



# Sound Practices for Hedge Fund Managers

**MANAGED FUNDS ASSOCIATION**

The Voice of the Global Alternative Investment Industry

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## Preface

### About Managed Funds Association

Hedge fund managers are vital participants in the global capital markets, yet they remain largely misunderstood by the media, the government, and the public-at-large. In light of the U.S. Court of Appeals for the District of Columbia decision overturning the SEC's rule requiring registration of most hedge fund managers, the recent pension reform legislation, and the tremendous growth and increased visibility of the industry, hedge fund managers are under heightened scrutiny in the United States and abroad. This scrutiny necessitates focused advocacy, consistent messages, and shared experiences for the industry.

For over 16 years, Managed Funds Association ("MFA") has been the unifying voice of the hedge fund industry. MFA's mission is to protect the interests of the industry, to educate policy makers, and to assist its Members better grow and conduct their businesses.

MFA achieves its success through four major areas:

#### **Protect**

MFA is the preeminent advocate for the hedge fund industry in the United States with a primary focus of protecting the integrity and the efficiency of the capital marketplace by representing the interests of industry participants on Capitol Hill. MFA works tirelessly with policy makers, in both Houses of Congress, and regulators, to shed light on what has been mischaracterized as a secretive industry. MFA navigates the political landscape through its lobbying initiatives and extensive contacts throughout Washington, D.C. MFA has strength in numbers that no individual Member or group can replicate—MFA's Members manage a vast majority of the almost \$2 trillion industry. MFA exports these advocacy efforts outside of Washington, D.C. to the states and internationally, including the United Kingdom, Japan, India, and other regions.

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### Promote

In conjunction with its advocacy efforts in Washington, D.C. and abroad, MFA works to reshape the media's misrepresentations and the public's misperceptions about the hedge fund industry. MFA is able to promote the benefits of alternative investments, including hedge funds, to the global financial marketplace as a whole, in a way that individual managers could not accomplish on their own. MFA operates as a clearinghouse of information by virtue of its representation of the industry so that it can engage the media and the public on a variety of issues impacting the industry without a spotlight shining on any one particular manager. MFA is able to dispel myths, to encourage understanding, and to disseminate messages to the media and among the general public with a uniform, collective voice to ensure consistent clarity.

### Educate

MFA recognizes that its initiatives with the government, the press, and the public are irrelevant if MFA's Members do not operate according to high ethical standards and reputable business practices. Therefore, MFA regularly educates its Members about the best practices for any hedge fund manager who wishes to enter the marketplace. *MFA's Sound Practices for Hedge Fund Managers* is the most recognized and well-respected resource for hedge fund managers seeking to foster a culture of compliance. MFA hosts conferences, seminars, and other educational events to help train hedge fund managers and industry counterparts, such as lawyers and accountants, and to lay the foundation for consistent market practices across the broad spectrum of hedge fund strategies. MFA's active involvement enables its Members to collectively help shape best practices that will foster growth of the industry. Additionally, MFA communicates to its Members about changes in legislation and regulation impacting all aspects of the industry.

### Participate

MFA's success is contingent upon the continued support of its Members. MFA seeks the financial support of industry participants and substantive involvement in MFA committees, activities, and events. MFA's Board of Directors and other committees are comprised of prominent industry participants. MFA's advocacy on Capitol Hill is most effective with the participation of its Members. Participation provides Members with access—both collectively and individually—to influential policy makers. Each conference,

seminar, and event is made possible by the involvement of individual Members. The largest participants in the hedge fund industry are MFA's most active Members and most significant financial contributors. Upon joining, each Member of MFA gains an instant peer group of the most influential leaders in the hedge fund industry and receives opportunities to interact with them in an unparalleled way.

MFA Members are paramount in helping the industry prosper. MFA Members provide two assets that are fundamental for MFA to succeed in its mission: financial support in the form of annual MFA Membership dues and conference sponsorship and attendance, and substantive participation in a variety of committees, working groups, and other activities. Without continued and growing support in the form of Member dues, MFA would not be able to succeed in its mission.

MFA is led by its President, Executive Vice President/Chief Operating Officer, Executive Vice President/Chief Administrative Officer, and an executive team of legal, government affairs, membership and marketing professionals. An administrative staff assists MFA executives with the details necessary to advance the association's strategic mission. For more information about MFA, visit [www.managedfunds.org](http://www.managedfunds.org).

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## Preface

### About the 2007 Edition

MFA has published the 2007 edition of its *Sound Practices for Hedge Fund Managers* in a new three-ring binder format and design, making the document easier to navigate and update. As needed and appropriate, MFA will circulate updated pages and sections to its Members, so that Members can simply replace the outdated pages or sections.

MFA is certain this new format will make the document more readily accessible to hedge fund managers as they seek to operate in accordance with industry best practices.

In preparing *Sound Practices for Hedge Fund Managers*, MFA consulted with Akin Gump Strauss Hauer & Feld LLP and, with respect to Appendix IV—Guidance for Hedge Funds and Hedge Fund Managers on Developing Anti-Money Laundering Programs (Release No. 2), with Schulte Roth & Zabel LLP.

# Sound Practices for Hedge Fund Managers

## Introduction

MFA publishes its *Sound Practices for Hedge Fund Managers* (“*Sound Practices*”) for the benefit of its Members and the global Hedge Fund<sup>1</sup> industry. Currently in its fourth iteration (previous editions were published in 2000, 2003, and 2005), *Sound Practices* contains recommendations that provide Hedge Fund Managers, operating as single-manager Hedge Fund complexes, with a framework of internal policies, practices, and controls from a peer-to-peer perspective (the “Recommendations”). MFA principally directs the Recommendations toward all Hedge Fund Managers, both U.S.-based and non-U.S., with business operations and investments in the United States and its territories. However, MFA recognizes the truly global structure of the Hedge Fund marketplace, and has developed *Sound Practices* so that the Recommendations are useful tools for Hedge Fund Managers around the world. As the pre-eminent resource for establishing standards of excellence, *Sound Practices* creates a framework from which all Hedge Fund Managers may tailor the Recommendations to meet their needs in order to develop and implement a culture of compliance.

### Public Policy & the Hedge Fund Industry

*Sound Practices* has been acknowledged by Hedge Fund Managers, as well as investors, regulators, and market counterparties, as the seminal resource for developing and maintaining sound business practices. For example, the “*Counterparty Risk Management Policy Group II*”, in its 2005 Report, *Toward Greater Financial Stability: A Private Sector Perspective*, encouraged “hedge fund managers, for the purpose of best practices,” to adopt an earlier edition of *Sound Practices*. The 2007 edition demonstrates the continued commitment of MFA and its Members to address both the current regula-

<sup>1</sup> *The terms “Hedge Fund” and “Hedge Fund Manager” are defined later in this Introduction under General Considerations Relating to Hedge Funds, Hedge Fund Managers, and Investors. Other capitalized and/or italicized terms and certain technical words and phrases used in this document that are not defined in the text itself are defined in Appendix I—The Glossary and Selected Sources Used.*

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tory environment and public policy issues surrounding Hedge Funds. MFA believes that the 2007 edition directly responds to the President's Working Group on Financial Markets' (the "PWG") *Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital*, which the PWG published in February 2007 to establish the current public policy approach for all private pools of capital, including Hedge Funds (the "*PWG Agreement*"). The principles set forth in the *PWG Agreement* apply equally to Hedge Fund Managers (and other managers of private pools of capital), their counterparties and creditors, investors and fiduciaries, and financial regulators, encouraging all parties to be vigilant in achieving soundness in the financial markets through collaborative market discipline:

*Private pools of capital bring significant benefits to the financial markets. However, these pools of capital also present challenges for market participants and policymakers. Investors, creditors, counterparties, pool managers, and supervisors must be aware of these challenges . . . and work to address them. Public policies that support market discipline, participant awareness of risk, and prudent risk management are the best means of protecting investors and limiting systemic risk.*  
PWG Agreement, Section 1.

The *PWG Agreement* strongly encourages Hedge Fund Managers to develop industry sound practices as a means of achieving the market discipline necessary to satisfy the PWG's public policy approach. Specifically, the *PWG Agreement* urges Hedge Fund Managers to "have information, valuation and risk management systems that meet sound industry practices that enable them to meet the expectations of creditors, counterparties, fiduciaries and investors." MFA has designed *Sound Practices* to respond to the PWG's recommendations by comprehensively addressing issues associated with the recent growth and dynamic nature of the Hedge Fund industry. Moreover, Hedge Fund Managers who adapt the Recommendations to their firms will contribute meaningfully to the internal soundness of individual Hedge Funds they operate and to the strength of the financial markets in which they participate.

The *PWG Agreement* is the PWG's first official statement applicable to Hedge Fund Managers since its 1999 report, *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management*, which included a specific recommendation that the Hedge Fund industry establish a set of sound

practices for risk management and internal controls. A small group of Hedge Fund Managers published the first edition of *Sound Practices for Hedge Fund Managers* in 2000 in direct response to this recommendation and focused primarily on risk management. MFA subsequently published 2003 and 2005 editions to reflect industry developments and to expand the subject matter covered.

The international regulatory community, including the “Group of Seven” and “Group of Eight” heads of state, has encouraged MFA and Hedge Fund Managers to continue to develop sound practices in order to strengthen market discipline through risk management practices. The Financial Stability Forum (“FSF”), established in 1999 by the Group of Seven Finance Ministers (the “G7 Finance Ministers”) and central bank governors, published its *Update of the FSF Report on Highly Leveraged Institutions* in May 2007 (the “FSF Report”), in response to a request by the G7 Finance Ministers to update the FSF’s 2000 report. The *FSF Report* highlights some of the recent private sector and public policy initiatives aimed at protecting against systemic risks and sets forth recommendations to build on these ongoing efforts. For Hedge Funds, the *FSF Report* states:

*The global hedge fund industry should review and enhance existing sound practice benchmarks for hedge fund managers in the light of expectations for improved practices set out by the official and private sectors.*

The FSF Report.

*Sound Practices* answers these international public sector calls to improve market discipline. As mentioned earlier, the Recommendations provide a framework for all Hedge Fund Managers, regardless of regulatory jurisdiction, to develop proper and sound internal business operations, which, if adhered to, will contribute to MFA’s and the Hedge Fund community’s dedication to a robust, competitive, and stable global financial marketplace.

## Hedge Funds, the Global Financial Marketplace, and MFA’s Recommendations

Hedge Funds, like credit providers (such as banks and other financial institutions), are key participants in international financial markets. However, the activities of Hedge Fund Managers differ greatly from those of credit providers. These other financial institutions generally seek to eliminate or minimize

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the risks of their businesses through hedging and other risk management methods. Hedge Fund Managers, on the other hand, are in the business of seeking and assuming calculated risks, and do so in order to achieve the absolute returns desired by their Hedge Fund investors. MFA believes, as do key policy makers, that this activity is beneficial to financial markets:

*[Hedge funds'] rapid growth is one of the most important developments in U.S. financial markets in the past decade or so. Hedge funds vary widely in their investment strategies and in the types of risks they take. Overall, however, most economists agree that the rise of hedge funds has been a positive development for investors and for financial markets. They have stimulated an extraordinary amount of financial innovation in recent years; and, using many of these new financial tools, they have greatly enhanced the liquidity, efficiency, and risk-sharing capabilities of our financial system.*

Remarks by Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, at the New York University Law School, New York, New York (April 11, 2007).

By participating in the market as risk seekers, Hedge Fund Managers provide needed liquidity to financial markets, which can help reduce systemic risk and, at the same time, ensure the overall viability of the marketplace. In this sense, Hedge Funds often act as risk absorbers in markets. They do so by serving as ready counterparties to those wishing to hedge risk, especially when markets are volatile, thereby reducing pressure on market prices while increasing liquidity. In addition, Hedge Fund Managers typically trade based on extensive research, which brings more accurate price information, and therefore, price efficiencies to the markets. Without the research and commitment of capital by Hedge Fund Managers, the markets potentially would have wider price spreads, as well as more pronounced pricing inefficiencies and illiquidity. Hedge Funds also often provide investors with valuable portfolio diversification—such diversification can reduce individual investor risk and, as a result, overall marketplace risk.

MFA recognizes, however, the concerns expressed by policy makers with respect to certain activities of Hedge Funds and the potential for systemic risk. Since the publication of the 2005 edition of *Sound Practices*, regulatory supervisors have taken particular interest in over-the-counter (“OTC”) “*derivatives*”, particularly credit derivatives. Regulators have expressed concern that a major credit event could have a substantial impact on global

financial markets. Consequently, the PWG specifically addresses OTC derivatives with respect to its directive that Hedge Fund Managers develop industry sound practices:

*[R]isk management and valuation policies employed by private pools of capital should comply with the industry sound practices. Such pools also should implement and comply with industry sound practices to strengthen processing, clearing, and settlement arrangements for credit derivatives and other over-the-counter derivatives.*

PWG Agreement, Section 9.2.

With the goal of reducing systemic risk *vis-à-vis* the derivatives marketplace, MFA works with major derivatives dealers, under the direction of the Federal Reserve Bank of New York, to address operational challenges of processing trades. MFA's experiences in this and other public policy and private sector initiatives have greatly shaped the Recommendations.

## Objectives of MFA's Recommendations

**1. Strengthen Business Practices of the Hedge Fund Industry through a Strong Framework of Internal Policies and Practices.** The Recommendations serve to educate Hedge Fund Managers by providing peer group consensus on standards for internal management controls on the subjects covered herein and by addressing the convergence of internal control standards across the financial services industry. The Recommendations go beyond the requirements imposed by U.S. laws or regulations. Moreover, MFA has developed and updated the Recommendations in the belief that the most effective form of industry oversight is self-discipline and self-monitoring by Hedge Fund Managers as part of a shared responsibility with market counterparties, investors, and regulators, to unify the overarching principles set forth in the *PWG Agreement*. The Recommendations, if adopted, should enhance the ability of Hedge Fund Managers to manage operations, satisfy responsibilities to investors, comply with applicable regulations, and address unexpected market events.

**2. Encourage Individualized Assessment and Application of Recommendations, as One Size Does Not Fit All.** The strategies, investment approaches, organizational structures, and amount of assets managed by individual Hedge Fund Managers vary greatly. Mindful of this reality, MFA has

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written the Recommendations with enough specificity and ample flexibility to provide meaningful guidance regardless of those differences. MFA cannot address all the considerations that should be taken into account in determining whether and how to apply a particular Recommendation. The Recommendations are not static, one-size-fits-all, prescriptive requirements that all Hedge Fund Managers must follow in exactly the same manner. Rather, each Hedge Fund Manager should assess the Recommendations based on the size, nature, and complexity of its organization, its strategies, and resources, as well as the objectives of the Hedge Funds it manages, and tailor and apply the Recommendations, as appropriate.

A Hedge Fund Manager may be able to implement some Recommendations fairly easily or unilaterally. Other Recommendations, however, may require substantial planning and significant budgetary commitments, internal systems changes, infrastructure development, and/or services and expertise offered by third parties. Some Hedge Fund Managers may have specific personnel who perform each of the various practices described in the Recommendations. Other, generally smaller, Hedge Funds may have personnel who perform multiple roles while still satisfying the objectives of the Recommendations. A Hedge Fund Manager may also use *Sound Practices* as a tool to conduct periodic self-assessments as to the effectiveness of its individual implementation of the Recommendations.

### **3. Enhance Market Discipline in the Global Financial Marketplace.**

By evaluating the Recommendations and applying those that are relevant to its particular business model, a Hedge Fund Manager can continue to strengthen its own business practices. In doing so, the Hedge Fund Manager enhances investor protection and abates systemic risk. Hedge Fund Managers, by individually adapting and tailoring the Recommendations to meet their business models, in aggregate will contribute to overall market soundness. MFA will further adapt and refine the Recommendations as the Hedge Fund industry and global financial markets continue to evolve.

## **General Considerations Relating to Hedge Funds, Hedge Fund Managers, and Investors**

**Hedge Fund Defined.** No statutory or regulatory definition of a Hedge Fund exists. Historically, the term “hedge fund” referred to an investment vehicle with the ability to hedge the value of its assets (*e.g.*, through the use of options or the simultaneous use of “long positions” and “short sales”).

However, the term “hedge fund” as understood in the current financial marketplace describes a wide range of investment vehicles that can vary substantially in terms of size, strategy, business model, and organizational structure. Thus, some Hedge Funds may not engage in “hedging” activities at all (*e.g.*, some Hedge Funds may engage only in “buy and hold” or other strategies that do not involve hedging in the traditional sense).

For purposes of *Sound Practices*, MFA defines a Hedge Fund as follows:

**A pooled investment vehicle that generally meets the following criteria:**

- (1) it is not marketed to the general public (*i.e.*, it is privately-offered);
- (2) it is limited to high net worth individuals and institutions;
- (3) it is not registered as an investment company under relevant laws (*e.g.*, U.S. Investment Company Act of 1940, as amended);
- (4) its assets are managed by a professional investment management firm that shares in the gains of the investment vehicle based on investment performance of the vehicle; and
- (5) it has periodic but restricted or limited investor redemption rights.

MFA does not intend the term Hedge Fund, as used in these Recommendations, to capture private investment funds that are “purely” traditional private equity, venture capital, or real estate funds. MFA recognizes, however, that individual Hedge Funds may pursue these and other investment strategies in accordance with their “offering documents”.

#### **Relationship between Hedge Funds and Their Hedge Fund Managers.**

MFA makes the following assumptions about the relationship between a Hedge Fund and its Hedge Fund Manager in setting forth the Recommendations:

- A professional investment management firm (*e.g.*, a Hedge Fund Manager) manages the assets of each Hedge Fund;
- The term Hedge Fund Manager includes Hedge Fund Managers that are registered with the U.S. Securities and Exchange Commission (“SEC”) as investment advisers, and those exempt from registration, under the Investment Advisers Act of 1940 (the “Advisers Act”), as amended;
- The Hedge Fund Manager is a legal entity governed by a person or group of persons, acting through a management committee, board of directors, or other body, or directly as officers or members of the Hedge Fund



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Manager, with the authority and responsibility to direct and oversee the Hedge Fund Manager's activities (a Hedge Fund Manager's "governing body");

- The organizational and constituent documents of the Hedge Fund Manager's governing body are the "governing documents";
- The "senior management" of a Hedge Fund Manager signifies the Chief Executive Officer, Chief Financial Officer, and others at the highest level of the decision-making process for the day-to-day operations of the Hedge Fund's business;
- The Hedge Fund Manager's governing body has the legal authority and responsibility to direct and oversee the activities of the Hedge Fund; and
- The governing body of the actual Hedge Fund may be the Hedge Fund Manager itself (*e.g.*, as the general partner or managing member of the Hedge Fund) or an independent body that delegates the investment management function of the Hedge Fund to the Hedge Fund Manager pursuant to an investment management agreement.

With those assumptions in mind, the client of a Hedge Fund Manager is the Hedge Fund. Although a Hedge Fund Manager has relationships with the investors in a Hedge Fund, the Hedge Fund Manager provides its investment advice to the Hedge Fund in accordance with the investment strategy and objectives set forth in the Hedge Fund's offering documents, rather than any specific objectives or directives of any individual Hedge Fund investor.

A Hedge Fund Manager typically receives compensation, in part, based on the performance of the Hedge Funds it manages and often significantly invests directly in those funds. This structure creates a strong alignment of interests between a Hedge Fund's other investors and the Hedge Fund Manager.

*N.B. The nature and structure of Hedge Funds and their relationships with Hedge Fund Managers vary substantially, and these assumptions may not apply to all Hedge Funds or Hedge Fund Managers. For the purposes of Sound Practices, MFA assumes that a Hedge Fund Manager will apply each relevant Recommendation, as deemed appropriate, to each of the Hedge Funds it manages.*

**Relationship between Hedge Funds and Their Investors.** Certain legal documents, which may include an offering memorandum, limited partnership or limited liability company agreement, subscription agreement, or similar contracts, govern the relationship between a Hedge Fund and its investors (referred to collectively in this document as “offering documents”). Whether investing in a U.S. domiciled limited partnership as a limited partner or in a non-U.S. domiciled company as a shareholder, the investor is typically a passive participant in the Hedge Fund with no right of participation in the management of the Hedge Fund and generally with limited voting rights. A Hedge Fund investor’s liability is generally limited to the extent of its investment in a Hedge Fund.

As noted above, although the client of a Hedge Fund Manager is the Hedge Fund, the Hedge Fund Manager generally communicates with the investors with respect to all matters related to the Hedge Fund, including its investment objectives, strategies, terms, and conditions of an investment in the Hedge Fund.

Regulatory restrictions generally require investors in Hedge Funds to meet certain requirements, such as net worth or other financial sophistication standards, which the *PWG Agreement* supports:

*Investor protection concerns can be addressed most effectively through a combination of market discipline and regulatory policies that limit direct investment in such pools to more sophisticated investors.*

*PWG Agreement, Section 2.*

U.S. laws and regulations, for instance, generally require investors in Hedge Funds—whether institutional or individual investors—to satisfy financial net worth and other criteria in order to invest in a Hedge Fund. To further bolster investor protection, managers of certain institutional investors, such as pension fund plans, are fiduciaries with a legal duty to act in the best interest of plan beneficiaries when making any investments on behalf of the institution, in Hedge Funds, or otherwise.

Since its inception, MFA has consistently promoted this policy approach as a means of achieving investor protection when needed.

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Irrespective of their jurisdiction of origin, investors in Hedge Funds should have the ability to understand and evaluate for themselves an investment in a Hedge Fund and the corresponding risks. Hedge Fund Managers also reasonably expect that investors in a Hedge Fund would not expose themselves to risks they could not tolerate. In furtherance of these expectations, investors generally conduct extensive due diligence of the Hedge Fund and the Hedge Fund Manager before making a financial commitment to invest. The *PWG Agreement* sets forth these concepts in its recommendations to investors.

### Overview and Organization of the Recommendations

Recognizing the shared responsibility to ensure the vitality, stability, and integrity of financial markets, MFA works collaboratively with other segments of the marketplace to develop solutions for areas deemed vulnerable by financial regulators. Above all, MFA and its Members recognize the need to be at the forefront of the development of sound industry practices, particularly in areas such as documentation and transactional practices, risk management, and valuation, in order both to mitigate risks to the financial system that could emanate from the activities of Hedge Funds or their counterparties and to ensure Hedge Funds continue to provide their recognized benefits to the global financial marketplace. MFA has crafted the Recommendations accordingly.

MFA has divided the Recommendations into the following seven substantive sections.

- Section 1: The management, internal trading, and information technology controls that a Hedge Fund Manager should establish.
- Section 2: Responsibilities to investors and proposed practices intended to assist a Hedge Fund Manager in fulfilling these responsibilities.
- Section 3: Determination of net asset value, including verification of assets and liabilities, valuation policies and procedures, and the financial statement close process.
- Section 4: Risk measurement and management practices to ensure that the risk policies of a Hedge Fund Manager are observed.

- Section 5: Key regulatory controls and compliance issues.
- Section 6: Trading relationships, monitoring, and disclosure, including recommendations for documentation policies, “*best execution*” practices, and soft dollar arrangements, which aim to help govern the relationship between a Hedge Fund Manager and its market counterparties.
- Section 7: Business continuity, disaster recovery, and crisis management planning.

In addition, *Sound Practices* contains the following seven appendices to the Recommendations:

- Appendix I: A glossary of key terms and selected sources used throughout *Sound Practices* (certain capitalized and/or italicized terms and certain technical words and phrases that are not defined in the body of the document can be found in the glossary).
- Appendix II: *A Model Due Diligence Questionnaire for Hedge Fund Investors* (commonly asked questions a Hedge Fund Manager should be prepared to receive from current or prospective investors).
- Appendix III: Supplemental information on risk monitoring practices for Hedge Fund Managers (in furtherance of Section 4).
- Appendix IV: *Guidance for Hedge Funds and Hedge Fund Managers on Developing Anti-Money Laundering Programs (Release No. 2)*.
- Appendix V: U.S. regulatory filings that may be applicable to a Hedge Fund Manager (not exhaustive, but provides a starting point for a Hedge Fund Manager in identifying applicable filing requirements and developing policies to comply with such requirements).

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Appendix VI: Checklist for Hedge Fund Managers to consider in developing a compliance manual (neither prescriptive, nor intended to cover each consideration that may be relevant for a particular Hedge Fund Manager).

Appendix VII: Checklist for Hedge Fund Managers to consider in developing a code of ethics (neither prescriptive, nor intended to cover each consideration that may be relevant for a particular Hedge Fund Manager).

### No Substitute for Legal or Other Professional Advice

The Recommendations are not intended to serve as, or be a substitute for, professional advice. This document neither seeks to cover the specific legal requirements with which a Hedge Fund Manager must comply, nor is it exhaustive. Hedge Fund Managers should consult with their professional legal, accounting, compliance, tax, and other advisers in determining the applicability of the Recommendations to their business operations and appropriate methods for implementing the applicable Recommendations.

# 1. Recommendations: Management, Trading, and Information Technology Controls

The Recommendations in Section 1 present fundamental policies for a Hedge Fund Manager in its management and trading operations. Section 1 includes Recommendations for a Hedge Fund Manager to establish trading and risk parameters corresponding to the investment objectives of each Hedge Fund it manages. The Recommendations provide guidance on the oversight of both internal and external portfolio managers, and on review processes to effectively monitor trading activities and operations to ensure compliance with the predetermined trading and risk parameters. The Recommendations also include information technology ("IT") guidance in order to control changes to any software applications, data, and IT infrastructure and to maintain proper security therein. Finally, the Recommendations in Section 1 provide guidance on relationships with third-party service providers that perform key business functions, such as calculating net asset value ("NAV") or monitoring risk.

## Management and Trading Controls

### 1.1

A Hedge Fund Manager should establish management policies and practices appropriate for its size, nature, and complexity and for its trading activities for each Hedge Fund it manages.

A Hedge Fund Manager should establish management policies for trading activities documentation, NAV determination, risk analysis, compliance, and other key areas as appropriate. A Hedge Fund Manager should adopt an organizational structure that facilitates effective oversight to ensure compliance with

the established management policies. A Hedge Fund Manager should review its policies and practices at least annually and update them as appropriate (*e.g.*, to reflect changes in structure or strategy, extraordinary market events, or new applicable regulations).

### 1.2

A Hedge Fund Manager should determine the investment, risk, and trading policies for each Hedge Fund it manages based on the specific investment objectives described in the respective Hedge Fund's offering documents.

A Hedge Fund Manager should allocate capital and risk among portfolio managers, strategies, asset classes, and other relevant categories, to fit each Hedge Fund's performance objectives and targeted risk profile. A Hedge Fund Manager should periodically re-examine allocations and adjust them as appropriate. In addition, a Hedge Fund Manager

should establish appropriate trading parameters and risk limits for each allocation, as these parameters fit into the portfolio. The Hedge Fund Manager should adjust the trading parameters and risk limits as necessary to reflect various market and other changes. These principles are developed more fully in Section 4—Risk Management.

## 1.3

A Hedge Fund Manager should impose appropriate controls to ensure that its portfolio management and trading activities are consistent with the allocation policies and trading parameters.

A Hedge Fund Manager's senior management should regularly review the trading activities and performance of each Hedge Fund's portfolio and regularly evaluate the associated risk levels. To do so, the Hedge Fund Manager should require internal reports that provide senior management with information regarding the trading activities, performance, and risk levels of each investment strategy. Each report should identify any and all deviations from trading parameters and risk limits.

A Hedge Fund Manager that manages one or more Hedge Funds and one or more managed accounts

(commonly referred to as "side-by-side management") should develop and implement internal policies and procedures to govern the allocation of investment opportunities across Hedge Funds and managed accounts. See Section 2, Responsibilities to Investors, Recommendation 2.8.

A Hedge Fund Manager's controls should also ensure that its portfolio management and trading activities are consistent with its policies and procedures governing transactions with counterparties. See Section 6—Trading Relationship, Management, Monitoring, and Disclosure.



## Management and Trading Controls

### 1.4

A Hedge Fund Manager should establish policies for monitoring the trading activities and performance of each portfolio manager to which it allocates capital.

A Hedge Fund Manager should subject all of its portfolio managers, including external portfolio managers, to controls and review processes based on the amount of assets managed, form of allocation, and trading strategy. A Hedge Fund Manager should monitor the trading activities and performance of all

portfolio managers on a periodic basis. Frequency of evaluation will depend on the form of the allocation (*e.g.*, monthly performance review of the management of a passive investment in a Hedge Fund versus more frequent review of the management of a significant “managed account” investment).

### 1.5

A Hedge Fund Manager should have appropriate approval processes and documentation for retaining sub-advisers and other external portfolio managers.

A Hedge Fund Manager should develop due diligence and approval processes for selecting and retaining a sub-adviser or other external portfolio manager to manage any capital over which the Hedge Fund Manager has investment discretion. When a Hedge Fund Manager invests such capital with an external

portfolio manager in a managed account, the Hedge Fund Manager should clearly define in a written agreement with the external portfolio manager the trading restrictions and limits, reporting requirements, and termination provisions applicable to their relationship.

## Information Technology Controls

### 1.6

A Hedge Fund Manager should establish policies and procedures to control changes to any software applications, data, and IT infrastructure.

A Hedge Fund Manager should establish control policies and procedures to ensure that any changes to the production software applications, data, and infrastructure (*e.g.*, hardware) that support the overall business processes occur only with authorization, testing, and approval. A Hedge Fund Manager should employ, to the extent feasible, the following policies and procedures:

- Authorization controls over the development or acquisition of IT resources (*e.g.*, hardware, software);

- Version control management;
- Segregation of personnel and technical environments for the development of, testing of, and implementation of changes;
- Appropriate testing and approval of changes prior to usage in production; and
- Back-out and recovery plans in the event of an implementation problem.

The Hedge Fund Manager should maintain documentation of the above policies and related activities.

## Information Technology Controls

### 1.7

A Hedge Fund Manager should establish policies and procedures for logical and physical security over software applications, data, and IT infrastructure.

A Hedge Fund Manager should establish information security policies and procedures in order to define the controls required to secure the data and systems used in its operations. In its policies and procedures, a Hedge Fund Manager should address the security and usage of computer applications, databases, operating systems, hardware, and networks. A Hedge Fund Manager should employ, to the extent feasible, the following policies and procedures:

- Personnel responsibilities for information security;
- Physical access controls to production systems and data storage (*e.g.*, media, USB keys);

- Authentication controls (*e.g.*, passwords) that govern how users and processes verify their identity to obtain access to systems and data;
- Entitlement controls that speak to the level of access (*e.g.*, read, update) a user or process has to systems and data; and
- Audit logging and monitoring controls internally and at the network perimeter.

Policies and procedures should take into account the addition of new personnel, modification of existing access rights, and removal of access. A Hedge Fund Manager should maintain documentation of the security administration activities.

## 1.8

A Hedge Fund Manager should establish policies and procedures for IT operations, including backup and recovery of data, scheduling, and problem management.

A Hedge Fund Manager should implement policies and procedures to help ensure that all necessary data is properly backed up so that it can be accurately and completely recovered if a system outage or compromise of data integrity occurs. In addition, a Hedge Fund Manager should prepare a detailed business continuity, disaster recovery, and crisis management (“BC/DR”) plan in order to help ensure the continuity of business operations in the event of disaster. A Hedge Fund Manager should test and update the plan on a regular basis. See Section 7—

Business Continuity, Disaster Recovery, and Crisis Management for more guidance.

A Hedge Fund Manager should also have procedures in place to execute programs, including data transmissions, as planned and to identify and resolve deviations from scheduled processing in a timely manner. A Hedge Fund Manager should implement policies and procedures in order to identify, resolve, review, and analyze any problems or incidents in a timely manner.

## Third-Party Service Providers

### 1.9

A Hedge Fund Manager should carefully select and monitor any mission-critical, third-party service providers performing key business functions (e.g., prime brokerage, risk monitoring, valuation, or BC/DR functions) or it or any Hedge Fund it manages based on such service provider's experience with those particular Hedge Fund operations.

Mission-critical service providers are those service providers a Hedge Fund Manager requires to ensure prompt and accurate execution and processing of transactions and to meet regulatory reporting requirements. A Hedge Fund Manager should define clearly in written agreements with mission-critical, third-party service providers the roles, responsibilities, and liability of such service providers. A Hedge Fund Manager should periodically evaluate the performance

of mission-critical service providers. A Hedge Fund Manager should disclose to the Hedge Funds it manages relationships between the Hedge Fund Manager and service providers that may give rise to potential material conflicts of interest. See the Recommendations in Section 7—Business Continuity, Disaster Recovery, and Crisis Management for the issues associated with third-party service providers.

