Sound Practices for Hedge Fund Managers

Sifting through all the legal and regulatory requirements is one of the most time-consuming and daunting tasks required for launching a hedge fund, yet it is one of the most important. With the Madoff scandal a not so distant memory and with the still struggling economy, there has been a call from the industry for independence and a higher standard of technology to assist in identifying fraudulent returns and activity. Setting up sound practices in your operations at your initial launch will allow you to meet the demands of the current market and set you apart when marketing to potential investors.

The Managed Funds Association (MFA) has provided a guide to Sound Practices for Hedge Fund Managers. We will provide you with a summary of that guidance and offer you solutions to accommodate for you as an emerging manager.

The MFA guide is divided into (7) sections as follows:

- Disclosure to investors and counterparties and practices to assist the fund in fulfilling its responsibilities to investors.
- Implementation of valuation policies and procedures and governance and oversight of the valuation functions.
- Risk measurement, monitoring and management designed to ensure that risk policies of the hedge fund manager are observed.
- Policies and procedures with respect to a hedge fund manager's core trading and business operational processes.
- Establishing a culture of compliance, including a compliance framework, to address regulatory compliance and managing potential and actual conflicts of interest.
- Developing an AML program
- Developing business continuity/disaster recovery plan.

DISCLOSURE AND INVESTOR PROTECTION:

A proper disclosure framework is critical to the protection of investors' interests and should also include guidelines for providing information to counterparties; keeping in mind the necessary confidentiality.

An inclusive disclosure framework should provide:

- ✓ An offering document or PPM
- ✓ Annual audited financial statements
- ✓ Performance information

- ✓ Investor communications and other reporting
- ✓ Timely disclosure of material information in certain circumstances
- ✓ Guidelines for the disclosure of potential conflicts of interest
- ✓ Guidelines for the qualifications of investors in the hedge fund
- ✓ Guidelines relating to disclosure to counterparties

The PPM or offering document should outline the hedge fund's operations, including descriptions of the investment philosophy, strategies, and products, the risks of an investment in the fund and any other information that may be necessary to allow the potential investors to make an informed decision. The offering documents are generally prepared by an attorney and it is recommended you seek counsel when considering the launch of a hedge fund. (For more information on the details found in offering documents, see our "Offering Documents" whitepaper)

Regular reporting of performance information to your investors plays a vital role in your operations and your ability to attract new investors to your fund. Performance information may be provided for in audited financial statements, performance estimates, net asset value statements or narrative discussions of your performance.

As an emerging manager, you may find that an annual audit during your first year or two of operations is not cost effective or necessary unless you have certain institutional or core investors requesting one. However, having an annual audit can bring legitimacy and investor confidence in your fund.

If you decide to provide estimates to your investors, it is important to make sure you clearly indicate that the performance is only an estimate and that it may not include other material expenses or items as used when calculating a Net Asset Value (NAV) statement.

Providing a monthly or quarterly NAV statement is the most common form of reporting performance information to investors. A NAV statement generally reflects each investor's account balance or share value taking into account fees and expense accruals, as well as, trading profits and losses for each investor.

Narratives may be in the form of investor letters or annual or quarterly summaries that discuss the fund's performance for during a relevant period of time.

Certain information or changes considered to be material should be disclosed immediately to underlying investors. For example, changes to your valuation policy, changes to key investment personnel or changes to a third party service provider should be immediately disclosed to your investors. Other material information disclosures may include disciplinary information of investment or other key personnel, entry into side letters that may adversely impact other investors, occurrence of operational issues that may adversely impact the hedge fund, discovery of fraud by the hedge fund manager or service provider and market events that may significantly impact the fund's performance.

As an emerging manager, you will want to develop guidelines for the disclosure of certain conflicts of interest that may impact the fund or its investors. Side letters that may adversely impact other investors should provide disclosure if the side letters enhanced control rights, transparency, provided preferential liquidity or redemption rights, provided for preferential fees or terms that materially alter the investment program or may affect the allocation of certain investments.

If, as a hedge fund manager, you operate a parallel account outside the hedge fund or manage another hedge fund, you should analyze whether the terms of the parallel account or other hedge fund may adversely impact the investors in your fund and make disclosures necessary for investors to assess the possible impact of the parallel account or additional hedge fund.

A hedge fund manager should evaluate and properly document how each investor's qualifications satisfies the legal requirements of the fund's structure. This documentation is usually adhered to through subscription agreements. The hedge fund manager should also obtain representations from the investor regarding the understanding of the PPM and organizational documents, as well as, confirming that the prospective investor has had the opportunity to obtain additional information, ask questions of the hedge fund manager and is making an independent decision based on the documents and the investor's independent investigation of the fund.

