to an increasingly global and complex financial world, there is greater need for them to develop and maintain robust infrastructure, controls and business practices. Moreover, as sophisticated institutional investors have committed more of their portfolios to alternative investments, they have demanded that hedge funds demonstrate appropriate infrastructure and controls in managing their activities. We can expect this to become even more important to investors in light of the revelation of a massive fraud that led to the loss of billions of dollars. Given all of the market turmoil and other tumultuous events of recent months, it is more important than ever for the hedge fund industry to stand behind a set of far-reaching best practices that will promote the key goals of the PWG of reducing systemic risk and fostering investor protection.

The AMC believes that the recommendations in this Report are responsive to these important concerns. We believe this Report raises the bar for the industry by providing strong and clear guidance to managers for strengthening their practices in ways that investors demand and the markets require, while also providing managers with appropriate flexibility to continue to innovate and grow. By adopting these practices,

hedge funds will strengthen infrastructure and risk management practices and controls that can help them more effectively manage market events or financial crises that may continue to arise. Indeed, we believe that these recommendations have withstood the test posed by the challenges of the tumultuous events that have occurred since the original publication and that they will be effective in accomplishing the PWG's goals of reducing systemic risk and fostering investor protection.

An Investors' Committee ("IC"), which the PWG formed concurrently with the AMC, is also releasing a best practices Report for investors to help them assess hedge fund investments. The IC Report and the AMC Report acknowledge that both investors and hedge fund managers are accountable and must implement appropriate practices to maintain strong controls and infrastructure in support of their activities. This is the first time that investors and managers have come together to achieve that goal. We worked closely with the IC and applaud its effort to provide guidance to investors considering hedge fund investments. We believe that hedge fund managers should use the IC Report as a guideline for their interaction with investors. We believe that together these Reports will result in better managed hedge funds and better educated investors.

The IC recommends in its best practices that investors use the AMC best practices as a guideline in conducting due diligence reviews of hedge funds. The investor community will be a strong partner in ensuring that hedge fund managers adopt suitably strong and appropriate practices to support their businesses.

We have designed this Report to raise the standards for all managers, even the largest and most sophisticated. Our mandate was to develop best practices to address systemic risk and foster investor protection, and it is these large firms whose capital collectively has the largest impact on the market. We recognize that not all of the practices in this Report will be applicable to all managers at all times. However, our goal is to provide managers of all sizes with standards that they can adopt to support and strengthen their businesses and operations.

We sought to identify and address the key areas where best practices would most effectively promote investor protection and reduce systemic risk. These areas are:

- *Disclosure*: Strong disclosure practices that provide investors with the information they need to determine whether to invest in a fund, to monitor an investment, and to make a decision whether to redeem their investment;
- *Valuation*: Robust valuation procedures that call for a segregation of responsibilities, thorough written policies, oversight and other measures for the valuation of assets, including a specific focus on hard-to-value assets;
- *Risk management*: Comprehensive risk management that emphasizes measuring, monitoring and managing risk, including stress testing of portfolios for market and liquidity risk management;

- *Trading and business operations:* Sound and controlled operations and infrastructure, supported by adequate resources and checks and balances in operations, to enable a manager to achieve best industry practice in all of the other areas; and
- *Compliance, conflicts and business practices:* Specific practices to address conflicts of interest and promote the highest standards of professionalism and a culture of compliance.

Our intention is for managers to carefully assess their specific practices against the practices in this Report and adopt the best practices applicable to their business. What is critical is that managers are able to explain to investors how they have implemented and adopted the practices in this Report.

## **Summary of AMC Report**

### ***Frameworks: A Comprehensive Approach to Best Practices***

This Report establishes a framework for each of the five key areas mentioned above – disclosure, valuation, risk management, trading and business operations, and compliance, conflicts and business practices – to help hedge fund managers take a comprehensive approach to adopting best practices and serve as the foundation upon which those best practices are established. To implement the frameworks, hedge funds need to assess their business as a whole. The frameworks, while tailored to each area, establish a consistent and strong approach that: 1) states the goal and essential elements of the framework; 2) outlines clear and consistently applied policies and procedures that provide a structure to help ensure better educated investors and better managed hedge funds implement the framework; 3) incorporates a regular process for reviewing and updating the framework; and 4) requires adequate resources and knowledgeable personnel to support the framework.

Within each framework, we set forth best practices for its implementation. We intend for managers to carefully assess their specific practices against the practices set forth in this Report. We have provided specific examples of types of best practices to guide managers as they conduct this assessment. For example, a long-short manager investing in exchange-traded securities over long time horizons likely requires a simpler valuation policy, that does not necessarily contain all of the practices set forth in this Report, than the policy of a manager trading complex OTC derivatives. Similarly, a manager trading equity securities globally in extremely high volumes needs more robust operating systems and a higher degree of automation than a manager that invests in a concentrated portfolio of U.S. equities.

The manner in which each manager implements the best practices will by necessity differ in light of each manager's size, strategies, products and other salient characteristics of its business. While we fully expect that smaller managers will be unable to adopt all of the practices in this Report, especially at inception, we believe this



Report will provide helpful guidance and direction as they build and develop their businesses.

A summary of our approach to the five key areas follows.

*(i) Disclosure*

This Report sets forth the basic elements of disclosure that managers should make available to all investors. Investors need material information to assess whether to invest in a fund or redeem an investment, as well as to monitor their exposure to their ongoing investment. The kinds of information managers disclose will vary depending on the strategies and structure of the fund. Looking beyond our own industry, we took note of the various ways in which public companies disclose information. Public companies in the United States are required to provide regular and ongoing information. Each year, they provide a comprehensive summary of their performance, including audited financial statements and extensive qualitative information. They also must publish quarterly reports, as well as updates upon the occurrence of significant events. In addition, investor relations departments respond to questions and provide a constant flow of information to investors.

In developing best practices that will provide hedge fund investors with information that they need to make and monitor their investments, we drew from key elements of the public company disclosure regime, which provides investors with material information at the time of making their investment and updates throughout the life of the investment. We sought to take the core principles of this regime and adapt them to the hedge fund industry.

The disclosure framework addresses the information that managers will disclose to investors to provide them with information to allow them to make an investment decision and to monitor it over time. This includes the provision of a private placement memorandum, annual audited financial statements, periodic performance information and other investor communications, as well as timely disclosure of significant events in light of the circumstances. Managers should determine (based on the specific characteristics of their business) the manner and frequency with which these disclosures will be made and clearly communicate this to investors. Public companies produce independently audited, GAAP-compliant financial statements. Because hedge fund investors share the need for accurate, independently verified financial information, we recommend that all hedge funds do (or continue to do) the same.

Managers should provide periodic performance information to investors and provide an investor letter or similar communication and risk report on at least a quarterly basis. We also recommend that managers provide qualitative discussion of performance information (in addition to quantitative data) to provide investors with a better understanding of the performance of the fund. This discussion is intended to provide context to the manager's performance and can be in any form or style the manager feels is most useful (*e.g.*, as part of its investor letter or other disclosure). The nature of this

discussion will vary depending on the nature of the strategies and business of the manager. It should also take into account the need to protect the confidentiality of the fund's positions and strategies.

In addition to disclosure to investors, we recommend that a manager's disclosure framework address its disclosure to counterparties, such as banks and broker-dealers. The relationships between hedge funds and counterparties are mutual and it is important for both sides to understand their respective credit exposures. Both parties should agree, at the time they initiate their relationship, on the types of information that will be made available. Information provided should be appropriate to the type of relationship between the fund and the counterparty, and be subject to appropriate protection of confidentiality. We believe this will help promote stable relationships with counterparties that will serve to mitigate systemic risk.

#### *(ii) Valuation*

This Report recommends that managers adopt a valuation framework that provides for consistent and documented policies and appropriate controls for segregation of responsibilities between portfolio managers and those responsible for valuations. Valuation of investments is of critical importance to investors in any investment vehicle, and in hedge fund context there are additional considerations. First, many funds invest in a wide range of types of assets, some of which do not have readily available market prices. Secondly, the funds are structured so that valuation has a direct impact on the compensation received by the manager.

An essential characteristic of hedge funds is the incentive fee (or allocation) arrangements pursuant to which the manager participates with investors in the fund's performance. This arrangement aligns the interests of managers and their investors and facilitates the ability of the industry to attract and retain top investing talent. However, it also creates the potential for conflicts of interest between a manager and the fund that need to be addressed and mitigated.

Not all fund investments raise the same degree of valuation issues. For exchange-traded securities, market price information is generally widely available and valuations are readily and independently verifiable. However, as a fund makes investments that are less liquid – where the market for the investment is limited or non-existent – fund valuations become more complex. For example, for certain over-the-counter (“OTC”) derivatives, the only pricing information will be from brokers dealing in those derivatives and, in some cases, only from the counterparty trading with the fund. For other investments, such as a private investment, there may be no readily ascertainable market value after the initial investment is made until the investment is realized. As such, potential conflicts in valuing these investments may be more pronounced.

Many financial institutions invest in illiquid or hard-to-value instruments and face the same challenges as hedge funds. Established mechanisms for minimizing conflicts include implementing a system of segregation of functions and controls with appropriate

oversight. This Report adopts this approach by establishing clear practices for effective control and segregation systems.

The framework in this Report also establishes a governance mechanism, such as a valuation committee, which will have ultimate responsibility for establishing and monitoring compliance with the manager's valuation policies.

Some have suggested that the use of third-party service providers can effectively eliminate valuation conflicts. We believe administrators can be helpful in taking on some of the responsibilities related to pricing the portfolio and providing checks and balances in support of the manager's policies. However, we do not believe that investors or managers should take undue comfort from the independence a third-party administrator brings to the valuation process, especially where a manager invests in hard-to-value assets. In such cases, it is appropriate, and indeed may be necessary, for the manager to be involved in the valuation process given that the manager may have the most knowledge about the assets in question. In addition, firms must still have appropriate infrastructure and resources to understand the valuation of their funds' portfolios and not place undue reliance on outsourcing. What is critical is that, whether or not the fund has a third-party administrator, the manager needs to have in place a valuation framework that provides for consistent application of a valuation policy and appropriate segregation of functions between portfolio managers and non-trading personnel who are responsible for implementing the valuation process.

We also believe that it is useful for investors to understand what portion of the fund is comprised of hard-to-value assets. Financial Accounting Standard 157 ("FAS 157") establishes a useful hierarchy of assets based on the reliability of available pricing information: Level 1 assets have observable market prices (such as New York Stock Exchange-listed stock prices); Level 2 assets have some observable market price information other than quoted market prices (such as broker quotes for certain OTC derivatives); and Level 3 assets have no observable market price information (such as private equity investments).

GAAP will soon require the percentage of assets at each level to be reported on an annual basis, as well as the percentage of realized and unrealized profit and loss ("P&L") 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.

Recognizing the value of this kind of information, this Report also recommends that managers go beyond the requirements of GAAP and report the percentage of their assets that are in each FAS 157 level to investors more frequently (at least quarterly), and provide the realized and unrealized P&L information for Level 2 assets in addition to Level 3 assets (also at least quarterly). We recognize that the implementation of FAS 157

and related practices will take time and require consultation with the fund's independent auditors.

We have also provided specific guidance on side pockets. A "side pocket" is an increasingly common mechanism used to account for certain investments in a fund that are illiquid and have no readily ascertainable market value. Side pockets are generally limited to investors who are invested at the time the investment is made and redemptions from side pockets are generally not permitted until the investment is removed from the side pocket account upon realization of a gain or loss.

By limiting participation in side pockets in this way, funds can protect investor interests by avoiding having them enter or exit such investments in the absence of reliable valuations. Most funds do not earn any incentive fee on the side-pocketed investment until the investment is deemed realized (*i.e.*, when some kind of market-based pricing information is available). Thus, an added advantage of side pockets is that they mitigate the valuation conflict for such investments. This Report provides guidance on the appropriate use of side pockets. In particular, it suggests considerations managers should use in deciding whether to move an investment into or out of a side pocket, in valuing the assets in the side pocket, and in determining both fees and the associated investment/redemption restrictions.