### 2. Recommendations: Responsibilities to Investors

The Recommendations in this section address the key elements a Hedge Fund Manager should consider in providing investment management services to a Hedge Fund, while balancing the interests of Hedge Fund investors. As described in the Introduction, investors in Hedge Funds—whether institutional or individual—are required by law or regulation to satisfy financial net worth and other criteria in order to invest in a Hedge Fund. For example, some institutional investors, such as pension plans, are represented by fiduciaries subject to heightened regulation of investment activities in order to protect beneficiaries. Irrespective of the type of investor, all Hedge Fund investors should have the tools to understand and evaluate for themselves any risks associated with an investment in a Hedge Fund. A Hedge Fund Manager should provide Hedge Fund investors with adequate information (as described in this section) to enhance the investors' ability to understand and evaluate their investment in the Hedge Fund. Moreover, a Hedge Fund Manager should develop policies and procedures to address situations involving potential or actual material conflicts of interest generally consistent with these Recommendations.

## Responsibilities to Investors

### 2.1

A Hedge Fund Manager should foster a management environment that appropriately recognizes its responsibility to act in the interest of each Hedge Fund it manages.

A Hedge Fund Manager is retained by a Hedge Fund to act as its investment manager. In that capacity, a Hedge Fund Manager has a responsibility to act in the interest of its client, the Hedge Fund, and in the interest of the Hedge Fund's investors. A Hedge Fund Manager must also act in accordance with its investment management agreement with the Hedge Fund, the offering documents of the Hedge Fund, and applicable law. When a Hedge Fund Manager has more than one client

(*e.g.*, other Hedge Funds or managed accounts), it should act in a manner consistent with its fiduciary duties to each client. This requires the Hedge Fund Manager to balance the interests of all client accounts against its own interests to the extent the Hedge Fund Manager's interests are reasonable and properly disclosed. Such balancing of interests, fiduciary duties, and resulting conflicts are the same as with other asset managers (*e.g.*, private equity firms, mutual funds, *etc.*).

### 2.2

A Hedge Fund Manager should provide prospective and existing Hedge Fund investors with information regarding the Hedge Fund's investment objectives and strategies, range of permissible investments, material risk factors, and the material terms of an investment in the Hedge Fund. This information should be sufficient to enhance the ability of investors to understand and evaluate their investment in the Hedge Fund.

As part of their due diligence review, prospective and existing Hedge Fund investors may ask a Hedge Fund Manager questions regarding the terms of an investment in a Hedge Fund, as well as the management and investment practices of

the Hedge Fund Manager. A sample checklist of commonly asked questions or requested information is provided in Appendix II—MFA's Model Due Diligence Questionnaire for Hedge Fund Investors. When asked questions from prospective

Hedge Fund investors, a Hedge Fund Manager may choose to respond to such questions with standardized answers that can be supplemented as needed.

Informative disclosure regarding the material terms of an investment in a Hedge Fund (*e.g.*, applicable charges, expenses, withdrawal or redemption rights and restrictions, reporting, use of “*side pockets*”, *etc.*) and the Hedge Fund’s investment objectives and strategies enhance the ability of investors to form proper expectations as to the Hedge Fund’s performance. Therefore, a Hedge Fund Manager should attempt to prepare appropriate disclosures for dissemination to Hedge Fund investors on a timely basis, without compromising proprietary information regarding the Hedge Fund’s trading positions. See Recommendation 2.4 below for a discussion of material risk factors that a Hedge Fund Manager should consider disclosing to Hedge Fund investors.

When a Hedge Fund Manager changes the objectives or strategies of a Hedge Fund, the range of permissible investments, or terms of an investment in a Hedge Fund, the Hedge Fund Manager should evaluate and consider consulting its legal counsel to determine whether disclosure to Hedge Fund investors is necessary and whether consent

should be obtained from Hedge Fund investors. After evaluating the circumstances, a Hedge Fund Manager may fairly determine that it need not make additional disclosure and/or obtain consent from investors to changes in the objectives or strategies of the Hedge Fund. A Hedge Fund Manager should evaluate the materiality of the change in light of the variety of objectives employed by the Hedge Fund Manager and any periodic communications that are made to Hedge Fund investors regarding a Hedge Fund’s activities.

A Hedge Fund Manager should review at least annually a Hedge Fund’s offering documents and any standardized answers or responses to a due diligence questionnaire to (1) ensure that the documents reflect current information and disclosures regarding the Hedge Fund’s objectives and strategies, and (2) determine if any modifications are required due to any changes in any material terms of an investment in a Hedge Fund, or any legal, regulatory, tax, or other developments. A Hedge Fund Manager should communicate any material modifications of a Hedge Fund’s offering documents to existing investors by delivery of the updated offering documents or by other correspondence.



## Responsibilities to Investors

### 2.3

A Hedge Fund Manager should assess whether its operations or particular circumstances may present actual or potential conflicts of interest and should attempt to appropriately disclose any material conflicts of interest to Hedge Fund investors.

A Hedge Fund Manager should develop policies and procedures to assess and appropriately disclose any material conflicts of interest to Hedge Fund investors. Potential conflicts that a Hedge Fund Manager may need to disclose, if applicable, include:

- Relationships with brokers and other service providers;
- Conflicts generated by fee arrangements;
- Proprietary trading of the Hedge Fund Manager and personal/employee trading;
- Use of “*Soft Dollar Arrangements*” and/or expense pass-through provisions;
- Conflicts that may arise in the context of side-by-side management of multiple accounts, such as the allocation of investment opportunities among Hedge Funds or accounts managed by the Hedge Fund Manager; and
- Conflicts generated by interested-party transactions or relationships with affiliated persons.

## 2.4

A Hedge Fund Manager should work with its legal counsel to identify and adequately describe risks to be disclosed to Hedge Fund investors.

Examples of the types of risks that a Hedge Fund Manager should consider disclosing are the risks associated with:

- Incentive compensation structure;
- Lack of assurance as to performance;
- A specific strategy or particular types of investment instruments and investment markets;
- Limited liquidity and restrictions on redemptions (*e.g.*, those resulting from redemption “*gates*” and side-pocket investments);
- Use of leverage and margin (including leverage embedded in derivative instruments);
- Potential loss of key management personnel;
- Taxation and “*ERISA*” status and considerations;
- Valuation of assets, including valuation of side-pocket investments or other illiquid or non-marketable investments;
- Broker and other “*counterparty*” insolvency; and
- Presence or absence of regulatory oversight of the Hedge Fund and Hedge Fund Manager.

## Responsibilities to Investors

### 2.5

A Hedge Fund Manager should periodically provide Hedge Fund investors with relevant performance data and, when appropriate, risk information regarding the strategy and terms of the Hedge Fund.

Relevant periodic disclosures to Hedge Fund investors may include:

- Performance measures, such as NAV calculations, strategy performance attribution, and similar information;
- Capital measures, such as assets under management; and
- Risk measures that are appropriate to the Hedge Fund.

### 2.6

When a Hedge Fund Manager has the discretion to grant (or has in the past granted)—through a side letter or similar arrangement—any more favorable rights to certain investors that may have a material impact on other investors, the Hedge Fund Manager should (1) make appropriate disclosures to investors in the Hedge Fund and (2) consider issues associated with the approval and monitoring of any special terms to investors.

Examples of certain types of rights that may have a material impact on other Hedge Fund investors may include, but are not limited to, more favorable transparency and/or liquidity rights.

Hedge Fund Managers with operations in the United Kingdom should exercise caution in connection with the use of side letters and other similar arrangements. The Financial Services Authority (the “*FSA*”) has pronounced that, when exercising regulatory functions, it will consider a guidance note issued by the

Alternative Investment Management Association, a U.K.-based alternative investment industry association, with respect to the use of these arrangements. The guidance note, in summary, states that firms are required to disclose the existence of side letters that contain terms enhancing an investor’s ability to redeem shares or interests or make a determination as to whether to redeem shares or interests that might reasonably be expected to put other investors in the same class of interests at a material disadvantage.

## 2.7

A Hedge Fund Manager should develop and maintain trade allocation policies, disclose the material aspects of these policies to its Hedge Fund investors, and document any material deviations therefrom. A Hedge Fund Manager should include the material aspects of its trade allocation policies in a Hedge Fund’s offering documents and, with respect to a U.S.-registered investment adviser, in the Hedge Fund Manager’s Form ADV that is filed with the SEC.

## 2.8

A Hedge Fund Manager should deliver annual audited financial statements to Hedge Fund investors in a timely manner or as may otherwise be prescribed by laws or regulations.

A Hedge Fund Manager should engage qualified independent auditors to audit the annual financial statements of any Hedge Fund with investors not affiliated with the Hedge Fund Manager. Detailed

guidance on the development of a Hedge Fund Manager’s policies to determine NAV and the Financial Statement Close Process (“FSCP”) are provided in Section 3—Determination of Net Asset Value.

## 2.9

A Hedge Fund Manager should develop valuation policies and procedures, recognizing that Hedge Fund investors may both subscribe to and redeem interests in a Hedge Fund in reliance on the values derived from such policies and procedures.

Detailed guidance on the development of a Hedge Fund Manager’s policies to verify assets and liabilities,

determine NAV, and the FSCP are provided in Section 3—Determination of Net Asset Value.

## Responsibilities to Investors

### 2.10

A Hedge Fund Manager should develop and maintain a code of ethics and personal trading policies that include the appropriate use of material, non-public information. A Hedge Fund Manager should communicate the material aspects of this code and policies to Hedge Fund investors.

A Hedge Fund Manager's code of ethics, personal trading policies, and monitoring of trading activity should seek to prevent and detect improper trading by its personnel, taking into account: the nature of the Hedge Fund Manager's business; type of investments or instruments traded; and applicable laws, rules, and regulations in all applicable jurisdictions. See Section 5—Regulatory Controls for additional guidance. See Appendix VII—Checklist for Hedge Fund Managers to Consider in

Developing a Code of Ethics for a menu of items that a Hedge Fund Manager may wish to consider in developing a code of ethics and personal trading policies. This code and policies may include: the use of blackout periods; restricted lists; reviews; holding periods; and prohibitions on certain types of trades and/or required pre-approval/clearance of certain transactions, such as initial public offerings, private placements/limited offerings, or securities on any restricted list.

## 2.11

A Hedge Fund Manager should establish policies and procedures designed to (1) safeguard information related to its Hedge Fund trading activities, as well as information subject to confidentiality obligations, and (2) prevent the misuse of this information (including investor or customer information), taking into account the nature of the Hedge Fund Manager's business and type of investments or instruments traded.

A Hedge Fund Manager's policies and procedures should address the protection of information relating to the Hedge Fund's trading activities, as well as the protection of confidential information provided to the Hedge Fund or the Hedge Fund Manager by the Hedge Fund investors and other third parties. In the United States, for example, with respect to individuals who

are investors in a Hedge Fund, the Hedge Fund Manager should ensure that its policies and procedures meet the requirements of the SEC's Regulation S-P promulgated under the Gramm-Leach-Bliley Act. Moreover, a Hedge Fund Manager should establish appropriate information barriers within its firm to effectuate the foregoing.

## Responsibilities to Investors

### 2.12

A Hedge Fund Manager should disclose to Hedge Fund investors its relationships with prime brokers and other brokers that involve potential material conflicts of interest and, taking into account the nature of the Hedge Fund Manager's business and type of investments or instruments traded, develop the appropriate policies and procedures.

Appropriate considerations, potential disclosures, and policies may include:

- Disclosure of material relationships between the Hedge Fund Manager and brokers;
- Disclosure of material affiliated or interested-party transactions;
- Policies and disclosures on use of Soft Dollar Arrangements (see Recommendation 2.13); and
- Discussion of how the Hedge Fund Manager seeks to meet its best execution obligations to clients and of any directed brokerage arrangements. See Section 6—Trading Relationship Management, Monitoring, and Disclosure, Recommendation 6.5.

## 2.13

A Hedge Fund Manager should disclose its use of Soft Dollar Arrangements to existing and potential investors in each Hedge Fund it manages. This disclosure should be made prior to engaging in such arrangements and should disclose the Hedge Fund Manager's policies with respect to these arrangements.

Disclosure of Soft Dollar Arrangements may include:

- Whether the Hedge Fund Manager's use of the products and services provided by a broker pursuant to Soft Dollar Arrangements does not exclusively benefit the Hedge Fund whose trades generate the relevant brokerage commissions or fees;
- The types of products and services that may be received through Soft Dollar Arrangements in an

appropriate level of detail, and whether the use of Soft Dollar Arrangements falls within the safe harbor of Section 28(e) of the Securities Exchange Act of 1934, as amended.

For guidance on a Hedge Fund Manager's determinations and policies relating to Soft Dollar Arrangements, see Section 6—Trading Relationship Management, Monitoring, and Disclosure, Recommendations 6.8 and 6.9.

## 2.14

A Hedge Fund Manager should establish and maintain policies relating to gifts and entertainment, and other payment or receipt of money or property from any person in a non-business capacity that may create the appearance of impropriety to Hedge Fund investors.



### 3. Recommendations: Determination of Net Asset Value

This section sets forth guiding principles a Hedge Fund Manager should consider in fulfilling one of the most important functions of its operations: the determination of NAV. A Hedge Fund Manager, in consultation with the governing body of a Hedge Fund, should establish policies and procedures for the determination of NAV that are fair, consistent, and verifiable. It is important for a Hedge Fund Manager to recognize that Hedge Fund investors may subscribe to and redeem interests in the Hedge Fund in reliance on the values derived from these policies and procedures. The Recommendations in this section cover various aspects of a Hedge Fund Manager's NAV policies and procedures, including: (1) policies and procedures with respect to verifying the existence of assets and liabilities (financial and non-financial); (2) policies for the manner and frequency of computing NAV based on U.S. generally accepted accounting principles ("U.S. GAAP") or International Accounting Standards ("IAS") with respect to each Hedge Fund; (3) policies regarding the appropriate disclosure of material, NAV-related information to Hedge Fund investors; (4) policies and procedures to ensure pricing is fair, consistent, and verifiable; (5) policies for the manner and frequency of computing portfolio valuation for the purposes of internal risk monitoring of the portfolio; and (6) policies and procedures for the establishment of the FSCP, which is the last part of the process for determining NAV.

## Verification of the Existence of Assets and Liabilities

### 3.1

A Hedge Fund Manager should establish procedures to independently verify the existence of financial assets and liabilities.

The existence of financial assets and liabilities is a critical element in the computation of NAV. A Hedge Fund Manager should develop practices to ensure trades are processed accurately and on a timely basis. A Hedge Fund Manager should establish these practices based on a review and understanding of the Hedge Fund Manager's business structure. A Hedge Fund Manager should establish, implement, and enforce robust policies, procedures, and internal controls for each stage of the trading cycle, including: trade initiation; execution; confirmation; settlement; reconciliation; and accounting.

In addition, a Hedge Fund Manager should establish, implement, and enforce procedures for the verification of non-financial assets and liabilities. A Hedge Fund Manager should maintain formal documentation to support its non-financial accruals. See Recommendation 3.12 regarding verification of non-financial assets and liabilities (*e.g.*, accruals for expenses and fees).

Section 1—Management, Trading, and Information Technology Controls and Section 6—Trading Relationship Management, Monitoring, and Disclosure provide a Hedge Fund Manager with additional guidance that may supplement the Recommendations provided in this section, focusing specifically on the determination of NAV.

## 3.2

A Hedge Fund Manager should establish policies and procedures for the control and processing of purchases and sales of financial assets and liabilities.

A Hedge Fund Manager should establish policies for the processing of purchases and sales of financial assets and liabilities. These policies may include thresholds for specific levels of approvals. A Hedge Fund Manager should also establish adequate segregation of duties among those who are authorized to trade, those who are responsible for recording trade activity, and those who are responsible for reconciling the trade activity. Logical access rights to data and software application supporting

these processes should enforce the required segregation of duties. In addition, a Hedge Fund Manager should develop and implement procedures prior to executing trades in new financial assets and liabilities or with new counterparties. See Section 6—Trading Relationship Management, Monitoring, and Disclosure for more information on documentation policies and procedures in transacting with counterparties.

## Verification of the Existence of Assets and Liabilities

### 3.3

A Hedge Fund Manager should establish policies and procedures for the periodic reconciliation of the Hedge Fund Manager's recorded financial assets and liabilities to statements produced by independent sources.

A Hedge Fund Manager should reconcile trade information entered into its portfolio accounting system with the trade information recorded by third parties on a daily basis. In addition, to the extent practical, a Hedge Fund Manager should reconcile cash balances to balances recorded or statements published by third parties at the end of each day. If a Hedge Fund Manager discovers any differences between these balances or statements, it should, to the extent practical, investigate any differences on a timely basis.

In order to verify the existence of financial assets and liabilities, a Hedge Fund Manager should reconcile its internal financial statements to statements produced by recognized independent financial institutions on a monthly basis. A Hedge Fund Manager should attempt to reconcile any differences between the statements, recognizing that differences could exist between a counterparty's statement and a prime broker's statement.

## 3.4

A Hedge Fund Manager should establish procedures for obtaining confirmations and performing periodic reconciliations of OTC derivatives with its respective counterparties.

To the extent applicable, a Hedge Fund Manager should implement and comply with evolving industry practices to strengthen its processing, clearing, and settlement arrangements for OTC derivatives. These practices may include the use of protocols for issuing and completing trade confirmations and obtaining prior written consent for assignments.

In addition, the industry has established protocols for basic derivatives documentation, including master agreements, master trade confirmations, security agreements, guarantees, and related documentation, as well as industry-standard documen-

tation for foreign exchange, currency forwards, currency options, and related OTC transactions. A Hedge Fund Manager should consider the use of such protocols and documentation to achieve operational efficiencies in the negotiation and execution of basic derivatives documentation with counterparties.

In addition to the foregoing, a Hedge Fund Manager should establish a practice of reconciling its OTC derivatives records with the records of its respective counterparties on a monthly basis. This practice would require that the Hedge Fund Manager receives monthly statements from its respective counterparties.

## Verification of the Existence of Assets and Liabilities

### 3.5

A Hedge Fund Manager should establish policies for maintaining sufficient internal documentation of transactions involving non-publicly traded financial investments (other than OTC derivatives) for the purpose of facilitating and ensuring the verification of the Hedge Fund's financial assets and liabilities.

For non-publicly traded financial assets and liabilities (other than the OTC derivatives described above), a Hedge Fund Manager should maintain adequate supporting documentation as evidence of the existence of a transaction. In addition, a Hedge Fund Manager should maintain internal documentation in a manner, and to a sufficient degree, to enable it to track and support unfunded commitments to third parties. The

purpose of this policy is to ensure the accuracy of amounts recorded as assets and liabilities.

A Hedge Fund Manager should establish and implement procedures for: the dissemination of regular corporate action updates; the determination of the applicable corporate action; and the recording of such corporate actions.

## Determination of Fair Value

### 3.6

A Hedge Fund Manager should adopt an appropriate accounting standard that incorporates the concept of “fair value”.

For NAV purposes, a Hedge Fund Manager should value investments according to U.S. GAAP or IAS. A Hedge Fund Manager should recognize that there may be differences in determining fair value of financial assets and liabilities as between U.S. GAAP and IAS 39: *Financial Instruments, Recognition and Measurement* under International Financial Reporting Standards. Under either standard, however, a Hedge Fund Manager should comply with the relevant accounting standard that incorporates the concept of fair value.

Generally, U.S.-based Hedge Fund Managers employ U.S. GAAP Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (“FAS 157”) to value their financial investments. Under FAS 157, fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In measuring fair value, FAS 157 also establishes a fair value hierarchy that prioritizes the inputs that are applied to valuation techniques.

## Responsibility for Valuation

### 3.7

A Hedge Fund Manager, in consultation with its governing body, should determine the party who bears ultimate responsibility for the valuation of investments and disclose this information to Hedge Fund investors.

If ultimate responsibility for valuation of investments does not lie with the Hedge Fund Manager, the Hedge Fund Manager should provide oversight in the valuation process. This oversight may include regular meetings and approvals of pricing methodologies.

A Hedge Fund Manager may deem it necessary to establish a separate committee, such as a valuation or pricing committee, to oversee the determination of fair value in the valuation process. The establishment of a valuation committee may mitigate the risk of actual or potential conflicts. A valuation committee, if formed, should be comprised of individuals who have the authority and experience to provide meaningful oversight of the valuation process. When a valuation committee regularly solicits and employs the advice

of external experts in the valuation process (such as Fund Administrators), the use of these experts could help prove the independence of the committee.

Where certain responsibilities (*e.g.*, position verification, pricing affirmation, *etc.*) for determining a Hedge Fund's NAV are contractually assigned to a Fund Administrator, a Hedge Fund Manager should review and analyze its contract with the Fund Administrator to determine the Fund Administrator's level of responsibility for determining NAV. Before a contract is executed between them, a Fund Administrator and a Hedge Fund Manager should agree as to the roles and responsibilities between them in valuing financial assets and liabilities of the Hedge Fund Manager and/or its Hedge Funds.



## Pricing Policies and Procedures

### 3.8

A Hedge Fund Manager's pricing policies and procedures should be fair, consistent, and verifiable.

A Hedge Fund Manager should, to the extent practical, either calculate or verify the accuracy of prices independent of the investment decision process. To that end, a Hedge Fund Manager should rely on price quotes from external sources whenever practical and establish policies for determining the value of assets for which appropriate external price quotes are not reasonably available. In addition, a Hedge Fund Manager should document the process used to determine whether to implement recommendations of a pricing service, as well as circumstances in which it is appropriate to override a pricing service's recommendation.

When available, a Hedge Fund Manager should consider validating prices of financial assets and liabilities with a secondary source and investigating significant differences between the primary and secondary source. For example, when a pricing model is used to value OTC investments, the output of the model may be compared to a counterparty quote. In addition, a Hedge Fund Manager should consider the role of the Fund Administrator in the

price validation process. Wherever possible, a Fund Administrator should independently price the financial assets and liabilities of the Hedge Fund.

Certain instruments held in Hedge Fund portfolios may have more than one official price that can be used for valuation purposes. Examples of this are financial assets and liabilities traded on multiple exchanges, (including dual-listed securities), those that trade across multiple time zones, and certain OTC derivatives. In determining which settlement price to use in these instances, a Hedge Fund Manager should consider the exit price and what the Hedge Fund would realize as of the time that the Hedge Fund closes its books and determines NAV. Should a security close on a foreign exchange prior to the valuation by the Hedge Fund Manager, the Hedge Fund Manager should consider the time zone movements that occur in markets subsequent to the foreign close, particularly in situations when there is shareholder activity in the relevant security.

## Pricing Policies and Procedures

### 3.9

A Hedge Fund Manager should establish pricing policies and procedures that assure that NAV is marked at fair value.

A Hedge Fund Manager should choose reliable and recognized pricing sources to the extent practical.

The existence of written pricing policies and procedures is a critical element to the control structure surrounding a Hedge Fund Manager's pricing of portfolio investment instruments. The Hedge Fund Manager's governing body should establish these policies based on a thorough review and understanding of the totality of the Hedge Fund Manager's business structure (*e.g.*, range and complexity of instruments traded, stipulations contained in the Hedge Fund's offering documents, liquidity terms offered to Hedge Fund investors, *etc.*). In addition, a Hedge Fund Manager should review these policies either (1) with the person(s) responsible for making investment decisions for the Hedge Fund or the valuation committee, as the case may be, or (2) with the Hedge Fund's independent auditors. In any case, a Hedge Fund Manager should consistently apply its pricing policies and procedures.

Pricing policies and procedures should clarify the role of each party in the valuation process, identify the pricing source for each instrument, and include resolution procedures

for pricing and capture exceptions. A Hedge Fund Manager should periodically update these policies and procedures for new types of instruments, as well as changes in applicable accounting standards.

Where practical, a Hedge Fund Manager should develop practices and/or systems for capturing pricing data for their trading positions from independent sources on a daily basis. A Hedge Fund Manager should also adopt procedures for periodically verifying the accuracy of pricing data and for reviewing any material discrepancies between price sources. Where an instrument is not actively traded or where obtaining price information requires significant effort, less frequent pricing may be appropriate depending on the nature and the size of the trading position and the size, structure, and investment objective and strategy of the Hedge Fund. For positions traded when the only external source of fair value may be quotes from relevant market-makers (the number of which, based on the liquidity of the position, may be very limited), a Hedge Fund Manager should also consider the number of quotes desired to gain comfort with the fair value. This may also lead to model

pricing as discussed below in this Recommendation 3.9.

The range of OTC instruments that may require alternate pricing sources include derivative instruments, asset-backed securities, fixed income instruments, and other similar instruments. However, if these alternate sources are unavailable, either because the transactions are one-of-a-kind or not actively traded, the only market for these instruments may be with the transaction's counterparty. These instruments could be valued: (1) by obtaining a quote or estimate from the counterparty; (2) based on a pricing model; or (3) any combination thereof. Where a pricing model is used, a Hedge Fund Manager should make sure that it is in a position to explain and support the model parameters used in determining the valuation. In addition, the Hedge Fund Manager should consider "*back-testing*" the pricing model in order to assess its accuracy.

Where market prices do not exist or are not indicative of fair value, a Hedge Fund Manager should establish valuation methods for NAV purposes. For example, in valuing certain instruments, a Hedge Fund Manager may consider seeking input

from its portfolio management team in order to take advantage of their expertise. Nonetheless, a Hedge Fund Manager must ensure that the appropriate amount of control and oversight exists, potentially through a valuation committee, as discussed in Recommendation 3.7.

A Hedge Fund Manager may use alternative approaches for valuing illiquid or otherwise hard-to-value financial assets and liabilities. Among the various approaches to valuing these types of assets and liabilities are: obtaining broker or counterparty quotes; performing model pricing; and receiving independent appraisals. These three types of approaches should be included in the overall valuation policy of a Hedge Fund Manager. When obtaining broker quotes to value illiquid and hard-to-value financial assets and liabilities, a Hedge Fund Manager should attempt to obtain multiple broker quotes and develop a methodology for calculating an average price, or be able to support the price ultimately used. For financial assets and liabilities valued using a pricing model, a Hedge Fund Manager should give consideration to obtaining counterparty quotes to assess the reasonableness of the pricing

## Pricing Policies and Procedures

### 3.9 continued

model valuation. Where independent appraisals are obtained, a Hedge Fund Manager should evaluate each independent appraiser's qualifications and experience in valuing an illiquid or otherwise hard-to-value financial asset or liability and the extent to which it can provide price assurance.

If a Hedge Fund Manager has used a mechanism to align the investment strategy of illiquid financial assets

and liabilities with investor interests in order to achieve fairness to investors (*e.g.*, side pockets), the Hedge Fund Manager should recognize that creation of this mechanism does not change the principles or methods used for determining fair value of the illiquid financial assets and liabilities.

A Hedge Fund Manager should monitor the performance of pricing services to ensure consistency in the services provided.

## Frequency of NAV Determinations

### 3.10

A Hedge Fund Manager should establish policies for the frequency of determining a Hedge Fund's NAV.

A Hedge Fund's official NAV is typically determined on an established periodic basis and is used for the purposes of disclosure and for the pricing of Hedge Fund investor subscriptions and redemptions. Separately, a Hedge Fund Manager may also prepare an estimated or

indicative NAV more frequently, based on estimates of accrued fees, income and expenses, and trading profits and loss, which may be used for internal purposes, such as risk monitoring. See also Section 4—Risk Management, Recommendations 4.12 and 4.17.

## Financial Statement Close Process

### 3.11

A Hedge Fund Manager should establish policies and procedures for periodic closing of books and records consistent with appropriate accounting principles.

The FSCP is the process whereby the results of various transactions are summarized, reviewed, consolidated, edited, and used for reporting to investors and management. In the FSCP, the calculation of NAV should take into account not only the fair value of the financial assets and liabilities (as described above) in the portfolio (sometimes referred to as “trading P&L”), consistent with appropriate accounting principles (U.S. GAAP or IAS), but also accruals of interest, dividends, and other receivables, as well as fees, expenses, and other payables. This is critical as Hedge Fund investors will both buy and sell interests in a Hedge Fund on the basis of NAV.

A Hedge Fund Manager should establish a policy around the FSCP that transforms the transactions reflected in accounting records into financial statements and related disclosures, and that generally represents a process entirely separate from

other accounting activities. This policy should include: (1) preparing the trial balance and any necessary consolidations; (2) accumulating, preparing, reviewing, and posting journal entries; and (3) drafting and reviewing the financial statements and related disclosures.

A Hedge Fund Manager should delegate the responsibility of the FSCP to personnel conversant in the relevant U.S. GAAP or IAS, as well as any applicable regulatory requirements. This delegation of responsibility will ensure that the financial statements prepared, whether they are internal management reports or external regulatory reports, are in compliance with U.S. GAAP or IAS, as the case may be, or applicable regulatory requirements. A Hedge Fund Manager should define access rights to data and software applications supporting the FSCP to enforce appropriate segregation of duties.

## 3.12

As part of the FSCP, a Hedge Fund Manager should incorporate procedures for the review and recordation of all financial and non-financial assets and liabilities (including accruals of interest, dividends, and recordation of all non-financial asset and liabilities, including management fees, incentive fees, and other liabilities).

A Hedge Fund Manager should have procedures in place to review the recordation of all financial and non-financial assets and liabilities. The recording of many of these accounts, such as the accruals for interest and dividends, ties in closely with the corporate action process that a Hedge Fund Manager should establish. For non-financial assets and liabilities, including management fees, incentive fees, and other liabilities, the Hedge Fund Manager should have a review process in place to ensure that these assets and liabilities are properly calculated and recorded when determining NAV.

When a Hedge Fund Manager uses a Fund Administrator, the Hedge Fund Manager should establish procedures to review the calculation of NAV provided by the Fund Administrator. This may include analyzing and reviewing in detail the package provided by the Fund Administrator when no internal records are kept, or reconciling the records provided by the Fund Administrator to the Hedge Fund Manager's internal records.

## Financial Statement Close Process

### 3.13

A Hedge Fund Manager should review the allocation of income and expense to Hedge Fund investors.

The allocation of income and expense to Hedge Fund investors is an integral part of the FSCP. Allocations are typically performed by the Fund Administrator or by a division within a Hedge Fund Manager's back office. A Hedge Fund Manager should establish, implement, and enforce procedures to ensure that all new investors and exiting investors are allocated profits or losses in appropriate periods. In addition, a

Hedge Fund Manager should take measures to ensure Hedge Fund investors are allocated their appropriate share of profits or losses within a given period. A Hedge Fund Manager can accomplish this by performing reasonableness checks on the returns of investors, such as calculating the rate of return of each investor for a period to verify that all investors with identical rights and fee arrangements have identical returns.

### 3.14

In relation to reporting to Hedge Fund investors, a Hedge Fund Manager should incorporate procedures that seek consistency between periodic reports and annual audited financial statements.

The way in which a Hedge Fund Manager reports to Hedge Fund investors should be consistent from period-to-period. A Hedge Fund Manager should also attempt to provide consistent information as between periodic reports and a Hedge Fund's annual audited

financial statements. By standardizing the way information is presented on a periodic basis to Hedge Fund investors and in annual financial statements, a Hedge Fund Manager will ensure that the investors receive consistent information throughout the year.



## 4. Recommendations: Risk Management

The Recommendations in this section address the key elements of a Hedge Fund Manager's risk management process. Hedge Fund Managers allocate Hedge Fund assets to mitigate risks in order to maximize associated returns. In this context, effective risk management is central to a Hedge Fund's success over time. Key aspects of a robust Hedge Fund process dealing with risk include: risk measurement; risk monitoring; and risk management. Additional information on risk monitoring is provided in Appendix III—Supplemental Information on Risk Monitoring Practices for Hedge Fund Managers.

A Hedge Fund's risk management process generally focuses on risks generating the largest potential losses, which for most Hedge Funds are "*market risks*". In addition, risk management gives appropriate consideration to other types of risk to which a Hedge Fund is exposed, including "*funding liquidity*" risks, counterparty "*credit risks*", and "*operational risks*". See Appendix I for definitions of the foregoing italicized terms.

## Structure of Risk Management Process

### 4.1

A Hedge Fund Manager should have a risk measurement process appropriate to its size, complexity, and portfolio structure.

The risk measurement process should: (1) develop risk metrics covering the major risks to which a Hedge Fund is exposed; (2) seek to develop qualitative information regarding risks that are not well captured by quantitative metrics; and (3) where feasible and appropriate in terms of a particular Hedge Fund's portfolio, develop approaches to compare return metrics with risk metrics in order to evaluate return earned on a Hedge Fund portfolio per unit of quantifiable risk taken on that portfolio.

The risk measurement process should include the regular calculation of risk metrics developed for quantifiable risks, as well as periodic gathering of qualitative information on risks that are not sufficiently captured by quantitative metrics.

A Hedge Fund Manager should calculate the various relevant risk metrics, as it deems appropriate, along various dimensions of disaggregation of the Hedge Fund's portfolio, such as risk type, product, and portfolio manager.