It is important for hedge fund managers to foster positive relationships with counterparties by providing adequate disclosures so that both the manager and the counterparty may properly assess the risk associated with the hedge fund or a prospective investor. Both parties should agree on the types and frequency of disclosure at the inception of their relationship.

VALUATION POLICIES AND PROCEDURES:

A hedge fund manager should provide a comprehensive valuation framework to provide clear, consistent valuations for all the assets in the hedge fund's portfolio. The valuation framework should include:

- ✓ A governance mechanism responsible for establishing and reviewing compliance with the hedge fund's valuation policies and for providing oversight and implementation of the manager's valuation policies and procedures.

- ✓ Development by the fund manager of documented valuation policies and procedures, as well as guidelines in evaluating exceptions.

- ✓ Knowledgeable and independent personnel supported by adequate resources who are responsible for the valuation of the hedge fund's investment positions and the implementation of the manager's valuation policies and procedures.

The governing body or valuation committee should include all key members of the hedge fund manager's senior management and should approve valuations. The valuation committee should be structured independently from portfolio managers and trading personnel. The typical responsibilities of the valuation committee are developing the methods and sources used for valuing various classes of investment positions and any material changes to methods and sources, reviewing and approving the hedge fund manager's guidelines and policies for classification of the fund's assets within the FAS 157 hierarchy, evaluating broker processes, sources and consistency when broker quotes are used to value the fund's assets and approving final valuations.

The valuation committee should review and test policies and procedures annually. As an emerging manager, utilizing the resources of your administrator will help you to ensure you have sound governance over the policies you set in place and valuation of your fund's assets.

A hedge fund manager should implement comprehensive, written valuation policies that provide for fair, consistent and verifiable valuation of all assets of the hedge fund. The fund manager's policies should identify all parties engaged in the valuation process, identify the methodologies used in valuing various types of investments, adopt an appropriate accounting standard (IFRS or GAAP), establish appropriate internal documentation procedures to support the valuation of each type of asset, establish procedures for valuing investments with no readily ascertainable market value and should provide guidelines regarding the use of side pockets and similar arrangements. (For more detailed information on Valuation Policies & Procedures, please refer to our Valuation Pricing whitepaper)

RISK MEASUREMENT, MONITORING AND MANAGEMENT:

Risk is inherent in the investment process of a hedge fund. The goal of risk management is to understand and manage risk as it relates to expected returns. Through the risk management framework, a hedge fund manager should identify the risks inherent in its investment strategies and measure and monitor the hedge fund's exposure. A sound risk management framework should identify material risks to the hedge fund and measure the principle categories of risk (liquidity risk, leverage risk, market risk, counterparty credit risk, operational risk and legal and compliance risk). The risk management framework should also provide for a regular process for risk monitoring, policies and procedures that establish measurement and monitoring criteria, as well as knowledgeable personnel to measure and monitor risk in accordance with policies and procedures.

A hedge fund's risk profile should be tailored to its size and strategy, as well as the hedge fund manager's investment activities. A hedge fund manager should provide adequate disclosure to investors that enable them to make informed decisions about the risk profile of the hedge fund and how the fund is performing in light of its risk profile. A member of senior management should establish the risk measurement criteria and implement the processes to monitor the hedge fund's risk.

The hedge fund manager should periodically review its risk measurement, monitoring and management activities to account for any relevant changes the fund's risk profile, historical events, new methodologies or other relevant factors. The fund manager should understand the biases and limitations of risk measurement methodologies and adjust for these when making decisions about risk. Key risk exposure reports should be prepared by the fund manager and distributed to senior management and other personnel with the frequency appropriate to the nature of the fund. Senior management should appoint personnel to supervise risk analysis, measuring and monitoring and to establish policies and procedures covering all areas of risk management. Senior management should not outsource risk monitoring or management. The training of relevant personnel on policies and processes on a periodic basis is also necessary.