### *(iii) Risk Management*

Risk is inherent in investing and cannot be eliminated. Simply put, taking risk is essential for returns. The first and most important aspect of risk management is that a manager determines the overall risk profile for the fund. The risk profile will depend upon the fund's size and strategy and the manager's portfolio management process.

We recommend that managers adopt a comprehensive framework to measure, monitor, and manage risk consistently with the intended risk profile. The common elements of the framework should be that managers identify risks to the portfolio, measure the principal categories of risk (such as liquidity risk, leverage, market risk, counterparty credit risk and operational risk), adopt policies and procedures that establish monitoring and measurement criteria, maintain a regular and rigorous process of risk monitoring, and retain knowledgeable personnel to measure and monitor risk.

Once a risk profile is determined, managers can develop a risk management process to measure, monitor and manage risk in order to achieve that intended risk profile. Disclosure to investors will then enable them to assess whether the risk profile is appropriate for them and their portfolios and how the investment is performing in light of that profile. This Report recommends that managers regularly disclose risk information, including an appropriate qualitative discussion that will help investors understand how the manager views the fund's risk profile. We recognize, however, that confidentiality remains important to the manager's business, so it is not expected that investors will be provided with all information used to monitor risk.

Because risk management is embedded in investment philosophy, the risk management process will necessarily vary by fund. Specifically, it will vary based upon the investment strategy, the instruments traded, leverage, and the overall risk profile. Therefore, this Report provides illustrative examples of how firms can approach different aspects of their risk measurement, monitoring, and management process, including desirable management tools for liquidity, leverage, market, counterparty, and operational risk. Managers should evaluate these practices in light of their fund's size, nature of business, portfolio management processes, and chosen investment strategies.

Finally, hedge funds deal with many counterparties, including prime brokers, derivatives dealers and lending, trading, cash management and depositor counterparties. Many of these are sources of liquidity. Depending on the extent of the fund's exposure, counterparty failure could have serious consequences for a fund's access to liquidity and overall success. We therefore recommend that managers assess the creditworthiness of counterparties and understand the complex legal relationships they may have with prime brokers or lending or derivative counterparties and their affiliates.

*(iv) Trading and Business Operations*

As hedge funds have become increasingly complex organizations trading in markets all over the world, operational requirements have increased. As a result, strong trading and business operations are more critical than ever to the sound and effective operation of hedge funds. These include appropriately segregated functions, processes for documenting relationships with counterparties, establishing appropriate infrastructure to accommodate the types of investments traded by the fund and adequately managing and accounting for the fund's internal operations. Managers must continuously assess the effectiveness of their operational and internal controls.

This Report recommends a comprehensive framework for a manager's trading and business operations. Here, too, the diversity among managers' operations and fund strategies means that considerable flexibility is required. Nevertheless, we believe there are elements that should be common to all managers: a member of senior management with responsibility for operations, supported by adequate resources; policies and procedures that address segregation of duties and reconciliation; checks and balances in operations and systems; and infrastructure and automation commensurate with a manager's business.

We believe that the Report's framework for business practices and controls, which includes checks and balances and appropriate use of third-party service providers, provides strong protection for investors. In particular, this Report also recommends that all hedge funds employ qualified, independent auditors, and should thoroughly investigate the qualifications of all service providers to the fund, including custodians, prime brokers (which will often provide custodial services) and, where applicable, third-party administrators. We believe that, when taken together with the recommendations in the Investors' Report, which stresses that investors review critical third-party service

providers as part of the diligence process, the goal of protection of investors and their assets will be well-served.

The sound and effective management of trading and business operations supports a manager's ability to achieve best industry practice in all of the other areas identified in this Report. For example, a manager's trade documentation and settlement procedures are critical to accurate valuation and disclosure to investors. In addition, having adequate procedures to control the creation of counterparty relationships is a critical part of counterparty credit risk management.

*(v) Compliance, Conflicts and Business Practices*

It is critical that there be a continued commitment to the highest standards of integrity and professionalism within the industry. We recommend that managers have a comprehensive framework that includes a written code of ethics; a written compliance manual, including a process for handling conflicts of interest and a robust training program to educate personnel regarding the manager's policies; and a compliance function that includes a Chief Compliance Officer, appropriate discipline and sanctions and an annual review of the compliance framework. Managers must implement the elements of the framework in light of their business and the size, strategy and profiles of their funds.

Regardless of size or structure, this framework must be supported by a culture of compliance that begins, first and foremost, at the very top of the organization. The role of the Chief Compliance Officer is undoubtedly of critical importance, but a Chief Compliance Officer alone cannot establish this culture. A successful compliance culture means a commitment from the most senior levels of management and an environment in which each person within the firm regards compliance as his or her own responsibility and feels empowered to raise concerns. This level of commitment is essential to achieve the results that investors and market participants are entitled to expect.

One issue of particular focus is conflicts of interest. As previously discussed, the potential for conflicts exists across the financial services industry and must be addressed for investors to continue to have confidence in the manager and in the financial markets as a whole. We looked to the experience of the financial services industry. The major investment banks were asked by the SEC to identify and analyze potential conflicts in their business. In this Report, we have taken it upon ourselves to identify potential conflicts relevant to the hedge fund industry, to help managers evaluate where conflicts might arise based on their own structure and operations. Many can be addressed with specific policies. However, it is impossible to anticipate every potential conflict. Accordingly, we recommend that managers establish a Conflicts Committee as the focal point for reviewing potential conflicts and addressing them as they arise.

## **Context for the Report**

### ***President's Working Group on Financial Markets***

The PWG was established by Executive Order in 1988. The PWG was given the mandate to enhance the integrity, efficiency, orderliness, and competitiveness of U.S. financial markets and to maintain investor confidence. The PWG includes the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Securities and Exchange Commission, and the Chairman of the Commodity Futures Trading Commission, or their designees.

In February 2007, the PWG released a set of principles to guide financial regulators as they addressed the rapid growth of private pools of capital.<sup>4</sup> The principles provided a foundation to address issues of investor protection and systemic risk. This Report is intended to take these principles and establish best practices to enable managers to operate their firms in a way consistent with the PWG's principles and guidelines.

### ***Industry Practices***

Many managers throughout the industry have developed strong and effective practices addressing many of the areas upon which we focus in this Report. Those managers have found that implementing strong internal controls and business practices has provided a platform for stability and growth, enhanced client relationships, and enabled them to carry out investment activities more effectively and efficiently. We have drawn upon many of these practices in drafting this Report.

We also reviewed the existing recommendations for sound industry practices developed by a variety of other groups, such as the Managed Funds Association, the UK Hedge Fund Working Group, the International Organization of Securities Commissions and the Alternative Investment Management Association. Their work had a significant impact on our thinking about this Report.

This Report does not explicitly address fund governance. Fund governance is, in part, dependent upon the particular organizational structure of the fund (*e.g.*, a fund that is structured as a corporation will have a board of directors). We believe that investors should be provided with information regarding the governance structure of a fund, but the nature of the governance structure does not eliminate the need for, or diminish the importance of, senior management's responsibility for all fund activities and operations. We believe that it is the responsibility of managers, and not of fund governing boards, to adopt and implement the best practices set forth in this Report.

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<sup>4</sup> We refer to "private pools of capital" in this Report as hedge funds.

## **Acknowledgements**

The AMC wishes to acknowledge and encourage the excellent work done by these and other groups in developing recommendations for sound practices in the hedge fund industry:

- The Managed Funds Association (MFA)
- The UK Hedge Fund Working Group (HFWG)
- The Alternative Investment Management Association (AIMA)
- CFA Institute
- Counterparty Risk Management Policy Group
- Dubai Financial Services Authority (DFSA)
- Financial Services Authority (FSA)
- International Organization of Securities Commissions (IOSCO)
- The Greenwich Roundtable

The AMC also wishes to thank the various members of the financial services industry that contributed time, expertise and perspective throughout the preparation of this Report. We heard from many interested parties and were very pleased with their interest in, and consideration of, the issues in the Report. In particular, the AMC wishes to acknowledge the contributions of PricewaterhouseCoopers LLP and Ernst & Young, who provided valuable assistance by helping the members of the AMC to develop the Recommendations on Valuation, and also Morgan Stanley and Goldman Sachs, who shared their perspectives as prime brokerage and other counterparty entities.



## **BEST PRACTICES**

### **Disclosure and Investor Protection**

#### **Disclosure Framework**

A Manager should establish a disclosure framework designed to disclose material information to investors with sufficient frequency and detail, including with respect to financial and risk information and potential conflicts of interest, so that investors are able to (i) make informed decisions regarding investments in the fund and (ii) appropriately monitor or manage the risks associated with exposure to the fund. A robust disclosure framework is critical to the protection of investors' interests. The framework should also include guidelines to address providing information to counterparties (commensurate with the relationship with the counterparties), subject to appropriate assurances of confidentiality.

The framework should include:

1. The information to be provided to investors and the manner and frequency with which it will be provided (recognizing that disclosure to investors may take a variety of forms), including:
  - (a) An offering or private placement memorandum ("PPM");
  - (b) Annual audited financial statements;
  - (c) Performance information;
  - (d) Investor communications (such as letters) and other reporting (such as risk reports); and
  - (e) Timely disclosure of material information in certain circumstances.
2. Guidelines for the disclosure of potential conflicts of interest;
3. Guidelines for the qualifications of investors in the fund; and
4. Guidelines relating to disclosure to counterparties.

#### **I. Disclosure of Material Information to Investors**

1. Disclosure begins with the fund's offering document, typically a PPM. The PPM outlines the scope of the fund's operations, including broad descriptions of the investment philosophy, strategies and products, as well as the significant risks of an investment in the fund.

- (a) A Manager should provide potential investors with a PPM or other offering documents or supplemental materials sufficiently in advance of a subscription to permit investors to adequately consider that information in formulating their investment decisions.
2. For funds open to new investments, PPMs should be updated or supplemented at least annually in light of ongoing developments or more frequently in the event that a material change occurs that makes the PPM materially inaccurate or misleading in light of other information previously provided by the Manager. Any updated PPMs should be provided to all investors in the fund. If a previously closed fund is reopened, the PPM should be assessed to determine if it should be updated to reflect developments since the last time the fund was open to new investments.
  3. The following is a (non-exhaustive) list of types of information that should be included in a PPM (to the extent such information is material and relevant to the fund):
    - (a) The legal structure of the fund, including jurisdiction of organization and control of the Manager of the fund;
    - (b) The fund's investment objectives, strategies and permissible investments;
    - (c) The key investment management and other senior personnel acting on behalf of the fund, including:
      - (i) Biographical information (including relevant educational and employment history and other business activities engaged in by any such person); and
      - (ii) Information regarding any material violations of securities or investment-related laws or regulations, or any disciplinary action for professional misconduct taken against any such person.
    - (d) The terms of an investment in the fund, including:
      - (i) A description of applicable fees and charges, including the fund's compensation structure (*e.g.*, the calculation of incentive fee (or allocation) arrangements and management fees);
      - (ii) Allocation of expenses such as research, legal fees and travel (*i.e.*, which expenses are borne by or among the fund(s) and which are borne by the Manager), including a Manager's policies on the use of soft dollars;

- (iii) A description of withdrawal or redemption rights and restrictions (including withdrawal payment and notice provisions, lock-up periods, notice requirements, withdrawal penalties or fees, gates, withdrawal suspension provisions and other redemption limitations, including variations in the time frame for investor redemptions);
  - (iv) Whether fees may be paid by the fund to affiliates of the Manager and, if so, for what services;
  - (v) A description of the Manager's trade allocation policies;
  - (vi) A description of the use of side pockets (where applicable), including the criteria for determining when and whether to place investment positions in and remove them from side pockets;
  - (vii) Provisions relating to liability and indemnification of the Manager to and by the fund; and
  - (viii) A description of the Manager's framework for providing information and financial statements to investors.
- (e) Discussion of the elements of the Manager's valuation framework, such as:
- (i) The use of fair value accounting in accordance with generally accepted accounting principles ("GAAP") in calculating valuations and net asset value ("NAV"). The discussion should also address the use of any non-GAAP measures to compute and report certain asset valuations, fees, subscriptions or redemptions;<sup>5</sup>
  - (ii) The role of any third parties, including (where applicable) the fund's third-party administrator, with significant involvement in the valuation of the investment positions in the fund's portfolio; and

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<sup>5</sup> Throughout this Report, reference to GAAP is to U.S. generally accepted accounting principles. However, the Report recognizes that there are other broadly accepted accounting principles, notably the International Financial Reporting Standards ("IFRS"), which a Manager may adopt for its funds. This Report supports the use of standards substantially similar to GAAP.