### 4.2

A Hedge Fund Manager should have a risk monitoring process appropriate to its size, complexity, and portfolio structure.

A Hedge Fund Manager's risk monitoring process should include the production of regular risk reports to an appropriate level of detail, representing a Hedge Fund's major risk exposures and highlighting key changes in these exposures.

Appropriate personnel of the Hedge Fund Manager should regularly

review reasonably detailed information on major risk exposures and should highlight any key developments for the governing body. This review should take into account risk reports and other relevant quantitative and qualitative information regarding the rationale for and the risks and returns of the Hedge Fund Manager's trading strategies.

## 4.3

A Hedge Fund Manager should have a risk management process appropriate to its size, complexity, and portfolio structure.

The governing body of a Hedge Fund Manager should periodically review quantitative and qualitative information regarding major risk exposures and realized and anticipated returns on risks taken.

The governing body of a Hedge Fund Manager should review the nature and magnitude of risk exposure at the Hedge Fund and/or strategy levels to ensure consistency with the risk and return information

that was communicated to Hedge Fund investors in the Hedge Fund's offering documents.

The periodic review process should include: (1) assessing the performance of trading strategies, traders, and trading positions; and (2) taking appropriate decisions to adjust any of these factors to enhance the risk-adjusted performance of the Hedge Fund.

## Market Risk

### 4.4

A Hedge Fund Manager should have controls to protect the integrity of information used in its risk measurement, monitoring, and management processes.

A Hedge Fund Manager should develop controls to protect the integrity of: (1) a Hedge Fund's trading positions and other information used in risk measurement and risk monitoring; and (2) the risk and return information produced and used in the measurement, monitoring, and management processes.

Risk measurement and monitoring processes should be implemented by personnel of the Hedge Fund Manager who can provide a critical perspective on the Hedge Fund's risk positions and are responsible to

the governing body of the Hedge Fund Manager.

The personnel team responsible for the risk measurement and monitoring processes should possess sufficient expertise to understand in detail the nature of the Hedge Fund Manager's trading strategies and the main drivers of the risk and anticipated returns of its investments. This team should also have access to all data and resources necessary to effectively execute their responsibilities.

## 4.5

A Hedge Fund Manager should measure quantifiable, position-level market risk exposures on a reasonably consistent basis across the various portfolios and trading positions of the Hedge Funds it manages.

A Hedge Fund Manager should generally quantify exposures using “risk-adjusted” metrics. These metrics may include, for example, delta-equivalent exposure for equity positions, PV01 and credit spread 01 for fixed income positions, and “*gamma*” and “*vega*” for material option positions.

A Hedge Fund Manager may find useful notional exposure measures

in its risk management processes as a supplement to risk-adjusted measures. A Hedge Fund Manager should not, however, use notional exposure measures without other measures in this context unless the notional exposure measures are materially identical to risk-adjusted measures or risk-adjusted measures cannot be estimated robustly.

## 4.6

A Hedge Fund Manager should calculate, report, and review aggregations of position-level market risk metrics along dimensions that highlight major aspects of a Hedge Fund’s market risk exposure.

The dimensions of aggregation relevant to market risk exposure will depend on a Hedge Fund’s risk exposures and organizational structure.

In terms of risk exposures, relevant dimensions of aggregation may include: principal risk factors (such as national markets for equity or yield curves for fixed income); type of instruments (such as government

bond, interest rate swap, interest rate option, corporate bond, credit default swap, *etc.*); industry sectors; and maturity.

In terms of organizational structure, relevant dimensions of aggregation may include the sub-portfolios managed within a Hedge Fund by individual portfolio managers.

## Market Risk

### 4.7

A Hedge Fund Manager should calculate, report, and review volatility metrics for portfolios and, if appropriate, relevant sub-portfolios.

Relevant portfolios for which volatility metrics can be calculated may include a Hedge Fund, as a whole, and sub-portfolios based on risk type and organizational structure.

Volatility metrics are generally most reliable as risk management tools. When relevant historical pricing data display reasonably stable volatilities and/or correlations, a Hedge Fund Manager should calculate and review volatility metrics for exposures.

One class of volatility metrics addresses the realized variability

of gains/losses for a portfolio over time (where the size and composition of portfolio positions may have changed). Metrics in this class include realized standard deviation of historical trading P&L or return and realized drawdown from peak.

A second class of metrics consists of forecasts of the anticipated future variability of gains/losses for a specific and unchanging portfolio. Examples of such metrics are referred to as “*Value-at-Risk*” or “*VAR*” and forecasted standard deviation of future trading P&L.

## 4.8

A Hedge Fund Manager should perform “stress tests” to determine how potential large changes in market prices and other risk factors could affect a Hedge Fund’s value.

Stress tests assess the impact of potential large market changes in prices on a Hedge Fund’s value, taking into account relevant non-linearities in the relationship between portfolio value and size of the change in market prices. Stress tests may consider large price changes in various markets one-by-one or jointly in multiple markets.

Stress tests of joint market price changes with a particular market or economic motivation are often called “*scenario analysis*” and may consist of scenarios of market behavior that are either historical or prospective.

## 4.9

A Hedge Fund Manager should understand the liquidity characteristics of the various assets in the portfolios of the Hedge Funds that it manages.

“*Asset liquidity*” is a measure of how easily and at what cost an asset can be sold in the market. Liquidity varies across asset types, time, and market conditions. Measures of liquidity may be expressed as the

amount held as a percentage of: daily trading volume; issue size; or open interest. Another measure of asset liquidity is the bid/ask pricing spread for an asset.

## Market Risk

### 4.10

A Hedge Fund Manager should be aware of limitations of the metrics and models that it uses in its market risk measurement, monitoring, and management processes.

A Hedge Fund Manager should not expect market risk metrics, individually or collectively, to provide a complete view of market risk. For example, measures of risk-adjusted exposure may prove misleading in cases where market behavior differs substantially from past behavior, or when non-linear price effects from options are substantial.

Measures of portfolio volatility, such as standard deviation and VAR, seek to assess the risk of moderately infrequent market movements. A Hedge Fund Manager should not rely on these measures as dispositive indicators of portfolio performance in highly extreme events. In addition, these measures may fail (to a smaller or larger extent) even as guides to the impact of mod-

erately infrequent events, because future market dynamics can differ from past dynamics. In light of this concern, a Hedge Fund Manager should periodically compare realized portfolio returns to standard deviation and VAR (or other measures of portfolio volatility).

Stress tests may fail to provide advance warning of a potential large loss if they do not adequately probe weaknesses in a Hedge Fund's present portfolio or if markets move in an unforeseen manner. In this regard, a Hedge Fund Manager should periodically update stress tests in light of recent developments in the structure of a Hedge Fund's portfolio and/or in the dynamics of financial markets.



## Funding Liquidity Risk

### 4.11

A Hedge Fund Manager should monitor and manage current and expected future sources of and draws on liquidity (cash).

A Hedge Fund needs cash liquidity to trade, meet margin calls, make payments to creditors and suppliers, and satisfy redemption requests. Robust funding liquidity can enhance Hedge Fund performance by providing flexibility to maintain or add to risk positions in periods when market stress presents trading opportunities.

In monitoring and managing current and expected future sources and uses of cash, the Hedge Fund Manager should generally take into account payment obligations, cash presently held, terms governing redemptions of Hedge Fund interests, the ability to raise cash by selling assets (taking account the asset liquidity of these assets), and funding arrangements negotiated with counterparties such as prime brokers and lenders.

### 4.12

A Hedge Fund Manager should plan for potential periods of funding liquidity stress characterized by a sharp rise in needed cash relative to available cash.

A Hedge Fund Manager should assess a Hedge Fund's cash and "*borrowing capacity*" under large historical drawdowns and under conditions of severe market stress. In addition to the factors relevant for more normal market conditions mentioned in Recommendation 4.11, this analysis should consider potential stress-period actions by creditors and investors.

Possible adverse actions by creditors include: reluctance to release collateral owed or to fund credit lines; decisions to increase "*haircuts*" and collateral requirements; and use of contractual rights to terminate trading relationships based on NAV triggers. Investors will more likely seek redemptions in a period of stress.

## Funding Liquidity Risk

### 4.13

To enhance the stability of financing and trading relationships, a Hedge Fund Manager should maintain an open dialogue with its credit providers and counterparties with respect to credit terms and conditions, including the extent of financial and risk information to be provided to such parties.

A Hedge Fund Manager and its counterparty should agree to the extent of risk information to be provided to each other depending on their requirements and the extent and nature of the relationship.

A Hedge Fund Manager should require a counterparty's credit

department to provide assurances that it will only use financial and other confidential information furnished by the Hedge Fund Manager for credit evaluation purposes and that it will not make available that information to any member of a counterparty's trading business.

## Counterparty Credit Risk

### 4.14

A Hedge Fund Manager should understand and manage its exposure to potential defaults by trading counterparties.

A Hedge Fund Manager should identify acceptable counterparties based on a counterparty's creditworthiness and set appropriate risk limits based on such analysis. A Hedge Fund Manager should establish, implement, and enforce appropriate documentation policies and procedures as set forth in the Recommendations in Section 6—Trading Relationship, Management, Monitoring, and Disclosure.

Once a trading relationship with a counterparty is established, a Hedge Fund Manager should ensure that the counterparty's creditworthiness is appropriately monitored. A Hedge Fund Manager should also seek to establish appropriate collateral arrangements with counterparties and, if possible, establish the ability to make and respond to collateral calls. See Section 6—Trading Relationship, Management, Monitoring, and Disclosure, Recommendation 6.4.

## Leverage

### 4.15

A Hedge Fund Manager should monitor leverage by considering metrics of financial statement-based leverage and metrics of risk-based leverage.

A Hedge Fund Manager should recognize that the term “*leverage*” may be defined in a variety of different ways and that, although not an independent source of risk, leverage can be important because of its magnifying effects on market risk, credit risk, and liquidity risk.

To ensure that the use of leverage is appropriate, a Hedge Fund Manager

should manage the leverage associated with its strategies by using appropriate risk monitoring measures. A Hedge Fund Manager should pay special attention to the manner in which leverage affects the Hedge Fund Manager’s ability to manage portfolio risks to which the portfolio is subject.

## Operational Risk

### 4.16

A Hedge Fund Manager should seek to limit a Hedge Fund's exposure to potential operational risks, including reconciliation errors, data entry errors, fraud, system failures, and errors in valuation or risk measurement models.

A Hedge Fund Manager should consider the following measures, among others, to limit or mitigate operational risk:

- Random, periodic spot checking of relevant activities;
- Monitoring of risk, either internally with an appropriate level of checks and balances to ensure objectivity of risk analysis, or through reliance on external service providers;
- Maintaining a single, centralized position data set (to avoid the errors inherent in maintaining multiple or regionalized data sets);
- Establishing adequate internal controls and review processes, including appropriate segregation of duties, controls over incoming and outgoing cash flows and balances with counterparties, daily confirmation of trades and positions, *etc.*; and
- Reviewing operational risk, including legal, compliance, and transactional policies. See the Recommendations in Section 5—Regulatory Controls and Section 6—Trading Relationship, Management, Monitoring, and Disclosure.

## Risk Monitoring Valuation

### 4.17

A Hedge Fund Manager should establish policies for determining when risk monitoring valuation methods may differ from NAV for operational or risk analysis reasons.

A Hedge Fund Manager should generally use portfolio values used to calculate NAV for risk monitoring valuation, unless the Hedge Fund Manager has determined that operational or risk analysis reasons may justify a different approach. For example, a Hedge Fund Manager may choose

to discount prices for risk analysis purposes if it is doubtful that quoted bids or offers are prices at which a trade could actually be executed. See Section 3—Determination of Net Asset Value, Recommendation 3.9 for additional guidance.

## 5. Recommendations: Regulatory Controls

The Recommendations in Section 5 are designed to encourage a Hedge Fund Manager to develop a strong regulatory compliance infrastructure. These Recommendations provide guidance to a Hedge Fund Manager with respect to monitoring and managing its regulatory responsibilities in all jurisdictions in which it has business operations or conducts investment activity. Depending on the size and scope of operations, this may require the commitment and management of significant internal and external resources. As provided in this section, a Hedge Fund Manager should assign oversight responsibilities to qualified personnel for: the internal regulatory compliance functions; development of compliance policies and procedures; training of personnel; and monitoring of developments in applicable laws, rules, and regulations. Moreover, a Hedge Fund Manager should retain qualified external professionals for needed expertise in discrete areas.

## Regulatory Controls

### 5.1

A Hedge Fund Manager should create a management environment that fosters a culture of compliance and should devote adequate internal resources to compliance with all laws, rules, and regulations applicable to its business operations and market conduct.

A Hedge Fund Manager, regardless of its registration status with a regulatory agency, is required to comply with a wide variety of laws, rules, and regulations (including those of local, state, federal, and international jurisdictions). These laws, rules, and regulations may include market surveillance requirements, which provide that a Hedge Fund Manager or Hedge Fund must furnish information and reports to regulators in connection with its trading and investment activities.

A Hedge Fund Manager registered with a regulatory body, such as the SEC, the Commodity Futures Trading Commission (“CFTC”), or with like-regulatory bodies in non-U.S. jurisdictions, is subject to specific obligations that a non-registered Hedge Fund Manager is not. A non-registered Hedge Fund Manager should evaluate which of the various laws, rules, and regulations are applicable to it despite its non-registered status (*e.g.*, anti-fraud rules). A non-registered Hedge Fund Manager should also evaluate non-mandatory laws, rules, and regulations and determine as a matter

of policy whether complying with them may assist in the furtherance of its compliance program for its business and investment activities.

Overall, a Hedge Fund Manager should, in reliance on its internal and external resources (including prime brokers, administrators, attorneys, and accountants), ensure that its personnel are cognizant of and adequately trained to comply with the laws, rules, and regulations applicable to its business operations, as well as those of the Hedge Funds it manages.

The regulatory environment for Hedge Funds and Hedge Fund Managers is evolving. Accordingly, a Hedge Fund Manager, using internal resources and/or external service providers, should be vigilant in ensuring that it monitors any developments with respect to laws, rules, and regulations to which it, or the Hedge Funds it manages, may be subject. A Hedge Fund Manager should ensure that its policies and procedures are updated periodically and that its personnel are appropriately trained.

A Hedge Fund Manager should monitor regulatory developments through consultations with attorneys and other advisers and through reviews of the various pronouncements

issued or published by regulatory bodies (including self-regulatory organizations) and relevant trade groups or associations, such as MFA.

## 5.2

The policies and procedures of a Hedge Fund Manager with regards to international operations or investment activity should be geared to comply with laws, rules, and regulations in all jurisdictions in which it conducts trading activities or business.

A Hedge Fund Manager's policies and procedures should take into account the requirements of the jurisdictions in which it and the Hedge Funds it manages conduct business or investment activities.

Each jurisdiction may have laws, rules, and regulations that govern market conduct, filings or reports, anti-money laundering ("AML") or "know your customer" rules, private placements, marketing, *etc.*



## Regulatory Controls

### 5.3

A Hedge Fund Manager's senior management should be involved in the compliance program and appoint or hire an individual to develop and monitor compliance with all applicable laws, rules, and regulations by the Hedge Fund Manager and the Hedge Funds it manages.

For purposes of these Recommendations, the individual who is appointed or hired to develop and monitor legal compliance is referred to in this section as the "chief compliance officer". The chief compliance officer may be a member of the Hedge Fund Manager's personnel, may serve in this capacity alone, or as one of several areas of responsibility. The selection criteria for the chief compliance officer should include seniority within the firm, knowledge of investment and trading strategies and business operations for each Hedge Fund managed by the Hedge Fund Manager, and familiarity with applicable legal requirements. For a SEC-registered Hedge Fund Manager, the Advisers Act requires that the Hedge Fund Manager designate a chief compliance officer to administer its policies and procedures, and that this person meets certain criteria as set forth in the act.

A Hedge Fund Manager should ensure that the chief compliance officer has the internal and external resources to carry out his or her duties and actively monitor and ensure that the Hedge Fund Manager and its Hedge Funds comply with U.S. and international laws, rules, and regulations applicable to the Hedge Fund Manager's business and the Hedge Fund Manager's activities.

A Hedge Fund Manager's chief compliance officer should be involved in all aspects of the compliance program, including preparation of policies and procedures, as well as compliance monitoring. A Hedge Fund Manager should give consideration to the reporting lines of the chief compliance officer and establish reporting lines that are adequate to help ensure appropriate involvement of senior management in the development of policies and procedures and compliance monitoring.

## 5.4

A Hedge Fund Manager should establish written compliance policies and procedures that comprehensively address all applicable laws, rules, and regulations tailored to its specific business operations.

A Hedge Fund Manager should have comprehensive policies and procedures in place specifically tailored to address the laws, rules, and regulations applicable to its investment management business and investment activities. While many service providers offer model or “off-the-shelf” compliance policies and procedures, a Hedge Fund Manager and its compliance personnel should tailor policies and procedures to the business of the Hedge Fund Manager and the Hedge Funds it manages. The tailored policies and procedures should take into account the types of investments made or instruments traded, as well as the jurisdictions in which the Hedge Fund Manager conducts business and investment activities.

While not exhaustive, the checklist available in Appendix VI—Checklist for Hedge Fund Managers to Consider in Developing a Compliance Manual contains possible components of compliance policies and procedures. For additional guidance regarding the regulations governing compliance policies and procedures (which are required to be adopted by investment advisers registered with the SEC) see the SEC’s Web site ([www.sec.gov/rules/final/ia-2204.htm](http://www.sec.gov/rules/final/ia-2204.htm)).

*N.B. The following Recommendations address more particular areas that should be addressed as part of the written policies and procedures for regulatory compliance.*

## Regulatory Controls

### 5.5

A Hedge Fund Manager should identify all required U.S. and international regulatory filings and clearly allocate responsibility for oversight of these filing obligations to appropriate personnel or service providers who will supervise and ensure timely compliance with applicable regulations and filing requirements.

The investment activities of Hedge Funds involve many types of instruments (*e.g.*, securities, bonds, or futures) across the global financial marketplace. Accordingly, a Hedge Fund Manager must comply with many filing obligations. Appendix V—U.S. Regulatory Filings by Hedge Fund Managers contains a list of certain

U.S. federal reporting requirements and other regulations that may be applicable to a Hedge Fund Manager operating, trading, and/or marketing in the United States. A Hedge Fund Manager should review similar types of filing requirements in other jurisdictions.

## 5.6

As part of its written compliance policies and procedures, a Hedge Fund Manager should include a code of ethics specifically designed for its business operations. The code should set standards of professional conduct for its personnel consistent with the Hedge Fund Manager's fiduciary duties and other applicable laws. The code should also include procedures for handling material, non-public information to the extent relevant and applicable.

A Hedge Fund Manager's written code of ethics should address, where applicable, the following: standards of conduct for covered persons; protection of material, non-public information; compliance with federal securities laws; reporting and reviewing personal securities transactions; and reporting violations of the code of ethics to a designated person.

A professional code of conduct or code of ethics should set forth guidelines and expectations for the conduct of a Hedge Fund Manager's personnel. A Hedge Fund Manager should develop a procedure to ensure that employees understand and accept the code. For example, a Hedge Fund Manager may require employees to undergo periodic verifications in the form of a written attestation of the relevant employee's understanding and acceptance of the code (*e.g.*, as required of SEC-registered Hedge Fund Managers), or in such other form as the Hedge Fund Manager determines is appropriate for its business.

Similar to the compliance policies and procedures referenced in Recommendation 5.4, a Hedge Fund Manager should develop a code of ethics tailored to the business of the Hedge Fund Manager. The code of ethics should adequately address any conflicts of interest that are present in the Hedge Fund Manager's business.

The SEC requires that registered-investment advisers adopt a code of ethics for their personnel in compliance with SEC regulations. A copy of these regulations is available on the SEC Web site ([www.sec.gov/rules/final/ia-2256.htm](http://www.sec.gov/rules/final/ia-2256.htm)).

While not exhaustive, the checklist available in Appendix VII—Checklist for Hedge Fund Managers to Consider in Developing a Code of Ethics contains sample components of a code of ethics.

## Regulatory Controls

### 5.7

As part of its overall regulatory compliance program, a Hedge Fund Manager should establish AML policies and procedures and ensure that its personnel and service providers follow appropriate investor identification procedures.

AML regulations are in force in nearly all jurisdictions in which Hedge Funds and Hedge Fund Managers operate. Through either internal resources or third parties such as Fund Administrators, a Hedge Fund Manager must ensure it follows all applicable AML regulations with respect to customer identification. The Hedge Fund Manager should also ensure it has established and implemented required AML policies and procedures.

For practical guidance in this evolving area of law, a Hedge Fund Manager should consult MFA's updated *Guidance for Hedge Funds and Hedge Fund Managers on Developing*

*Anti-Money Laundering Programs (Release No. 2)* (the "AML Guidance"), attached to Appendix IV.

Counterparties that are subject to the "know your customer" requirements in various jurisdictions may require a Hedge Fund Manager or a Hedge Fund to provide extensive information. Accordingly, a Hedge Fund Manager should prepare itself for the due diligence processes conducted by counterparties. As part of this process, a Hedge Fund Manager may wish to use the AML attestation letter (attached as Annexes B-1 and B-2 to the *AML Guidance* at Appendix IV) to facilitate this process.

## 5.8

As part of its compliance program, a Hedge Fund Manager should develop document retention policies and procedures and create and retain required books and records related to business operations.

A Hedge Fund Manager should design policies and procedures to ensure the retention of accurate and complete records. It should employ, where reasonable, appropriate electronic data management systems. A Hedge Fund Manager should also establish a policy relating to the appropriate length of time records are retained, taking into consideration its organizational structure and business activities.

For an SEC-registered Hedge Fund Manager, the SEC's rule relating to the maintenance of books and records is detailed as to the types of records required. The SEC has interpreted this rule to include retention of relevant email. The types of records generally relate to business accounting matters such as:

accounting ledgers, bank statements, and bills; written agreements with investors; performance history; and recommendations distributed to a certain number of persons. Generally, an SEC-registered Hedge Fund Manager is required to retain records for five years.

With respect to performance and valuation data, a Hedge Fund Manager should give consideration to the retention of records to support the valuation of a Hedge Fund's investments and the determination of a Hedge Fund's performance. A Hedge Fund Manager should adequately verify the use of a particular track record of an individual trader or portfolio manager relating to their employment with the Hedge Fund Manager.

## Regulatory Controls

### 5.9

A Hedge Fund Manager should adequately train all personnel to be familiar and comply with its compliance policies and procedures.

A Hedge Fund Manager should develop procedures to ensure that employees understand and accept its compliance policies and procedures. These procedures may include a verification of an employee's understanding and acceptance of the policies and procedures, which may take the form of a written attestation or in such other form as the Hedge Fund Manager determines is appropriate for its business. A Hedge Fund Manager should require new employees to undergo verification upon the commencement of employment and existing employees to renew their verification at appropriate intervals.

Areas in which a Hedge Fund Manager should consider training employees include: misuse of material, non-public information; use of third-party paid consultants; AML; protection of investors' confidential information; securities reporting requirements; *etc.* A Hedge Fund Manager may customize training by job functions. Other subject areas may require training of all personnel (*e.g.*, personal trading, anti-discrimination, anti-sexual harassment, gifts, and entertainment).

A Hedge Fund Manager should devote adequate resources to ongoing training programs for its personnel, which should include appropriate follow-up training, as applicable.

## 5.10

A Hedge Fund Manager should regularly review and update its compliance policies and procedures and should establish internal controls to monitor compliance.

A Hedge Fund Manager should review and update its compliance policies and procedures at least annually. A Hedge Fund Manager may conduct the review on a one-time annual review basis, on a rolling annual review basis, or other appropriate schedule to ensure that the policies and procedures remain current.

A Hedge Fund Manager should regularly monitor whether its personnel are complying with the Hedge Fund Manager's policies and procedures through spot-checks, risk assessments, and other appropriate measures.



## 6. Recommendations: Trading Relationship Management, Monitoring, and Disclosure

The Recommendations in this section are intended to provide Hedge Fund Managers with guidance on how to manage their trading relationships with third parties. These relationships include those with brokers and those in which a Hedge Fund transacts on a principal-to-principal basis. These Recommendations cover a Hedge Fund Manager's pursuit of a consistent and methodical approach to documenting transactions with third parties in order to enhance the legal certainty of its investments. In addition, to the extent applicable, this section also provides guidance on seeking to obtain best execution and establishing guidelines for using and disclosing Soft Dollar Arrangements.

## Documentation Policies and Controls

### 6.1

A Hedge Fund Manager should seek to ensure timely execution of necessary transaction documents and enforceability of transactions.

To the extent practical, a Hedge Fund Manager should implement the following practices:

- Establish procedures for entering into counterparty trading relationships, taking into consideration the nature of the trading counterparty, the type of trading relationship being created, and the specific product to be traded;
- Establish appropriate documentation procedures for trading depending on market practice, type and tenor of transaction, and relative related risk. These documentation procedures may include requirements for written agreements (including master agreements) and confirmations. Generally, a Hedge Fund Manager should seek to ensure that written agreements are in place with counterparties prior to executing any transactions or as soon as practical thereafter. Where a Hedge Fund Manager conducts certain trading activities in the absence of a written agreement (or prior to the conclusion of a written agreement), the Hedge Fund Manager should consider, among other factors, its trading relationship with the counterparty in question, and the materiality of the risk in trading in reliance on an oral agreement (e.g., "Statute of Frauds" considerations);
- Establish procedures for ensuring: (1) communication between and among counterparties, Fund Administrators, and/or other third-party service providers; (2) that the appropriate service providers have the proper trade capture and other capabilities to enable timely execution and documentation of transactions; and (3) that service providers are aware of and able to implement the Hedge Fund Manager's transactional policies and procedures; and
- Use multi-lateral electronic transaction matching and confirmation systems for OTC derivatives to the extent acceptable and economically feasible for a relevant product.

## 6.2

A Hedge Fund Manager should consider using a database to track the status of trading documentation and key provisions and terms it has negotiated, such as termination events and events of default. The Hedge Fund Manager should manage any risks associated with variations in these key provisions.

## 6.3

A Hedge Fund Manager should seek consistent bilateral terms with counterparties to the extent appropriate and feasible in order to enhance stability during periods of market stress or declining asset levels.

For example, to the extent approvable and feasible, a Hedge Fund Manager may seek to negotiate standardized events of default and other termination or collateral events to achieve consistency in documentation. A Hedge Fund Manager should consider avoiding provisions that permit counterparties to terminate or make demands for collateral solely at their discretion or based upon subjective determinations. Alternatively, a Hedge Fund Manager should

at a minimum seek to mitigate the risk associated with such provisions through use of notice and cure periods. Over time, factors such as creditworthiness, market standards, market conditions, regulations, operational capacity, or trading platforms may change. A Hedge Fund Manager should assess from time to time whether it is advisable to attempt to renegotiate its trading terms with its various counterparties in response to such changes.

## Documentation Policies and Controls

### 6.4

A Hedge Fund Manager should seek to negotiate bilateral collateral agreements for certain types of transactions, taking into account the relative creditworthiness of the parties and the nature of the transactions.

Bilateral collateral agreements are appropriate in many OTC derivatives transactions, as well as certain exchange-traded derivative transactions. To the extent a Hedge Fund Manager enters into bilateral collateral arrangements, a Hedge Fund Manager should seek to establish such arrangements either internally or through reliance on external resources that permit the Hedge

Fund Manager to effectively and regularly make calls for deliveries and returns of collateral from counterparties when permitted.

Generally, a Hedge Fund Manager should ensure that appropriate security interests are created and perfected when collateral is received as part of a transaction or trading relationship.

## Best Execution

### 6.5

A Hedge Fund Manager should seek best execution in its trading activities for the benefit of the Hedge Funds it manages

Generally, when seeking best execution for all types of instruments, a Hedge Fund Manager should execute transactions in such a manner that the execution quality on an aggregate, periodic basis is the most favorable under the circumstances. In assessing whether this standard is met, a Hedge Fund Manager should consider the full range and quality of a counterparty's services. Factors a Hedge Fund Manager may consider in seeking best execution include, but are not limited to:

- Prompt and reliable execution;
- The quality, comprehensiveness, timeliness, and frequency of available research and market information provided by the executing broker;
- The financial strength, integrity, and stability of the broker or counterparty;
- The ability of the executing broker to execute transactions (and commit capital) 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.

Due to the lack of transparency in the market for certain non-equities, such as certain structured products and derivative products, the review process and analysis of best execution for such products will be different than for equity trades (e.g., the factors listed above may be weighted differently) and will involve additional factors specific to structured and derivative products transactions.

A Hedge Fund Manager should be mindful of actual conflicts of interest that arise when transacting with brokers and counterparties and disclose them as appropriate. See Section 2—Responsibilities to Investors, Recommendation 2.3.

For regulatory guidance on the subject of best execution, a Hedge Fund Manager should review the SEC's release on *Guidance Regarding Client Commission Practices Under Section 28(e)* ([www.sec.gov/rules/interp/2006/34-54165.pdf](http://www.sec.gov/rules/interp/2006/34-54165.pdf)), and the FSA's *Consultation Papers on Best Execution* ([www.fsa.gov.uk/pubs/cp/cp154.pdf](http://www.fsa.gov.uk/pubs/cp/cp154.pdf)) and *Bundled Brokerage and Soft Commission Arrangements* ([www.fsa.gov.uk/pubs/cp/cp176.pdf](http://www.fsa.gov.uk/pubs/cp/cp176.pdf)).

## Best Execution

### 6.6

As part of its compliance policies and procedures, a Hedge Fund Manager should periodically review the firm's relationship with each counterparty executing transactions on behalf of every Hedge Fund it manages to assess whether the counterparty continues to provide best execution.

The degree to which a Hedge Fund Manager engages with a particular counterparty will largely determine the need for and frequency of these periodic reviews

of counterparty relationships. In its review, a Hedge Fund Manager should use a methodology that is appropriate for its business.

## Execution and Clearing Arrangements

### 6.7

A Hedge Fund Manager should carefully consider the selection of its execution and clearing counterparties based on factors relevant to the trading relationship.

A Hedge Fund Manager's process for entering into execution and clearing arrangements with a particular counterparty often involves entering into legal agreements, developing operational documents, and accepting financing rates. In selecting a counterparty for execution or clearing services, a Hedge Fund Manager should weigh relevant factors including, but not limited to:

- The operational efficiency with which transactions are processed and cleared, taking into account the order size and complexity;
- The operational expertise and range of services offered by the clearing broker in providing clearing and custody services for the products traded by the Hedge Fund Manager;
- The commission rate and other financing terms charged by the clearing broker;
- The clearing broker's responsiveness to the Hedge Fund Manager;
- The clearing broker's confidentiality policies and procedures;
- The clearing broker's regulatory oversight and responsibilities; and
- The clearing broker's creditworthiness.

## Soft Dollar Arrangements

### 6.8

Because Soft Dollar Arrangements may impact the evaluation of best execution, a Hedge Fund Manager, if applicable to its operations and trading activities, should make determinations regarding its Soft Dollar Arrangements and should develop policies relating to the use of these arrangements.

If a Hedge Fund Manager uses Soft Dollar Arrangements, its policies should include procedures and documentation requirements for third-party arrangements with brokers and other counterparties. In making determinations and policies, a Hedge Fund Manager should consider arrangements relating to transactions in instruments other than securities. Applicable laws, rules, or regulations can also guide a Hedge Fund Manager's determinations and policies. For example, if the Hedge Fund Manager has operations in the United Kingdom, it should consider any FSA consultation papers on the subject. Additionally, if the Hedge Fund Manager is subject to ERISA, it should ensure its arrangements do not violate ERISA. Policies may also vary depending on a Hedge Fund Manager's customized advisory arrangements.

Policies may include, depending on the nature of the Hedge Fund Manager's business: (1) commission sharing arrangements and proprietary arrangements addressing, as appropriate approved broker-dealers and products/services; (2) reliance or non-reliance on the safe harbor of Section 28(e); and (3) procedures for approval of such arrangements and related terms.

A Hedge Fund Manager should make a good faith determination that the amount of commission is reasonable in relation to the value of the brokerage and research services provided by the broker-dealer and in light of the terms of the particular transaction or the Hedge Fund Manager's overall responsibilities with respect to its discretionary accounts.



A Hedge Fund Manager relying on the safe harbor provided by Section 28(e) should determine whether the brokerage and research services are covered within the safe harbor (as set forth in Section 28(e)(3)). The SEC indicates that “the focus should be on whether the product or service provides lawful and appropriate assistance to the money manager in the carrying out of his responsibilities.”<sup>1</sup>

A Hedge Fund Manager with Soft Dollar Arrangements that fall outside of the safe harbor provided by Section 28(e) should ensure that its arrangements are consistent with its duties to investors and determine whether the products and services received fall within the disclosed usage of Soft Dollar Arrangements. See Section 2—Responsibilities to Investors, Recommendation 2.13.

