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Risk Management Update
June 2008

HEDGE FUND BEST PRACTICES

Two private-sector committees of the President's Working Group on Financial Markets recently published separate but related reports providing guidelines for best practices relating to hedge fund management and investment. The Asset Managers' Committee ("AMC") released a report entitled "Best Practices for the Hedge Fund Industry," which calls on hedge fund managers to adopt new standards relating to several aspects of their business. The Investors' Committee ("IC") released "Principles and Best Practices for Hedge Fund Investors," which sets standards for investing in hedge funds and overseeing hedge fund investments.

Both reports propose comprehensive recommendations that go beyond existing industry standards. The reports complement one another by addressing the important aspects unique to each segment of the hedge fund industry, and acknowledging that both hedge fund investors and managers are accountable and must implement and maintain strong controls.

BETTER MANAGEMENT OF HEDGE FUNDS

The AMC report sets forth new far-reaching standards for the hedge fund industry to reduce systemic risk and foster investor protection. The report provides a detailed framework for implementing comprehensive best practices in each of the following five key areas relating to hedge fund management:

- Disclosure – to ensure that investors have sufficient information to allow them to make an investment decision and monitor it over time, best practices include the provision of a private placement memorandum, annual audited GAAP compliant financial statements, periodic performance information and timely disclosure of material events.
- Valuation – managers should establish procedures for the consistent application of a valuation policy that provides for segregation of functions between portfolio managers and those responsible for valuations and calls for more frequent reporting of the percentage of assets that are illiquid or particularly difficult to value through the use of independent valuation consultants when necessary.
- Risk Management – based on a particular fund's size and strategy, managers should determine the overall risk profile for the fund by identifying potential risks, measuring principal categories of risk, establishing and maintaining a risk monitoring process.
- Trading and Business Operations – taking into account the diversity among fund operations and strategies, managers should establish policies for the segregation of duties, institute operational checks and balances, and establish appropriate infrastructure to accommodate the investments traded by the fund

- Compliance, Conflicts and Business Practices – it is recommended that firms should develop a written code of ethics, a compliance program including a Chief Compliance Officer and a process for handling conflicts of interest relevant to the hedge fund industry.

In recognition of the growth and evolution of the hedge fund industry, the AMC report on best practices addresses the need for hedge funds to develop internal controls and best business practices designed to better protect investors.

RECOMMENDING AND ADMINISTERING HEDGE FUND INVESTMENTS

The IC report includes a "Fiduciary's Guide" and an "Investor's Guide." The report uses the term "fiduciary" to refer to those with portfolio oversight responsibilities and "investor" narrowly refers to investment professionals charged with implementing a hedge fund program. The Fiduciary's Guide outlines the best practices for evaluating the appropriateness of hedge funds as a component of an investment portfolio. The "Investor's Guide" sets forth detailed guidelines for executing and administering a hedge fund program once it becomes part of the client's investment portfolio.

Individuals and organizations with portfolio oversight responsibilities must consider whether a hedge fund investment will promote the client's objectives. Best practices of fiduciaries considering hedge fund investments include carefully assessing the appropriateness of a hedge fund program, evaluating the skill and sophistication of hedge fund managers, analyzing and assessing the hedge fund managers' track record and developing policies that define the characteristics and objectives of the program. In determining the suitability of hedge funds, fiduciaries should have the capacity to tolerate investing in innovative strategies as well as the knowledge and experience to understand the associated risks and uncertainties involved in hedge fund investing. Specifically, fiduciaries must consider the investment reasons and risk tolerance of the individual investor for including hedge funds within a client account and the appropriate amount to allocate to the overall portfolio. Depending on the hedge fund's portfolio allocation percentage, fiduciaries must consider proper diversification among different funds, strategies and managers.

Investment professionals administering a hedge fund program should conduct thorough due diligence and regularly monitor the managers' business model, performance track record and investment style in order to better understand and evaluate the funds' risks and returns. Those with due diligence responsibilities should develop formal risk management programs to protect assets and better evaluate the type and degree of investment risks of each particular hedge fund, including the periodic review of hedge fund compliance manuals. More than any other investment vehicle, hedge funds require thorough and continuous oversight by investors and careful consideration must be paid to the various legal and regulatory matters concerning hedge funds as well as each manager's performance, strategy and organization. Adhering to these best practices will ensure more responsible investment in hedge funds and increase the accountability for hedge fund investors and managers alike.

These comprehensive industry best practices are designed to promote the strongest, most effective policies throughout the entire hedge fund industry. These new standards address the decision to invest in hedge funds, and provide guidance for the management and oversight of hedge fund investments. For more information, please contact us at (619) 298-2880.

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