- (iii) A description of the Manager's valuation policy and the manner in which the Manager oversees its valuation policy, such as a Valuation Committee. A Manager's disclosure regarding its valuation policy should include (to the extent relevant):
- A description of the methodologies used to value the fund's investment positions, including the methodology used in valuing various types of investment positions and the use of internal and external pricing sources; and
  - Ways in which the Manager mitigates potential conflicts of interest in the valuation process (including involvement of portfolio management personnel in the valuation process).
- (f) The possible risks associated with an investment in the fund, such as risks associated with:
- (i) The fund's incentive fee (or allocation) arrangement;
  - (ii) Reliance on and potential loss of key investment personnel;
  - (iii) Lack of assurance as to the success of the fund's investment strategies;
  - (iv) Specific strategies or particular types of investment instruments and markets;
  - (v) Valuation of investment positions, including valuation of investments with no readily ascertainable market value (*see also the section on Valuation*);
  - (vi) Limited liquidity and potential restrictions on redemptions (including restrictions relating to redemption gates, side pocket investments and withdrawal suspensions);
  - (vii) Use of leverage and margin (including leverage embedded in derivative instruments) and the possible loss of funding;
  - (viii) Broker and other counterparty credit risk exposure and impact of potential failure;
  - (ix) Investors' reliance on a Manager's discretion in making investment decisions;

- (x) A Manager's flexibility, to the extent disclosed in the PPM, to allocate investments by the fund among different strategies and instruments;
  - (xi) Investments in foreign jurisdictions;
  - (xii) Presence or absence of regulatory oversight; and
  - (xiii) Other factors related to investment strategy or products that make an investment speculative or risky.
- (g) Potential conflicts of interest in the fund's operations (*see also the section on Compliance, Conflicts and Business Practices*);
  - (h) Tax, regulatory and other legal matters relevant to the fund, including timing on the provision of Schedule K-1s (where applicable);
  - (i) Identity of any third-party administrator(s) used by the fund; and
  - (j) Use of prime brokers or other lending sources.

## **II. Ongoing Information Provided to Investors**

1. The Manager should provide investors with updated, material information on a regular and ongoing basis and communicate that information to investors as set forth in the Manager's disclosure framework.
  - (a) The nature of the communications and the information included in the communications described below should be tailored as appropriate to the structure of the Manager and the fund, consistent with the principles outlined in this section and recognizing, in certain circumstances, the importance of protecting confidential information that, if disclosed, could adversely impact the interests of the fund's investors.
  - (b) Updated information may be communicated to investors in a variety of forms, depending on the nature of the information being communicated (*i.e.*, whether the information is a material development or part of the regular or ongoing provision of information about the fund).
2. The following are types of information that Managers should consider providing to investors:
  - (a) **Investor Letters or Other Similar Communications** – For many Managers, investor letters (or other similar communications) provide

the opportunity to communicate in their own voice. Accordingly, it may be written in any form or style that the Manager desires (preferably at least on a quarterly basis) and would generally be expected to include updated information on developments relating to the fund, such as:

- (i) Significant shifts in investment strategy or key risk exposures (such as market, credit, leverage, liquidity, and operational risk);
- (ii) Changes in key personnel;
- (iii) Performance information together with examples or narrative as the Manager considers appropriate or useful (*discussed further below*); and
- (iv) Business, market or other significant developments, as appropriate.

(b) **Risk Reports** – Given the dynamic nature of the risks in the portfolio, many Managers send risk reports to investors to provide information regarding the fund’s risk profile. Because the extent of risk taken and the approach to risk management are integral to the investment approach of a Manager, a Manager should disclose its approach to investors and provide information it believes will be informative to investors in light of that approach. Accordingly, a Manager should communicate regular risk information (preferably on a monthly basis) that is appropriate to the fund and its investment strategies, such as information regarding:

- (i) Assets under management;
- (ii) Risk management (including qualitative discussions, as appropriate), including:
  - Asset types;
  - Geography;
  - Leverage employed in the fund (including the basis on which it is calculated);
  - Concentration of positions; and
  - Material changes in asset allocation.

(c) **Performance-Related Financial Information** – Regular reporting of performance may take a variety of forms and should be provided with a frequency established by the Manager that is appropriate to the nature of the fund and the information being provided. The timing and content may include:

(i) Quantitative information:

- Annual audited financial statements prepared in accordance with GAAP;
- Estimated fund performance (at least on a monthly basis) that clearly indicates it provides only an estimate of the fund's performance and may not include other material expenses and items that go into calculating NAV (*e.g.*, it may not include fee and expense accruals); and
- NAV to each investor (preferably on a monthly basis) which should reflect each investor's specific capital account balance or share value, taking account of fee and expense accruals in addition to trading profit and loss attributable to each investor's capital account.

(ii) Qualitative information about fund performance:

- The goal of this information is to provide a narrative description, from the Manager's perspective, that will help investors better understand the fund's financial performance during the relevant period of time, recognizing that financial statements provide limited opportunities for qualitative discussion. This discussion may be in any form (*e.g.*, investor letters, annual summaries or other disclosure) that the Manager desires and should include factors underlying the fund's performance.

(d) **Investment-Related Financial Information and FAS 157** – In addition to performance information, the Manager should provide financial information supplementing FAS 157 to help investors assess the risks in the valuation of the fund's investment positions (*i.e.*, the potential for variability in the ultimate realization of the fund's investment positions). Managers will need to work closely with their auditors for purposes of implementing FAS 157 and the related practices. Depending upon the extent to which the Manager invests in illiquid and difficult-to-value investments, the disclosures should occur at least quarterly and include:

- (i) Disclosure of the percentage of the fund’s portfolio value that is comprised of each level of the FAS 157<sup>6</sup> valuation hierarchy: Level 1 (generally assets that can be priced using exchange or other highly liquid market prices), Level 2 (generally assets that have no quoted price but for which there are similar assets with quoted prices or pricing models using significant observable inputs) and Level 3 (generally assets for which observable prices or inputs are not available and that are generally priced using models or other valuation techniques); and
  - (ii) Supplementing FAS 157’s requirement that Managers disclose the percentage of realized and unrealized profit and loss (“P&L”) that is derived from Level 3 assets, by making such disclosure with respect to Level 2 assets.
    - If the Manager deems it advisable, the Manager should discuss with its auditors or counsel how the information set forth above should be provided (*e.g.*, on a net or gross basis) and inform investors of the chosen methodology. In addition, the Manager should identify if the manner of determining the information is not consistent across positions or levels.
- (e) **Quotes** – Managers should consider disclosing the percentage of the value of the fund’s portfolio for which only one quote was relied upon and the percentage for which multiple quotes were relied upon.
- (f) **Specific Event Reporting** – In certain circumstances, it is appropriate to disclose updated information or the occurrence of specific events to investors on a more timely basis than that provided in the regular course of the Manager’s disclosure framework.
- (i) As with all its disclosure to investors, Managers should assess the materiality of the event in considering whether disclosure is appropriate. In determining the appropriate timing and form of any reporting of specific events to investors, Managers should take into account factors such as:

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<sup>6</sup> FAS 157 establishes a “fair value hierarchy” that differentiates between the types of inputs used to determine the fair value of an asset or liability. The level in the fair value hierarchy within which the fair value measurement is classified is determined based on the lowest level input that is significant to the fair value measurement in its entirety. The examples provided are for illustration only and will vary depending on the facts and circumstances surrounding the asset valuation.



- The nature of the information;
- The fund’s investment program;
- Whether disclosure of such information may compromise the fund’s competitive position or ability to properly manage the portfolio; and
- Whether the fund is currently accepting subscriptions or redemptions.

(ii) Depending on the circumstances, the following are types of information that should, when material, be disclosed to investors promptly after occurrence:

- Changes to the fund’s valuation policies;
- Changes to certain key investment personnel (*e.g.*, partners and executive officers) or with key third-party service providers (such as the fund’s administrator) other than in the ordinary course of business;
- Changes in biographical or disciplinary information in respect of investment and other key personnel of the Manager;
- Entry into side letters (or parallel managed accounts) that grant terms to certain investors that may, in certain circumstances, adversely impact other investors (*discussed further below in sub-section III.A*);
- Occurrence of operational issues that may have an adverse impact on the fund; and
- Discovery of fraud or wrongdoing by the Manager or a significant service provider.

3. A Manager should endeavor to provide all investors with a consistent level of information. In providing diligence information, a Manager may consider developing its own standard presentation.<sup>7</sup> Managers may employ different forms of presentation among investors, or individually

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<sup>7</sup> Managers may wish to look to guidance provided by the Managed Funds Association’s 2007 *Sound Practices for Hedge Fund Managers* and the Alternative Investment Management Association (“AIMA”) in developing a standard presentation.

answer questions from investors in the course of due diligence reviews or ongoing investor inquiries, provided the Manager does not selectively disclose material information among investors.

4. Where a Manager receives requests from an investor for additional disclosure or clarification of existing disclosure, the Manager should consider whether to make the disclosure and, if appropriate, should be willing to make such information available to all investors upon request.

### **III. Side Letters and Parallel Managed Accounts**

#### **A. Side Letters**

1. A “side letter” generally means an agreement whereby a Manager agrees to provide an investor with certain information, makes certain representations or provides investment terms in the fund that are not made available to other investors in the fund. While the use of side letters may frequently benefit all investors in the fund (*e.g.*, in that it enables a Manager to attract early or large investors), or otherwise be immaterial to other investors, in certain circumstances the terms of a side letter may have the potential to adversely impact other investors in the fund.
2. In circumstances where side letters provide certain investors with terms that may adversely impact other investors in the fund, the Manager should make such disclosure as may be reasonably necessary to enable other investors to assess the possible impact of such side letters on their investments.
3. The Manager should disclose, in the manner the Manager deems appropriate, the existence and terms of side letters containing terms such as those set forth below, which are generally more likely to adversely impact other investors:
  - (a) Enhanced control rights (*e.g.*, over investment decisions or the hiring of or changes in key personnel);
  - (b) Preferential liquidity/redemption rights, “key personnel” provisions and redemption “gate” waivers;
  - (c) If preferential fees are made available, a statement to that effect; and
  - (d) Terms that materially alter the investment program disclosed in the fund’s offering documents.

## **B. Parallel Managed Accounts**

1. A “parallel managed account” is a separate account established by a manager for a specific investor that is not an investment in a fund, but through which the investor invests in substantially similar strategies and investments as a fund. Parallel managed accounts may be sought by investors for a variety of reasons, including the need to comply with particular regulatory requirements or to impose limits on the fund’s investment program beyond what has been agreed to by other investors in the fund.
  - (a) In certain circumstances, parallel managed accounts may give rise to issues similar to those arising in the context of side letters or may provide investors with terms that may, under certain circumstances, adversely impact other investors in the fund.
  - (b) In such circumstances, the same principles that apply to the disclosure of side letters should apply, as appropriate, to the disclosure of parallel managed accounts.