POLICIES AND PROCEDURES FOR CORE TRADING AND BUSINESS OPERATIONS:

A hedge fund manager should develop a comprehensive and integrated framework to manage his trading and business operations. The framework should include policies and procedures that provide for appropriate checks and balances for the hedge fund manager's key operational systems and accounting controls. The framework should include:

- ✓ Appropriate selection and management of counterparty relationships
- ✓ Effective management of cash, margin, and collateral requirements
- ✓ Careful selection and monitoring of key service providers
- ✓ Strong infrastructure and operational practices
- ✓ Strong operational and accounting processes, including appropriate segregation of business operations and portfolio management personnel
- ✓ Adequate documentation of trading activities
- ✓ Systems, infrastructure, and automation commensurate with the scale of the business and trading operations of the hedge fund manager, including regular review of such infrastructure to assess operational risks in light of both internal and external changes
- ✓ Adequate best execution practices or processes.

A hedge fund manager should have a member of its senior management primarily responsibility for managing the fund manager's trading and business operations, supported by adequate internal and/or external personnel with the appropriate level of skills and experience.

The fund manager should develop investment and trading policies for each hedge fund it manages based upon the fund's specific investment objectives as described in its offering documents. The fund manager should annually review and update its investment and training policies, as well as its operational policies and practices. Any updates should address material changes to a hedge fund's structure or investment strategy, market events or applicable regulations.

Hedge fund managers interact with a variety of counterparties and should conduct reasonable due diligence when selecting the counterparties of the hedge fund that they manage. A hedge fund manager should negotiate and maintain with its counterparties signed agreements governing the terms of the counterparty relationship. The fund manager should carefully review and understand the details of the terms of counterparty agreements and the risks that can affect a counterparty's obligation to extend credit or provide other services.

The fund manager should also have a framework for effectively managing his cash balances; processing any margin or collateral calls from the prime brokers; financing; and OTC derivative counterparties. He should also periodically evaluate the effectiveness of his cash management framework.

Hedge fund managers have commonly looked to outside parties for assistance with setting up and running a hedge fund. Managers should select reputable service providers that have the expertise and experience necessary to appropriately support its business. Some of the service providers might include accounting, consulting, proxy services, information technology product vendors, legal counsel, fund administrators, sub-advisers or external portfolio managers. The hedge fund manager's selection and monitoring process for its service providers should take into consideration each service provider's independence and controls over its activities. The fund manager should monitor the quality of service provided by any outside service provider.

A hedge fund manager should develop and document core infrastructure and operational practices tailored to its business. The fund manager should designate a member of senior management or an appropriate designee to regularly review trading activities and the performance of each Hedge Fund portfolio; evaluate the associated risk levels and ensure that the fund's management and trading activities are consistent with the policies and practices set out in the fund's governing documents. The fund manager should also adopt procedures or processes for clearing and settling transactions and for wiring funds.

If a hedge fund manager undertakes material trading activities in the OTC derivatives market or other complex markets, 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. The fund 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.

The hedge fund manager needs to have appropriate systems, processes, and personnel in place, such that the trading activities of its hedge 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, regulatory reporting (as appropriate), and tax reporting requirements. Having an outside, independent administrator has become an industry standard and to put it simply, makes operating your hedge fund easier and provides you with an additional edge when trying to win over those prospective investors.

A hedge fund manager should seek best execution in its trading activities for the benefit of each Hedge Fund he manages. There are numerous factors the fund manager should consider when seeking best execution including prompt and reliable execution, the financial strength, integrity and stability of the broker, the quality, timeliness, and frequency of available research and market information provided by the executing broker, the ability of the executing broker to execute transactions of size in liquid and illiquid markets without disrupting the market for the security, the competitiveness of commission rates in comparison with other brokers satisfying the hedge fund manager’s other selection criteria and the ability of the executing broker to maintain confidentiality, just to name a few.

COMPLIANCE AND CONFLICTS:

A hedge fund 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 hedge fund manager and its personnel with respect of the ethical, regulatory, compliance, and conflict of interest situations that can occur. Critical to the success of the framework is a strong culture of compliance.

A solid compliance and conflict resolution framework should include the following:

- ✓ A written code of ethics that establishes principles governing the conduct of the fund manager’s personnel
- ✓ A written compliance manual that addresses the various rules and regulations governing the hedge fund manager’s operations, potential conflicts of interest that may arise in the course of those operations and the maintenance and preservation of adequate records
- ✓ The establishment of a conflicts committee or other responsible body (the “Conflicts Committee”) to review and address potential conflicts

- ✓ Regular training of personnel on the material elements of the compliance program
- ✓ A compliance function that includes a Chief Compliance Officer to monitor and maintain the hedge fund manager's compliance program, appropriate disciplinary procedures and sanctions to address violations of the manager's compliance program and an annual review of the manager's compliance program.

A hedge fund manager should establish a culture of compliance, grounded in the commitment and active involvement of the most senior leaders of the management and fostered throughout the organization.