<sup>1</sup> See *SEC Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, as amended.*

## Soft Dollar Arrangements

### 6.9

A Hedge Fund Manager should evaluate the types of products and services subject to its Soft Dollar Arrangements.

As part of its evaluation, a Hedge Fund Manager should determine the extent to which products or services have research functions or are developed by a third party and provided by a broker. A Hedge Fund Manager relying on Section 28(e) should make proper allocation of products or services with mixed uses (*i.e.*, computer hardware that assists an adviser in research functions and in non-research functions) so that non-research services are paid for from the Hedge Fund Manager's funds. Certain arrangements, such as commission sharing arrangements, can assist a Hedge Fund Manager in obtaining best execution by allowing it to use the broker providing best execution to execute the trade and to pay commissions to other brokers from whom it receives research or services through Soft Dollar Arrangements.

The SEC's *Guidance Regarding Client Commission Practices Under Section 28(e)* ([www.sec.gov/rules/interp/2006/34-54165.pdf](http://www.sec.gov/rules/interp/2006/34-54165.pdf)) provides steps for analyzing: (1) whether a particular product or service is an eligible research or brokerage service within the specific statutory limits of the safe harbor; (2) whether the product or service actually provides lawful and appropriate assistance

in the performance of an adviser's investment decision-making responsibilities, including the appropriate treatment of "mixed-use" items; and (3) whether the amount of client commissions paid is reasonable in light of the value of the products or services provided by the broker-dealer. The release also discusses third-party research and the permissibility of client commission arrangements under the safe harbor.

Additional guidance can be found in the FSA's Consultation Paper on *Bundled Brokerage and Soft Commission Arrangements* ([www.fsa.gov.uk/pubs/cp/cp176.pdf](http://www.fsa.gov.uk/pubs/cp/cp176.pdf)). This publication makes two main proposals: (1) that goods and services that are reasonably anticipated should be excluded from those that can be purchased with commission, whether under soft or bundled arrangements (and the document sets out the goods and services to which this restriction should apply); and (2) where a Hedge Fund Manager buys any other services additional to trade execution with its customers' commission, it should determine the cost of those services and rebate an equivalent amount to its customers' funds.

## 7. Recommendations: Business Continuity, Disaster Recovery, and Crisis Management

The Recommendations in this section provide a Hedge Fund Manager with guidance on developing policies and procedures to prepare for unexpected events that would either interfere with or cause harm to its personnel or infrastructure, or hamper or prohibit the continuation of business operations. While the need to establish functional BC/DR plans is not unique to Hedge Fund Managers, they have responsibilities to the Hedge Funds they manage to have such plans in place. The inability to carry out routine trading and risk monitoring functions (even on a very short-term basis) as a result of a disruption could lead to large financial losses.

# Business Continuity, Disaster Recovery, and Crisis Management

## 7.1

A Hedge Fund Manager should develop a comprehensive BC/DR plan that establishes clear policies and procedures for internal personnel and external service providers to prepare for unexpected events.

In developing a BC/DR plan, a Hedge Fund Manager should consider and prepare for events that could have a significant impact on personnel, investment, and other key business operations. The primary goals of any BC/DR plan are to protect personnel from harm and to maintain business operations for Hedge Funds under management.

Certain Hedge Fund Managers may be subject to regulatory or self-regulatory agencies that require them to have BC/DR plans. The components of a comprehensive BC/DR plan should address, without limitation:

- The loss of a “*key person*”;
- National or local natural disasters;
- Acts of terrorism;
- Pandemics;
- Fires;
- IT system malfunctions or corruption; and
- Similar highly disruptive events.

The preparation involved to protect a Hedge Fund Manager’s operations will likely be extensive and, depending on the size of operations, may require substantial internal personnel resources to develop the BC/DR plan. For a Hedge Fund Manager with smaller operations, it may be advisable to seek the assistance of external third parties with appropriate expertise.

A Hedge Fund Manager’s senior management should work with personnel responsible for IT, treasury, accounting, trading, and operations to develop a plan specifically tailored for the business realities of the Hedge Fund Manager and the Hedge Funds it operates. The plan should consider the personal safety and security of the Hedge Fund Manager’s employees.

Overall, a Hedge Fund Manager should designate one member of its personnel team with ultimate responsibility for developing and executing the BC/DR plan, if circumstances require. Developing the plan will likely require senior management to review business-

critical applications, test the BC/DR plan for resiliency, and update the plan as needed.

External service providers and government agencies may provide

templates for BC/DR plans. See Recommendation 7.12 for suggested government and private sector sources of information.

## 7.2

A Hedge Fund Manager should establish a BC/DR plan that provides contingencies in the event of the death or incapacity of its founder or one of its key persons, including succession planning.

A Hedge Fund Manager's BC/DR plan should include plans to ensure compliance with any key person provisions that may exist in partnership or similar agreements, side letters, and master agreements, as well as policies and procedures to promptly disclose such an event. In drafting a BC/DR plan, a Hedge

Fund Manager with key person provisions that give investors withdrawal rights should also consider the impact of the potential withdrawals by investors on business operations. Moreover, a Hedge Fund Manager should develop a succession planning protocol in the event of the loss of a key person.

## 7.3

A Hedge Fund Manager should establish policies and procedures to protect personnel in the event of a crisis making the work environment unsafe.

A Hedge Fund Manager's BC/DR plan should include policies that prepare for: (1) the potential need to immediately evacuate the premises; or (2) any condition that makes the Hedge Fund Manager's office(s) unusable. Possible crisis event scenarios include: (1) basic evacuation in the

case of a fire; or (2) plans for working offsite when personnel cannot reach their office due to (a) hazardous conditions (*e.g.*, severe storms or terrorist attacks), and (b) diseases or epidemics that make it inadvisable for personnel to travel to the Hedge Fund Manager's offices.

## Business Continuity, Disaster Recovery, and Crisis Management

### 7.4

A Hedge Fund Manager should establish a written BC/DR plan that outlines practices to be followed in an emergency or significant market disruption.

A Hedge Fund Manager should ensure, to the greatest extent practical, that appropriate personnel will have the ability to monitor a Hedge Fund's existing portfolio positions and execute transactions when necessary in the event of a market emergency or other severe market disruption. The Hedge Fund Manager should establish time objectives for recovery of trading positions or operations that are appropriate to its business.

The most important element in a BC/DR plan is the identification and replication of mission-critical systems, meaning those systems a Hedge Fund Manager requires to ensure prompt and accurate processing of transactions and to meet regulatory reporting requirements. A Hedge Fund Manager should consider, among others, the following basic elements in developing a

BC/DR plan that addresses market disruptions:

- Financial assessments and operations;
- Means of communication between and among managers, personnel, and Hedge Fund investors;
- The physical location of the parties;
- The ability to evaluate the impact of an event on the Hedge Fund Manager and the Hedge Funds it manages and their counterparties; and
- Mechanisms to ensure the safety and preservation of the Hedge Fund's assets until they can be redeemed in order to ensure the orderly liquidation of assets in the case where the Hedge Fund Manager's business cannot continue.

## 7.5

A Hedge Fund Manager should review its BC/DR plan to ensure it is consistent with applicable laws, rules, and regulations. A Hedge Fund Manager's BC/DR plan should establish practices to be followed in an emergency or significant market disruption with respect to communications with personnel or external parties.

A Hedge Fund Manager should consider addressing the following items in a written BC/DR plan:

- Developing a communication plan to contact essential parties (*e.g.*, senior management, portfolio managers, risk managers, brokers and trading counterparties, legal or compliance officers, directors of human resources, vendors, and disaster recovery specialists);
- The communication plan should include an instant or early notification to alert personnel and key outside parties of an actual or potentially disruptive event or emergency;
- The communication plan should include policies on email in the event of a disruptive event; and
- The communication plan should be tested and updated, as appropriate.

## Business Continuity, Disaster Recovery, and Crisis Management

### 7.6

A Hedge Fund Manager's BC/DR plan should include systems for storing and protecting hard and soft copies of documents, trade records, and essential communications.

The policies and procedures should include:

- Backing up or copying essential documents and data and storing the information offsite in hard-copy or electronic format; and
- Considering the impact of business interruptions encountered by third parties and identifying ways to minimize that impact.

### 7.7

A Hedge Fund Manager's BC/DR plan should provide for IT contingency arrangements that factor in geography, accessibility of records, security, environment, and cost.

A Hedge Fund Manager should consider maintaining back-up power supplies onsite in the event that the main power source is disrupted.

Additionally, a Hedge Fund Manager should consider establishing back-up facilities or the ability to continue business in a separate geographic area from the Hedge Fund Manager's primary facilities. Such a site may be "hot", or "mirrored", and could be either synchronous or asynchronous. A "hot site" is configured with all system hardware, infrastructure, and support personnel, and the "mirrored site"

is more comprehensive as it has fully redundant infrastructure, systems, and data. A Hedge Fund Manager should consider one of these types of alternate sites in accordance with the Hedge Fund Manager's size and budgetary constraints.

A Hedge Fund Manager, to the extent that its own personnel are not trained in providing redundant IT and other services, should consider working with outside consultants in order to determine its needs and the available technologies and services designed to meet these needs as part of its BC/DR plan.



## 7.8

A Hedge Fund Manager's BC/DR plan should establish a person or team responsible for monitoring regulatory and reporting compliance requirements in the event of a disaster or interruption with trading operations.

A Hedge Fund Manager may be subject to a number of reporting requirements with U.S. or international regulators. A regulator may not suspend these requirements in the event of a crisis or emergency affecting a particular Hedge Fund Manager. This would be most applicable in the case where the emergency or disruption is limited to an individual Hedge Fund Manager,

rather than an event impacting a larger geographic area or a financial market or markets. Accordingly, the Hedge Fund Manager should designate appropriate personnel responsible for ensuring that any regulatory obligations can be fulfilled in the event of an unexpected disruption to business operations, to the extent practical or feasible.

## 7.9

A Hedge Fund Manager should determine whether it is necessary to use third-party service providers and vendors in establishing its BC/DR plan.

## 7.10

A Hedge Fund Manager should establish contingency plans for responding to the failure of a third-party fund administrator, credit provider, or other mission-critical party that would affect a Hedge Fund's market, credit, or liquidity risk.

Contingency planning should address responses to a third party's failure to provide services necessary for a Hedge Fund Manager to conduct operations. This would include addressing transfers to back-up

clearing systems and offsite retention storage, and failures of prime brokers, credit providers, and other service providers, including back-up providers.

## Business Continuity, Disaster Recovery, and Crisis Management

### 7.11

A Hedge Fund Manager should test and update its BC/DR plan at least annually, to ensure that all personnel know their roles and that technology is sufficient during the BC/DR contemplated event.

### 7.12

A Hedge Fund Manager should be aware of resources available from the federal and local governments, and international regulators, if applicable, to gather information about threat dissemination services that are targeted at the financial services sector and that provide information regarding threats to physical and cyber security.

To the extent that the federal, state, and local governments offer threat alert services, a Hedge Fund Manager should investigate subscribing to these services as part of its business continuity and disaster recovery program. One such service is the Financial Services/Information Sharing Alert Center (“FS/ISAC”), ([www.fsisac.com](http://www.fsisac.com)).

The National Futures Association requires its member commodity trading advisors and commodity pool operators to maintain a BC/DR plan ([www.nfa.futures.org](http://www.nfa.futures.org)).

A Hedge Fund Manager with international operations may also consult “*MiFID*”, which provides expectations on BC/DR plans.

## APPENDIX I

# Glossary and Selected Sources Used

Certain capitalized and/or italicized terms and certain technical words and phrases in the Recommendations are defined in the glossary. Terms contained in this glossary are defined for the purpose of the Recommendations and may have a wider or different meaning outside the context of the Recommendations.

**Advisers Act** | Investment Advisers Act of 1940, as amended.

**AML** | Anti-money laundering.

**Asset liquidity** | See **liquidity** and **liquidity risk**.

**Back-test** or **back-testing** | An examination of the results generated by a model (*e.g.*, a Value-at-Risk model) as compared to actual or realized results in order to assess the accuracy of the model.

**Balance sheet leverage** | See **leverage measures**.

**BC/DR** | Business continuity, disaster recovery, and crisis management.

**Best execution** | Generally means the execution of client trades at the best net price in consideration of all relevant circumstances.

**Borrowing capacity** | The amount of money a Hedge Fund can borrow from a broker or dealer or other credit provider (*e.g.*, in order to fund purchases of securities). For example, according to Regulation T of the Federal Reserve Board (12 C.F.R. 220.4), a borrower may borrow up to 50% of the value of a security, depending on the type of security.

**Cash** | Cash balances held in bank accounts and short-term, high-quality marketable securities, such as government bonds.

## Glossary

**Cash market** | A market in which goods are purchased either immediately for cash, as in a cash and carry contract, or in which they are contracted for presently, with delivery and payment occurring shortly thereafter. All terms of the contract are negotiated between buyer and seller.

**CFTC** | The United States Commodity Futures Trading Commission.

**Chief compliance officer** | An individual responsible for developing and monitoring compliance with all applicable laws, rules, and regulations by a Hedge Fund Manager and the Hedge Funds it manages.

**Collateral** | An asset that is pledged as security, or whose title is transferred to a secured party, in order to secure payment or performance obligations. If the party providing collateral defaults, the asset pledged or transferred may be taken and sold by the secured party to satisfy obligations of the pledgee/transferee. Instruments that are typically accepted as collateral under collateral agreements include government securities, cash and, to a lesser extent, corporate debt, agency debt, equities, and letters of credit. Collateral generally serves to mitigate counterparty credit risk (see **credit risk**).

**Collateral agreement** | An agreement between two parties governing the delivery and use of collateral. Key provisions of such agreements are: collateral delivery and return requirements; the rights of the secured party in the collateral; the level of unsecured credit risk that each party is willing to assume (*i.e.*, mark-to-market exposure thresholds above which the transfer of collateral is required); the type of instruments that can be posted as collateral; minimum transfer amounts; haircut provisions; among others.

**Collateral call** | A notice given by a secured party to the provider of collateral informing the latter that the change in the market value of a position has required the posting of collateral.

**Collateral event** | An event that triggers an increase in the amount of collateral related to a transaction or group of transactions under a collateral agreement or master agreement (for example, rather than causing a termination of all transactions that are subject to a master agreement).

**Commodity** | Generally, an article of commerce or a product that can be used for commerce. In the United States, the term is often narrowly used to refer to products underlying futures contracts traded on regulated futures

exchanges. The types of commodities that underlie such contracts include both physical and financial commodities such as agricultural and energy products, metals, foreign currencies, and interest rate and equity instruments (see **futures**). Commodities are also traded in the forward and cash markets.

**Concentration** | Arises when a significant percentage of a Hedge Fund's portfolio is exposed to the same or similar market factors or other risk factors, increasing the risk of losses caused by adverse market or economic events affecting such risk factors. Hedge Fund Managers may track concentration levels with respect to asset classes, industry sectors, regions, or other relevant areas.

**Confirmation** | Generally refers to the written statement that follows any trade in the securities markets. Confirmation is issued immediately after a trade is executed. It spells out settlement date, terms, commission, *etc.*

**Correlation** | A standardized measure of the relative movement between two variables, such as the prices of two different securities. The level of correlation between two variables is measured on a scale of  $-1$  to  $+1$ . If two variables move up or down together, they are positively correlated. If they tend to move in opposite directions, they are negatively correlated.

**Counterparty** | A third party that enters into transactions with a Hedge Fund.

**Counterparty Risk Management Policy Group II** | A group of senior officials from major financial institutions and chaired by E. Gerald Corrigan, Managing Director of Goldman Sachs, seeking to examine efficiency in the private sector and stability of the global financial system.

**Credit provider** | A bank, securities firm, or other third party that extends credit to a Hedge Fund, either in connection with financing a Hedge Fund's purchases of securities or other instruments or through stand-alone loan facilities. A counterparty may be viewed as a credit provider when it engages in synthetic financing OTC derivative transactions with a Hedge Fund.

**Credit risk** | The risk that an issuer of a security (asset credit risk) or a counterparty (counterparty credit risk) will not meet its obligations when due. Asset credit risk also includes sovereign risk where the potential loss is related to the financial solvency of a sovereign issuer of a security.

## Glossary

Counterparty credit risk is frequently broken down into component risks for monitoring purposes (see, *e.g.*, **settlement risk** and **pre-settlement risk**).

**Credit spread** | The difference between the yield (or percentage rate of return) of a Treasury security and a non-Treasury debt security (*e.g.*, a corporate bond) that are identical in most respects (particularly the term of the obligation), except with respect to credit rating.

**Derivative** | This refers to a financial instrument in which the value depends on, or is derived from, the value of an underlying asset, index, rate, or instrument.

**Equity** | In the context of investing, a synonym for stocks or shares of companies. When used in connection with accounting, equity refers to the amount by which the assets of an entity exceed its liabilities. With respect to Hedge Funds, equity refers to capital investment.

**ERISA** | The United States Employee Retirement Income Security Act of 1974, as amended.

**Fair value** | Generally refers to the price at which a single unit of an instrument would trade between disinterested parties in an arm's-length transaction. Fair value does not generally take into account control premiums (the price difference between the market price per share of an individual security and the price per share of a block of securities that carries the power to control a corporation) or discounts for large or illiquid positions (see **liquidity**).

**FAS 157** | Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*, issued under U.S. GAAP.

**Financial statement-based leverage** | See **leverage measures**.

**Form ADV** | The SEC's uniform application for investment adviser registration.

**FSA** | The United Kingdom's Financial Services Authority.

**FSCP or Financial Statement Close Process** | The process whereby the results of various transactions are summarized, reviewed, consolidated, edited, and used for reporting to investors and management.

**FSF** | The Financial Stability Forum is a body convened in April 1999 to promote international financial stability through information exchange and international cooperation in financial supervision and surveillance. The FSF brings together on a regular basis national authorities responsible for financial stability in significant international financial centers, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts. The FSF seeks to coordinate the efforts of these various bodies in order to promote international financial stability, improve the functioning of markets, and reduce systemic risk. The FSF issued a report in May 2007 reassessing the financial stability issues and systemic risks posed by hedge funds. The report recognizes the contribution hedge funds have made to financial innovation and market liquidity. At the same time, it notes heightened risk measurement, valuation, and operational challenges for market participants and makes various recommendations.

*FSF Report* | The *Update of the FSF Report on Highly Leveraged Institutions* published in May 2007 by the FSF.

**Fund Administrator** | Refers to a third-party service provider offering certain back and front office administrative services to a Hedge Fund and/or Hedge Fund Manager. Such services may include maintaining the principal corporate records, communicating with a Hedge Fund's investors and sending financial statements to its investors, providing registrar and transfer agent services in connection with the issuance, transfer, and redemption of interests in a Hedge Fund, processing subscription and redemptions, calculation of NAV, and providing other clerical services in connection with the day-to-day administration of the Fund.

**Funding liquidity** | See **liquidity** and **liquidity risk**.

**Gamma** | Refers to the rate of change in an option's delta for a one-unit change in the price of the underlying asset. As a measure of a measure, it is considered a secondary derivative of the underlying asset's price.

**Gate** | Refers to a restriction on withdrawals or redemptions from a Hedge Fund whereby the Hedge Fund limits redemptions to a pro rata portion of requested redemptions up to a pre-determined percentage of capital for a specific redemption period.

## Glossary

**Governing body** | Refers to a person or group of persons, acting through a management committee, board of directors, or other body, or directly as officers or members of the Hedge Fund Manager, with the authority and responsibility to direct and oversee the Hedge Fund Manager's activities.

**Governing documents** | Refers to the organizational and constituent documents of the Hedge Fund Manager entity.

**Gross balance sheet assets** | See **leverage measures**.

**Group of Seven** | A group comprised of Finance Ministers and Central Bank Governors of Canada, France, Germany, Italy, Japan, the United States, and the United Kingdom for the purpose of monitoring fiscal and monetary policies.

**Group of Eight** | An international forum for the governments of Canada, France, Germany, Italy, Japan, Russia, the United Kingdom, and the United States. Together, these countries represent about 65% of the world economy. The group's activities include year-round conferences and policy research, culminating with an annual summit meeting attended by the heads of government of the member states.

**Haircuts** | The difference between the market value of an asset posted as collateral and the value attributed to the asset by a secured party in determining whether the collateral requirements related to the asset have been met. A haircut is intended to protect a party that receives collateral from fluctuations in the value of such collateral.

**Hedge Fund** | A pooled investment vehicle that generally meets the following criteria: (1) it is not marketed to the general public (*i.e.*, it is privately-offered); (2) it is limited to high net worth individuals and institutions; (3) it is not registered as an investment company under relevant laws (*e.g.*, U.S. Investment Company Act of 1940); (4) its assets are managed by a professional investment management firm that shares in the gains of the investment vehicle based on investment performance of the vehicle; and (5) it has periodic but restricted or limited investor redemption rights.

**Hedge Fund Manager** | A professional investment management firm that serves as investment manager for a Hedge Fund and manages the Hedge Fund's assets and investments.



**Holding period** | The period over which Value-at-Risk is calculated (*e.g.*, one day, three days, one week, 10 days). The holding period should reflect the amount of time it would take to liquidate or neutralize the positions in the relevant portfolio.

**IAS** | International Accounting Standards.

**Illiquid instrument** | See **liquidity**.

**Interest rate term structure** | The relationship among interest rates of fixed income instruments with different maturities usually depicted as a graph, also referred to as a “yield curve”.

**IT** | Information technology.

**Key person** | An individual, principal, or member of a Hedge Fund’s personnel that is critical to the operations and performance of the Hedge Fund Manager.

**Legal risk** | The risk of loss arising from uncertainty in laws, regulations, or legal actions that may affect transactions between parties. Legal risk may include issues related to the enforceability of netting agreements, the perfection of collateral, the capacity of parties, and the legality of contracts, among others.

**Leverage** | A factor (rather than an independent source of risk) that influences the rapidity with which changes in market risk, credit risk, or liquidity risk change the value of a portfolio.

**Leverage measures** | Generally, Hedge Funds use two types of leverage measures. Financial statement-based leverage measures compare the nominal sizes of Hedge Fund balance sheet positions to a Hedge Fund’s equity. Risk-based leverage measures assess the relationship between the risk of a Hedge Fund’s portfolio and its capacity to absorb the impact of that risk.

**Liquidity** | There are two separate, but related types of liquidity. Funding liquidity is the ability of a Hedge Fund to hold its market positions and meet the cash and/or collateral demands of counterparties, other credit providers, and investors (see **collateral call** and **redemption**). Asset liquidity refers to the ability to liquidate an asset quickly, and in large volume,

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without substantially affecting the asset's price. An asset that cannot be liquidated in a short period of time without substantially affecting the asset's price is considered an illiquid instrument.

**Liquidity risk** | With respect to asset liquidity, the inability to sell an asset quickly and/or in large volume at a reasonable price. With respect to funding liquidity, the risk that a party will not have or cannot obtain sufficient funds to meet its obligations.

**Long positions** | Generally, this term means that an investor has purchased a stock with the expectation that its price will rise. A long position is sometimes referred to as being “long the market”. Investors who are “bullish” about the market will take a long position, expecting higher prices in the future. The vast majority of investors take a long position in the market when they invest and investors who purchase for the long-term almost always take a long position. Investors who subscribe to the theory of “buying low and selling high” will take a long position. The opposite of a long position is a short position. Investors who short the market sell stock (as opposed to buying stock) in the expectation of lower prices in the future.

**Margin** | A certain amount of assets that must be deposited in a margin account in order to secure a portion of a party's obligations under a contract (see **margin account**). For example, to buy or sell an exchange-traded futures contract, a party must post a specified amount which is determined by the exchange, referred to as an “initial margin”. In addition, a party will be required to post “variation margin” if the futures contracts change in value. Margin is also required in connection with the purchase and sale of securities where the full purchase price is not paid upfront or the securities sold are not owned by the seller.

**Margin accounts** | The account in which margin is held for securities or exchange-traded futures or options. Positions that are subject to margin requirements are generally valued, or “marked-to-market”, daily, and additional margin may be required if the market value of a position declines.

**Market factors** | Refers collectively to interest rates, foreign exchange rates, equity prices, commodity prices, and indices constructed from these rates and prices, as well as their volatility and correlation.

**Market risk** | Narrowly defined, it is the risk of a decline in value of a Hedge Fund's portfolio resulting from changes in market factors. Since asset liquidity risk and the credit risk of an asset's issuer may also affect the value of instruments in a portfolio, Hedge Funds frequently manage all of these risks jointly as market risk.

**Master agreement** | An agreement, such as the *1992 ISDA Master Agreement* form published by the International Swaps and Derivatives Association, Inc., that sets forth the overarching terms and conditions governing all OTC transactions between two parties that are subject to such master agreement. A master agreement typically includes payment netting and closeout netting provisions (see **netting**).

**MFA** | Managed Funds Association.

**MiFID** | Markets in Financial Instruments Directive.

**Model** | A program or process that is designed to create a depiction of reality through graphs, pictures, or mathematical representations.

**NAV or net asset value** | The fair value of a Hedge Fund's assets minus the fair value of its liabilities. Under U.S. GAAP, NAV computations should include accrued interest, dividends, and other receivables of the Hedge Fund, as well as accrued expenses and other payables. NAV would generally not include special adjustments that may be made to valuations for risk monitoring purposes, such as adjustments for illiquidity concerns. NAV is the basis for determining the prices applicable to investor subscription and redemptions.

**Netting** | Netting involves aggregating payment amount, collateral or closeout valuation exposures on multiple transactions between the same two counterparties and reducing them down to a single net exposure amount by offsetting the positive exposures with the negative. Netting provisions are typically included in master agreements and collateral agreements between a Hedge Fund and its counterparty.

**Off-balance-sheet transaction** | A transaction entered into by a Hedge Fund that does not appear on its balance sheet. Until the adoption of Financial Accounting Standards Board's Statement 133, most derivatives had been treated as off-balance-sheet transactions.

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**Offering documents** | Refers to documents such as an offering memorandum, limited partnership or limited liability company agreement, subscription agreement, or similar contracts governing the relationship between a Hedge Fund and its investors.

**Operational risk** | The risk of loss due to system breakdowns, employee fraud or misconduct, errors in models or natural or man-made catastrophes, among other risks. It may also include the risk of loss due to the incomplete or incorrect documentation of trades. Operational risk may also be defined by what it does not include: market risk; credit risk; and liquidity risk.

**OTC or over-the-counter transaction** | A transaction between parties that is not executed on an organized exchange, but instead privately negotiated on a bilateral basis between the parties. Stocks of smaller companies, forward contracts on physical commodities and currencies, bank and securities loans, repurchase agreements, and derivatives are traded in OTC markets.

**Pooled investment vehicle** | An investment entity, such as a limited partnership, limited liability company, trust, corporation, or similar form of enterprise operated for the purpose of trading securities or other investment instruments, and that is exempt from registration under the U.S. Investment Company Act of 1940.

**Portfolio manager** | A person who invests and manages an amount of capital allocated to it by a Hedge Fund Manager on behalf of a Hedge Fund. Portfolio managers may be either employees of the Hedge Fund Manager itself or external managers who are actively managed by the Hedge Fund Manager or with whom the Hedge Fund Manager makes a passive investment.

**Pre-settlement risk** | A form of credit risk; refers to the risk that a counterparty will default on an OTC derivative contract prior to the contract's settlement at expiration.

**PWG** | President's Working Group on Financial Markets.

***PWG Agreement*** | *The Agreement among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital*, published on February 22, 2007.

**Prime broker** | A brokerage firm providing multiple services to a Hedge Fund that are beyond the scope of those offered by a traditional broker, such as clearing and settlement of securities transactions, financing, recordkeeping, custodial services, and research capabilities.

**Recommendations** | The recommendations set forth in *Sound Practices*.

**Redemption** | The redemption of shares or other interests in, or withdrawals of funds from, a Hedge Fund by an investor.

**Risk-based leverage measure** | See **leverage measures**.

**Scenario analysis** | Similar to a stress test, the practice of subjecting a model (*e.g.*, a Value-at-Risk model) to adjusted inputs in order to assess the impact of a specified scenario of market events on a Hedge Fund's portfolio. (See **stress test**, **Value-at-Risk**, and **model**). A scenario could be historical (*e.g.*, by reproducing the events of October 1987) or hypothetical (*e.g.*, by simulating an event that would stress the market factors to which the Hedge Fund is most exposed).

**SEC** | The United States Securities and Exchange Commission.

**Section 28(e)** | Section 28(e) of the Securities Exchange Act of 1934, as amended.

**Senior management** | Refers to members of a group of senior executives or other management body with the authority and responsibility to direct and oversee a Hedge Fund Manager's day-to-day activities on behalf of a Hedge Fund(s).

**Settlement risk** | The risk that a counterparty will fail to perform its obligations under a contract on the settlement date; a form of credit risk.

**Sharpe Ratio** | A measure that is widely used by investors to evaluate the performance of a portfolio or to compare the performance of different portfolios on a "risk-adjusted" basis. The numerator of the Sharpe Ratio is a measure of a portfolio's return during a given period, generally the return earned on the portfolio in excess of the risk-free rate of return over one year. The denominator of the ratio is a measure of the risk incurred in achiev-

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ing the return, usually measured as the standard deviation of the portfolio's daily return. The higher the Sharpe Ratio, the better the portfolio's return in risk-adjusted terms. While the Sharpe Ratio contains information similar to that contained in a VAR measure, the two measures have different purposes and different perspectives. VAR is a forward-looking measure that is strictly a risk measurement tool; the Sharpe Ratio is a retrospective measure that compares risk and return information for an elapsed period.

**Short sale** | Generally, means borrowing a security (or commodity futures contract) from a broker and selling it, with the understanding that it must later be bought back (hopefully at a lower price) and returned to the broker. Short selling is a technique used by investors who try to profit from the falling price of a stock.

**Side-by-side management** | The management by a Hedge Fund Manager managing both one or more Hedge Funds and managed accounts.

**Side letter** | Generally, refers to an agreement with an investor that varies the terms of a Hedge Fund's governing documents with respect to that investor.

**Side pocket** | Generally, refers to an investment in an illiquid or non-marketable instrument that is accounted for separately from the other assets of the Hedge Fund.

**Soft Dollar Arrangement** | An arrangement whereby a Hedge Fund Manager directs transactions to a broker, in exchange for which the broker provides, in addition to transaction execution, other products and services to the Hedge Fund Manager.

**Sound Practices** | MFA's *Sound Practices for Hedge Fund Managers*.

**Spread** | The excess of the price or yield on a particular security or instrument relative to a benchmark. For example, the "spread over Treasury" is the difference between the yield for a certain fixed income instrument and the yield for a comparable U.S. Treasury security.

**Standard deviation** | Technically, a statistical measure of the dispersion of a set of numbers around a central point. Standard deviation measures the volatility, or uncertainty, of investment returns, and is therefore commonly used to measure the risk of a portfolio. The higher the standard deviation of a portfolio, the higher the uncertainty of the portfolio's return.

**Statute of Frauds** | A collective term describing the various statutory provisions that render unenforceable certain types of contracts unless they are evidenced by a written document.

**Stress test** | A general term for the practice of subjecting a model (*e.g.*, a Value-at-Risk model) to inputs that are adjusted to represent extreme or unusual changes in market factors. The sources of stress may be actual historical changes in market factors or hypothetical changes.

**Systemic risk** | The risk that the failure of a significant market participant in a payment or settlement system to meet its obligations when due will cause other participants or financial institutions to be unable to meet their obligations. Such a failure could potentially cause significant market liquidity or credit problems and threaten the stability of financial markets.

**Third-party service provider** | A firm that provides certain administrative, technical, financial, or other services to a Hedge Fund Manager that chooses to outsource parts of its operations.

**Trading P&L** | The fair value of the financial assets and liabilities in a Hedge Fund's portfolio.

**U.S. GAAP** | United States generally accepted accounting principles.

**Valuation** | The process of determining the value of positions in a Hedge Fund portfolio. Valuation serves two distinct purposes: it provides the base input for both the risk monitoring process and the calculation of a Hedge Fund's NAV, which serves as the basis for pricing investor subscriptions and redemptions.

**Value-at-Risk or VAR** | An integrated measure of the market risk of a portfolio of assets and/or liabilities. At the most general level, VAR is a measure of the potential change in value of a specified portfolio over a specified time interval or holding period, resulting from potential changes in market factors (*e.g.*, prices and volatilities). The VAR measure is based on the distribution of potential changes in the value of the portfolio and is expressed in terms of a confidence level. A Hedge Fund Manager's risk management team may choose to use VAR to estimate the maximum expected amount a Hedge Fund could lose over a specified time horizon at a specified probability level. For instance, the risk management team could calculate the maximum

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expected loss for a one-day period at a 95% probability level (*i.e.*, the level of loss that should be exceeded on only five trading days out of 100).