## **IV. Participation of Investors**

1. Managers should evaluate whether, and document how, each investor’s qualifications satisfy requisite legal standards appropriate to the structure of the fund, typically through subscription agreements. In addition to addressing the specific standards necessary for exemptions from registration under the Securities Act of 1933, the Investment Company Act of 1940 and other applicable U.S. and non-U.S. registration requirements, Managers should obtain representations from investors that the investor is likely to understand the material risks of investing in the fund, such as:
  - (a) An acknowledgement that the investor has received and understands the fund’s PPM and organizational documents, has had an opportunity to obtain additional information and ask questions of the Manager and is making an independent investment decision based on these documents and the investor’s independent investigation of the fund;
  - (b) An acknowledgement that the investor has the experience and knowledge in financial and business matters necessary to evaluate the merits and risks of the investment and is able to bear such risks; and
  - (c) An acknowledgement that the investor understands the terms of its investment and the operation of the fund, including minimum investment, withdrawal rights, liquidity provisions, allocation and fee structure and other terms that the Manager thinks appropriate.

## V. Disclosure to Counterparties<sup>8</sup>

1. A Manager should foster positive and cooperative relationships with credit and lending counterparties (including prime brokers, derivative counterparties and other creditors), so that both the Manager and counterparties may adequately assess the risks associated with the relationship. Commensurate with the scope and nature of the relationship between the Manager and its counterparties, the Manager and its counterparties should agree at the beginning of their relationship as to the types of information and frequency with which it will be provided. Types of appropriate information may include:
  - (a) Quantitative and qualitative disclosures regarding the strategies employed by the fund and the allocations between or among such strategies;
  - (b) Disclosure of the Manager's risk management framework (including its approach to market and liquidity risk); and
  - (c) Quantitative and qualitative disclosures of the fund's performance and NAV.
2. In making disclosures to counterparties, the Manager should be willing to assist counterparties in understanding and interpreting disclosures. This may include making investment management and other key personnel available upon reasonable request of the counterparty to answer questions as part of counterparty due diligence.
3. As a general matter, the Manager should consider whether it is appropriate for the level of communication with its counterparties to increase under certain circumstances (*e.g.*, during times of market stress that may affect the fund's strategies and performance, including during periods of increased volatility or tightening credit terms).
4. In connection with any disclosures to counterparties, the Manager should consider information about the counterparties' information barriers and policies regarding the separation of functions generally and consider whether it is appropriate to seek assurance, as part of its counterparty contracts, that financial and other confidential information provided by the Manager is only used for credit evaluation purposes and will not be made

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<sup>8</sup> Additional guidance and discussion of information sharing with counterparties is provided in the Report of the Counterparty Risk Management Policy Group II, *Toward Greater Financial Stability: A Private Sector Perspective* (July 27, 2005).

available to any member of the counterparties' trading desk(s) or department(s).

## **Valuation**

### **Valuation Framework**

A Manager should establish a comprehensive and integrated valuation framework to provide for clear, consistent valuations of all the investment positions in the fund's portfolio, while minimizing potential conflicts that may arise in the valuation process.

The framework should include:

1. A governance mechanism, such as a Valuation Committee or other responsible body; this body should have ultimate responsibility for (i) establishing and reviewing compliance with the Manager's valuation policies and (ii) providing consistent and objective oversight and implementation of the Manager's valuation policies and procedures;
2. The development by the Manager of well-documented valuation policies, as well as guidelines to evaluate exceptions and to test and review compliance with policies and procedures; and
3. Sufficiently knowledgeable and independent personnel supported by adequate resources that are separate from and do not report to the trading or portfolio management function and that are responsible for the valuation of the fund's investment positions and for implementing the Manager's policies and procedures.

### **I. The Valuation Committee**

1. A Manager should establish a governance mechanism, such as a valuation committee or other responsible body (referred to herein as the "Valuation Committee") that has oversight responsibility for the Manager's valuation framework.
2. Participants in the Valuation Committee should include key members of the Manager's senior management (such as its Chief Executive Officer and Chief Financial Officer, if applicable, it being understood that their responsibilities may include portfolio management).
  - (a) The Valuation Committee should approve valuations. It is understood that the Valuation Committee will not review the valuation for every investment in the fund's portfolio, but will ascertain that the methodology set forth in the valuation policy is being followed. In addition, the Valuation Committee will review material adjustments or exceptions to the valuation policy.

- (b) While it will often be useful and important for portfolio managers or trading personnel to participate in the Committee (*e.g.*, to assist the Committee in understanding and evaluating the valuation of certain investment positions, especially those with no readily ascertainable market value), the Committee should be structured to provide an appropriate measure of independence from the portfolio management function. The goal is to enable the Committee to benefit from the expertise of such personnel while mitigating potential conflicts of interest created by their involvement with the Committee.
- (c) Once established, the role of the Committee should be designed based on the structure, investment strategies and portfolio of the fund. Typical functions the Committee should perform include:
  - (i) Developing the methods and sources used for valuing various classes of investment positions and material changes in such methods and sources;
  - (ii) Reviewing and approving the Manager's guidelines and policies for classification of the fund's assets within FAS 157's valuation hierarchy;
  - (iii) Where broker quotes are relied upon to value a particular type of asset, reviewing quantitative and qualitative information such as the appropriateness and consistency of the sources (*e.g.*, counterparty, prime broker or other source), recent trade activity and outliers and, where appropriate, the process by which such quotes are obtained and reconciled (such process having been appropriately documented);
  - (iv) Approving the final valuations for the fund's portfolio (and reviewing reconciliations with the fund's third-party administrator, where applicable); and
  - (v) Designating certain individuals or groups (*discussed below in sub-section II*) to be responsible for undertaking or reviewing certain valuation decisions.
- 3. The Committee should periodically review the Manager's valuation policies and procedures, including whether any patterns emerge that warrant modifications. Reviews should be conducted no less frequently than annually, or upon the occurrence of certain material events (*e.g.*, a shift in the fund's investment strategy, geographies, assets, instruments or sectors, or a change in market conditions or availability of pricing information for certain types of investment positions).

- (a) Reviews should address issues such as:
    - (i) The fairness of the valuation policies and their consistent application;
    - (ii) The continued ability of the Manager's personnel to consistently, fairly and accurately apply the valuation policies;
    - (iii) The selection and oversight of third-party service providers with significant involvement in the valuation process (including, if any, the fund's administrator) and the continued ability of those providers to consistently, fairly and accurately apply the Manager's valuation policies;
    - (iv) Valuation methodologies used by the Manager and appropriate changes in inputs or market conditions, including illiquid markets; and
    - (v) Any material exceptions that were made to the fund's valuation policies and procedures (*e.g.*, material price overrides).
  - (b) Part of this review should include periodically back-testing a sample of valuations, to the extent possible and where it is likely to provide a reasonable base of comparison, against the recent sale prices of investment positions. The goal of the analysis is to provide an input to the Manager to help it assess the quality of models and other evaluative processes being employed internally or by third-party service providers. As such, back-testing may be particularly appropriate for assets in Levels 2 and 3 of the FAS 157 valuation hierarchy.
    - (i) The focus of any back-testing would be on identifying trends in valuations versus sale prices, not the accuracy of individual marks for individual investment positions. Differences should be expected and viewed in the context of the overall analysis, especially since back-testing has inherent limitations, particularly during periods of market stress.
4. Finally, the Committee should have the authority and resources available to consult with the fund's independent auditor, third-party administrator (if any), a third-party valuation firm or legal advisor, when appropriate, to understand and assess new accounting requirements impacting fair value and in situations where it is unclear how the valuation policy should be applied to certain investment positions or to unique facts and circumstances.



## **II. Implementation of Valuation Policies**

1. A Manager should have knowledgeable and qualified internal personnel (who may also perform other functions for the fund) or qualified third parties to implement the valuation policy on a day-to-day basis. As a general matter, the Manager should have a sufficient complement of personnel (internal or external) with an appropriate level of knowledge, experience and training that is commensurate with the nature, size and complexity of the fund's portfolio.
2. The personnel carrying out the valuation function should be responsible for the appropriate pricing of the portfolio in accordance with the valuation policy and should handle the collection and evaluation of counterparty prices, broker quotes, exchange prices and third-party pricing feeds.
3. The valuation function should be appropriately segregated from the Manager's portfolio management function. It is recognized that portfolio management personnel may be involved in valuation analysis and methodology given their expertise in certain positions.
  - (a) In the event that portfolio management personnel do not believe that the valuation of an investment is appropriate, a Manager should have in place policies that seek to mitigate any conflict between portfolio management personnel and valuation personnel. For example, the Manager may develop a process for portfolio management personnel to "challenge" the determinations of valuation personnel in which the ultimate decision as to the appropriate price for a "challenged asset" would be made by participants in the Valuation Committee after consideration of pricing support provided by valuation personnel and input from the applicable portfolio management personnel.

## **III. Valuation Policies and Procedures**

1. The adoption and implementation of comprehensive, written valuation policies and procedures, consistent with best industry practice, is critical to the design and effectiveness of the Manager's portfolio valuation process. The valuation framework should be designed to promote consistent application of such policies and procedures and seek to provide appropriate information to investors and counterparties with a clear understanding of the limitations of such policies and procedures.

## A. Baseline Elements of the Valuation Policy

1. The following are elements of the valuation policy that a Manager should consider adopting (to the extent such policies are relevant to the fund).

Policies that:

- (a) Identify (by title or group) the parties (inside and outside the Manager) engaged in the valuation process:
  - (i) This would include external parties involved in the valuation process (*e.g.*, fund administrators or third-party valuation firms), participants in the Valuation Committee and personnel responsible on a day-to-day basis for implementing the Manager's valuation policies.
  - (ii) With respect to external parties involved in the valuation process, the Manager should clearly delineate such parties' roles and responsibilities (particularly with respect to third-party administrators valuing portfolios and with respect to investment positions where the third-party is unable to independently substantiate prices) and provide for appropriate oversight and monitoring of the third-party.
- (b) Establish the appropriate methodologies to be used in valuing various types of investments:
  - (i) Valuation methodologies should be established contemporaneously with the acquisition of a particular type of asset (where not otherwise already established) and applied consistently thereafter. Where the Manager undertakes a new type of investment, the valuation methodology should be documented and become part of the valuation policy. If there is a change in the investment that warrants a change in the application of policy, this change should be approved by the Valuation Committee.
  - (ii) Methodologies should include sources of prices for different types of investment positions, the priority of sources within the valuation process and how such sources were used, such as:
    - Automated price feeds from exchanges and liquid OTC markets (*e.g.*, for valuing exchange-traded securities);
    - Common models used widely by other market participants and based on market observable inputs such as prices of similar actively traded assets and liabilities (*e.g.*, for valuing

a total return swap on a corporate bond or exchange-traded equity);

- Broker quotes for certain OTC securities (*e.g.*, for valuing convertible bonds and derivatives), including policies to address the existence and quality of multiple broker quotes for a particular investment;
- Discounted cash flow analysis and how discount rates are developed (*e.g.*, for valuing a private loan);
- Customized or proprietary models used for investment positions with unique features, based in part on unobservable (*i.e.*, non-market) inputs (*e.g.*, for valuing a private equity investment);
- Other valuation methodologies appropriate for the type of asset; and
- The process used to effect valuation adjustments.

(c) Establish appropriate internal documentation procedures to support the valuation for each type of asset:

- (i) A Manager should generally maintain robust and contemporaneous documentation to support the valuation of illiquid investment positions with no readily ascertainable market value, in accordance with guidelines established by the Valuation Committee, after considering various qualitative and quantitative factors. In this regard, it would be prudent for the Manager to engage in a dialogue with the fund's independent auditor in respect of the adequacy of the Manager's documentation procedures for its various types of investment positions.