As an emerging manager, having such a robust structure may not be possible. However, it is important to establish guidelines for compliance, conflict resolution and a code of ethics within your organization and with outside third party service providers.

DEVELOPING AN AML (ANTI-MONEY LAUNDERING) PROGRAM:

Although the Department of the Treasury has not issued rules for hedge funds and hedge fund managers, funds and their managers should adopt and implement AML programs consistent with Section 352 of the USA PATRIOT Act as a matter of sound business practice. As part of the fund's AML program, the fund manager should adopt written policies and procedures that are designed to prevent and detect money laundering and any activity that facilitates money laundering, the funding of terrorist activities, or violations of OFAC regulations.

The basic elements of an AML program include:

- ✓ The designation of a compliance officer
- ✓ The development of internal policies, procedures, and controls
- ✓ An ongoing employee training program
- ✓ An independent audit function to test programs and recordkeeping

The senior management team of the hedge fund should approve the AML program, as well as designate an Anti-Money Laundering Compliance Officer who has the authority and resources to effectively implement the fund manager's AML program. The AML Compliance Officer should be responsible for coordination and monitoring day-to-day compliance with applicable laws, regulations and the fund's own AML program. He should also be responsible for the employee training programs and, in conjunction with senior management, should decide whether to accept or reject a prospective investor based on the money laundering risks identified. The AML Compliance Officer should also decide if delegation of investor identification procedures is appropriate. He should review any reports of suspicious activity and arrange for the performance of an independent audit to evaluate the fund's AML policies and procedures.

The fund manager should have established identification procedures that take into account the specific risks presented by the fund's investor base. The hedge fund manager should complete identification procedures prior to accepting an investment from a prospective investor and should perform the following due diligence:

- ✓ Undertake due diligence to identify the direct investor is acting on its own behalf and not for the benefit of any third party
- ✓ If the investor is investing on behalf of other investors, reasonable due diligence efforts should be made to identify the investor and the underlying investors
- ✓ Determine that it is acceptable to rely on the due diligence performed by a third party, such as a fund administrator

The fund manager may wish to develop a due diligence checklist and needs to ensure the subscription documents provide proper representations and documentation. In order to confirm the identity of a natural person investor, a Hedge Fund Manager should take reasonable steps to ascertain the investor's name and address, and, if applicable, social security number or taxpayer identification number. (For more detailed information on AML Policies and Procedures please refer to our AML/KYC (Know Your Client) whitepaper)

BUSINESS CONTINUITY AND DISASTER RECOVERY:

As a fiduciary, a hedge fund manager should provide for the continuation of its essential operations and services in the event of a natural disaster, market disruption, terrorist attack, loss of a key person, or business emergency. The following principles should be incorporated into a business continuity, disaster recover, and crisis management plan (BC/DR Plan). The plan should be designed to:

- ✓ Identify and prioritize critical business functions
- ✓ Protect the fund manager's personnel from harm
- ✓ Permit orderly continuation of key business operations
- ✓ Protect client assets
- ✓ Permit the fund manager to maintain communications with clients, Investors, regulators and other necessary parties

The fund manager's BC/DR Plan needs to provide clear written policies and procedures designed to facilitate the manager's preparations for such events. Each BC/DR Plan should include long-term and short-term strategies and be tailored to fit the individual needs of a Hedge Fund Manager.

A comprehensive BC/DR Plan should address, without limitation, the loss of key personnel, facilities, technology and equipment/service, due to natural disasters, weather and geographical events, fires, acts of terrorism, pandemics and information technology system malfunctions or corruption.

In developing a BC/DR Plan, the hedge fund manager should:

- ✓ Identify and assess all mission critical systems, financial assessments, operations middle, back and front office functions, equipment and outsourced dependencies and relationships, the likelihood of a failure and minimum service requirements
- ✓ Identify and assess credible risks and potential risks that could reasonably be expected to affect the fund manager's ability to conduct business
- ✓ Establish back-up facilities and systems that are located in one or more reasonably separate geographic areas from the manager's primary facilities and systems
- ✓ Consider how to comply with any required regulatory reporting
- ✓ Develop a communication plan to contact essential parties such as employees, customers, brokers, service providers, disaster recovery specialists and regulators
- ✓ Determine how the fund manager will safeguard or conduct the orderly liquidation of its clients' funds and securities in the even the manager determines that it is unable to continue business

On an annual basis, the fund manager should conduct testing and provide training to its personnel on its BC/DR policies and procedures.