The challenge in calculating an accurate VAR is determining the distribution of potential value changes for market factors, which requires the risk management team to choose a methodology for modeling potential changes in market factors. Different methods are currently used to determine such distribution when calculating VAR (*e.g.*, Historical Simulation Method, Monte Carlo Simulation Method, Analytic Variance—Covariance Method).

**Vega** | One of the Greek factor sensitivities used by traders to measure exposures in derivatives portfolios.

**Volatility** | A measure of risk based on the standard deviation of an asset's return (see **standard deviation**). The greater the degree of an asset's volatility, the greater the risk of the asset.

**Worst historical drawdown** | The largest decrease in the value of a Hedge Fund measured as the difference between the highest and lowest value since its inception or during a given period of time (*e.g.*, last five years).



## Selected Sources Used

Readers of this document may wish to review the select sources listed below that are cited in *Sound Practices*.

- President's Working Group on Financial Markets' *Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital*, published in on February 22, 2007.
- Counterparty Risk Management Policy Group II 2005 Report, *Toward Greater Financial Stability: A Private Sector Perspective*.
- SEC's Regulation S-P, *Privacy of Consumer Financial Information*, promulgated under the Gramm-Leach-Bliley Act, as amended.
- U.S. GAAP's Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*.
- Investment Advisers Act of 1940, as amended.
- Commodity Exchange Act, as amended.
- Securities Act of 1933, as amended.
- Securities Exchange Act of 1934, as amended.
- USA PATRIOT Act of 2001, as amended.
- MFA's updated *Guidance for Hedge Funds and Hedge Fund Managers on Developing Anti-Money Laundering Programs (Release No. 2)*.
- *Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934*, as amended ([www.sec.gov/rules/interp/2006/34-54165.pdf](http://www.sec.gov/rules/interp/2006/34-54165.pdf)).
- *Consultation Papers on Best Execution* ([www.fsa.gov.uk/pubs/cp/cp154.pdf](http://www.fsa.gov.uk/pubs/cp/cp154.pdf)).
- *Bundled Brokerage and Soft Commission Arrangements* ([www.fsa.gov.uk/pubs/cp/cp176.pdf](http://www.fsa.gov.uk/pubs/cp/cp176.pdf)).
- Financial Services/Information Sharing Alert Center ([www.fsisac.com](http://www.fsisac.com)).
- National Futures Association ([www.nfa.futures.org](http://www.nfa.futures.org)).

## APPENDIX II

# Model Due Diligence Questionnaire for Hedge Fund Investors

This Model Due Diligence Questionnaire was prepared and published by Managed Funds Association (“MFA”) in consultation with Hedge Fund Members of MFA and outside groups representing Hedge Fund investors. This questionnaire was designed to identify the kinds of questions that a potential investor may wish to consider before investing in a Hedge Fund. In particular, we have tried to identify questions that may help amplify on or provide additional details to the disclosure in a Hedge Fund’s offering documents.

We believe that Hedge Funds are valuable to our capital markets and provide investors with valuable portfolio diversification and risk management. Our goal is to provide potential investors in Hedge Funds a questionnaire to be used as a reference in performing their due diligence before investing in a Hedge Fund.

MFA Members have diverse strategies, investment styles, risk tolerances and legal structures. Therefore, this questionnaire is designed to provide a basis for investors to commence their due diligence and is not designed to be an exhaustive list of questions that may be relevant to an investor. We encourage the use of this document as a resource in conducting due diligence in connection with an investment in a Hedge Fund, but also urge users to modify this document to address their particular needs and to address any additional matters that they consider material to an investment in a Hedge Fund. This document is also incorporated into MFA’s *Sound Practices for Hedge Fund Managers* (2007 Edition) as Appendix II.

Before responding to any question in this, or any other questionnaire, a Hedge Fund Manager must recognize and take into consideration applicable securities laws and its responsibilities under those laws. Therefore, an investor should bear in mind that a Hedge Fund Manager may modify, as it deems appropriate, in light of the Hedge Fund Manager’s business and legal or regulatory obligations, any question in this or any other questionnaire. In addition, a Hedge

## Model Due Diligence Questionnaire for Hedge Fund Investors

Fund Manager may choose not to respond to a particular question in light of confidentiality concerns. Any information provided in this questionnaire by a Hedge Fund Manager is current only as of the date this questionnaire is completed and the Hedge Fund Manager has no obligation to update or supplement any of the answers given, and assumes no responsibility for the accuracy of the answers provided after the date the questionnaire is completed.

### About MFA

MFA is the voice of the global alternative investment industry. Its Members include professionals in hedge funds, funds of funds, and managed futures funds. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA Members represent the vast majority of the largest Hedge Fund groups in the world who manage a substantial portion of the almost \$2.0 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

For more information, please contact Managed Funds Association's government relations team at 202.367.1140 or visit our Web site at [www.managedfunds.org](http://www.managedfunds.org).

*This document is for informational purposes only and is not and should not be construed as an offer to sell or a solicitation of an offer to buy any interest in any entity or investment vehicle. Any offer to sell or solicitation of an offer to buy will only be made pursuant to a confidential private offering memorandum of the applicable investment vehicle ("Memorandum"). The information in this document is qualified in its entirety and limited by reference to such Memorandum, and in the event of any inconsistency between this document and such Memorandum, the Memorandum shall control. This document is not a complete description of the businesses engaged in by the Hedge Fund Manager and/or any of its affiliates or clients. Accordingly, this document does not contain all material information that may be useful to your evaluation and contains generalizations and categorizations in light of the format of these questions.*

# I. Investment Manager Overview

## A. General Information:

1. Firm Name:
2. Firm Headquarters:
3. Placement Agent, if any:
4. Placement Agent Address:
5. Contact Name:
6. Contact Telephone Number:
7. Contact Fax:
8. Contact Email:

## B. Firm Description

Please provide a brief description of the firm.

## C. Investment Manager Entities and Organizational Structure

Please describe the relevant entities of the investment manager or adviser and their ownership structure. Have there been any material changes to the entities themselves (*e.g.*, additions or deletions) or to the ownership structure of those entities in the past three years?

## D. Personnel

1. Please briefly describe the background of the firm's key investment personnel.
2. For the firm's key investment personnel that have left the firm over the past three years, please explain any non-routine reasons for the departures.
3. Please describe the firm's supervisory structures (*e.g.*, management committees).

## Model Due Diligence Questionnaire for Hedge Fund Investors

4. How many employees does the firm have supporting investment management businesses in total? How many by function? If the firm or its affiliates maintain multiple offices, how are these employees distributed geographically?

### E. Service Providers

#### 1. Auditor

- a. Who audits the investment vehicles managed by the firm?
  - b. Does the auditor have an affiliation or any business relationship with the firm or any of its affiliates outside of the audit relationship itself? Has the firm or any of its affiliates retained the auditor or any of its affiliates for other engagements, such as consulting services, financial statement preparation, or tax services? If so, please describe.
  - c. Has the current auditor audited the firm's investment vehicles in each of the last three years? If not, please describe the circumstances of any audit engagement changes made.
  - d. Has any investment vehicle managed by the firm ever received a qualified audit opinion? If so, please describe.
  - e. Has an auditor ever requested a material restatement of financial statements or performance results of any investment vehicle managed by the firm? If so, please describe.
2. Has the firm engaged any third-party marketing agent? If so, please describe the terms of this engagement.
  3. Who serves as legal counsel for the firm?
  4. Does the firm outsource any accounting or operational functions to third parties? If so, please describe. Does the firm periodically review the performance of any such service providers? How is this review conducted?

## F. Compliance System and Registrations with Regulatory Authorities

1. Please describe the firm's compliance regime. Does the firm have a designated Chief Compliance Officer (CCO)? If so, please briefly describe the background of the CCO, and explain whether the CCO has any responsibilities other than those relating to compliance matters.
2. Is the firm or any of its affiliates registered with any regulatory authorities? If so, please describe. If the firm has not registered with the U.S. Securities and Exchange Commission as an investment adviser, please explain the exemption upon which the firm currently relies and if it intends to register in the next 12 months.
3. Does the firm maintain and periodically review written compliance policies and procedures, including a code of ethics? If not, please explain.
4. Does the firm have a written policy on the handling and safeguarding of any material, non-public information in its possession, including a process to educate employees? If not, how is material, non-public information protected, and how are these processes communicated to employees?
5. Does the firm have written policies regarding personal account trading by employees? If so, please describe. If not, is personal account trading monitored, and how are standards of conduct communicated to employees?
6. Does the firm maintain written procedures on the provision and receipt of gifts and entertainment? If not, how is such activity monitored, and how are standards of conduct communicated to employees?
7. Does the firm maintain written Anti-Money Laundering ("AML") procedures? Is there a designated AML compliance officer? If not, how are AML checks conducted?
8. Please describe any material soft dollar arrangements the firm currently maintains.
9. Please describe any material directed brokerage arrangements the firm currently maintains.

## Model Due Diligence Questionnaire for Hedge Fund Investors

### G. Legal Proceedings

1. In the past five years: (a) have there been any criminal or administrative proceedings or investigations against the firm, a principal or key employee of the firm, or any affiliate of the firm; or (b) have there been any civil proceedings against the firm, a principal or key employee of the firm, or any affiliate of the firm in each case that resulted in an adverse disposition? If so, please describe.
2. Is the firm currently aware of any pending criminal or administrative proceedings against the firm, a principal or key employee of the firm, or any affiliate of the firm?
3. Have any adverse dispositions materially impacted any of the funds or accounts managed by the firm?

### H. Infrastructure and Controls

1. Please describe the firm's current trading, portfolio management, and post-trade reconciliation and accounting infrastructure, identifying any significant deployments of third-party software.
2. Please describe how trades are generally executed. What types of controls are typically used to help prevent unwanted executions from occurring?
3. Please describe the typical trade reconciliation process and frequency. What segregations of duty are generally employed in the process?
4. Please describe how cash or other asset transfers can be authorized, both for transfers within a vehicle managed by the firm, as well as to external parties. What types of controls are generally used to prevent unwanted transfers from occurring?
5. Please describe how the firm handles trading errors.
6. Does the firm or its affiliates retain errors and omissions insurance?

## I. Business Continuity

Does the firm maintain a written BC/DR plan? If not, how does the firm plan to maximize its ability to recover from business interruptions?

## II. Overview of Activities of the Investment Manager

### A. Vehicles Managed

1. Please provide a description of the major investment vehicles managed by the investment manager.
2. What are the aggregate assets under management of the investment manager?
3. Does the firm manage separate accounts? If so, please describe.
4. Does the investment manager or any of its employees have an interest in any of the investment vehicles managed by the investment manager? If so, what is the amount of this interest in the aggregate?

### B. Other Businesses

Does the investment manager engage materially in other businesses apart from asset management? If so, please describe.

### C. Conflicts of Interest

1. Please describe those conflicts of interest that you consider material to the management of the investment vehicles. How do you address these conflicts?
2. Does the firm engage in cross-trades or principal cross-trades with or among the accounts and/or investment vehicles it manages? If so, what controls are generally in place to protect the participating investment vehicles or accounts?



## Model Due Diligence Questionnaire for Hedge Fund Investors

3. Does the firm have any affiliates or subsidiaries that are broker-dealers or execution agents? If yes, do these broker-dealers or execution agents:
  - (a) execute on behalf of investment vehicles managed by the firm; and
  - (b) charge commissions or mark-ups on these executions or otherwise bill expenses to investment vehicles managed by the firm in instances in which the investment vehicle is not the sole owner of the execution agent or broker-dealer? If so, please describe these arrangements.

### III. Fund Information

#### A. Fund Overview and Investment Approach

1. Please describe the fund's legal structure.
2. Please provide a brief description of the investment strategies generally deployed by the fund.
3. What types of financial instruments does the fund generally trade?
4. In which geographical markets does the fund generally trade?
5. Approximately how many positions does the fund generally hold? What is the typical maximum position size?
6. Please describe the portfolio turnover.

#### B. Fund Capital and Investor Base

1. What is the capital base of the fund?
2. How many investors are currently invested in the fund?
3. If the fund maintains a master-feeder structure with both U.S and non-U.S. feeder entities, what percentage of the capital base is invested in the U.S. fund? The non-U.S. feeder fund?

## C. Fund Terms

1. Are there multiple classes of interests or multiple feeder entities in the fund?
2. Please list, for each class of interest or feeder:
  - a. Investment minimum;
  - b. Management fee;
  - c. Performance fee, including hurdle rates, high-water marks, and loss carryforwards, if any; and
  - d. Redemption terms, including any fees payable, lock-ups, gating provisions, or other restrictions.
3. Can the investment manager suspend redemptions, suspend the payment of redemption proceeds, pay redemption proceeds in-kind, or otherwise elect to deviate from the redemption terms described in 2(d) above? If so, please describe.
4. Have gates been imposed in the past? If so, under what circumstances were the gates imposed? If gates have been imposed in the past, have those gates been lifted? If so, under what circumstances were the gates lifted?
5. Does the firm generally charge additional expenses to the fund, including operating expenses, audit fees, administrative fees, fund organizational expenses, legal fees, sales fees, salaries, rent, or other charges not detailed in (2) above? If so, please describe. What was the total amount of these expenses in each of the last three calendar years as a percentage of total fund assets under management, if applicable?
6. What is the firm's policy with regard to side letters? Do any investors in the fund experience fee or redemption terms that differ materially from those listed above? If so, please describe.

## Model Due Diligence Questionnaire for Hedge Fund Investors

### D. Performance History

Please provide a performance history for the fund.

### E. Risk Management

1. Please describe the firm's risk management philosophy and discuss the approach used by the firm in the management of the fund's exposure to: equity, interest-rate, currency, and credit market risk (as applicable); financing and counterparty risk; and operational risk.
2. Does the firm rely on third parties to perform any portion of its risk management function?
3. What types of risk measures does the firm use in its risk management function?

### F. Valuation

1. Please describe the process of valuation of the fund's positions, including valuation process for positions that do not have a market price. Please discuss in particular the frequency of valuation and whether any third-party services are employed in the valuation process (and, if so, how these third parties are monitored).
2. Has the fund had a material restatement of its financial statements or any prior results since inception? If so, please describe. Was the restatement the result of an audit by an external auditing firm?

### G. Fund Service Providers

1. If the fund employs an administrator, please provide its contact information.
2. Please provide information concerning legal counsel used by the fund, if any.
3. Please name the main prime brokers used by the fund.

### H. Investor Communications

What types of investor communication does the fund currently provide, and with what frequency?

*Unless otherwise indicated, the information below is as of [recent date].*

## Supplemental Information on Risk Monitoring Practices for Hedge Fund Managers

The objective of this appendix is to elaborate upon the supplemental discussion of risk management practices contained in Section 4—Risk Management. This appendix describes the general array of risk management techniques and methodologies currently available, in addition to addressing the specific techniques and methodologies that should be considered as part of sound risk monitoring practices for Hedge Fund Managers. The latter discussion includes further explanations of valuation, liquidity, and leverage from the perspective of Hedge Fund Managers.

This appendix begins by providing an overview of the risks faced by a Hedge Fund Manager in Section 1—Management, Trading, and Information Technology Controls.<sup>1</sup> The descriptions of the practices for monitoring market risk (Section 2—Responsibilities to Investors), funding liquidity risk (Section 3—Determination of Net Asset Value), and leverage (Section 4—Risk Management) form the core of this appendix and address the following key issues:

- **Risk monitoring techniques.** This appendix will discuss generally certain techniques that are often
- **The importance of analyzing funding liquidity risk.** While the measures for monitoring funding liquidity described in this appendix are used in other industries, Hedge Fund Managers should focus significant attention on funding liquidity given the impact it can have on the viability of a Hedge Fund; and
- **Leverage in the context of Hedge Funds.** While leverage is not unique to Hedge Funds, the

used in financial markets for monitoring market risk—VAR, scenario analyses and stress tests, and back-testing;

<sup>1</sup> *Valuation policies and practices are discussed in Sound Practices in Section 3—Determination of Net Asset Value. While not explicitly part of the risk management team, proper valuation practices are crucial to effective risk monitoring.*

## Supplemental Information on Risk Monitoring Practices for Hedge Fund Managers

market risk inherent in a Hedge Fund, coupled with the constraints imposed by funding liquidity, make the amplifying effect of leverage of particular concern to a Hedge Fund Manager.

This appendix describes a group of static leverage measures, both financial statement-based and risk-based leverage measures. Also described in this appendix are dynamic leverage measures that can provide additional information to the Hedge Fund Manager.

This appendix concludes with a description of practices for monitoring counterparty credit risk (Section 5—Regulatory Controls). Because Hedge Funds generally deal with counterparties having high credit quality, the credit risk of counterparties may be of less concern to Hedge Fund Managers than the other sources of risk, but should nonetheless be appropriately monitored.

### I. Overview: The Risks Faced by a Hedge Fund Manager

Effective risk management requires that the Hedge Fund Manager recognize and understand the source of the returns the Hedge Fund is earning (i.e., the risks to which the Hedge Fund is exposed). Consequently, one of the primary responsibilities of the Hedge Fund Manager's risk management team is to identify and quantify the sources of risk.

While observers often distinguish four broad types of risk—market risk, credit risk, liquidity risk, and operational risk<sup>2</sup>—it is important to recognize that these risks are inter-related. Indeed, Hedge Fund Man-

agers should recognize that “market risk” incorporates elements of credit risk and liquidity risk. Defined most narrowly, market risk focuses on the impact of changes in the prices of (or rates for) securities and deriva-

<sup>2</sup> “Sovereign risk” may be viewed either as “credit risk”, if the potential loss is related to the financial solvency of the sovereign, or as “market risk”, if the potential loss is related to policy decisions made by the sovereign that changes the market value of positions (e.g., currency controls). “Legal risk”, other than those covered by the preceding discussion of “sovereign risk”, would be included as “operational risk”.

tives, the volatilities of those prices, and the correlations between pairs of prices on the value of the portfolio. However, elements of liquidity risk and credit risk have a similar focus. For example:

- Changes in liquidity impact on the value of a security or derivative. This element of liquidity risk is sometimes referred to as asset or “market” liquidity risk; and
- Changes in the creditworthiness of an entity impact on the value of a security or derivative issued by or indexed to that entity.

Because these three risks all focus explicitly on changes in the value of an asset or the portfolio, Hedge Fund Managers should integrate the monitoring and management of them (*i.e.*, view them as a group, rather than individually). Hence, in Section 2 of this appendix, “market risk” will encompass the credit risk associated with assets held in the portfolio and asset (or market) liquidity risk, as well as the more commonly cited market risk factors: interest rate risk; foreign exchange rate risk; equity price risk; and commodity price risk.

In addition to having an impact on the value of securities or derivatives held by the Hedge Fund, changes in funding liquidity can impact the

Hedge Fund Managers’ ability to finance its positions. Section 3 of this appendix will indicate why this risk is of greater concern to Hedge Fund Managers than to other entities and will describe the techniques that should be used by Hedge Fund Managers to monitor funding liquidity risk.

The Hedge Fund Manager should also consider “leverage”. However, leverage is not an independent source of risk; rather, it is a factor that influences the rapidity with which changes in market risk, credit risk, or liquidity risk factors change the value of the portfolio. Indeed, it is essential to consider what leverage means—or does not mean—in the context of a Hedge Fund:

- **A single leverage number may not contain very much information.** As will be illustrated in this appendix, a risk-reducing transaction can increase some leverage measures while decreasing others;
- **The liquidity or price volatility of the position being leveraged is relevant to assessing effective leverage.** The leverage employed by a Hedge Fund that holds one-year Treasury bills with ten-to-one leverage may be of less concern than that employed by a Hedge Fund levered two-to-one with respect to the S&P 500 Index;

## The Risks Faced by a Hedge Fund Manager

- **A Hedge Fund’s capacity to absorb losses—its “funding liquidity”—is relevant to assessing its effective leverage.** Leverage should be measured relative to a Hedge Fund’s capacity to absorb losses. A Hedge Fund that has a relatively high level of financial statement-based leverage may pose a smaller risk than a less levered Hedge Fund with low cash positions, limited borrowing capacity, or Hedge Fund investors that can withdraw their funds on short notice; and
- **Other factors may also be relevant to the assessment of Hedge Fund’s effective leverage.** These may include such considerations as the level of position concentration in the Hedge Fund portfolio, overall market volatility and correlation conditions, and other “situation-specific” considerations.

### Stylized Portfolios

In Sections 2, 3, and 4, of this appendix, a collection of stylized portfolios and balance sheets are used to illustrate and compare the measures of market risk, funding liquidity risk, and leverage that are also discussed in the Recommendations. As described below, these simple portfolios are composed of various combinations of three hypothetical securities (which are denoted as Asset 1, Asset 2, and Asset 3) and two derivative contracts. Two of the securities are lower risk assets, with annualized volatility of 30% and 25%, respectively. The third asset is a higher risk asset with annual volatility of 60%. The two derivatives are simple futures contracts on the two low risk securities; therefore, they have the same volatility as those securities.

Each portfolio is part of a simple balance sheet. It is assumed that \$100 of investor equity funds each strategy. To calculate all of the various risk measures, the stylized balance sheets also indicate a cash position, a futures margin position, and a liability account that reflects any financing transactions. The required futures margin is 10% in cash, which is not counted as liquidity. In addition, up to 50% of Asset 1, 2, or 3 can be borrowed, and 50% of the proceeds from a short sale are available to finance investments.

For each portfolio, various measures of market risk, liquidity, and leverage have been calculated. Note that not all the risk measures are relevant for every portfolio.

- Portfolios 1 and 2 illustrate positions with identical market risk but different investments to implement the strategy. Portfolio 1 is an un-leveraged investment in Asset 1, while Portfolio 2 uses the futures contract on Asset 1 to implement the same strategy.
- Portfolios 3 and 4 are leveraged versions of Portfolios 1 and 2. The use of balance sheet leverage (Portfolio 1) or additional derivatives contracts (Portfolio 2) has the effect of increasing the market risk of both portfolios.
- Like Portfolios 3 and 4, Portfolio 5 is more risky than Portfolios 1 and 2. Instead of employing traditional leverage, however, the additional risk arises because the manager switches from a lower-risk strategy (invests in Asset 1) to a higher-risk investment strategy (invests in Asset 3).
- Portfolios 6 and 7 use long and short investments to illustrate the effect of a type of hedging by being long in one asset and short in another that is positively correlated with the first. In Portfolio 6, the strategy is implemented in the cash market, while Portfolio 7 achieves identical market risk using a combination of cash and futures. As discussed later, these portfolios illustrate the complexity that can appear as the portfolio increases in size—although Portfolios 6 and 7 are generally less risky than Portfolios 3 and 4, there are conditions under which these can become significantly more risky.
- Portfolios 8 and 9 are used to illustrate the effect of matched book assets—either in the futures market or the cash market—on traditional leverage and liquidity measures. Portfolios 8 and 9 represent the same net positions as Portfolios 1 and 2; however, the positions are established by combining a short position in Asset 1 or futures on Asset 1 (*i.e.*, -20) with long positions in the same asset (*i.e.*, 100), rather than only long positions (*i.e.*, 80).



## The Risks Faced by a Hedge Fund Manager

Table 1: Stylized Portfolios

	Unlevered Cash versus Futures		Levered Cash versus Futures		Unlevered High Risk	Long/Short Strategy Cash versus Futures		Unlevered Strategy with Matched Book Assets	
	Cash Only	Futures Only	Levered Cash	Futures	High Risk Cash	Long/ Short Cash	Long/ Short Mixed	Hedged Cash	Hedged Futures
<i>Portfolio</i>	1	2	3	4	5	6	7	8	9
<b>Summary Balance Sheet</b>									
Capital	100	100	100	100	100	100	100	100	100
Borrowing (outright or repo)	0	0	30				30		
Investments									
Cash Market Transactions									
Asset 1	80		120			120	120	100	-20
Asset 2						-60			
Asset 3					80				
Derivatives Market Transactions									
Futures on Asset 1		80		120					100
Futures on Asset 2							-60		-20
Cash	20	92	10	88	20	10	4	10	88
Futures Margin	0	8	0	12	0	0	6	0	12

As noted above, for Hedge Fund Managers, changes in credit quality that affect the value of the portfolio through a change in the price of securities owned are incorporated into “market risk”. However, Hedge Fund Managers are also exposed to counterparty credit risk. Changes in the credit quality of counterparties can impose costs on the Hedge Fund either in the form of an increase in expected losses due to counterparty failure to perform or by forcing the Hedge Fund Manager to find alternative counterparties.

Operational risks faced by Hedge Fund Managers are much the same as those faced by other financial institutions—data entry errors, fraud, reconciliation errors, and system failures and errors in valuation or risk measurement models. The appropriate techniques and practices to deal with these risks are, likewise, the same techniques and practices used by other entities. As noted in the Recommendations, these include random spot checks, maintenance of a single, centralized data set, contingency plans for responding to failures in the Hedge Fund Manager’s systems, or for responding to the failure of a third-party service provider.

## II. Market Risk

Encompassing the credit risk associated with securities and derivatives in the portfolio and asset liquidity risk, as well as interest rate risk, foreign exchange rate risk, equity price risk, and commodity price risk.

A Hedge Fund Manager should employ a consistent framework for measuring the risk of loss for a portfolio (and relevant subcomponents of the portfolio). In order for the Hedge Fund Manager to manage the risks that the Hedge Fund faces, its risk management team needs to produce some useful measures and analyses of risk. While the choice of framework or model for measuring risk should be left to each Hedge Fund Manager, the Hedge Fund Manager should be aware of the structural limitations of the model selected and actively manage these limitations, including the impact of any model breakdown.

For example, measuring the degree to which the portfolio is diversified (*e.g.*, the percentages of the portfolio allocated to different asset classes or to different geographical regions) may be useful, but it is important for the Hedge Fund Manager to recognize and understand the correlations between positions. For complex portfolios, many summary measures of market risk do not reflect such correlations.

One model that is intended to provide a summary market risk measure that incorporates correlations between positions is VAR. VAR measures the maximum change in the value of the portfolio that would be expected at a specified confidence level over a specified holding period. For example, if the 95% confidence level one-day VAR for a portfolio is \$500,000, one would expect to gain or lose more than \$500,000 in only five of every 100 trading days on average. One of the roles of the risk management team is to identify the factors affecting the risk and return of the Hedge Fund's investments, both within individual portfolios and across the entire range of activities of the Hedge Fund Manager. Those factors should be incorporated into the risk monitoring process and, where appropriate, be included in the market risk model. Factors that are commonly incorporated in a market risk model include:

- Prices for equities and/or equity indices;
- Level and shape of the interest rate term structure in relevant currencies;

## Market Risk

- Foreign exchange rates;
- Commodity prices;
- Credit spreads;
- Nonlinearities (particularly for instruments with elements of optionality);
- Volatilities; and
- Correlation.

The risk management team may also consider incorporating “asset liquidity” (*i.e.*, the potential exposure to loss attributable to changes in the liquidity of the market in which the asset is traded) as an additional factor. Measures of asset liquidity that may be considered include:

- The number of days that would be required to liquidate and/or neutralize the position in question; and
- The value that would be lost if the asset in question were to be liquidated and/or neutralized completely within such period.

### Parameter Selection

In order to calculate a VAR measure, a number of parameters should be input; these parameters describe the positions in the portfolio and the underlying markets. In addition, users of VAR should select across three

methodologies that have become standard forms of VAR over the past several years:

- **Variance/Covariance.** Under this method, which is probably the most widely used VAR methodology, the program draws volatility (variance) and correlation (covariance) information from data histories, for each position in the portfolio, and calculates the volatility estimate under the assumption that the returns for the overall portfolio will assume a normal distribution. It is the least process intensive and perhaps the easiest of the VAR methodologies;
- **Historical Volatility.** Under this approach, the VAR portfolio actually is repriced each day over the data history, a daily trading P/L calculation is derived and ranked in ascending order. The risk estimate is then set at the level consistent with the confidence interval selected for the analysis. Historical volatility is very process intensive, but is considered by many to be the most effective form of VAR; and
- **Monte Carlo Simulation.** Under the Monte Carlo approach, the portfolio is repriced across large numbers of random observations that are consistent with the volatility history of the underlying

instruments. Like historical VAR, these observations are then ranked in ascending order, and the risk estimate is set at a level consistent with the applicable confidence interval. Historical Monte Carlo VAR is typically only used for very complex portfolios, featuring abundant nonlinearities.

Each method, if applied accurately and in a manner consistent with the risk and capital allocation policies of the Hedge Fund, can be an effective, if imperfect, means of estimating exposure.

In addition to the selection of VAR methodology, for a given portfolio, the parameters most likely to have a significant impact on the VAR value are the time horizon or holding period (the period of time that would be necessary for the portfolio to be liquidated or neutralized), the confidence level (the probability that the change in the value of the portfolio would exceed the VAR), and the variance-covariance data (which reflects the volatility of the individual market factors and the correlation between pairs of factors). These parameters are explained further below.

### **Time Horizon**

The time horizon or holding period used in the VAR calculation is intended to reflect the time period

necessary to liquidate (or neutralize) the positions in the portfolio. In practice, if the Hedge Fund has positions in thinly traded or illiquid instruments, it is difficult to determine the correct liquidation/neutralization period for the portfolio. Consequently, good practice is to use standard holding periods (*e.g.*, one day, three days, five days, and 10 days in the base-case VAR calculation and then employ stress tests to determine the degree of holding period risk in the portfolio).

### **Confidence Level**

There is no mathematical formula that defines the appropriate confidence level; the appropriate confidence level is determined by the business circumstances of the entity. Different types of businesses should and do use different confidence levels. The appropriate confidence level for a specific Hedge Fund will be a business decision that is determined by the specific circumstances of the Hedge Fund. Senior management of the Hedge Fund Manager should be actively involved in this determination.

### **Variance-Covariance Data<sup>3</sup>**

While the measure of the risk of individual market factors (*i.e.*, the variances of the market factors) is important, the question of the

<sup>3</sup> Parameter selection is only applicable for Variance/Covariance matrix.

## Market Risk

degree of correlation (*i.e.*, covariance) between pairs of market factors is critical, because correlation has such a large impact on the VAR calculation. A number of VAR models use historic correlations. However, since historic correlations are unstable (especially during periods of market stress), the Hedge Fund Manager should employ scenario analyses and stress testing (see below) to ascertain the impact of inaccurate correlation assumptions.

### Beyond a Single VAR Number

Hedge Fund Managers should recognize that a single VAR number is not sufficient to capture all risks faced by the Hedge Fund and that successful risk management requires the risk management team to analyze both the sensitivity of the VAR to alternative market conditions and the reliability of the VAR calculations.

### Scenario Analysis

By their nature, VAR calculations are based on “typical” market days. Periods of market stress or crisis—the very times of greatest concern—will not be well represented in the data for a typical period; so the resulting VAR number will underestimate the risks of severe markets.

To address this limitation, the Hedge Fund Manager should perform scenario analyses regularly, to assess the VAR for the current portfolio in periods of market stress.

In creating scenario analyses, a Hedge Fund Manager should use both historical stress periods (*e.g.*, October 19, 1987 when the equity markets “crashed”, the Asian financial crisis of 1997, and the stock market declines after March 2000 (bursting of the “dot-com” bubble)).

### Stress Testing

Hedge Fund Managers should stress test the VAR number by changing the parameters of the VAR model. Stress tests permit the Hedge Fund Manager to see what will happen to the VAR number if the actual values of market factors (*i.e.*, prices, rates, volatilities, *etc.*) differ from the values used as inputs in the base-case VAR calculation.

Among the potential changes in market conditions that should be considered in stress testing are:

- Changes in prices;
- Changes in interest rate term structures; and
- Changes in correlations between prices.

If the portfolio contains options or instruments with options characteristics, additional changes that should be considered as part of stress testing are:

- Changes in volatilities; and
- Changes in nonlinearities (e.g., convexity or gamma).

Hedge Fund Managers also should consider including the effects of changes in the liquidity of various assets in their stress testing. For example, Hedge Fund Managers could examine the effects of changing the holding period. A horizon of several days may reveal strings of losses (or gains) that, while individually consistent with the one-day predicted distributions, in total add up to a significant deviation from the market risk model's predicted distribution.

Rather than changing the holding period to reflect the illiquidity of securities or derivatives, the Hedge Fund Manager could gauge the impact of illiquidity by inputting changes for the appropriate market risk factors that are reflective of multiple-day market price movements (as opposed to single-day changes).