(d) Establish appropriate procedures for the use of pricing sources, including price feeds, inputs to models, broker quotes and other information received from third-party valuation service providers;

(e) Establish procedures for the valuation of investments placed in side pockets (where applicable);

(f) Establish appropriate procedures for recording any material exceptions taken to the Manager's ordinary valuation policies and the reasons for such exceptions; and

- (g) Provide for procedures and controls to mitigate potential conflicts of interest in the valuation process (including the involvement of portfolio management personnel in the valuation process).

**B. Investment Positions with No Readily Ascertainable Market Value**

1. Certain investment positions in the fund’s portfolio may have no readily ascertainable market value. For many Managers these types of investments (*e.g.*, private equity investments) are an important source of potential returns for the fund. Generally, as part of the disclosure in the PPM, investors should be informed of whether these types of investments may be made by the fund.
2. While a fund should generally seek competent and independent review or generation of its final valuations, in the case of investment positions with no readily ascertainable market value it may be necessary or appropriate to utilize properly controlled internal valuations given the absence of adequate external valuations. Accordingly, the Manager must be particularly vigilant as the potential conflicts inherent in valuing investment positions can be more pronounced in this context.
3. To mitigate these conflicts, valuation policies and procedures should address the circumstances in which the Manager may rely upon models, the required support and documentation when using a model and the manner and frequency of reviewing models. In particular, any material exceptions or unusual situations arising in the context of a pricing model (*e.g.*, the creation of a unique pricing model for a particular asset) should be documented and reviewed by the Valuation Committee.

**C. Side Pockets and Other Similar Arrangements**

1. A “side pocket” is an increasingly common mechanism used to account for certain investments of a fund that are illiquid and have no readily ascertainable market value. Certain funds provide for side pockets to protect investors by avoiding the need for them to transact (redeeming or investing) in respect of such investments, where there is greater inherent subjectivity in their valuation prior to realization or other key event. Moreover, by not assessing an incentive fee or allocation until the investment in a side pocket is realized (or deemed realized) an additional valuation conflict is avoided.
2. Where a fund provides for the use of side pockets, the Manager should include in its policies and procedures guidelines regarding their use, such as:

- (a) The appropriate considerations for determining if/when an asset should be moved into or out of a side pocket (including, where applicable, any related hedges and financial transactions). Relevant considerations include:
- (i) The availability of third-party evidence of value (*i.e.*, whether any observable market inputs, broker quotes or other types of evidence exists that can provide an indication of value);
  - (ii) The extent to which the investment is inherently difficult to value (*e.g.*, equity investments in private versus public companies);
  - (iii) The nature of the market for the investment (*i.e.*, whether the market is developed or emerging, highly liquid or illiquid and the extent to which the market is regulated);
  - (iv) The anticipated ability to exit the investment (including whether the investment is freely tradable or subject to contractual, legal or regulatory limitations on its realization, or, where applicable, the stage of development of a business and how soon it may be ready to go public); and
  - (v) Any applicable contingencies or special events upon which the investment's realization will depend.
- (b) The policies for valuation of investments held in side pockets (which should be the same as the policies applied to investments not held in side pockets, as required by accounting rules). The nature and frequency of review of particular side pockets should be appropriate to the type of investment and market conditions that may be expected to have an impact on that investment.
- (c) Regular review and approval by appropriate personnel of any transfer of an investment to a side pocket, other than at the time the investment is made. Recognizing that there are many circumstances in which a transfer of an investment to a side pocket may be appropriate, the Manager should have a process to review and approve such transfers. It may be prudent for the Valuation Committee to review or approve any such transfers.

## **Risk Management**

### **Risk Management Framework**

Risk is inherent in the investment process and is essential for return. The goal of risk management is not to eliminate risk but to manage it prudently. A Manager should establish a comprehensive and integrated risk management framework that is suited to the size, portfolio management process and investment strategies of its funds. Through the risk management framework, the Manager should identify the risks inherent in its chosen investment strategies, and measure and monitor its exposure to these risks to be consistent with the Manager's intended risk profile. The risk management framework should be communicated to investors to enable them to assess whether the fund's risk profile is appropriate for them and how the investment is performing against that profile.

The framework should address:

1. Identification of material risks to which the portfolio may be subject;
2. Measurement of the principal categories of risk (including liquidity risk, leverage, market risk, counterparty credit risk and operational risk);
3. A regular process of risk monitoring, appropriate for the size of the fund, its portfolio management process and the complexity of its investment strategies;
4. Policies and procedures establishing measurement and monitoring criteria; and
5. Knowledgeable personnel to measure and monitor risk as established by the policies and procedures.

### **I. The Manager's Approach to Risk Management**

#### **A. Identification and Design**

1. Senior management should determine the overall risk profile for the fund.
2. The Manager should identify risks and determine how it intends to manage these risks to meet the fund's risk profile. The Manager should develop a risk management process designed to measure and monitor the risks and enable investors to make informed decisions about the risk profile of the fund and its fit within their own risk tolerance.
  - (a) The principal, widely recognized categories of risk are liquidity risk (including both asset and funding liquidity), leverage, market risk, counterparty credit risk and operational risk (*each discussed further in*

*sub-section II*). The Manager should consider the extent to which these categories of risk apply to its fund, and the kinds of methods that will be used to measure, monitor and manage the applicable risks (such as stress testing and scenario analysis, VaR, volatility measures, concentrations metrics and other approaches). In particular, stress testing and scenario analysis are often desirable risk management practices.

- (b) While objective measures of risk are critical to understanding how the portfolio behaves, qualitative factors are also important when analyzing portfolio risks.
3. A member of senior management, such as a Chief Risk Officer (or other person with similar responsibilities), or a Risk Committee, should establish risk measurement criteria and implement a process to monitor the portfolio's risk profile.
- (a) Implementation would be based on the overall structure of the portfolio, investment and trading strategies, the level of centralization of the decision-making process, the capital allocation process and consistency with the overall investment and risk profile of the fund.
  - (b) When implementing a risk management framework, a Manager should consider the issues set forth above to determine:
    - (i) Which risk measures (*e.g.*, capital, concentration or liquidity) should be monitored within the overall framework; and
    - (ii) Whether to apply constraints in risk management (such as limits) and how to apply them (*e.g.*, whether to adopt hard limits, which can never be exceeded, or soft guidelines, which involve discussions of the current risk level faced by the portfolio).

## **B. Measurement, Monitoring and Management**

1. Where possible, material risks taken by the fund should be quantified and monitored at a frequency appropriate to the characteristics of the fund's portfolio.
2. Those material risks which are not quantifiable or measurable should still be monitored.
3. No risk management process is capable of providing a complete representation of all of the risks facing the portfolio or accurately measuring every one of those risks. The portfolio should be reviewed on a periodic basis (the frequency of this review depending on factors such as

the nature of the portfolio and market conditions). This review should qualitatively assess whether the portfolio is performing consistently with expectations (based on the identified and measured risks) and, when it varies, review the factors that might be affecting the portfolio.

4. As risk management is a subjective process, the Manager should understand the biases and limitations of its chosen risk measurement methodologies (including models) and adjust for these in measuring and making decisions about risk.
5. Risk reports describing the portfolio's exposures to the key risks identified by the Manager should be prepared and distributed to senior management responsible for the portfolio with a frequency appropriate to the nature of the portfolio.

### **C. Personnel**

1. Senior management should appoint knowledgeable personnel to supervise risk analysis, measurement and monitoring and to take responsibility for the creation of policies and procedures covering all areas of risk management.
  - (a) This supervisory role may be performed by a Chief Risk Officer (or other person with similar responsibilities) or by a formal Risk Committee comprised of members of senior management with sufficient experience and the relevant background to understand the complexities of the risk framework. In that role, these persons may also be involved in the portfolio management process.
  - (b) The Chief Risk Officer (or other person with similar responsibilities) should have open access to and engage in regular dialogue with the portfolio managers as well as the fund's senior management, so that he/she can acquire a clear understanding of the fund's positions and strategies.
2. Senior management should not outsource risk monitoring or management, and must maintain responsibility for the overall risk framework. If a determination is made to use the services of an external provider only for risk measurement, outsourcing should not be a substitute for an adequate understanding of risk by senior management personnel.
  - (a) Responsibility for any outsourced parts of the process should continue to lie with the senior management or its designees, such as the Chief Risk Officer or designated Risk Committee.



## II. Categories of Risk

The emphasis on the categories of risk that will need to be measured, monitored and managed will vary depending on the products the Manager trades, investment strategies, and frequency of trading it chooses for its funds. Accordingly, within the Manager's risk management framework, the Manager should consider what categories of risk are material to the fund and adopt risk management measures most appropriate to its investment approach.

To assist Managers in this regard, the balance of this section describes the principal categories of risk that a Manager may need to measure, monitor and manage in the operation of its business. The discussion also provides examples of measuring techniques and risk management tools that may be applicable to each category of risk.

While Managers should reflect on the broad categories of risk (*discussed immediately below*), the particular risk management methods undertaken by a Manager should be appropriately tailored to the specific risks faced by the fund and the fund's risk profile. Accordingly, in many cases certain of the risk management tools described below may be less relevant to a particular Manager, while in other cases a Manager may determine that it should use risk management tools not described here.

### A. Liquidity Risk

1. Liquidity is the Manager's ability to meet its need for cash. Sufficient levels of liquidity enable the Manager to meet its obligations. The following are types of factors that a Manager should take into account in managing liquidity:
  - (a) The risk of a reduction in the funding provided by lending counterparties, including changes to initial margins/credit support and timing or size of variation margin calls, as per various agreements with counterparties;
  - (b) The terms of redemption rights by investors and the amount of investor capital that is subject to those redemption rights; and
  - (c) Changes in market liquidity conditions (including trading volume, bid-ask size and spread and the possible effect of crowdedness/concentration of trading strategies) that may alter the ability of the Manager to sell securities with minimum adverse price impact or otherwise manage the liquidity of the portfolio.
2. The Manager should seek to increase the stability of external factors affecting the portfolio through prudent agreements with lenders and investors.

3. The Manager should thoroughly understand and regularly review the material terms in its credit and lending agreements, including the interaction of those terms, cross-default and cross-collateralization provisions, and their impact on collateral management and requirements. These terms may affect the availability of funding in the event of certain extreme market conditions or triggering events (*e.g.*, limitations on prime brokers' obligations to provide financing under certain circumstances or NAV triggers) and the overall risk faced by the fund. In addition, the Manager should review these agreements from the perspective of how they protect the fund from the risks arising in the event of adverse developments with respect to the counterparty.
4. The Manager should consider regularly conducting liquidity stress scenario analyses on the portfolio(s) in order to understand and better manage its ability to meet obligations in light of the fund's portfolio.
5. The Manager should be aware of the risks of holding certain short-term cash-like instruments (such as money market investments and short term securities that depend on a liquidity put) as a substitute for cash in light of the potential for illiquidity, unexpected delays in satisfying redemptions and the resulting mis-matches in funding requirements.

## **B. Leverage Risk**

1. Leverage is the practice of using borrowed money to make investments. For portfolios without derivative contracts, leverage may be defined as the market value of assets relative to the fund's capital. For more complex portfolios or portfolios containing derivatives, it may be more appropriate to estimate leverage by analyzing the risk of different strategies and understanding the potential for extreme losses arising from those strategies. The Manager should manage its use of leverage to match the risk profile established for the fund based on its size, portfolio structure and specific investment strategies. The Manager should monitor changes in this measure over time as part of its risk management framework, and should take account of on- and off-balance sheet assets (*e.g.*, derivative instruments, including OTC derivatives) in measuring leverage.
  - (a) The Manager should monitor leverage with a frequency appropriate to the characteristics of the underlying portfolio taking into account the potential impact of various inter-related factors such as:
    - (i) Asset types, sectors and positions;
    - (ii) Overall liquidity profile of the portfolio;
    - (iii) Trading strategies employed by the Manager;

- (iv) Volatility of assets and trading strategies; and
  - (v) The crowdedness/concentration of trading strategies.
- (b) The Manager should thoroughly understand the terms on which prime brokers, lenders and other trading counterparties provide leverage to the fund and seek sustainable credit, margin and funding terms in order to manage its leverage prudently and minimize additional stress when market conditions become volatile. Important terms may include constraints on the portfolios (*e.g.*, concentration, diversification and liquidity limits) and prime brokers' and counterparties' rights to alter these terms.
- (c) The Manager should take into account the impact of employing leverage on any positions with embedded leverage, such as certain types of derivatives and other structured products.

### **C. Market Risk**

1. Market risk is the financial risk brought about from changes in the market price of investments in the portfolio. The Manager should regularly evaluate market risk, incorporating some or all of the following risk measures, as applicable to the fund's size and portfolio management processes and the complexity of its investment strategies. The list below comprises the primary market risk processes used in the industry. A Manager should model its risk management framework through the inclusion of some or all of these in such framework:
  - (a) Risk exposures for different market variables and asset classes:
    - (i) The Manager should seek to identify the size and direction of its exposures to major market risk factors (*e.g.*, equity indices, interest rates, credit spreads, foreign exchange rates and commodities prices).
    - (ii) These exposures should be considered both on a gross (longs plus shorts) and net (longs less shorts) basis and examined both within individual strategies and portfolios and across the entire fund. Risk systems should also distinguish between linear exposures (*i.e.*, prices that change proportionately with changes in the overall market) and non-linear exposures (*i.e.*, those that arise from instruments such as options, convertibles and callable bonds).
  - (b) Conducting stress tests and scenario analyses:

- (i) The Manager should conduct stress tests and scenario analyses of its portfolio. Stress testing and scenario analyses can be useful in assessing the vulnerability of a portfolio to various events. They should be designed to capture both market events (directional movements) and situations of market illiquidity. The frequency of such testing should depend on the nature of the portfolio, the risks to which it is exposed, the frequency of turnover and changes in market conditions, among other factors. The Manager should identify which market variables to stress, how much to stress them by and over what time frame.
- (ii) Stress tests/scenario analyses can be based on standardized measures, historical events or unique scenario analyses.
  - Standardized stress tests involve shocking major market factors by a constant amount or percentage moves (*e.g.*, “All interest rates rise by 100 basis points”, or, “Equity prices drop by 10%”). Using both approaches enhances stress testing with regard to factors that may undergo regime shifts (*i.e.*, moving from tight to wider credit spreads, or from a low to higher volatility environment). These tests are useful tools to translate risk exposures into potential profits and losses given a major change in the market.
  - Historical scenario analyses aim to measure the expected behavior of the portfolio if a period of known market stress reoccurs in the future. The calculation process must adjust for new instruments and changes in market structure.
  - Unique scenario analyses aim to measure the expected behavior of the portfolio during an unexpected period of stress, as specified by risk management.

(c) Use of historical statistical risk measures of the portfolio:

Historical risk measures aim to understand the historical behavior of a portfolio versus expectations and can be used as a predictor of future behavior when asset composition and market conditions are relatively stable.

- (i) If the Manager determines to monitor historical statistical portfolio risk measures, the Manager should do so by analyzing measures such as realized volatility, return as a function of volatility, worst drawdown, historical beta and correlation with relevant market indices.

- It is prudent to analyze these measures at a frequency appropriate to the characteristics of the fund in order to understand how these realized risk measures may differ over various time horizons.

- (ii) Such measures may become less relevant if the asset or strategy composition of the portfolio changes frequently, the market structure evolves (*e.g.*, regime shifts) or the periodicity of valuation is inappropriate (*e.g.*, daily volatility may be an inappropriate measure for investment positions that are marked-to-market monthly).

(d) Use of forward-looking statistical risk measures:

Forward-looking statistical risk measures aim to forecast the expected behavior of the portfolio through quantitative techniques using assumptions on the volatility and correlations of assets in the portfolio.

- (i) If the Manager determines to use prospective statistical measures as a risk monitoring tool, the Manager should consider which forecasted statistical measures are applicable to its portfolio. Two common, though not universally used, examples are Value at Risk and Expected Loss.
  - (ii) When using forward-looking statistical measures, their shortcomings should be recognized. These measures commonly use a normal distribution of returns as the basis of the calculations. However, because financial markets frequently exhibit unusual, so called “fat-tailed” behavior, many forward-looking statistics systematically underestimate portfolio risk. Moreover, assumptions concerning the volatility of the assets in the portfolio and the correlations between assets may not reflect actual experience. In addition, these measures may be difficult to calculate for multi-asset portfolios and portfolios with optionality.
2. Where applicable to the fund and its investment strategies, the risk management process should examine whichever it uses of the measures outlined above at both the overall fund or portfolio level as well as by individual investment strategy, asset class, industry group, geographical region or other dimensions.
  3. In light of the use of assumptions and uncertainty with respect to events, risk measures may provide more insight when looked at over time. A particular data point may be more useful when viewed in the context of

how that same measure has changed over previous days, weeks and months.

4. It is important to periodically review the performance of models used to measure and monitor market risk and adjust as appropriate to maximize effectiveness. This may be performed by measuring risk estimates over time against the realized return of the portfolio.
  - (a) Changes to models and assumptions should be made to factor in new data and to account for previously unrecognized relationships or risk factors; and
  - (b) Managers should understand the limitations inherent in risk models, such as assumptions in the inputs and limitations of historical data. They should use results from these risk models after quantitatively taking into account these limitations.

#### **D. Counterparty Credit Risk**

1. The Manager should monitor its fund's exposure to counterparty credit risk (including, as applicable, prime brokers, derivatives dealers and lending, trading, cash management and depositor counterparties) and understand the impact of potential counterparty loss of liquidity or failure.
  - (a) The Manager should assess creditworthiness when selecting and transacting with counterparties (recognizing that subsidiaries and affiliates of counterparties may have different creditworthiness than parent companies).
  - (b) The Manager should understand the complexity of the legal relationships a fund may have with its prime brokers and any other significant lending or derivatives counterparties and their affiliates, including:
    - (i) Understanding the legal entity with which the fund has contracted. the fund's ability or inability to close out or net positions with a certain counterparty or prime broker and its affiliates in the event of an insolvency proceeding or other default and the impact of insolvency on the fund's rights with respect to and its ability to access positions;
    - (ii) Understanding the way in which the prime broker finances the fund's positions, including whether it uses US and/or non-US broker-dealers or banks, whether assets are segregated and rehypothecated and the location in which its positions are held; and

- (iii) Knowing the identity of custodians and sub-custodians used by the prime broker in various locations and, depending on the availability of resources, assessing the risk associated with the use of such custodians and sub-custodians, particularly in developing markets. Factors to be taken into account include the risk/reward of investing and the size of the business with that particular sub-custodian.
- 2. The Manager should measure and monitor its credit exposure to each counterparty (as appropriate given the level of the fund's exposure to each counterparty).
  - (a) As part of this process, the Manager should weigh the desirability of diversifying counterparty credit risk by using multiple prime brokers and counterparties against any increases in the complexity and practicality of settlement, reconciliation processes and daily collateral management. The Manager should dedicate appropriate resources to manage its collateral movements and, where possible, aim to reduce mismatches at a counterparty (*e.g.*, by maintaining reasonably hedged portfolios at each prime broker).
  - (b) To minimize risk in the event of market stress, the Manager should consider taking steps to increase its access to liquidity, such as opening cash and custody accounts at financial institutions other than its prime brokers.

## **E. Operational Risk**

- 1. The Manager should have a strong operational infrastructure that is commensurate with the complexity of its business, to manage and mitigate operational risks resulting from inadequate or failed internal processes, people and systems, or from external events.
  - (a) One or more senior operating officials, who may include a Chief Operating Officer, with functions separate from investment management, should oversee the Manager's operational areas.
  - (b) The Manager should implement and maintain strong internal controls to minimize the risk of loss as a result of operational risk.
  - (c) Controls to reduce operational risk may include (as applicable to a Manager):
    - (i) Use and maintenance of a centralized position data set;
    - (ii) Adoption of trade capture devices; and

- (iii) Prompt reconciliation of trading information with the fund's prime broker or settlement agent and administrator.
- (d) The Manager should monitor its overall level of operational risk, either internally or through third-party review. This review may take into account the following characteristics of the Manager (as applicable to a particular fund):
  - (i) Assets and products;
  - (ii) Staffing and resources;
  - (iii) Infrastructure (including information technology resources, business continuity, and disaster recovery planning); and
  - (iv) Compliance and regulation.
- (e) *Additional guidance on managing operational risk is provided in the section on Trading and Business Operations.*



## **Trading and Business Operations**

### **Trading and Business Operations Framework**

A Manager should develop a comprehensive and integrated framework to manage trading and business operations, taking into account the size and complexity of its activities, the nature of its investment, and the requirements of its investment strategies.

The framework should include:

1. Policies and procedures which provide for appropriate checks and balances for the significant operational and accounting controls, including:
  - (i) appropriate selection and management of counterparty relationships;
  - (ii) effective management of cash, margin and collateral requirements;
  - (iii) careful selection of key service providers;
  - (iv-v) strong infrastructure and operational practices;
  - (vi) strong operational and accounting processes, including appropriate segregation of business operations and portfolio management personnel; and
  - (vii) a disaster recovery process;
2. Systems, infrastructure and automation commensurate with the scale of the business and trading operations of the Manager, including regular review of such infrastructure to assess operational risks in light of both internal and external changes; and
3. A member of senior management, such as a Chief Operating Officer or person with similar responsibilities, with responsibility for the Manager's business operations, supported by internal personnel or, where applicable, external resources, with skills appropriate to the complexity of the Manager's business operations. This role and the operational areas of the firm should coordinate and work in partnership with the investment professionals and senior management.

### **I. Counterparties**

#### **A. Selection of Counterparties**

1. Managers interact with a variety of counterparties and should exercise reasonable due diligence in selecting the counterparties of the funds that they manage. Typical counterparties that a fund will encounter include:
  - (a) Brokers;
  - (b) OTC derivative counterparties;
  - (c) Prime brokers;

- (d) Stock loan and repo counterparties;
  - (e) Banks; and
  - (f) Cash management counterparties.
2. When selecting counterparties, the key factors that a Manager should consider include:
- (a) Creditworthiness, reputation, experience and identity of the specific entity;
  - (b) Ability to provide an appropriate level of service to the Manager in light of the Manager's business needs (including complexity of products and frequency of trading), such as:
    - (i) Efficient and timely transaction processing, reporting, clearing and settlement;
    - (ii) Financing capabilities necessary to support the Manager's business;
    - (iii) Adequate staff to be able to service the Manager's needs, including the support and reporting of information to prepare books and records; and
    - (iv) Terms and conditions for movements of margin and cash required by transactions.
  - (c) Regulatory environment in which the counterparty operates; and
  - (d) Stability of terms on which the counterparty is willing to provide service to the Manager (such as term funding lock-ups for prime brokers).

**B. Relationships with Counterparties**

1. The Manager should negotiate and maintain with its counterparties signed agreements governing the terms of the relationship (*e.g.*, account opening, prime brokerage, stock lending, ISDA and give-up agreements).
2. The Manager should carefully review the details of the terms of these agreements to understand risks that can affect the counterparty's obligation to extend credit or provide other services (such as terms that can increase collateral requirements).

3. Where multiple counterparties are used, the Manager should devote appropriate resources to managing the operations of the fund across those multiple counterparties.