If specific asset liquidity factors are incorporated in the market risk model, these asset liquidity factors can be “stressed” to examine the impact of: (1) changes in the value that could be lost if the position in question were to be liquidated and/or neutralized completely during the standard holding period; or (2) changes in the number of days required to liquidate and/or neutralize the position in question.

Of particular concern to Hedge Fund Managers are “breakdowns” in the correlations reflected in current market data. In times of market crisis, the correlations between asset prices or rates can change dramatically and unexpectedly, with the result that positions that were thought to be diversifying—or even hedging—end up compounding risk. While it remains difficult to hedge correlation risk, stress tests to evaluate the impact of correlation changes permit the Hedge Fund Manager to help ensure that, when the Hedge Fund Manager selects the assets to be included in the portfolio, the Hedge Fund is accepting the desired level of correlation risk (and is being compensated for bearing that risk).

## Market Risk

### Illustrative Risk Measures

Table 2 contains several illustrative VAR measures for each of the nine stylized portfolios introduced earlier:

- Standard VAR – A 95% One-Day VAR is calculated using the historical volatilities for the assets and assuming the correlation between Assets is 0.3;
- Stressed VAR 1 – The 95% One-Day VAR is recalculated increasing the volatility of each asset by 50% (*i.e.*, to 45% for Asset 1, to 37.5% for Asset 2, and to 90% for Asset 3) and increasing the correlation between all assets to 0.9; and
- Stressed VAR 2 – The 95% One-Day VAR is recalculated again increasing the volatilities by 50% as above, but decreasing the correlation between assets to zero.

Table 2 provides confirmation of some general propositions regarding the VAR measures:

- Identical positions have the same VAR regardless of whether they are implemented in the cash market (*e.g.*, Portfolio 1) or the futures market (*e.g.*, Portfolio 2). Identical in this case refers to the fact that the cash and futures positions represent the price risk associated with the same asset and in the same amount as discussed below, other risk measures, such as liquidity, are not identical;
- VAR can be increased *via* traditional balance sheet leverage or the use of additional derivatives contracts. Portfolios 3 and 4 illustrate the effect of leverage on the first two portfolios;
- VAR can be increased by choosing higher risk assets, regardless of leverage, as illustrated in Portfolio 5; and
- A hedge is not always a hedge. The “hedge” established *via* Portfolios 6 and 7 presumes that Assets 1 and 2 are positively correlated. Under normal conditions (*i.e.*, when correlation equals 0.3 in this example) the tendency of Asset 1 and Asset 2 to move together results in the VAR of Portfolio 6 being similar to the VAR of Portfolio 3 even though the total position size is larger. When the correlation gets more positive (Stressed VAR 1), the hedge is better, and VAR stays

**Table 2: Markets of Market Risk**

	Unlevered Cash versus Futures		Levered Cash versus Futures		Unlevered High Risk	Long/Short Strategy Cash versus Futures		Unlevered Strategy with Matched Book Assets	
	Cash Only	Futures Only	Levered Cash	Futures	High Risk Cash	Long/Short Cash	Long/Short Mixed	Hedged Cash	Hedged Futures
<i>Portfolio</i>	1	2	3	4	5	6	7	8	9
<b>Summary Balance Sheet</b>									
Capital	100	100	100	100	100	100	100	100	100
Borrowing (outright or repo)	0	0	30				30		
Investments									
Cash Market Transactions									
Asset 1	80		120			120	120	100	-20
Asset 2						-60			
Asset 3					80				
Derivatives Market Transactions									
Futures on Asset 1		80		120					100
Futures on Asset 2							-60		-20
Cash	20	92	10	88	20	10	4	10	88
Futures Margin	0	8	0	12	0	0	6	0	12
<b>Risk Measures</b>									
Standard VAR (asset Correlation = 0.3)	2.50	2.50	3.76	3.76	5.01	3.61	3.61	2.50	2.50
Stressed VAR 1 (Vol+50%; Asset Correlation = .90)	3.76	3.76	5.64	5.64	7.51	3.67	3.67	3.76	3.76
Stressed VAR 2 (Vol+50%; Asset Correlation = 0)	3.76	3.76	5.64	5.64	7.51	6.10	6.10	3.76	3.76
Sharpe Ratio	1.05	1.05	1.05	1.05	1.32	0.69	0.69	1.05	1.05

relatively unchanged even though overall volatility in the market has increased by 50%. However, when the correlation gets less positive (Stressed VAR 2), the hedge is much less effective and the combined effect of higher volatility and lower correlation results in a significantly larger VAR. As was the case with the earlier portfolios, the use of futures or cash market investments does not change the market risk measure, as evidenced by the identical VAR of Portfolios 6 and 7.



## Market Risk

### Back-testing

Perhaps even more important than analyzing the sensitivity of the VAR number is “back-testing” the VAR to see how it performed. By comparing actual changes in the value of the portfolio to the changes generated by the VAR calculation, the Hedge Fund Manager can gain insight into whether the VAR model is accurately measuring a Hedge Fund’s risk.

In back-testing, one expects that the portfolio will lose more than the VAR from time to time. For example, a 95% one-day VAR should be exceeded five days in every 100 trading days on average. When the actual changes in the value of the portfolio exceed VAR, the Hedge Fund Manager should determine the source of the discrepancy (*i.e.*, whether the VAR measure is flawed or whether this loss is simply one which was expected given the confidence level employed). Other potential sources of deviations include:

- A change in the composition of the portfolio between calculation and observation;
- Pricing models under/overstated obtainable prices;
- A change in the underlying market, including changes in the volatility, correlation, or liquidity of the factors used in the market risk model; and

- Model(s) did not adequately capture sources of risk.

### Relating Earnings and Risk

It was noted at the outset that effective risk management requires the Hedge Fund Manager to recognize and understand the risks the Hedge Fund faces. That, in turn, requires the Hedge Fund Manager to understand the various sources of the Hedge Fund’s earnings, both the size of the earnings and their volatility.

One way that Hedge Fund Managers can accomplish this attribution is by decomposing the daily value changes by market factors. The objective is to determine if the actual changes were what would have been predicted, given the now known changes in the market factors. If the observed change in the value of the portfolio differs significantly from the change that would be expected, given the composition of the portfolio and the observed changes in the market factors, the differences should be reconciled.

Such a source-of-return and source-of-risk attribution process sets the stage for linking performance measurement with risk measurement. The Sharpe Ratio is widely used by

investors to measure a portfolio's risk-adjusted performance over a specific period.<sup>4</sup> The numerator of the Sharpe Ratio is a measure of portfolio return during the period; the denominator is a measure of the risk incurred in achieving the return. (For example, over the past decade the Sharpe Ratio for the S&P 500 has been approximately 1.2.) Investors prefer higher Sharpe Ratios, since a higher Sharpe Ratio indicates that the portfolio earned superior returns relative to the level of risk incurred.

There are a number of ways in which return and risk could be calculated. Below is the Sharpe Ratio for an arbitrary portfolio—designated as Portfolio<sub>j</sub>—calculated using the most common conventions for measuring return and risk. The numerator is the return earned on the portfolio ( $R_j$ ) in excess of the risk-free rate of return ( $R_f$ ) (*i.e.*, the interest rate earned on risk-free securities such as U.S. Treasury securities) over the same period. The denominator—the risk incurred—is measured as the standard deviation of the portfolio's daily return  $\sigma_j$ .

$$(\text{Sharpe Ratio})_j = \frac{R_j - R_f}{\sigma_j}$$

While VAR and the Sharpe Ratio contain some similar information, the two measures are different tools, designed for different purposes. VAR is primarily a risk measurement tool. The Sharpe Ratio is a summary measure, combining both risk and return information. Moreover, while VAR is a risk measure and the denominator of the Sharpe Ratio contains a risk measure, these two risk measures are quite different. The risk measure used in the denominator of the Sharpe Ratio is a historical measure; it characterizes the actual volatility of the return over some historical period. In contrast, VAR is intended to be a prospective measure of risk.

<sup>4</sup> *The Sharpe Ratio is attributed to William F. Sharpe, who described a measure of “return to variability” for use in comparing investment performance.*

### III. Funding Liquidity Risk

While other entities face funding liquidity risk, this risk is a more central concern to Hedge Fund Managers than others, because funding liquidity problems can rapidly increase a Hedge Fund's risk of failure. As is described in the following box, a lack of funding liquidity can contribute to a crisis situation for the Hedge Fund.

#### Liquidity Crisis Cycle

Hedge Fund Managers should be concerned about a confluence of risks (*i.e.*, market or credit risk events affecting illiquid positions that are leveraged). Such a confluence of events could require the Hedge Fund to liquidate positions into a market that cascades in price because of a high volume of liquidation orders. Such a situation could be decomposed into three stages:

1. A loss that acts as the triggering event.
2. A need to liquidate positions in a disorderly manner to raise cash because of this loss. The liquidation may be required either because the Hedge Fund should post margin with its counterparties or because of redemptions by investors due to the loss.
3. A further drop in the Hedge Fund's NAV as the market reacts to actions by the Hedge Fund. Obviously, attempts by the Hedge Fund to sell in too great a quantity or too quickly for the market liquidity to bear can cause a further drop in prices, precipitating a further decline in the Hedge Fund's NAV, and leading in turn to yet a further need to liquidate to satisfy margin calls or redemptions. This downward spiral can be exacerbated if other market participants have information about the Hedge Fund's positions.

The point of no return comes when the effect of liquidation has a greater impact on the value of the remaining Hedge Fund position than the amount of cash raised from the liquidation. If this happens, the Hedge Fund is caught in an accelerating, downward spiral, and eventually it will not be able to satisfy the demands of its creditors or investors. Once the losses move beyond a critical point, it becomes a self-sustaining crisis that feeds off of the need for liquidity, a need imposed by the demands of the Hedge Fund's creditors and investors.

Because of its importance, Hedge Fund Managers should focus significant attention and resources on measuring and managing funding liquidity risk. There exist a range of measures Hedge Fund Managers can use to track funding liquidity risk. Hedge Fund Managers should monitor the liquidity available in the Hedge Fund by tracking its cash position (*i.e.*, cash and short-term securities issued by high-credit-quality entities) and its borrowing capacity (*e.g.*, access to borrowings under margin rules or credit lines).

Beyond measures of available liquidity, Hedge Fund Managers should also monitor measures of relative liquidity. Hedge Fund Managers should relate the measures of liquidity (Cash or Cash + Borrowing capacity) to the need for that liquidity. The following measures are indicators of a Hedge Fund's potential need for liquidity:

- **Equity or NAV.** Generally, a larger Hedge Fund will require greater levels of liquidity. However, a Hedge Fund's need for liquidity during periods of market stress is determined not only by the size of the portfolio, but also by the characteristics of the assets it holds (in addition to a Hedge Fund's need to fund redemptions). Consequently, Hedge Fund Managers

need to have measures of potential liquidity that reflect the riskiness of the portfolio;

- **Worst Historical Drawdown.** This indicator provides a measure of risk and of the amount of liquidity the Hedge Fund has required in the past. This measure is, however, a backward-looking measure of risk and may not be indicative of the Hedge Fund's current exposure; and
- **VAR.** As aforementioned, VAR is currently the most widely used prospective measure of market risk. Consequently, tracking the ratio of Cash or Cash + Borrowing capacity to VAR provides the Hedge Fund Manager with an indication of whether the Hedge Fund's liquidity relative to its need for liquidity is rising or falling.

## Funding Liquidity Risk

### Illustrative Liquidity Measures

Table 3 on page 20 contains the results of calculating five of the liquidity measures discussed in this section for each of the nine stylized portfolios.

Available liquidity is measured by cash that is not committed as margin, and by cash plus the “borrowing capacity” of the assets. For the three cash market assets, it is assumed that 50% of the value of a long position can be borrowed (*i.e.*, assume current Regulation T margin requirements if the three assets were equities). For simplicity, short positions in the assets are assumed to have a 50% margin requirement, in effect, allowing 50% of short trades to be used to fund long positions, or for cash.

Several features of funding liquidity risk measurement are evidenced by the stylized portfolios.

- Other things being equal, futures (and derivatives in general) require the Hedge Fund Manager to use significantly less cash (at origination) than would an equivalent position established *via* a cash market transaction. This is evidenced by Portfolios 1 and 2. However, not reflected in these numbers is the interrelation of market risk, funding liquidity risk, and leveraging. While the cash position uses more cash at origination than does the futures position, if the value of the underlying asset were to change dramatically, the resulting margin call on the futures position could have a significant impact on the Hedge Fund’s cash position.
- For the same amount of initial capital, the use of leverage (*e.g.*, Portfolios 3 and 4) both consume borrowing capacity and increase VAR; so, measures of available liquidity and relative measures indicate that liquidity declines.
- Use of leverage in the cash market decreases available cash faster than the identical strategy implemented with futures. The increase in traditional balance sheet leverage (*i.e.*, use of margin to buy assets) in Portfolio 3 sharply reduces both absolute and relative measures of liquidity since either cash or borrowing capacity is consumed in the process. The identical economic leverage is obtained using futures in Portfolio 4, but the decrease in liquidity is less pronounced. The caveat about future cash requirements for futures positions that was raised in the first point applies here, as well.

- Use of a relative liquidity measure (*e.g.*,  $\text{VAR}/(\text{Cash} + \text{Borrowing capacity})$ ) captures the impact of investing in higher risk assets, while holding the amount invested constant. Portfolio 5 shows that while absolute liquidity is the same as for Portfolio 1, liquidity relative to VAR has decreased (*i.e.*, VAR is a higher percentage of available cash).
- Portfolios 6 and 7 illustrate once again that identical market risk portfolios present different funding liquidity risk profiles. Portfolio 7, which uses futures to short Asset 2 while borrowing against Asset 1, is less liquid than Portfolio 6 that shorts Asset 2 in the cash market. The difference is simply that short positions in futures (and derivatives in general) do not generate cash.

Additional insight about funding liquidity can be gained by looking at the variability in the relative liquidity measure over time. A relative liquidity measure that varies over time is evident and consistent with “effective liquidity” (*i.e.*, the assets are liquid and the manager is willing to take advantage of that liquidity).

Beyond simply monitoring liquidity, Hedge Fund Managers should manage liquidity in several dimensions. Foremost is the use of the Hedge Fund Manager’s experience and judgment to maintain liquidity levels that are adequate given the risk of loss and/or the likelihood of investor

redemptions. Also, Hedge Fund Managers should strengthen lines of communication with their credit providers, providing them with summary measures of the Hedge Fund’s risk and liquidity consistent with the nature of the relationship. Hedge Fund Managers should actively manage (or monitor) the cash in margin accounts. Similarly, Hedge Fund Managers should negotiate haircuts, the speed at which prime brokers can dictate an increase in margin rates, and bilateral collateral agreements, where appropriate, to further reduce the likelihood of running out of liquidity.

# Funding Liquidity Risk

Table 3: Measures of Liquidity

	Unlevered Cash versus Futures		Levered Cash versus Futures		Unlevered High Risk	Long/Short Strategy Cash versus Futures		Unlevered Strategy with Matched Book Assets	
	Cash Only	Futures Only	Levered Cash	Futures	High Risk Cash	Long/Short Cash	Long/Short Mixed	Hedged Cash	Hedged Futures
<i>Portfolio</i>	1	2	3	4	5	6	7	8	9
<b>Summary Balance Sheet</b>									
Capital	100	100	100	100	100	100	100	100	100
Borrowing (outright or repo)	0	0	30				30		
Investments									
Cash Market Transactions									
Asset 1	80		120			120	120	100	-20
Asset 2						-60			
Asset 3					80				
Derivatives Market Transactions									
Futures on Asset 1		80		120					100, -20
Futures on Asset 2							-60		
Cash	20	92	10	88	20	10	4	10	88
Futures Margin	0	8	0	12	0	0	6	0	12
<b>Standard VAR (asset Correlation = 0.3)</b>	2.50	2.50	3.76	3.76	5.01	3.61	3.61	2.50	2.50
<b>Liquidity Measures</b>									
Measures of Available Liquidity									
Cash	20	92	10	88	20	10	4	10	88
Cash + Borrowing Capacity	60	92	40	88	60	70	34	60	88
Relative Measures									
Cash/Equity	20%	92%	10%	88%	20%	10%	4%	10%	88%
(Cash + Borrowing Capacity)/Equity	60%	92%	40%	88%	60%	70%	34%	60%	88%
VAR/(Cash + Borrowing Capacity)	4.2%	2.7%	9.4%	4.3%	8.3%	9.0%	10.6%	4.2%	2.8%

## IV. Leverage

As the Recommendations made clear, leverage is neither a concept that can be uniquely defined, nor is it an independently useful measure of risk. Nevertheless, leverage is important to Hedge Fund Managers because of the impact it can have on the three major quantifiable sources of risk: market risk; credit risk; and liquidity risk.

Leverage is not a uniquely defined concept. For example, a variety of “leverage” measures are used in the areas of banking and finance. These measures, which are described in more detail below, may be financial statement-based (also referred to as “asset-based”), risk-based, or investor-based. The financial statement-based measures attempt to capture the traditional notion of leverage as “investing borrowed funds”. Using borrowed money (or its equivalent) enables an investor to increase the assets controlled for a given level of equity capital. Financial statement-based measures of leverage relate some measure of asset value to equity. Both returns and risk, relative to equity, are magnified through the use of traditional, financial statement-based leverage. The risk-based measures of leverage capture another aspect associated with leverage, namely, the risk of insolvency due to changes in the value of the portfolio. The risk-based measures relate a measure of a Hedge Fund’s market risk to its equity (or liquidity). Although useful in this capacity, as described below, risk-based lever-

age measures do not convey any information about the role borrowed money plays in the risk of insolvency. Investor-based leverage measures the extent to which dollars entering a hedge fund are themselves levered. No single measure captures all of the elements that market participants, regulators, or market observers attribute to the concept of leverage. Indeed, examples will be presented in which a risk-reducing transaction increases some leverage measures while decreasing others. This leads to the observation that leverage is not an independently useful concept, but should be evaluated in the context of the quantifiable exposures of market, credit, and liquidity.

While continuing to track and use financial statement-based measures of leverage, Hedge Fund Managers should focus their attention on measures of leverage that relate the riskiness of the portfolio to the capacity of the Hedge Fund to absorb that risk (*i.e.*, the measures should include elements of market risk (including the credit risk associated with assets in the portfolio)



## Leverage

and funding liquidity risk). Hedge Fund Managers should focus on such measures because traditional financial statement-based leverage by itself does not necessarily convey risk of insolvency. To say that one Hedge Fund is levered 2-to-1 while another is not levered does not necessarily mean that the levered Hedge Fund is more risky or more likely to encounter liquidity problems. If the levered Hedge Fund is invested in government securities while the Hedge Fund that is not levered is invested in equities, financial statement-based leverage would lead to erroneous conclusions about the risk of the two funds. In this sense, financial statement-based measures of leverage are arguably deficient since they convey the least information about the nature and risk of the assets in a portfolio.

Risk-based measures, see below, present a measure of market risk (usually VAR) relative to a measure of the resources available to absorb risk (cash or equity). However, in doing so, risk-based measures effectively condense several dimensions of risk into a single number. The result of this compression is that some of the detail is lost; the specific effect of leverage is intertwined with dimensions of market, credit, and liquidity risk. To illustrate, consider two funds with identical risk-based leverage. One Hedge Fund employs 2-to-1 accounting leverage while

investing in “low risk” strategies (*e.g.*, long/short strategies) using borrowed funds, while the other Hedge Fund uses no accounting leverage but employs “high risk” strategies (*e.g.*, macro-directional) and large cash reserves. One is “high risk” and “high cash” and the other is “low risk” and “low cash/high borrowing”, yet each achieves the same risk-based leverage. This comparison highlights the second reason why leverage measures are not independently useful—more comprehensive measures blend the effect of multiple risk dimensions. To assess the contribution of leverage requires additional information.

### Financial Statement-Based Leverage Measures

There exist a number of widely used and generally accepted financial statement-based measures of leverage. In addition to the pragmatic recognition that counterparties and credit providers routinely request these measures, a more compelling rationale for calculating these measures is that they can contribute to an understanding of leverage measures that incorporate risk. This is particularly true when accounting and risk-based leverage are tracked over time.

Certain accounting measures can also provide information regarding

how much direct or indirect credit in the form of repurchase agreements, short sales, or derivatives are employed by a Hedge Fund. However, it should be recognized that even these financial statement-based measures have serious weaknesses, discussed below, particularly as stand-alone measures of leverage.

The most widely used and generally accepted financial statement-based measures of leverage are those that relate items from a Hedge Fund's balance sheet.

- **“Gross Balance Sheet Assets to Equity: On-Balance-Sheet Assets/Equity.”** This straightforward measure is easily calculated from published financial statements; however, it fails to incorporate two important elements of a Hedge Fund's effective leverage:

- The risk-reducing effect of on-balance-sheet hedges is not recognized. Adding a hedge to the balance sheet increases assets and thereby increases this leverage measure, even though the transaction may substantially offset the risk of another asset; and
- The full notional amount of derivative instruments is not required to be recorded on the balance sheet. To the extent the full notional amount is not recorded, this measure may understate the Hedge Fund's true economic risk.

- **Net Balance Sheet Assets to Equity: (On-Balance-Sheet Assets-Matched Book Assets)/Equity.** While this measure requires more detailed information about the positions in a Hedge Fund's portfolio, it does provide a partial solution to the shortcomings of the Gross Balance Sheet Assets to equity measure by including off-sets and direct hedges as reflected in matched book assets. However, important elements of the Hedge Fund's effective leverage are still not incorporated:

- This measure does not reflect portfolio correlation or less direct hedges that fall outside the definition of matched book assets; and
- This measure does not incorporate off-balance-sheet instruments.

Other financial statement-based measures have been proposed to capture off-balance-sheet transactions (*e.g.*, forward contracts, swaps and other derivatives).

### Risk-Based Leverage Measures

Risk-based leverage measures reflect the relation between the riskiness of a Hedge Fund's portfolio and the capacity of the Hedge Fund to absorb the impact of that risk. While

## Leverage

not the only measure that could be used, the Hedge Fund's equity provides a useful measure of "capacity". There are, however, different measures of market risk that could be used as the risk measure:

- **Volatility in Value of Portfolio/Equity.** This is a measure of actual performance volatility over a given horizon relative to equity. While useful, it is subject to criticism. Since it is a retrospective measure, it is less useful if the composition of the portfolio changes or if future market conditions are not like historical conditions. Moreover, it does not isolate the effect of financing on the risk of the Hedge Fund since it includes financed assets;
- **VAR/Equity.** This measure gives a picture of the Hedge Fund's capacity to absorb "typical" market movements. The criticism of such a measure is that it does not reflect the risk of the Hedge Fund's portfolio in extreme markets; and
- **Scenario-Derived Market Risk Measure/Equity.** To assess the impact of extreme events, the leverage measure could be calculated using a market risk measure derived from analysis of extreme event scenarios (or stress tests). This measure gives senior management information about the Hedge Fund's ability to absorb extreme market events.

## Illustrative Leverage Measures

Table 4 contains the results of calculating all of the financial statement-based leverage measures and two of the risk-based leverage measures discussed in this section. Note that net balance sheet leverage and net accounting leverage are only relevant for Portfolios 8 and 9, because these portfolios are the only ones in which the long and short positions can be netted under accounting rules.

Leverage can be interpreted in several ways: as the use of borrowed money to fund larger asset positions than would otherwise be achievable; and as the use of economic leverage to increase effect of a given change in market prices on the value of a Hedge Fund's equity.

The illustrative portfolios demonstrate several common features of financial statement-based and risk-based leverage:

- The most common leverage measure, gross balance sheet leverage (or assets/equity) is not indicative of the types of assets employed or the amount of risk assumed. In the illustration, gross balance sheet leverage is the same in Portfolios 1, 2, 4, 5, and 9 even though the risk and investment strategy differ significantly across portfolios. Similarly, while the amount of risk assumed in Portfolio 8 is identical to the risk assumed in Portfolio 1, the levels of gross balance sheet leverage differ;
- The purpose of the net balance sheet leverage measure is to adjust for matched book assets. Comparison of net balance sheet leverage with gross balance sheet leverage for Portfolio 8 shows an instance where this occurs;
- Gross accounting leverage, which sums assets, liabilities, and futures is not informative about investment strategy (cash versus futures) or the market risk of the portfolio. Note that the riskiest portfolio as measured by VAR, Portfolio 5, has the lowest accounting leverage. Similarly, Portfolios 1 and 2 are low risk, yet gross accounting leverage varies by 80% between them;

*continued*

## Leverage

- Net accounting leverage adjustments for matched book assets and derivatives that hedge on-balance-sheet positions are seen by comparing gross accounting leverage with net accounting leverage for Portfolios 8 and 9. Note that this measure does not capture the use of a futures position to offset an identical futures position (*i.e.*, the matched futures in Portfolio 9). The risk-based leverage measures come closer to capturing the nature of the risks as reflected in the specific strategies. (Note Portfolios 1, 2, 8, and 9.) However, they too miss certain aspects of the risk picture. For example, Portfolios 3 and 4 have the same VAR/equity, but the cash market strategy employed in Portfolio 3 uses more cash and borrowing capacity, and is therefore riskier from a liquidity standpoint (VAR is 9.4% of liquidity in Portfolio 3 compared to only 4.3% of liquidity in Portfolio 4); and
- Stress and scenario analysis are essential elements of liquidity and leverage analyses. The long/short strategy employed in Portfolios 6 and 7 is similar in risk-based leverage to Portfolios 3 and 4 until one looks at the stress scenarios. Because of the reliance on correlation, the leverage of Portfolios 6 and 7 is potentially much larger in a period of market stress.

**Table 4: Measures of Leverage**

	Unlevered Cash versus Futures		Levered Cash versus Futures		Unlevered High Risk	Long/Short Strategy Cash versus Futures		Unlevered Strategy with Matched Book Assets	
	Cash Only	Futures Only	Levered Cash	Futures	High Risk Cash	Long/Short Cash	Long/Short Mixed	Hedged Cash	Hedged Futures
<i>Portfolio</i>	1	2	3	4	5	6	7	8	9
<b>Summary Balance Sheet</b>									
Capital	100	100	100	100	100	100	100	100	100
Borrowing (outright or repo)	0	0	30				30		
<b>Investments</b>									
<b>Cash Market Transactions</b>									
Asset 1	80		120			120	120	100	-20
Asset 2						-60			
Asset 3					80				
<b>Derivatives Market Transactions</b>									
Futures on Asset 1		80		120					100, -20
Futures on Asset 2							-60		
Cash	20	92	10	88	20	10	4	10	88
Futures Margin	0	8	0	12	0	0	6	0	12
<b>Standard VAR (asset Correlation=0.3)</b>	2.50	2.50	3.76	3.76	5.01	3.61	3.61	2.50	2.50
<b>Leverage Measures</b>									
<b>Accounting-Based Measures</b>									
Gross Balance Sheet Leverage	1	1	1.3	1	1	1.6	1.3	1.2	1
Net Balance Sheet Leverage								1	1
Gross Accounting Leverage	1	1.8	1.6	2.2	1	2.2	1	1.4	2.2
Net Accounting Leverage								1.2	2.2
<b>Risk-Based Measures</b>									
VAR/Capital	2.50%	2.50%	3.76%	3.76%	5.01%	3.61%	3.61%	2.50%	2.50%
Stress 1 VAR/ Capital	3.76%	3.76%	5.64%	5.64%	7.51%	3.67%	3.67%	3.76%	3.76%
Stress 2 VAR/ Capital	3.76%	3.76%	5.64%	5.64%	7.51%	6.10%	6.10%	3.76%	3.76%

## Leverage

While the preceding leverage measures are the ones most commonly used by Hedge Fund Managers, other measures may be used to analyze leverage. Indeed, because of the interrelation between market risk, funding liquidity risk and leverage, measures of funding liquidity risk described in Section 4—particularly Cash + Borrowing Capacity relative to VAR—also provide the Hedge Fund Manager with insights about a Hedge Fund’s leverage.

### Dynamic Measures of Leverage

A crucial factor influencing a Hedge Fund’s ability to absorb the impact of extreme market events is the degree to which a Hedge Fund can modify its risk-based leverage, especially during periods of market stress.

Treating equity as constant, there are two ways a Hedge Fund Manager could reduce risk-based leverage:

- If a Hedge Fund Manager wishes to continue an existing investment strategy, risk-based leverage could be reduced by reducing traditional leverage resulting from either on- or off-balance-sheet transactions; and
- A Hedge Fund Manager could reduce risk-based leverage by reducing the level of risk that is being accepted (*e.g.*, by changing strategy or the types of assets being held in the portfolio). To track the degree to which the Hedge Fund is able to modify its risk-based leverage, the Hedge Fund Manager should track variations in the Hedge Fund’s market risk measure (*e.g.*, VAR) over time.

The following two measures could be used to track the relationship over time between measures of market risk and actions taken by the Hedge Fund Manager to adjust leverage. Both of these measures consider a short time interval (one day, two days, . . . , one week); and, both assume that equity is constant:

- **Changes in Portfolio Market Risk.** A decline in a portfolio’s market risk measure (*e.g.*, VAR) in a period following an increase in that market risk measure in the preceding period could be evidence of the Hedge Fund Manager’s ability to de-lever the portfolio during a period of market stress (the market risk measure could be VAR or the observed volatility of the value of the portfolio during the relevant period); and

- **Relationship between a Change in Market Risk and a Subsequent Change in Cash + Borrowing capacity.** All other things being equal, if a Hedge Fund Manager is able to reduce the portfolio's financial statement-based leverage, the result would be an increase

in cash or in borrowing capacity. Therefore, an increase in Cash + Borrowing capacity in a period following an increase in the market risk measure for the portfolio (*e.g.*, VAR) could be evidence of the Hedge Fund Manager's reacting to market stress by reducing leverage.

## V. Counterparty Credit Risk

Hedge Fund Managers enter into transactions with a variety of counterparties including banks, securities firms, exchanges, and other financial institutions. The risk of loss to the Hedge Fund as a result of the failure of a counterparty to perform as expected constitutes counterparty credit risk.

Credit risk is present to some extent in almost any dealing with a third party, including the settlement of securities and derivatives transactions, repurchase agreements, collateral arrangements, and margin accounts. It is also present in open derivatives positions where the exposure of one counterparty to another will change over the life of the contract as the contract's value fluctuates. Hedge Fund Managers should be aware of and track concentrations of credit risk with particular counterparties, and where applicable, different regions of the world.

One of the factors that should be considered in determining how willing a Hedge Fund Manager should be to enter into a transaction with a

specific counterparty is the loss that its Hedge Fund would suffer were the counterparty to default. That, in turn, depends on the magnitude of the Hedge Fund's exposure to the counterparty and the likelihood of default (*i.e.*, the counterparty's creditworthiness).

An assessment of exposure to a particular counterparty should include analysis of the following elements of exposure:

- **Current replacement cost.** The amount the Hedge Fund would lose if its counterparty were to become insolvent immediately and the Hedge Fund Manager had to replace the contract in the market;



## Counterparty Credit Risk

- **Potential exposure.** A probabilistic assessment of the additional exposure that could result if the counterparty does not default immediately but instead defaults at some date in the future. Potential exposure is particularly applicable to derivatives transactions where exposure is reciprocal and likely to change substantially before the contract expires;
- **The probability of loss.** The likelihood of a default by the counterparty over the relevant time horizon. This is a function of the counterparty's current credit quality, the length of the transaction, and possibly the nature of the transaction itself; and
- **Risk mitigation and documentation.** The extent to which collateral, netting provisions, or other credit enhancement reduces the magnitude of the exposure to a counterparty. Hedge Fund Managers can greatly reduce their credit exposure to counterparties by negotiating bilateral netting and collateral provisions in their documentation and establishing document management processes to ensure transactions are documented consistently and in a timely manner.

APPENDIX IV

# Guidance for Hedge Funds and Hedge Fund Managers on Developing Anti-Money Laundering Programs (Release No. 2)

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# Guidance for Hedge Funds and Hedge Fund Managers on Developing Anti-Money Laundering Programs

## Introduction

Managed Funds Association (“MFA”) is pleased to publish the second release of the *Guidance for Hedge Funds and Hedge Fund Managers on Developing AML Programs* (the “2007 AML Guidance”). This document is incorporated into *Sound Practices for Hedge Fund Managers* (“*Sound Practices*”) so that Hedge Fund Managers may incorporate AML recommendations into their overall internal controls and procedures.<sup>1</sup> This document is the first update to MFA’s original *Preliminary Guidance for Hedge Funds and Hedge Fund Managers on Developing AML Programs*, published on March 28, 2002 (the “*Preliminary Guidance*”).