## **II. Cash, Margin and Collateral Management**

1. The Manager should have a framework for managing its cash balances and processing any margin or collateral calls from its prime brokers, financing and OTC derivative counterparties. In developing this framework, Managers should carefully consider industry practices and developments in this area.
2. The Manager should:
  - (a) Understand and monitor its compliance with credit agreements;
  - (b) Understand and monitor the amount and type of collateral required to support positions;
  - (c) Verify marks used by the fund's counterparties to value the fund's positions for collateral purposes; and
  - (d) Verify and meet margin calls in a timely manner.

## **III. Selection of Key Service Providers**

1. The Manager should select reputable service providers that have expertise and experience suitable to appropriately support its business. These service providers may include, where appropriate:
  - (a) Providers of accounting, consulting, and proxy services, IT product vendors, and legal counsel; and
  - (b) The fund's administrator (where one exists).
2. The Manager's selection and monitoring process for its service providers should take into consideration each service provider's independence and controls over its activities.
3. In engaging key service providers, the Manager should enter into agreements that clearly delineate the service levels to be provided to it. Such services should be appropriate in light of the Manager's internal infrastructure and the complexity of the Manager's operations.
4. The Manager should monitor the quality of service provided by key service providers.

5. Responsibility for any outsourced parts of the process continues to lie with senior management or its designees.

#### **IV. Core Infrastructure and Operational Practices**

1. The Manager should develop infrastructure and operational practices tailored to its business. Requirements for the infrastructure needed will vary depending on the types of investments, frequency of trading, and the need for manual processing, as opposed to the availability of automated systems.
2. The Manager should consider whether the implementation of automated processing systems is appropriate to reduce settlement risk. Depending on the size and complexity of the organization, automation may be appropriate, where available.
3. The Manager should provide for appropriate reporting-up policies for resolving material breaks, errors or other matters that could potentially cause risk of loss to the fund. The Manager should employ business-process monitoring, analysis and optimization techniques to identify and address breaks and inefficiencies.
4. Depending on the size and complexity of the organization, the Manager should endeavor to cross-train personnel or otherwise have appropriate back-up, so that key operations functions are not dependent solely on one individual.

##### **A. Operational Procedures**

1. The Manager should adopt procedures for clearing and settling transactions and for wiring funds. Such procedures may address:
  - (a) The reconciliation of positions and cash accounts across counterparties, such as prime brokers, futures clearing accounts, the fund's administrator and front office, including prompt resolution of failed trades;
  - (b) An appropriate procedure for cash movements, including authorized signatories and appropriate checks and balances;
  - (c) The appropriate segregation of duties between investment and operational personnel, including confirmations that should be sent to non-trading personnel;
  - (d) The use of industry utilities and software tools (such as DTCC Deriv/Serv) in an effort to automate the Manager's OTC derivatives

processes, where the volume and complexity of a Manager's business warrants it;

- (e) A process for addressing corporate actions, such as mandatory elections, voluntary elections, dividends, splits and reorganizations; and
- (f) A process for monitoring and taking timely action on all positions that have expiration dates (*e.g.*, options, warrants, rights and conversions).

## **V. Additional Infrastructure and Operational Practices**

1. If a Manager undertakes material trading activities in the OTC derivatives market or other more complex markets (such as bank debt, mortgage-backed securities, equity derivatives, structured credit trading or private transactions), the Manager should devote the resources necessary to maintain infrastructure, personnel and processes that are sufficiently robust to handle the added complexities of these instruments and markets, including working closely with counterparties and remaining informed of, and responsive to, overall market trends. A Manager who trades in complex products should consider the need to maintain additional systems or to hire or engage personnel with specific skill sets necessary to appropriately manage such complex products. The lists below represent examples of derivative and complex product practices and are neither exclusive nor exhaustive.

### **A. OTC Derivative Practices**

1. The fact that OTC derivatives are individually negotiated transactions that can have unique characteristics and terms makes them especially challenging to manage from an operational and business perspective. Accordingly, when trading in OTC derivatives, the Manager should consider the need for the following:
  - (a) Negotiating appropriate ISDA master agreements with all of its OTC derivatives counterparties (*discussed further above in sub-section I.B.1*);
  - (b) Negotiating bilateral collateral agreements with its counterparties whenever possible;
  - (c) Appropriate systems to record all material terms of all OTC contracts to facilitate the appropriate pricing and risk management of these portfolios;

- (d) Processes to monitor and promptly report-up the resolution of any derivative transaction not supported by a counterparty term sheet detailing the economics of the trade;
- (e) Procedures for monitoring outstanding confirmations (*e.g.*, not yet received, in review, disputed, or aged) and performing risk analysis, timely mitigation (*e.g.*, prioritization) and expeditious resolution of outstanding confirmations;
- (f) Review of counterparty OTC margin calls and a process for assessing when the Manager should make its own OTC margin calls to brokers, as appropriate;
- (g) Appropriate processes and procedures to facilitate the Manager's ability to adhere to the industry's novation protocol and transaction processing timelines, and other industry protocols that may develop; and
- (h) Review of final payoffs for complex derivatives.

## **B. Practices for Other Complex Products**

1. **Bank Loans** – The Manager should assess whether it has the appropriate systems and personnel to manage the extended settlement cycles and unique features of these products. In addition, legal advice from appropriately skilled internal or external counsel is often needed to manage the documentation around these transactions, particularly in the distressed arena.
2. **Mortgaged Backed Securities/CMOs** – The Manager should assess whether it has appropriate systems and personnel to manage the unique features of these products, such as processing monthly paydowns and understanding payment waterfalls.
3. **Structured Credit Trading** – The Manager should assess whether it has the appropriate systems and personnel necessary to manage the unique features of these products, such as the financing component, waterfall structures and correlations.
4. **Private Transactions** – The Manager should assess whether it has appropriate resources such as internal and external legal, tax and structuring expertise that is adequate to support these transactions. In addition, custodial arrangements may be needed to provide for appropriate safeguarding of investment positions of this type. There should be periodic confirmation with counterparties of open positions.

5. **Transactions in Foreign Markets** – These types of transactions require an understanding by personnel or service providers of local regulatory, market and tax infrastructure and settlement conventions.

### **C. Staffing and Resources**

1. The Manager should regularly assess the appropriate level of staffing and resources for complex or unique trading strategies from an operational and business risk perspective and be willing to maintain that level.

## **VI. Core Accounting Processes**

1. The Manager needs to have appropriate systems, processes, and personnel in place, such that the trading activity of its funds and all related contractual arrangements and agreements can be appropriately recorded from an accounting perspective to allow for the calculation of both fund-level and investor-level net NAVs, as well as the production of other important financial data that is necessary to meet investor, risk, financial statement and tax reporting requirements. In this regard:
  - (a) The Manager should have internal or external personnel with an appropriate level of accounting knowledge and experience;
  - (b) The Manager should have access to systems appropriate to the needs and complexities of the firm, capable of correctly recording the trading and non-trading activities of the funds from an accounting perspective. These may include:
    - (i) Systems that maintain important trading-related data, including quantity, cost-basis, market-value, realized and unrealized trading gains/losses, interest and dividends, and trading-related fees and expenses;
    - (ii) A general ledger that includes trading data (whether in detailed or summarized form), as well as non-trading-related data, such as management fees and expenses;
    - (iii) An allocation process that allocates the fund level results to individual investors to allow for reporting at the investor level; and
    - (iv) Processes (*in addition to the valuation processes discussed above in the section on Valuation*) to ensure that all non-trading-related activities are appropriately recorded from an accounting perspective, including management fees, incentive fee (or

allocation) arrangements and other fees and expenses, as outlined in the fund's organizational documents.

- (c) The Manager should implement a month-end close process (or if not monthly, then at least as often as required by the fund's organizational documents). Some processes that may be appropriate in light of the characteristics of the fund include:
    - (i) Verification that any material valuation adjustment is appropriately recorded;
    - (ii) Verification that all non-trading-related activity is appropriately recorded;
    - (iii) Allocation of the fund level NAVs to individual investors; and
    - (iv) Preparation and distribution to investors of statements that detail their current NAV and other related financial data.
  - (d) The Manager should implement an annual process to produce its annual financial statements and related footnotes, which will be audited by the fund's independent accounting firm;
  - (e) The Manager should implement an annual process to produce investor level tax information, as needed by investors, in accordance with the regulations promulgated by the relevant taxing authority; and
  - (f) The Manager should periodically assess its operational controls in light of the changing needs of its business, particularly where there have been changes to the activities of the organization.
2. Responsibility for any outsourced parts of the process continues to lie with the senior management or its designees.

## **VII. Disaster Recovery/Business Continuity**

1. To mitigate financial loss in the event of disaster or other business disruption, the Manager should establish a comprehensive Business Continuity/Disaster Recovery plan. The Plan should include a business impact analysis to identify and prioritize critical processes for the Manager. It should also clearly articulate business recovery and resumption objectives. This plan may include written procedures and documentation, test plans and test scenarios as well as other procedures for addressing unforeseen events in an emergency.



2. Business continuity planning should cover all operational business functions and should not be limited to technology-based disaster recovery plans.<sup>9</sup>

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<sup>9</sup> Additional guidance on the development of disaster recovery/business continuity planning is provided in the Managed Funds Association's 2007 *Sound Practices for Hedge Fund Managers*.

## **Compliance, Conflicts and Business Practices**

### **Compliance, Conflicts and Business Practices Framework**

A Manager should establish a comprehensive and integrated compliance and business practices framework that is supported by adequate resources. The goal of the framework is to provide guidance to the Manager and its personnel in respect of ethical, regulatory compliance and conflict of interest situations. Critical to the success of the framework is a strong culture of compliance.

The framework should include:

1. A written code of ethics that establishes principles governing the conduct of the Manager's personnel;
2. A written compliance manual that addresses (i) the various rules and regulations governing the Manager's operations; (ii) potential conflicts of interest that may arise in the course of those operations; and (iii) the maintenance and preservation of adequate records;
3. The establishment of a Conflicts Committee to review conflicts;
4. Regular training of personnel on the material elements of the compliance program; and
5. A compliance function that includes (i) a Chief Compliance Officer to monitor and maintain the Manager's compliance program; (ii) appropriate discipline and sanctions to address departures from the Manager's compliance program; and (iii) an annual review of the Manager's compliance program.

#### **I. Culture of Compliance**

1. Critical to the success of the compliance and business practices framework is a culture of compliance, grounded in the commitment and active involvement of the most senior leaders of the firm and fostered throughout the organization.
2. Particularly important to creating a culture of compliance are the following:
  - (a) Encouragement by senior management to personnel to raise any concerns or questions (facilitated by an environment that is free from fear of retribution);
  - (b) Ability to communicate concerns to senior management;

- (c) Active participation by senior management in compliance meetings and training sessions;
  - (d) The role of the Chief Compliance Officer (or other person with similar responsibilities) should be regarded as institutionally significant; and
  - (e) Senior management should consult regularly and encourage employees to consult regularly with the Chief Compliance Officer and his or her delegates whenever issues arise that could raise compliance issues.
3. Maintaining high ethical standards of integrity in the Manager's business must be the responsibility of senior management and each employee.