In October 2001, immediately following the enactment of the USA Act of 2001 (the “PATRIOT Act” or the “Act”), MFA began analyzing the Act’s potential impact on MFA members and preparing Members for expected AML regulations. The *Preliminary Guidance* was published as a result of these initial efforts. At the time of publication of the *Preliminary Guidance*, the Financial Crimes Enforcement Network of the U.S. Department of Treasury (“FinCEN”) had not yet published final rules requiring AML compliance with the PATRIOT Act. In the years since the PATRIOT Act, and in the absence of formal defined AML obligations, MFA’s members have used the *Preliminary Guidance* to develop their internal AML policies. FinCEN has since published proposed rules for the Hedge Fund industry, investment advisers (“IAs”) and commodity trading advisors (“CTAs”). Although, as of August 2007, Hedge Funds, IAs, and CTAs still were not subject to final AML rules, the proposed rules, together with a number of other significant developments in AML regulation and industry practice, have impacted the AML compliance of Hedge Funds and Hedge Fund Managers.

MFA recognizes that AML compliance has been and continues to undergo great change as regulations implementing the PATRIOT Act are promulgated and as industry practice develops. Accordingly, MFA is publishing this

<sup>1</sup> The terms “Hedge Fund” and “Hedge Fund Manager” are defined consistently with *Sound Practices for Hedge Fund Managers*. These and other definitions applicable to the anti-money laundering (“AML”) procedures (such as “Investor”), are set forth in Annex A to the Appendix to the 2007 AML Guidance for convenience. When the term “Recommendation” is used in the 2007 AML Guidance, it refers to the numbered recommendations in this appendix.

second release, the *2007 AML Guidance*, in connection with the publication of *Sound Practices* in order to inform its members of relevant AML developments and to help Hedge Funds and Hedge Fund Managers implement or enhance their AML programs in a timely manner. MFA will publish a third release of this document once final AML regulations for Hedge Funds, IAs and CTAs are issued.

## Historical Background

Presently, Hedge Funds and Hedge Fund Managers are subject to certain existing laws, including federal, state, and foreign statutes criminalizing money laundering, certain relevant reporting provisions of the Bank Secrecy Act (“BSA”), and the economic sanctions programs administered by the U.S. Department of Treasury’s Office of Foreign Assets Control (“OFAC”).

Title III of the PATRIOT Act, entitled the *International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001*, amended the BSA to expand AML measures and apply them to many financial institutions. Notably, as discussed more fully below, Section 352 of the PATRIOT Act provides that each financial institution must establish an AML program.

As defined in the PATRIOT Act, the term “financial institution” includes, among others, any entity that is “an investment company”, as well as any entity that is registered (or required to register) as a commodity pool operator (“CPO”) or a CTA under the Commodity Exchange Act (“CEA”). At the time that MFA originally published its *Preliminary Guidance*, it was not clear whether the reference to an investment company would be construed to include a Hedge Fund, which is excepted from the definition of an investment company under the Investment Company Act of 1940 (“Investment Company Act”). When U.S. Department of Treasury issued interim final rules applying the AML program requirements of Section 352, among others, to banks, registered securities broker-dealers, futures commission merchants, and mutual funds, it recognized the definition of “investment company” under the Investment Company Act, as well as the exclusions from the definition, and deferred extending the rule to unregistered investment companies. Specifically, U.S. Department of Treasury temporarily exempted closed-end investment companies and Hedge Funds, as well as CPOs and CTAs, among others, from the requirements of Section 352.<sup>2</sup> At

## Guidance for Hedge Funds and Hedge Fund Managers on Developing Anti-Money Laundering Programs

the time, U.S. Department of Treasury stated that it expected to review and analyze the extent to which the exempted businesses might be used by money launderers or terrorist financiers and to issue a series of additional rules that would require the exempted businesses to establish AML programs.

The U.S. Department of Treasury has clearly confirmed its intention to require Hedge Funds, commodity pools, and similar investment vehicles to establish AML programs under Section 352 of the PATRIOT Act. On September 18, 2002, FinCEN issued a proposed AML program rule, (this rule as amended and supplemented shall be herein after referred to as the “Proposed AML Program Rule”), requiring certain investment companies that are not registered with the Securities and Exchange Commission (“SEC”) to establish AML programs.<sup>3</sup> Those entities included private investment funds, Hedge Funds, private equity funds, venture capital funds, commodity pools, and real estate investment trusts (collectively, “Unregistered Investment Companies” or “UICs”).

The proposed rule was consistent, in many respects, with the approach taken by MFA in the *Preliminary Guidance*. Of particular note, however, in this proposed rule was a provision requiring every UIC to file a notice identifying itself and providing basic contact and other descriptive information with FinCEN.

Specifically, the Proposed AML Program Rule for UICs applies to: (1) an issuer that, but for the exclusions provided would be an investment company under the Investment Company Act; (2) a commodity pool; and (3) a company that invests primarily in real estate and/or interests therein. To narrow the definition of a UIC so that it encompassed only those companies that pose a risk of money laundering activities, FinCEN proposed three limitations on the definition and three exceptions to the scope of the term.<sup>4</sup> Under

<sup>2</sup> *The exemption, which was initially set to expire on October 24, 2002, was extended on October 28, 2002 until the final rules are issued for deferred financial institutions.*

<sup>3</sup> *The Proposed AML Program Rule was issued partially in response to a recommendation in an investment company study undertaken at the request of Congress, which was issued by the Secretary of the U.S. Department of Treasury, in conjunction with the Federal Reserve and the SEC. See A Report To Congress In Accordance With Section 356(c) Of The Uniting And Strengthening America By Providing Appropriate Tools Required To Intercept And Obstruct Terrorism Act (PATRIOT Act) (Dec. 31, 2002).*

the proposed definition, a UIC would include only those companies that:

- Permit an Investor to redeem any portion of his or her ownership interest within two years after that interest was purchased;
- Have total assets of \$1,000,000 or more (including received subscriptions to invest) as of the end of the most recently completed calendar quarter; and
- Are organized under the laws of a State or the United States, sell ownership interests to U.S. persons, or are organized, operated, or sponsored by U.S. persons.

In addition, on April 28, 2003, FinCEN simultaneously issued Proposed AML Program Rules for IAs and CTAs. The Proposed AML Program Rule for IAs applies to:

- (1) SEC-registered advisers that have a principal office and place of business in the United States and that report to the SEC that they have assets under management on form ADV; or
- (2) Advisers in the United States that are not registered with the SEC, but have \$30 million or more of assets under management, and are relying on the registration exemption under Section 203(b)(3) of the Investment Advisers Act of 1940.<sup>5</sup>

The Proposed AML Program Rule for CTAs applies to any CTA that is both

<sup>4</sup> *The rule exempts: (a) family companies, i.e., companies owned by a single family as described in section 2(a)(51)(A)(ii) of the Investment Company Act, but without regard to the amount of assets owned by such companies; (b) employees' securities companies, i.e., investment companies established by employers for the benefit of employees; (c) employee benefit plans that are not construed to be pools; and (d) companies that are another type of financial institution under the BSA (such as broker-dealers) and required to establish their own AML programs under the BSA.*

<sup>5</sup> *The Proposed AML Program Rule excludes from the AML Program requirement the following types of IAs: (1) small, state registered firms with less than \$30 million in assets under management that are not registered with the SEC; (2) IAs that are registered with the SEC, but do not manage client assets; and (3) unregistered IAs required to have an AML Program under the BSA as a financial institution in another capacity and examined by a Federal functional regulator in that other capacity. The Proposed AML Program Rule also permits IAs covered by the rule to exclude from their AML Programs any investment vehicle they advise that is already subject to the AML Program requirement under the BSA.*

## Guidance for Hedge Funds and Hedge Fund Managers on Developing Anti-Money Laundering Programs

registered or required to be registered with the Commodity Futures Trading Commission (“CFTC”) under the CEA and that directs client commodity futures or options accounts.<sup>6</sup>

### MFA’s Efforts to Promote Sound Practices in AML for the Hedge Fund Industry

Although the Proposed AML Program Rules for UICs, IAs, and CTAs are not yet final, MFA continues to believe, as it did at the time of the issuance of the *Preliminary Guidance*, that Hedge Funds and their Hedge Fund Managers should adopt and implement AML programs consistent with Section 352 of the Act as a matter of sound practice<sup>7</sup>. As with the *Preliminary Guidance*, this *2007 AML Guidance* is intended to highlight what MFA believes to be key elements for Hedge Funds and their Hedge Fund Managers to consider in developing an effective AML program, including the requirements to which they are subject under the BSA, and their obligations to comply with the OFAC sanctions programs. As stated above, this *2007*

<sup>6</sup> Under the Proposed AML Program Rule, the following are not subject to the AML Program requirements: (1) any person who is not registered as a CTA by virtue of 7 U.S.C. 6m or CFTC Rule 4.14(a); (2) CTAs that provide commodity trading advice, but do not direct accounts; and (3) persons that choose to register with the CFTC as CTAs, even though they are not required to register, and who do not direct client accounts. Like the Proposed AML Program Rule for IAs, the Proposed AML Program Rule for CTAs permits them to exclude from their AML programs pooled investment vehicles (such as UICs) they advise, which are also subject to the AML Program requirement.

<sup>7</sup> MFA believes that Hedge Fund Managers and Hedge Funds should adopt effective AML programs for a number of compelling reasons, including, but not limited to: the existence of the Proposed AML Program Rules by the U.S. Department of Treasury that encourage the adoption of an effective AML program for investment advisers and unregistered investment companies which may become final; ensuring compliance with applicable criminal statutes prohibiting money laundering and terrorist financing and the economic sanctions programs administered by OFAC; satisfying anticipated due diligence inquiries from prime brokers and other financial institutions subject to the provisions of and regulations promulgated under the BSA, as amended by the PATRIOT Act; existing BSA reporting requirements; and minimizing exposure to reputational and legal risks, e.g., risks associated with accepting an investment from a Prohibited Investor (as defined below).

*AML Guidance* updates and replaces the *Preliminary Guidance* issued by MFA in March 2002.

Moreover, since the PATRIOT Act's enactment, MFA has actively pursued an on-going dialogue with the regulators responsible for developing the applicable AML regulations to educate them regarding relevant issues and to advocate Members' interests and views regarding regulations under consideration. Meetings and discussions also regularly occur in a more informal manner as particular issues arise regarding implementation of the PATRIOT Act by the Hedge Fund industry.

For example, MFA has submitted comment letters to U.S. Department of Treasury with respect to the proposed rules<sup>8</sup>. On November 25, 2002, MFA submitted a comment letter with respect to the UIC proposed rule, in which it requested clarification of certain provisions. In particular, MFA addressed the provision with respect to delegation to third parties and asserted that Hedge Funds would be aided by sound regulatory guidance when delegating to a third party the performance of Investor due diligence and offered suggestions as to how Hedge Funds should be able to avoid strict liability for the AML deficiencies of its third-party delegates. MFA also identified issues presented by the proposed rule's requirement that federal examiners be permitted to inspect a third party delegate's records for the purpose of the UIC's AML program.

Subsequently, on July 7, 2003, MFA submitted another comment letter with respect to the Proposed AML Program Rules for IAs and CTAs. In the letter, MFA recommended, among other suggestions, that U.S. Department of Treasury adopt parallel exclusions under the rule for CTAs as were proposed under the rule for IAs regarding assets under management. MFA sought to exclude from the AML requirements a CTA's responsibility for those accounts that are maintained with a futures commission merchant that are already subject to an AML program rule, as the CTA is not involved in the flow of assets in and out of such accounts. MFA also sought to provide IAs with the ability to rely on certain entities for the performance of Investor identification procedures. MFA also requested that IAs and CTAs be permit-

<sup>8</sup> *MFA, Comment Letters, Nov. 25, 2002 (UICs) and July 7, 2003 (IAs and CTAs), available at (www.managedfunds.org).*



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ted to rely on the AML programs of foreign financial institutions to the extent that such reliance is determined to be appropriate.

Additionally, in an effort to educate and inform members regarding their AML responsibilities, MFA has also organized several informative programs in partnership with prominent prime brokers for the benefit of their Hedge Fund clients. In addition, MFA has actively participated in conferences and seminars addressing the PATRIOT Act's requirements, including programs organized by Bloomberg, AML Law and Compliance Conference, 100 Women in Hedge Funds, and the Institute for International Research, among others. MFA has also engaged in a dialogue with a number of other industry organizations representing the broker-dealer industry, the futures industry, and the mutual fund industry, where the concerns among these industries have overlapped. For example, MFA has engaged in a dialogue with a wide range of major international financial institutions to create a standard letter for Hedge Fund Managers, including both registered and unregistered IAs and non-U.S. regulated IAs, attesting to counterparties such as prime brokers, banks, and other financial institutions that they have established AML policies and procedures and that these policies and procedures are consistent with MFA's recommendations (attached hereto as Annex B is MFA's *Model AML Attestation*, developed in consultation with a wide range of major international financial institutions).

### Applicability of the 2007 AML Guidance

As with *Sound Practices* overall, this *2007 AML Guidance* is intended primarily for U.S.-based Hedge Funds and Hedge Fund Managers, and offshore Hedge Funds with U.S.-based Hedge Fund Managers. MFA also believes that the *2007 AML Guidance* may be applicable to offshore Hedge Funds and Hedge Fund Managers to the extent that they utilize U.S.-based prime brokers, since, in order to comply with the requirements of the PATRIOT Act and implementing regulations, these prime brokers may require comfort regarding their fund clients' AML policies, procedures, and controls. Similarly, the *2007 AML Guidance* may also be applied more generally to commodity pools, CPOs, and CTAs based in the United States.<sup>9</sup>

<sup>9</sup> *Entities registered with the CFTC must also consider applicable rules and regulations issued by the CFTC and the National Futures Association.*

As U.S.-based Hedge Fund Managers often work with offshore Hedge Funds and/or administrators, it is also important for U.S.-based Hedge Funds to be aware of relevant non-U.S. AML structures, which may be different from, as well as more or less, stringent than the U.S. AML structure. These differences may impact the practices of Hedge Fund Managers, including for example, the subscription documentation they may require of their Investors.

In light of MFA's expectation that most Hedge Funds will rely on their Hedge Fund Managers for development of and compliance with an appropriate AML program, the *2007 AML Guidance* has been written from the perspective of the Hedge Fund Manager. If a Hedge Fund were to develop an AML program without involvement of its Hedge Fund Manager, the *2007 AML Guidance* would apply equally to the Hedge Fund itself. Similarly, to the extent that a Hedge Fund Manager delegates any AML functions to an administrator, that administrator would have to adopt the relevant AML program provisions of the Hedge Fund Manager, although the Hedge Fund Manager would retain responsibility for compliance under the AML regulations. The *2007 AML Guidance* therefore speaks of "Hedge Fund Managers" as a generic term for the personnel with operating authority over a Hedge Fund or commodity pool, whether that be the personnel of the Hedge Fund, the commodity pool, or the employees of the IA, CTA, or CPO. Where the Guidance draws more specifically from the rules for UICs, IAs, or CTAs, it so indicates. In addition, use of the terms "Unregistered Investment Company" and "Hedge Fund" encompasses commodity pools unless otherwise indicated.

### **Individualized Assessment and Application of *2007 AML Guidance***

Each Hedge Fund Manager should assess the *2007 AML Guidance* in light of the characteristics of its Investor base, its business model, and the resources of its organization, and, based upon this assessment, apply the *2007 AML Guidance*, as appropriate.

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Given the considerable differences among Hedge Funds, Hedge Fund Managers, and the Investors with whom they deal, MFA believes that no one standard or model AML program can be appropriate for all Hedge Funds. Hedge Funds vary not only in size, strategy, and organizational structure, but also in the profile of their Investor bases. Some Hedge Funds may have mainly natural persons as Investors, whereas others may have primarily an institutional client base; some maintain relationships with Investor intermediaries and nominees, while others have predominantly “*Direct Investors*”; some have an international client base, while others are purely domestic; and some may limit their Investors to insiders and other Investors that are known to the Hedge Fund Manager, while others deal with Investors from a wide variety of sources. The characteristics of a Hedge Fund’s Investor base should influence the AML policies and procedures adopted by the Hedge Fund Manager.

Consequently, the *2007 AML Guidance* should not be viewed as definitive requirements that could be rigidly applied by all Hedge Fund Managers or that should serve as a basis either for auditing a Hedge Fund Manager’s AML policies and practices or for any legal claim or action. Nor should the *2007 AML Guidance* be viewed as exhaustive or addressing the only issues to consider in developing an AML program. In evaluating the relevance of the *2007 AML Guidance* and its ability to implement the recommended policies and procedures, a Hedge Fund Manager should recognize that, while some recommendations can be implemented easily or unilaterally, others may require planning, and in some cases negotiation with, and cooperation by, third parties.

As U.S.-based Hedge Fund Managers often work with offshore Hedge Funds and/or administrators, it is also important to note, as discussed above, that U.S. Hedge Fund Managers may be obligated to implement policies that reflect the AML regime of foreign jurisdictions. Since MFA’s issuance of its *Preliminary Guidance*, foreign jurisdictions have significantly enhanced their AML requirements for offshore Hedge Funds and/or administrators.

For instance, documents required of Investors in Hedge Funds may be dependent upon the AML structure of the particular foreign jurisdiction. Also, U.S.-based Hedge Fund Managers, which are not yet required to file suspicious activity reports (“SARs”) in the United States, may, depending on the foreign jurisdiction in which the offshore fund or administrator is located, be required to file a SAR. This *2007 AML Guidance* does not address any of these potentially divergent practices concerning the varying AML regimes of foreign jurisdictions.

In developing an AML program, a Hedge Fund Manager should consult with its professional legal and accounting advisers. The *2007 AML Guidance* is not intended to serve as a substitute for such professional advice, and neither Hedge Funds nor their Hedge Fund Managers should rely upon the *2007 AML Guidance* as a substitute for such advice.

# Guidance for Hedge Funds and Hedge Fund Managers on Developing Anti-Money Laundering Programs

## Recommendations

### I. Fundamental Elements of AML Programs

#### 1.1 General

*Broad Policy Statement.* As part of its AML program, a Hedge Fund Manager should adopt a broad statement, at its highest executive level, that clearly sets forth its policy against money laundering and any activity that facilitates money laundering or the funding of terrorist activities.

*Objectives.* The Hedge Fund Manager should clearly state the objectives of its AML program, which may include the detection and deterrence of instances of money laundering, terrorist financing, and other illegal activity.

#### 1.2 Basic Elements of the AML Program

The Proposed AML Program Rules for UICs, IAs, and CTAs provide that these entities devise and implement, within 90 days following publication of a final rule, an AML program that includes, at a minimum, the four basic elements set forth in Section 352 of the Act and as developed in more detail on the following pages:

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

The AML program should be in writing and approved by “*Senior Management*”. This could be reflected in an approval by their board of directors or trustees, or if they do not have such a board, their general partner, sponsor, organizer, operator, or other person that has a similar Senior Management function with respect to the company.<sup>11</sup>

<sup>11</sup> *A sample resolution of the board of directors of a Hedge Fund Manager adopting a policy statement against money laundering and terrorist financing is attached as Annex E.*

### 1.3 Internal Policies, Procedures, and Controls

The Hedge Fund Manager should develop written policies, procedures, and controls reasonably designed to prevent them from being used to launder money or finance terrorist activities and to achieve compliance with applicable requirements of the BSA and its implementing regulations. These policies, procedures, and controls should address the vulnerabilities of the Hedge Fund Manager, which will vary depending on the nature of its particular clients and services.

Employees of the Hedge Fund Manager should be generally informed of the AML policies and procedures adopted by the Hedge Fund Manager and familiar with the substance and intent of the Hedge Fund Manager's AML policy and procedures.

### 1.4 Role of Senior Management and the AML Compliance Officer

*Designation of Anti-Money Laundering Compliance Officer.* The Hedge Fund Manager should designate an "Anti-Money Laundering Compliance Officer", who should be, where possible, an officer of the Hedge Fund Manager who is competent and knowledgeable regarding applicable requirements and money laundering risks. The Hedge Fund Manager should provide the Anti-Money Laundering Compliance Officer with adequate authority and resources to effectively implement the Hedge Fund Manager's AML program and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures.

*Involvement in Policy Development and Enforcement.* Senior Management and the Anti-Money Laundering Compliance Officer should be involved in the development, adoption, and enforcement of written AML policies, procedures, and controls so as to ensure the efficacy of the Hedge Fund Manager's AML program.

*Involvement in Decision-Making.* The AML policies, procedures, and controls should provide that the decision to accept or reject an Investor involves the Anti-Money Laundering Compliance Officer when money laundering risks have been identified. Consistent with the Hedge Fund Manager's policies, the Anti-Money Laundering Compliance Officer may consult with Senior Management on such decisions, as appropriate.

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*Determinations Regarding Third Party Reliance.* As discussed in Part V, the Anti-Money Laundering Compliance Officer should be involved in any decision to delegate the performance of Investor identification procedures to a third party.

### 1.5 Investor Identification Policies and Procedures

*Establishing Investor Identification Policies and Procedures.* The Hedge Fund Manager should establish written policies and procedures regarding Investor identification that are reasonably designed to be both feasible and effective in achieving the stated objectives of the AML program. Key elements to consider in developing these procedures are addressed in Part II. The *2007 AML Guidance* also addresses the delegation to third parties of the performance of Investor identification procedures (as defined below) in Part V.

*Review and Update as Necessary.* The Hedge Fund Manager should periodically review and update their AML policies and procedures based on applicable amendments to existing AML legislation and regulations, as well as changes in the characteristics of the Investor base of the Hedge Fund. In this regard, MFA expects to update the *2007 AML Guidance* to reflect changes in AML law and regulation applicable to the Hedge Fund industry, once the proposed rules become final. In particular, a Hedge Fund Manager should ensure that Investor due diligence checklists and procedures are updated on a periodic basis and that changes are independently reviewed and approved by the Anti-Money Laundering Compliance Officer.

### 1.6 Responsibilities of the Anti-Money Laundering Compliance Officer

The Anti-Money Laundering Compliance Officer's responsibilities should specifically include, among other things:

- Coordinating and monitoring of the Hedge Fund Manager's day-to-day compliance with applicable AML laws and regulations and its own AML program;
- Arranging for employee training programs for appropriate personnel related to the Hedge Fund Manager's AML program;

- Reviewing any reports of suspicious activity from personnel of the Hedge Fund Manager; and
- Arranging for the performance of an independent audit to evaluate the Hedge Fund Manager's AML policies and procedures.

The Anti-Money Laundering Compliance Officer may serve other functions and may serve multiple departments within the Hedge Fund Manager's organization. However, the Anti-Money Laundering Compliance Officer should not be responsible for functional areas within the organization where money laundering activity may occur.

### 1.7 Employee Training Program

*Establishment and Content of Program.* The Hedge Fund Manager should establish AML training programs for all relevant personnel to be conducted on a periodic basis, as appropriate. The level, frequency, and focus of the training should be determined by the responsibilities of the employees and the extent to which their functions bring them into contact with activities susceptible to possible money laundering or transactions that could trigger BSA reporting obligations. For employees whose functions may expose them to such transactions or activities, the training should occur when the employee assumes those duties and periodically during the course of employment. Employees should be notified of any new regulatory requirements, with additional training as deemed necessary by the Anti-Money Laundering Compliance Officer. The training program should, among other things:

- Review applicable AML laws and regulations and recent trends in money laundering, including the ways in which such laws and trends relate to Hedge Funds; and
- Address elements of the Hedge Fund Manager's own AML program, particularly its Investor identification procedures and policies regarding detection of suspicious activity.

*Requiring Attendance.* The Hedge Fund Manager should develop and maintain policies, procedures, and controls reasonably designed to ensure that all appropriate personnel attend the AML training programs, as required.



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*Recordkeeping.* Records of all AML training sessions conducted, including the dates and locations of the training sessions and the names and departments of attendees, should be retained for at least five years, or for a longer period as may be required by applicable laws or regulations.

### 1.8 Independent Audit Function

The Hedge Fund Manager's AML program should include an independent audit function on a periodic basis to assess compliance with and the effectiveness of its AML program. The independent audit function should involve:

- Evaluation by the Hedge Fund Manager's legal and compliance director or officer, external auditors, or counsel of the Hedge Fund Manager's compliance with applicable AML laws and regulations and the Hedge Fund Manager's own AML program; and
- Reporting of the results of this evaluation to the audit committee of the board of directors or similar oversight body of the Hedge Fund or Hedge Fund Manager.

The Hedge Fund Manager's AML program should also provide for appropriate follow-up to ensure that any deficiencies detected in the course of the audit of its AML program are addressed and rectified.

### 1.9 Representations to Counterparties on Policies and Procedures

The Hedge Fund Manager, including registered and unregistered IAs and non-U.S. regulated IAs, should be prepared to attest to counterparties such as prime brokers, banks, and other financial institutions that they have established AML policies and procedures and that their policies and procedures are consistent with MFA's recommendations. Major institutions should find acceptable MFA's *Model AML Attestation*, attached hereto as Annex B and developed in consultation with a wide range of major international financial institutions.

## II. Investor Identification Policies and Procedures

### 2.1 General

*Objective.* As part of an AML program, a Hedge Fund Manager should establish and maintain reasonable procedures that are designed to identify an Investor to the extent reasonable and practical (such procedures are referred to generally as “Investor identification procedures”). Although Hedge Fund Managers and Hedge Funds are not yet subject to customer identification program requirements or other AML due diligence under the PATRIOT Act, these Investor identification procedures are designed to reduce their exposure to criminal liability and reputational harm.

*Consider Characteristics of Investor Base.* The Hedge Fund Manager’s Investor identification procedures should take into account the specific risks presented by the Investor base of the Hedge Fund(s) it manages.

*General Premise.* The Hedge Fund Manager’s Investor identification procedures should further be based on the premise that the Hedge Fund Manager should accept an investment from a new Investor only after its performance of one of the following due diligence steps:

- The Hedge Fund Manager has undertaken reasonable due diligence efforts with respect to the identity of a Direct Investor that is acting on its own behalf and not for the benefit of any third party;
- If the Investor is investing on behalf of other underlying Investors, the Hedge Fund Manager has undertaken reasonable due diligence efforts with respect to the identities of the Investor and the underlying Investors; or
- The Hedge Fund Manager has determined that it is acceptable to rely on the Investor due diligence performed by a third party, such as a fund administrator or an Investor intermediary, with regard to the Investor (and underlying Investors, if applicable). Reliance upon Investor identification procedures performed by a third party is addressed in Part V.

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## 2.2 Investor Identification Procedures

*Perform Procedures Appropriate to Type of Investor.* Where the Hedge Fund Manager undertakes to conduct reasonable due diligence efforts with respect to the identity of an Investor (rather than relying on its fund administrator or another third party, as discussed in Part V), it should conduct Investor identification procedures based upon the specific characteristics presented by an Investor. Possible identification procedures are presented in Recommendations 2.2.1 and 2.2.2, and procedures for screening for “Prohibited Investors” (as defined below) are addressed in Recommendation 2.3. Possible enhanced procedures for addressing “high risk” Investors are addressed in Recommendation 2.4. These procedures are provided as examples only and are not intended to be prescriptive or exhaustive. For example, a Hedge Fund Manager may elect to apply alternative Investor identification procedures based upon the specific characteristics of an Investor or apply enhanced measures for reasons other than those discussed in the *2007 AML Guidance*.

*Timing.* A Hedge Fund Manager should complete appropriate Investor identification procedures with regard to an Investor prior to (or if necessary, within a reasonable time thereafter), accepting an investment from the Investor in order to make an assessment regarding the Investor’s identity and whether additional due diligence should be conducted with respect to the Investor.

*Due Diligence Checklists.* A Hedge Fund Manager may wish to develop a due diligence checklist to facilitate the performance of Investor identification procedures.

*Document Procedures Undertaken.* A Hedge Fund Manager should retain copies of all documents reviewed or checklists completed in connection with its Investor identification procedures in accordance with its Investor records retention policies. See Recommendation 2.6.

*Appropriate Identity Provisions Included in Subscription Documents.* Fund subscription documents should generally require an Investor to:

- Represent and covenant that all evidence of identity provided is genuine and all related information furnished is accurate;

- Agree to provide any information deemed necessary by the Hedge Fund Manager to comply with its AML responsibilities and policies; and
- In the case of a Direct Investor, represent that it is investing solely as principal and not for the benefit of any third parties.<sup>12</sup>

*Investor Representations.* Hedge Fund subscription agreements should contain a general set of representations from the Investor, stating that they are in compliance with various U.S. federal, state, and international laws and regulations, as well as a set of other disclosures relevant to AML and OFAC compliance. The representation should include statements with respect to the legitimacy of the source of funds being invested, the status of the Investor as a Prohibited Investor, or “Senior Foreign Political Figure/Politically Exposed Person” or “SFPP/PEP”, and if the Investor is a fund of funds or an entity that is acting as an agent or nominee, the representation that the Investor has adopted AML procedures. See Recommendation 2.4.

### 2.2.1 Natural Persons as Investors

In order to confirm the identity of a natural person, 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. Where funds are wired to the Hedge Fund Manager or the administrator from a financial institution located in a “FATF jurisdiction”<sup>13</sup> in which the investor is a customer, no additional information is generally necessary, unless the Investor is considered a Prohibited Investor or high risk Investor, as discussed in Recommendations 2.3 and 2.4, on the following pages.

<sup>12</sup> *Sample provisions that could be included in subscription documents are attached as Annex D-3. The Hedge Fund Manager may also wish to include some or all of these sample provisions in amendments (in the form of a letter or otherwise) to subscription documents with existing Investors.*

<sup>13</sup> *The term “FATF jurisdiction” is defined in Annex A to the 2007 AML Guidance. In establishing a risk-based approach for its AML program, a Hedge Fund Manager may wish to classify certain FATF jurisdictions as high risk for money laundering based on certain publicly available data (such as the International Narcotics Control Strategy Report (“INCSR”), which is an annual report issued by the U.S. Department of State that assesses the money laundering risks of various countries and jurisdictions).*

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Where the Investor's bank is not located in a FATF jurisdiction, the Hedge Fund Manager should undertake reasonable due diligence efforts with respect to the identity of the Investor in the Hedge Fund by obtaining additional forms of identification from the Investor that may be used to confirm the Investor's identity (*e.g.*, government issued identification, such as official driver's license with photograph, passport, utility bill containing the Investor's name and address, and/or reports from credit bureaus) or other generally available public information confirming the Investor's identity.

In addition to these document requirements, if the Hedge Fund Manager believes it would be reasonable to rely upon a certificate from the Investor that the Investor is not a prohibited Investor or high risk Investor, as set forth in Recommendations 2.3 and 2.4 below, respectively, such an "AML Certification" should be obtained.

### 2.2.2 Corporations, Partnerships and Comparable Legal Entities as Investors

In order to confirm the identity of a legal entity, the Hedge Fund Manager should take reasonable steps to ascertain the entity's name, address, and if applicable, taxpayer identification number, and its authority to make the contemplated investment. Where funds are wired to the Hedge Fund Manager or the administrator from a financial institution located in a FATF jurisdiction where the investor is a customer, no additional information is generally necessary, unless the Investor is considered a Prohibited Investor or high risk Investor, as discussed in Recommendations 2.3 and 2.4, below.

Where the Investor's bank is not located in a FATF jurisdiction, the Hedge Fund Manager should undertake reasonable due diligence efforts with respect to the identity of the Investor in the Hedge Fund by obtaining additional forms of identification from the Investor that may be used to confirm the Investor's identity (*e.g.*, documents certifying the existence of the entity such as certified articles of incorporation, a government-issued business license, a partnership agreement, or a trust instrument) or other generally available public information confirming the Investor's identity.

Where the investor is neither a publicly-traded company listed on a major, regulated exchange (or a subsidiary or a pension fund of such a company), nor a regulated institution organized in a FATF jurisdiction, the Hedge Fund Manager may wish to gain additional comfort regarding the Investor's identity by obtaining certain of the following, as appropriate, under the circumstances:

- Evidence that the Investor has been duly organized in its jurisdiction of organization;
- A list of directors, senior officers, and principal equity holders (in order to ensure, for example, that none of these persons is a prohibited Investor, as set forth in Recommendation 2.3), and/or, if the Hedge Fund Manager believes it can reasonably rely upon an AML Certification from the Investor, it can obtain a certificate from the Investor that it has implemented and complies with AML policies, procedures, and controls that, for example, seek to ensure that none of its directors, officers, or equity holders are Prohibited Investors, as set forth in Recommendation 2.3;
- In the case of a trust, evidence of the trustee's authority to make the contemplated investment and either an AML Certification from the trustee (if the Hedge Fund Manager believes it would be reasonable to rely upon such a certificate) or, alternatively, the identities of beneficiaries, the provider of funds (*e.g.*, settlor(s)), those who have control over funds (*e.g.*, trustee(s)), and any persons who have the power to remove trustees, as well as the trust and the persons authorized to act on behalf of the trust;
- Description of the Investor's primary lines of business;
- Publicly available information from law enforcement agencies or regulatory authorities; or
- If appropriate, Investor's financial statements and/or bank references.