## **II. Code of Ethics**

1. The Manager should develop and adopt a written code of ethics that establishes guidelines that are designed to foster integrity and professionalism among the Manager and its personnel and its commitment to act in the best interests of the fund. Whether particular policies or subjects are addressed in the code of ethics or compliance manual (*discussed further below in sub-section III*) should be determined by the Manager taking into account what it believes is most effective for its business.
2. These guidelines should address, at a minimum, the following issues, to the extent relevant to the Manager's structure and operations:
  - (a) Standards of conduct that require the Manager's personnel to operate with integrity and professionalism;
  - (b) The fiduciary capacity of the Manager and its personnel (including the priority of the interests of the fund and its investors over the interests of the Manager and its personnel);
  - (c) Protection of confidential information about the fund and its investors and any such information received by the Manager from third parties;
  - (d) Personal trading by the Manager's personnel;
  - (e) The receipt or provision of gifts and entertainment;
  - (f) A review or approval process for considering the compatibility of personnel's internal role with outside directorships and other business interests;
  - (g) An internal reporting mechanism for conduct inconsistent with the code of ethics; and

- (h) Other policies that the Manager considers appropriate given its particular characteristics and operations.
- 3. The code of ethics should apply to all employees. To the extent that certain policies do not apply, or apply differently to certain types of employees, depending on the nature of their responsibilities, duties and access to information, the Manager should clearly identify the types of employees (for example, investment professionals) to whom those policies apply.
- 4. The code of ethics should reflect the nature of the Manager's business. While "off the shelf" codes or manuals may provide useful background and guidance, the code should be appropriately adapted to fit the Manager's business.
- 5. Employees should certify that they have read the code of ethics and that they will act in conformity with it.

### **III. Compliance Manual**

#### **A. General Elements of the Compliance Manual**

- 1. The Manager should evaluate the critical elements to be addressed in its compliance manual in light of the focus of, and conflicts relating to, its business and operations.
- 2. The Manager should develop a written compliance manual that outlines its policies and procedures for complying with laws, rules and regulations (domestic or international) applicable to the fund's business operations and trading activities.
- 3. The following are topics that a Manager should consider addressing in its compliance manual (to the extent relevant):
  - (a) Marketing and Communication:
    - (i) Procedures for communicating with third parties (including media communications);
    - (ii) Procedures for using third-party marketers to solicit investments, where this practice is permitted; and
    - (iii) Procedures for review of any marketing materials used by the Manager, including review of performance presentation standards.

(b) Anti-Money Laundering:<sup>10</sup>

- (i) Anti-money laundering policies and procedures and compliance with the Bank Secrecy Act, as applicable, such as:
  - Procedures for identifying investors prior to subscription and periodic review of the fund's investor base; and
  - Where anti-money laundering compliance is delegated to an administrator or other third-party, periodic review of the delegate's practices (including its consistent application of those practices).

(c) Trading and Business Practices:

- (i) A procedure for the prompt and accurate recording of transactions;
- (ii) Trade allocation policies, such as policies in respect of allocations among funds and managed accounts or proprietary accounts, where applicable;
- (iii) A procedure for proxy voting;
- (iv) A trade error policy;
- (v) A best execution policy that includes selection criteria for executing brokers, and provides for identification and review of such criteria by a best execution committee (where applicable) or by senior management;
- (vi) A policy for the use of soft-dollar arrangements and bundled commissions that may include:
  - Review of the Manager's use of soft dollars for consistency with the practices outlined in disclosure to investors or compliance with Section 28(e) of the Securities Exchange Act of 1934 (where applicable); and
  - Heightened review of transactions with affiliated broker-dealers (where applicable) to monitor that the use of soft

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<sup>10</sup> Additional guidance is provided in Appendix IV of the Managed Funds Association's 2007 *Sound Practices for Hedge Fund Managers*.

dollars is consistent with what has been disclosed to investors.

- (vii) Policies prohibiting manipulation, such as:
  - Prohibition of late trading or market-timing;
  - Prohibition of front-running;
  - Prohibition of spreading of false rumors and wash sales, as appropriate in light of the Manager's business;
  - Procedures for hedging and short sales in connection with offerings of securities (such as in connection with PIPE transactions); and
  - Procedures for participating in new issuances of securities and complying with representations to brokers regarding eligibility for such issuances.
- (viii) Policies and procedures to prevent, detect, and address the misuse of material non-public information and insider trading (including in respect of price- or market-sensitive information and confidential information obtained from brokers, consultants or other third parties), which may include the use of information barriers, restricted lists or other appropriate procedures;
- (ix) Policies and procedures designed to prevent obtaining material non-public information while conducting research and information gathering when investing in public companies;
- (x) Policies and procedures for personal trading by personnel of the Manager, such as identifying Manager personnel subject to restrictions and establishing appropriate procedures to control that trading (*e.g.*, mandatory pre-approval or clearance of certain transactions and investments in initial public offerings or private placements, prohibition of or restriction on trading certain types of investments, restricted lists, black-out periods and holding periods); and
- (xi) Policy on compliance with securities law ownership reporting requirements, such as the Hart-Scott-Rodino Antitrust Improvements Act of 1976, Sections 13 and 16 of the Securities Exchange Act of 1934, short sale reporting and comparable non-U.S. reporting requirements.

(d) Surveillance:

- (i) The Manager should establish a system to monitor compliance with its compliance policies and procedures; and
- (ii) Appropriate surveillance will vary with the nature of the Manager's activities and the characteristics of the fund, but should include review of records or other documentation produced in the ordinary course of business that can be useful in assessing the Manager's compliance with its policies.

**B. Recordkeeping**

1. Business records that are important to the Manager and fund should be maintained. Examples include contracts, constituent documents, trade data, accounting records, documents relating to valuation, records of meetings of any principal committees (such as the Risk, Valuation, and Conflicts Committee), investor communications and correspondence. The Manager should establish policies and procedures for the creation, maintenance and retention of business records that are appropriate to its size and level of activity. These policies and procedures should focus on key business records and should address, where applicable:
  - (a) The duration of retention, which may vary by type of record;
  - (b) The manner of retention, which should protect against unauthorized alteration or untimely destruction;
  - (c) Communication of the retention policy to all employees as it applies to them;
  - (d) Accurate and complete recording of trading activities; and
  - (e) Methods to access documents retained pursuant to the policy.

**C. Conflicts of Interest**

1. Conflicts are inherent in the asset management business as in many other financial services businesses. The key to appropriately handling conflicts is to have a process in place for identifying them and addressing them. The types of conflicts that may exist in a Manager's business will vary based on its structure, the structure of its funds and the types of activities that it conducts.
2. The following are types of potential conflicts that may be applicable to a particular fund and that a Manager should consider in light of its business:

- (a) Conflicts between the Manager and its fund(s), such as:
    - (i) Conflicts arising from proprietary trading or proprietary holdings in specified investments;
    - (ii) Conflicts arising from the valuation process;
    - (iii) Conflicts relating to the allocation of costs and expenses between the Manager and the fund;
    - (iv) Conflicts relating to transactions or business arrangements with affiliates, such as brokerage arrangements, cross-trades, principal trades and the provision of any other services by affiliates; and
    - (v) Conflicts relating to relationships with third-party service providers (*e.g.*, prime and other brokers, vendors and administrators), such as the use of soft dollars, capital introduction and consulting services or use of affiliated brokers or custodians.
  - (b) Conflicts between funds managed by the same Manager or between funds and separate accounts managed by the same Manager (*e.g.*, conflicts in the allocation of investment opportunities);
  - (c) Conflicts between employees (including family members) of the Manager and the fund, such as:
    - (i) Conflicts arising from personal trading (including front-running);
    - (ii) Conflicts arising from private investment activities;
    - (iii) Conflicts arising from outside business activities; and
    - (iv) Conflicts arising from the receipt or provision of gifts and entertainment.
  - (d) Conflicts between investors, such as conflicts arising from side letters or parallel managed accounts that may grant preferential terms to certain investors or adversely impact others.
3. The Manager should adopt policies and procedures to identify and address potential conflicts of interest that may arise in its specific businesses. Whenever a conflict can be mitigated or addressed in a consistent and standardized way (such as in relation to personal trading policies), the Manager should adopt policies and procedures to deal with that conflict.



Recognizing that circumstances may require a review of specific facts and that not all potential conflicts can be predicted, the Manager should also establish a Conflicts Committee.

- (a) The purpose of the Committee would be to assess new or potential conflicts, as they arise, that have not previously been addressed.
- (b) The Committee should also determine whether amendments or new policies are necessary or appropriate in light of its review.
- (c) The Committee may include the Manager's Chief Compliance Officer and other members of senior management (as appropriate to the internal organization of the fund).
- (d) The Committee should review at least annually the effectiveness of the Manager's conflict management process.
- (e) The Committee should keep appropriate records of how material conflicts were addressed.

#### **D. Training and Educating Manager's Personnel**

1. The Manager should establish a robust training program to educate personnel in respect of its compliance program. This training program should be developed in light of the following considerations (to the extent relevant):
  - (a) Training should foster an understanding of all parts of the compliance framework;
  - (b) Training should be tailored to the type of business undertaken by the Manager and should incorporate examples relevant to that business. It should focus on identifying compliance issues particular to the Manager's operations and on preventing market abuse;
  - (c) At least annually the Manager should organize and make available to personnel performing a significant business function a compliance training session addressing topics identified by the Chief Compliance Officer and by employees as relevant to the activities of such employees. The Manager may enlist the services of outside experts, such as outside counsel, to conduct these sessions;
  - (d) Training should address circumstances where it would be appropriate to seek guidance from the Chief Compliance Officer or other member of senior management regarding a compliance matter; and

- (e) Because junior personnel will often develop greater compliance awareness through open and informal discussions with their supervisors and the Chief Compliance Officer, such contact should be encouraged as part of the training process.

#### **IV. Compliance Function**

1. The Manager should establish and devote adequate resources to a compliance function to oversee, implement and review the Manager's compliance program.

##### **A. Chief Compliance Officer**

1. A Chief Compliance Officer or other member of senior management (as appropriate to the size, complexity and resources of the Manager), with sufficient knowledge and experience, should be appointed to oversee the Manager's compliance program.
  - (a) The Chief Compliance Officer's duties may include:
    - (i) Identifying compliance risks (in consultation with other senior personnel);
    - (ii) Monitoring compliance with policies and procedures;
    - (iii) Conducting an annual review and assessment of the Manager's compliance framework (including the compliance manual); and
    - (iv) Providing for staff awareness of the Manager's compliance policies and procedures through training and other methods appropriate for the Manager's business.
  - (b) The Chief Compliance Officer should have adequate resources to seek the advice of external experts on compliance matters when needed. This may be especially important where the Manager operates in international markets outside the location of the Manager.
  - (c) The Chief Compliance Officer should be able to devote sufficient time to the performance of his or her functions.
  - (d) Employees should report all compliance matters to the Chief Compliance Officer or other designated staff.
2. In addition to a Chief Compliance Officer, other members of senior management may be appointed to oversee compliance in specific areas.

## **B. Discipline and Sanctions**

1. Non-compliance with the policies or procedures described in the various parts of the compliance framework should be reviewed and handled promptly and conclusively. To this end, policies and procedures may provide for the following:
  - (a) Non-compliance with the code of ethics or compliance manual should be internally reported to the Chief Compliance Officer according to the reporting procedures stated in these documents.
  - (b) Disciplinary responsibility generally lies with senior management. Accordingly, the Chief Compliance Officer should have access to and report to senior management and should recommend appropriate disciplinary action to senior management.
    - (i) The Chief Compliance Officer or General Counsel should conduct an internal review of allegations or evidence of wrongdoing, as necessary; and
    - (ii) A range of sanctions may be appropriate for non-compliance, such as (depending on the severity of the infraction and an employee's compliance history) reprimands, censure, suspension, termination and, where applicable and practical, restitution and disgorgement of profits.

## **C. Annual Compliance Review**

1. The Manager's compliance framework, including compliance policies and procedures, should be reviewed at least annually to assess its effectiveness. A more frequent review of aspects of the compliance framework is appropriate upon the occurrence of events that necessitate more immediate changes. Each component of the compliance framework should be reviewed by the Chief Compliance Officer in light of significant changes and factors relevant to the Manager's business, such as:
  - (a) Legislative and regulatory developments;
  - (b) Changes in business practices;
  - (c) Variations in the Manager's strategies and products;
  - (d) The growth of the Manager's business; and
  - (e) Employee conduct.