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### 2.3 Prohibited Investors

A Hedge Fund Manager should not accept any investment from or on behalf of any Investor ( a “Prohibited Investor”) that is:

- An individual or entity whose name appears on any lists of prohibited persons and entities as may be mandated by applicable law or regulation, including the *List of Specially Designated Nationals and Blocked Persons* administered by OFAC<sup>14</sup> (“OFAC List”) as such lists may be amended from time to time;
- An individual or entity who is from a country or territory prohibited by the OFAC sanctions programs;
- Resident in, or organized or chartered under the laws of, a jurisdiction that has been designated by the Secretary of the U.S. Department of Treasury under Section 311 of the PATRIOT Act as warranting special measures due to money-laundering concerns; or
- A “*Prohibited Foreign Shell Bank*” (see below).

(See Part IV below for a discussion of OFAC Policies and Procedures.)

*Necessity of Checking for Updates to the OFAC Lists.* A Hedge Fund Manager should update the information that it maintains and relies upon for the purposes of checking the above lists as necessary in order to ensure that it does not accept an investment from a Prohibited Investor or permit a redemption to an Investor that has been added to the OFAC Lists.<sup>15</sup>

*Prohibited Foreign Shell Banks.* Hedge Fund Managers should not accept investments from or on behalf of a Prohibited Foreign Shell Bank. With respect to Investors that are Foreign Banks, Hedge Fund Managers may wish to consider obtaining a representation that the bank either: (1) has

<sup>14</sup> For a description of the lists maintained by OFAC, please refer to Annex H. The complete OFAC lists may be accessed at ([www.treas.gov/ofac](http://www.treas.gov/ofac)).

<sup>15</sup> Where compliance resources are limited, a Hedge Fund Manager may wish to consider using a third-party compliance service for assistance with monitoring OFAC lists.

a “*Physical Presence*”; or (2) does not have a Physical Presence, but is affiliated with a regulated financial group; and (3) does not provide services to Prohibited Foreign Shell Banks.

## 2.4 High Risk Investors

Prior to accepting an investment from an Investor that the Hedge Fund Manager has reason to believe presents high risk factors (a “High Risk Investor”) with regard to money laundering or terrorist financing, the Hedge Fund Manager should conduct enhanced due diligence with regard to the Investor, in addition to standard Investor identification procedures.

The enhanced due diligence procedures undertaken with respect to High Risk Investors should be well documented and any questions or concerns with regard to a High Risk Investor should be directed to the Anti-Money Laundering Compliance Officer. The decision to accept or reject an investment by a High Risk Investor should directly involve a more senior level of management than is typically involved in establishing an Investor relationship. Documentation of this decision-making process should also be retained.

The following are examples of types of Investors that may be deemed to present high risk factors with regard to money laundering or terrorist financing:

- Investors not located in a FATF jurisdiction;
- Non-U.S. “*Private Investment Companies*”;
- A SFPF/PEP or an immediate family member or close associate of a SFPF/PEP;
- Any Investor resident in, or organized or chartered under the laws of, a “*Non-Cooperative Jurisdiction*” or “*NCCT jurisdiction*”;<sup>16</sup>

<sup>16</sup> *There are presently no countries or territories that have been designated by FATF as non-cooperative with international AML efforts.*



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- Any Investor whose subscription funds originate from, or are routed through, an account maintained at a Prohibited Foreign Shell Bank, or an “*offshore bank*”, or a bank organized or chartered under the laws of a Non-Cooperative Jurisdiction, or a bank or financial institution subject to special measures under Section 311 of the Patriot Act;
- Any Investor that is a Foreign Bank subject to enhanced due diligence under Section 312 of the PATRIOT Act;<sup>17</sup> or
- Any Investor who gives the Hedge Fund Manager reason to believe that the source of its subscription funds may not be legitimate.

Examples of enhanced due diligence procedures that a Hedge Fund Manager might consider in order to address high risk factors presented by Investors are detailed in Recommendations 2.4.1 (for natural persons) and 2.4.2 (for legal entities).

### 2.4.1 Natural Persons as High Risk Investors

Below are examples of measures a Hedge Fund Manager might consider, as appropriate, in order to seek comfort with respect to certain High Risk Investors who are natural persons:

- Reviewing pronouncements of U.S. governmental agencies and multilateral organizations such as FATF and the INCSR Report with regard to the adequacy of AML and counter-terrorism legislation in the Investor’s home country jurisdiction;

<sup>17</sup> *Foreign Banks subject to enhanced due diligence pursuant to Section 312 of the PATRIOT Act are banks: (1) that operate under an offshore banking license; (2) that have a license issued by a non-U.S. country that has been designated as non-cooperative with international money laundering principles or procedures by an intergovernmental group or organization of which the United States is a member and with which designation the U.S. representative to the group or organization concurs; or (3) that are licensed in a non-U.S. country that has been designated by the Secretary of the U.S. Department of Treasury as warranting special measures due to money laundering concerns, such as Section 311 special measures.*

- Assessing the Investor’s business reputation through review of generally available media reports or by other means;
- Considering the source of the Investor’s wealth, including the economic activities that generated the Investor’s wealth, and the source of the particular funds intended to be used to make the investment; and in particular, where a SFPF/PEP is involved, taking steps to determine whether the funds are derived from political corruption; and
- Reviewing generally available public information, such as media reports, and other publicly available databases to determine whether the Investor has been the subject of any allegations, investigations, indictments, convictions, or other criminal, civil charges, or regulatory actions based on violations of AML laws or regulations, or involving allegations of corruption, or relating to the financing of terrorists.

#### 2.4.2 Legal Entities as High Risk Investors

Below are examples of measures a Hedge Fund Manager might consider, as appropriate, in order to seek comfort with respect to certain High Risk Investors who are legal entities:

- Reviewing recent changes in the ownership or Senior Management of the Investor;
- If applicable, determining the relationship between the Investor and the government of its home country jurisdiction, including whether the Investor is a government-owned entity;
- Reviewing pronouncements of U.S. governmental agencies and multilateral organizations such as FATF with regard to the adequacy of AML and counter-terrorism legislation in the Investor’s home country jurisdiction;
- Assessing the Investor’s business reputation through a review of generally available media reports or by other means;
- Considering the source of the Investor’s wealth, including the economic activities that generated the Investor’s wealth, and the source of the particular funds intended to be used to make the investment; and in particular, where a SFPF/PEP is involved, taking steps to determine whether the funds are derived from political corruption; and

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- Reviewing generally available public information, such as media reports, and other publicly available databases to determine whether the Investor has been the subject of any allegations, investigations, indictments, convictions, or other criminal or civil charges or regulatory actions, including, violations of AML laws or regulations, or involving allegations of corruption, or relating to the financing of terrorists.

### 2.5 Inadequate Information

If there is inadequate information or Investor identification procedures that cannot be performed, the Hedge Fund Manager may refuse to accept the investment from the Investor, and file a voluntary SAR, if appropriate. See Recommendation 3.2. If the Investor's subscription to the Hedge Funds is approved, the Anti-Money Laundering Compliance Officer should consider whether ongoing monitoring is necessary, and, if appropriate, establish a method for review by Senior Management and the Anti-Money Laundering Compliance Officer.

In addition, Hedge Fund Managers should consider conducting their review of publicly available databases on at least an annual basis in order to determine whether to continue the relationship.

### 2.6 Investor Records Retention

The Hedge Fund Manager should establish procedures requiring that copies of documents reviewed as part of the performance of its Investor identification procedures be retained for an appropriate period of time and, at a minimum, the period of time required by applicable law or regulation. For example, a Hedge Fund Manager might require that documents be retained for so long as an Investor remains invested in one of the Hedge Funds it manages and for a minimum of five years following the final redemption by the Investor.

The following are examples of the types of documents that the Hedge Fund Manager might wish to retain as part of its Investor records retention policy:

- Copies of documents reviewed in connection with Investor identification procedures or enhanced due diligence procedures;
- Investor identification checklists, if any, or similar due diligence documentation; and
- Any other documents required to be retained by applicable AML legislation.

## **2.7 Risk-Focused Review of Existing Investors**

Based on its own risk assessment, a Hedge Fund Manager should periodically review, for example, as part of the audit function addressed in Recommendation 1.8, the adequacy of due diligence performed on existing Investors. As appropriate, a Hedge Fund Manager should consider undertaking a periodic review of its existing Investor base in order to ensure that no Investor is a Prohibited Investor, as defined in Recommendation 2.3.

## **2.8 Anti-Money Laundering Risks Associated with Receipt/Transfer and Redemption of Funds**

Hedge Fund Managers should consider adopting procedures whereby they only accept wire transfers from a financial institution that is incorporated or has its principal place of business in a FATF jurisdiction. Funds received into a Hedge Fund from an Investor or prospective Investor's bank or brokerage account, should be credited upon redemption to the same bank or brokerage account, unless there is a legitimate reason for, and the Anti-Money Laundering Compliance Officer authorizes, such payment into another account. If an exception is made and the Anti-Money Laundering Compliance Officer or other appropriate officer agrees otherwise, the officer should document the rationale behind permitting transfer or payment into another account. Funds received from an Investor or prospective Investor should not be transferred or credited to any other investment interest without Anti-Money Laundering Compliance Officer or Senior Management approval. In the event an Investor makes a request for an early redemption, the Anti-Money Laundering Compliance Officer, in conjunction with Senior Management, should

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evaluate the reasons for the request to determine whether there are any AML concerns. Such decisions regarding the request for early redemption, including the rationale for granting the request in the event such request is approved, should be documented.

### III. Suspicious and/or Criminal Activity Monitoring and Reporting

#### 3.1 Suspicious Activity Monitoring

Although Hedge Funds and Hedge Fund Managers are not currently required to monitor and report suspicious activity under Section 356 of the PATRIOT Act, in the Proposed AML Program Rule, FinCEN encourages Hedge Funds and Hedge Fund Managers to file Suspicious Activity Reports voluntarily. Moreover, an offshore Hedge Fund or administrator may be required to file a comparable suspicious activity report under the laws of its own jurisdiction. Therefore, a Hedge Fund Manager's policies, procedures and controls should provide for the detection of suspicious activity and should include examples of the types and patterns of activities that may require further review to determine whether the activity is suspicious. For example, in some circumstances, the following activities or requests, none of which *per se* constitutes suspicious activity, may be indicative of activity that may require further investigation:

- An Investor exhibits an unusual concern regarding the Hedge Fund's compliance with government reporting requirements, particularly with respect to the Investor's identity, type of business and assets, or the Investor is reluctant or refuses to reveal any information concerning business activities, or furnishes unusual or suspect identification or business documents;
- An Investor attempts to make frequent subscriptions or redemptions outside of the normal periods;
- An Investor (or a person publicly associated with the Investor) has a questionable background or is the subject of news reports indicating possible criminal, civil, or regulatory violations;

- An Investor appears to be acting as the agent for another entity, but declines, evades or is reluctant, without legitimate commercial reasons, to provide any information in response to questions about that entity;
- An Investor wishes to engage in investments that are inconsistent with the Investor's apparent strategy;
- An Investor has difficulty describing the nature of his or her business or lacks general knowledge of the industry he or she is apparently engaged in;
- An Investor makes a misrepresentation to the Hedge Fund that its name does not appear on an OFAC List, but the name is discovered during the due diligence review process;
- An Investor wishes to engage in investments that are inconsistent with the Investor's apparent investment strategy;
- An Investor attempts, with unusual frequency (taking into account the differences between Direct Investors and Investor intermediaries, as appropriate), to make investments, request redemptions, or transfer funds;
- An Investor engages in unusual or frequent wire transfers (taking into account the differences between Direct Investors and Investor intermediaries, as appropriate), particularly to unfamiliar bank accounts;
- An Investor requests that redemption proceeds be wired to unrelated third parties or to bank accounts in countries other than the Investor's country of origin;
- An Investor insists on dealing only in cash or cash equivalents;
- An Investor requests that a transaction be processed in such a manner so as to avoid the Hedge Fund's normal documentation requirements;
- An Investor exhibits a total lack of concern regarding the investment program, related risks, the management team, *etc.*;
- An Investor has difficulty describing the reasons for request for wire transfers to unfamiliar bank accounts or jurisdictions other than the Investor's country of residence;

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- An Investor makes frequent investments followed by requests for redemptions, especially if the requests are that the proceeds be wired to unrelated third parties or bank accounts in foreign countries;
- An Investor makes non-economic transfers (*e.g.*, substantial financial investments followed by a request for redemption with indifference as to penalty amounts charged by the Hedge Fund Manager for engaging in such transactions);
- An Investor makes or requests transfers to accounts in countries where drug trafficking is known to occur or to other high risk countries;
- An Investor attempts to transfer funds to jurisdictions other than its home country jurisdiction;
- An Investor requests a transfer of an investment interest from a foreign government to a private person; or
- An Investor requests a transfer of an investment to an unrelated third party without a reasonable explanation.

### 3.2 Suspicious Activity Reporting

The Hedge Fund Manager's AML program should require any employee who detects suspicious activity or has reason to believe that suspicious activity is taking place to immediately inform his or her immediate supervisor, as well as the Anti-Money Laundering Compliance Officer, who should determine whether to report the suspicious activity to law enforcement.

As discussed in Part V below, a Hedge Fund Manager should seek to establish effective lines of communication for addressing suspicious activity detected by its fund administrator or another third party on which the Hedge Fund Manager relies for Investor due diligence and provide, for example, that the fund administrator or other third party should, where permitted by law, immediately notify the Hedge Fund Manager's Anti-Money Laundering Compliance Officer of any suspicious activity relating to the Hedge Fund Manager's funds.

The AML program should also remind all employees of the fact that reports of suspicious activity are confidential and may not be disclosed to any person involved in the transaction and that it is a violation of the BSA for a Hedge Fund Manager or the Hedge Fund or its directors, officers, employees, or agents, to notify any person involved in the transaction or any third party that a SAR has been filed, except where requested by FinCEN or an appropriate law enforcement or regulatory agency. The AML program should also address the procedures the Hedge Fund Manager must follow in order to maintain the confidentiality of a SAR in the event it receives a subpoena or is otherwise requested to disclose a SAR or the information contained in a SAR. In that situation, the Hedge Fund Manager must decline to produce the SAR or to provide any information that would disclose that a SAR has been prepared or filed, and contact FinCEN for guidance.

Transactions involving terrorist financing or ongoing money laundering schemes should be immediately reported to FinCEN via the Financial Institutions Hotline (1-866-556-3974), in addition to filing a SAR regarding the activity in a timely manner, when appropriate.

### **3.3 Recordkeeping**

The Hedge Fund Manager should maintain copies of all documentation, records, and communications relating to a reported transaction on behalf of each Hedge Fund. All SARs and supporting documentation related to the SARs shall be retained for a period of at least five years.

## **IV. OFAC Policy And Procedures**

Hedge Funds and Hedge Fund Managers based in the U.S. are subject to regulations administered by OFAC and, therefore, must comply with a series of laws that impose economic and trade sanctions against: (1) certain foreign governments and their agents; (2) agencies, organizations and individuals that sponsor terrorism; and (3) international narcotics traffickers.



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In order to determine whether either an Investor or the source of a funds transfer is covered by an OFAC sanctions program, the Hedge Fund Manager should screen the names of Investors, and to the extent known to the Hedge Fund, any of such Investors' directors, general partners, managing members, trustees, settlors, beneficiaries, or beneficial owners (as applicable), against the OFAC List and the list of countries subject to OFAC's sanctions programs. Such checks should be done at the time an investment is made, any time the OFAC List is updated, and at the time of redemption.

If an Investor resides in, is a citizen of, or an entity has a place of business in, a country or territory named on the OFAC List, or the Investor's name appears on the OFAC List, Hedge Fund Manager personnel should report the information to the Anti-Money Laundering Compliance Officer, who will determine whether the transaction must be rejected or blocked, and whether the transaction must be reported to OFAC.

The Hedge Fund Manager must also file an annual report with OFAC regarding all blocked property held by the Hedge Fund.

The procedures may be contracted out to a third-party service provider approved by the Anti-Money Laundering Compliance Officer or delegated to the administrator, subject to the Anti-Money Laundering Compliance Officer's satisfaction with the administrator's compliance procedures (see Part V, the *2007 AML Guidance*).

### **V. Performance of Investor Identification and other AML Procedures by Third Parties**

#### **5.1 Relationships between Hedge Fund Managers and Third Parties**

The Proposed AML Program Rules recognize the ability of a Hedge Fund or Hedge Fund Manager to contractually delegate the implementation and operation of certain aspects of their AML compliance program to other entities through which the company conducts its business, such as fund administrators, IAs, CPOs, CTAs, broker-dealers (including prime brokers), and futures commission merchants. Consistent with this approach, a Hedge Fund Manager typically delegates to a fund administrator the processing

of subscription documents and compliance with AML laws and regulations applicable in the fund's jurisdiction of organization.<sup>18</sup> Under the Proposed AML Program Rules, a Hedge Fund and Hedge Fund Manager that delegates responsibility for aspects of the AML program would continue to remain fully responsible for the effectiveness of the program.

In addition, the Hedge Fund Manager often relies on third parties such as placement agents or asset aggregators for the introduction of Investors to the fund. Likewise, certain Investor intermediaries, including fund of funds and nominees, may invest in a Hedge Fund on their clients' behalf. These third parties often have direct contact and maintain the primary relationship with the Investor and are consequently in the best position to "know the Investor." As a result, a Hedge Fund Manager may directly or indirectly rely upon the Investor identification procedures performed by such third parties, as set forth in Part II above.

## **5.2 Delegation of Elements of Hedge Fund Manager's AML Program to Third Parties - Administrators, IAs, CTAs**

The Anti-Money Laundering Compliance Officer should be directly involved in the decision to delegate to, and the selection of, a third party to perform certain elements of the Hedge Fund Manager's AML Program, including Investor identification procedures and SAR and in determining whether, and to what extent, such delegation is reasonable and appropriate. Such a decision will often be predicated on the Hedge Fund Manager's interest in directing its AML and due diligence efforts where they are most likely to be productive. Taking into account applicable law and regulation, its own risk assessment of its Investors and available resources, the Anti-Money Laundering Compliance Officer might determine that, absent any specific money laundering concerns, it will generally be appropriate to delegate particular Investor identification or other AML procedures to a third party, such as an administrator, IA, or CTA.

<sup>18</sup> *In addition, fund administrators organized under the laws of the Bahamas, Bermuda, and the Cayman Islands are required to comply with AML laws and regulations enacted in these jurisdictions during the past few years. The AML laws and regulations of these jurisdictions impose detailed "know your customer" obligations on fund administrators.*

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### 5.3 Reliance on Third Parties: Placement Agents/Financial Institutions

Based on these same considerations, the Anti-Money Laundering Compliance Officer might also determine that it will generally be appropriate (absent any specific money laundering concerns) to rely on the Investor identification procedures performed by certain other categories of third parties that have introduced the Investor to the Hedge Fund and, therefore, may be better suited to conduct those procedures. Such third parties can include placement agents or asset aggregators. In addition, Hedge Funds may choose to rely on other financial institutions such as:

- A U.S.-regulated financial institution where the Investor is a customer of the U.S.-regulated financial institution and the Investor's investment funds are wired from its account at the U.S.-regulated financial institution;<sup>19</sup>
- A regulated foreign financial institution organized in a FATF jurisdiction, where the Investor is a customer of such foreign financial institutions and the Investor's investment funds are wired from its account at the foreign financial institution;
- An Investor intermediary, nominee, fund of funds, or asset aggregator that is itself a U.S.-regulated financial institution; or
- An Investor intermediary, nominee, fund of funds, or asset aggregator that is itself a regulated foreign financial institution organized in a FATF jurisdiction.

To the extent that the Hedge Fund Manager believes that the Investor identification procedures performed by a placement agent or regulated foreign financial institution, although reliable, may not include procedures that are included in the Hedge Fund Manager's AML policies and procedures (e.g., determination of whether an Investor is a Prohibited Investor as defined in Recommendation 2.3), the Hedge Fund Manager should either expressly

<sup>19</sup> *As used herein, the term "U.S.-regulated financial institution" would include institutions subject to the AML provisions of the PATRIOT Act, such as a registered broker-dealer and a U.S. branch or agency of a Foreign Bank. Where doubt exists as to the existence of a formal customer relationship between such a financial institution and an Investor, the Hedge Fund Manager may wish to obtain representations from the financial institution confirming the existence of a customer relationship and the performance of customer due diligence.*

request that the foreign financial institution confirm that it has performed the necessary additional procedures or otherwise provide for the performance of such procedures prior to accepting an Investor through the financial institution.

#### 5.4 Allocation of Responsibilities Between the Parties

Regardless of whether a Hedge Fund delegates its Investor identification procedures to an administrator, IA, or CTA, or whether it relies on a financial institution acting as a placement agent or asset aggregator that introduced the Investor, agreements with such third parties that either introduce or process Hedge Fund investments should clearly allocate AML responsibilities between the third party and the Hedge Fund and its Hedge Fund Manager, as appropriate. The Hedge Fund Manager should conduct due diligence with respect to the AML policies of the third party by familiarizing itself with such policies (by, for example, obtaining a copy or a summary of the third-party's AML policies) and determining whether the policies meet the standards set by the Hedge Fund Manager. Agreements with third parties should also seek to establish effective lines of communication for addressing Investor due diligence issues and suspicious activity or circumstances as they arise. Such agreements should also contemplate means by which a Hedge Fund or its Hedge Fund Manager may periodically verify or audit the third party's compliance with its AML policies, procedures, and controls.

*Agreements with Fund Administrators.* A Hedge Fund's agreement with its fund administrator should specifically allocate between the administrator, on the one hand, and the fund and the Hedge Fund Manager, on the other hand, their respective obligations for compliance with applicable U.S. AML laws and regulations, as well as the laws and regulations applicable in the fund's home country jurisdiction.<sup>20</sup> Sample representations and covenants that could be sought from fund administrators are included in Annex D-1.

<sup>20</sup> *The Hedge Fund Manager may wish to seek amendments (in the form of a letter or otherwise) to its existing agreements with fund administrators.*

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*Agreements with Certain Investor Intermediaries.* A Hedge Fund Manager's agreement with an introducing firm or asset aggregator should clearly allocate responsibilities for Investor identification in accordance with the policies adopted by the Hedge Fund Manager. Sample representations and covenants that could be sought from Investor intermediaries in this regard are included in Annex D-2.

### 5.5 Risk-Based Assessment of Third Parties' Anti-Money Laundering Procedures

As part of its determination as to whether it should delegate to or rely on a third party in performing particular AML functions, a Hedge Fund Manager should undertake a risk-assessment of any money laundering concerns relating to the third party, taking into account the jurisdiction in which the third party is located, as well as various other factors indicative of the quality of their AML procedures. This is particularly important, for example, when dealing with unregulated entities or entities that are not based in jurisdictions that have been pre-determined to be acceptable to the Hedge Fund Manager (*e.g.*, non-FATF jurisdictions). In determining whether the Hedge Fund Manager may delegate to or rely on a third party for the purposes of performing certain AML functions, the Hedge Fund Manager may wish to consider various factors, as appropriate, such as:

- Jurisdiction in which the third party is based and the existence of applicable AML laws and regulations. In order to gain comfort regarding the AML structure of another jurisdiction, a Hedge Fund Manager may wish to review pronouncements of U.S. governmental agencies and multilateral organizations<sup>21</sup> regarding the AML laws and regulations in such other jurisdiction:
- Regulatory status of third party and affiliates;
- Reputation and history of third party in the investment industry; and
- The AML and Investor due diligence policies, procedures and controls implemented by the third party.

<sup>21</sup> *In this regard, a Hedge Fund Manager may wish to consult pronouncements and publications by FATF (see also Annexes F and G hereto), FinCEN (see also Annex I hereto) and the U.S. Department of State's INCSR Report.*

## 5.6 Further Assurances

Should the Hedge Fund Manager determine that further assurances from any third party are warranted, it may also wish to consider some of the following possibilities:

- Requiring the third party to provide the Hedge Fund Manager with a copy of its AML and Investor due diligence policies, procedures and controls and to promptly notify the Hedge Fund Manager of any amendment thereto;
- Requiring the third party to certify and covenant that it complies and will continue to comply with its AML and Investor due diligence policies, procedures, and controls;
- Requiring meaningful written representations and covenants as to Investors verified by the third party, *e.g.*, a covenant that it will ensure that no such Investors are Prohibited Investors, as set forth in Recommendation 2.3;
- Requiring the third party to provide access, upon request, to copies of documents reviewed by the third party in performing Investor due diligence;
- Requiring the third party to submit to a review or audit of its AML policies, procedures, and controls and its compliance with them as they relate to the funds managed by the Hedge Fund Manager; and
- In the case of an intermediary or nominee, obtaining evidence of or representations as to its authority to make the contemplated investment.

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## VI. Additional BSA Requirements

### 6.1 Policy Relating to Cash and Cash Equivalents

Given the close association between cash transactions and money laundering, a Hedge Fund Manager should consider limiting the acceptance of cash or cash equivalents such as money orders and traveler's checks. Where such a policy has been adopted, requests for exceptions to this policy should be brought to the Anti-Money Laundering Compliance Officer for approval, and for possible filing of cash transaction reports on an IRS/FinCEN Form 8300.

Pursuant to both the PATRIOT Act and the Internal Revenue Code, the Hedge Fund Manager and each Hedge Fund must report the receipt of one or more related cash or cash equivalent transactions that exceed \$10,000. The transactions are reportable on IRS/FinCEN Form 8300 and must be filed by the 15th day after the date the cash or cash equivalent was received. The AML procedures should describe these requirements and the timing for filing these forms, as well as the legal prohibition against "structuring" such cash transactions in order to avoid the reporting requirement. Whenever patterns of structuring are identified, the Anti-Money Laundering Compliance Officer should be notified.

### 6.2 Foreign Bank and Financial Accounts Report

The AML procedures should also address the responsibility of a Hedge Fund and Hedge Fund Manager to report any financial interest in, or signature or other authority over, any non-U.S. financial accounts, including bank, securities, or other types of financial accounts in a foreign country, if the aggregate value of those financial accounts exceeds \$10,000 at any time during the calendar year. Such reports must be made each calendar year by filing TD 90-22.1 with FinCEN on or before June 30 of the succeeding year. MFA has recently sought guidance from the Internal Revenue Service ("IRS"), with respect to the reporting rule and how it applies in various scenarios that commonly arise in the Hedge Fund industry.

### **6.3 Reports of Transportation of Monetary Instruments**

The AML procedures should also address the responsibility of a Hedge Fund and Hedge Fund Manager to file reports of the physical transportation of cash or cash-like monetary instruments, (*e.g.*, all traveler's checks and various other negotiable instruments and securities in bearer form) of more than \$10,000 into or outside of the United States to the U.S. Customs Service on a Report of International Transportation of Currency or Monetary Instruments ("FinCEN Form 105" or "CMIR"). The procedures should also address the prohibition on structuring of the transaction so as to avoid the CMIR reporting requirement. All questions about CMIR reporting should be directed to the Anti-Money Laundering Compliance Officer.

## **VII. General Recordkeeping Requirements**

All documentation related to a Hedge Fund or Hedge Fund Manager's AML program not addressed above should be retained for a period of at least five years.



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### ANNEX A: Definitions

1. *2007 AML Guidance* is MFA's *Guidance for Hedge Funds and Hedge Fund Managers on Developing Anti-Money Laundering Programs* (Release No. 2).
2. **AML** is defined as anti-money laundering.
3. The **Anti-Money Laundering Compliance Officer** is the person appointed by Senior Management, among other things, to administer the Hedge Fund Manager's AML program.
4. The **BSA** is the Bank Secrecy Act, as amended.
5. A **Close Associate** of a SFPF/PEP is a person who is widely and publicly known (or is actually known by the Hedge Fund Manager or the Hedge Fund) to be a close associate of such an individual.
6. The **CFTC** is the U.S. Commodity Futures Trading Commission.
7. A **CMIR** or **FinCEN Form 105** is a form published by the U.S. Customs Service on a Report of International Transportation of Currency or Monetary Instruments.
8. The **CEA** is the Commodity Exchange Act, as amended.
9. A **Commodity Pool Operator** or **CPO** is defined under the CEA as "any person engaged in a business that is of the nature of an investment trust, syndicate, or similar form of enterprise and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in any commodity for future delivery on or subject to the rules of any contract market or derivatives transaction execution facility," subject to certain exceptions. Section 1a(5) of the CEA, 7 U.S.C. § 1a(5).

10. A **Commodity Trading Advisor** or **CTA** is defined under the CEA as “any person who, for compensation or profit, engages in the business of advising others, either directly or [indirectly], as to the value . . . or . . . advisability of trading in any contract of sale of a commodity for future delivery made or to be made on or subject to the rules of a contract market or derivatives transaction execution facility, or any commodity option authorized under section 6c [of the CEA], or any leverage transaction authorized under section 23 [of the CEA], or for compensation or profit, and as part of a regular business, issues or promulgates analyses or reports concerning any of the activities referred to above, subject to certain exemptions. Section 1a(6) of the CEA, 7 U.S.C. § 1a(6).
11. A **Direct Investor** is an Investor who invests in a Hedge Fund as principal and not for the benefit of any third party.
12. The **Financial Action Task Force** or **FATF** is an international organization comprised of representatives of the financial, regulatory, and law enforcement communities from around the world, which serves as the world leader in the development of effective AML programs. A list of current FATF-member jurisdictions is available at ([www.oecd.org/fatf](http://www.oecd.org/fatf)), and included in Annex F attached hereto.
13. A **FATF Jurisdiction** is a country or territory that is a member in good standing of the FATF.
14. A **Foreign Bank** means a bank organized under foreign law, or an agency, branch, or office located outside the United States. The term does not include an agent, agency, branch, or office within the United States of a bank organized under foreign law.
15. **FinCEN** is the Financial Crimes Enforcement Network of the U.S. Department of Treasury.
16. A **Hedge Fund** is a pooled investment vehicle that generally meets the following criteria: (1) it is not marketed to the general public (*i.e.*, privately-offered); (2) it is limited to high net worth individuals and institutions; (3) it is not registered as an investment company under relevant laws (*e.g.*, U.S. Investment Company Act of 1940); (4) its

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assets are managed by a professional investment management firm that shares in the gains of the investment vehicle based on investment performance of the vehicle; and (5) it has periodic but restricted or limited investor redemption rights. The term Hedge Fund, as used in these Recommendations, is not intended to capture private investment funds that are “purely” traditional private equity, venture capital, or real estate funds, although MFA recognizes that individual Hedge Funds may in accordance with their offering documents pursue these and other investment strategies.

17. A **Hedge Fund Manager** is a professional investment management firm that serves as investment manager for a Hedge Fund and manages its assets and investments.
18. A **High Risk Investor** is an Investor that a Hedge Fund Manager has reason to believe presents high risk factors with regard to money laundering or terrorist financing. Examples of high risk factors with regard to money laundering and terrorist financing can be found in Recommendation 2.4.
19. An **Immediate Family Member** of a SFPP/PEP means a spouse, parents, siblings, children, and spouse’s parents or siblings.
20. The **International Narcotics Control Strategy Report** or INCSR is an annual report issued by the U.S. Department of State that assesses the money laundering risks of various countries and jurisdictions.
21. The **IRS** is the U.S. Internal Revenue Service.
22. An **Investment Adviser** or **IA** is defined in the Investment Advisers Act of 1940 as “any person who, for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or . . . issues . . . analyses or reports concerning securities,” subject to certain exceptions. Section 202(a)(11) of the the Investment Advisers Act of 1940, 31 U.S.C. § 80b-2(a)(11).

23. An **Investment Company** is defined under section 3 of the Investment Company Act as “any issuer which . . . is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities,” subject to certain exemptions. 15 U.S.C. §§ 80a-3(a)(1)(A), (c)(1) and (c)(7).
24. **Investment Company Act** is the U.S. Investment Company Act of 1940, as amended.
25. The term **Investor** includes, unless otherwise indicated, any Direct Investor, and any intermediary or nominee that makes an investment on behalf of other Investors.
26. The term **Investor identification procedures** refers to those procedures a Hedge Fund Manager establishes and maintains that are designed to identify an Investor to the extent reasonable and practical and to reduce the Hedge Fund Manager’s exposure to criminal liability and reputational harm.
27. **MFA** is the Managed Funds Association.
28. A **Non-Cooperative Jurisdiction** or **NCCT jurisdiction** means any foreign country that has been designated as non-cooperative with international AML principles or procedures by an intergovernmental group or organization, such as FATF, of which the United States is a member and with which designation the United States representative to the group or organization continues to concur.
29. **OFAC** is the U.S. Department of Treasury’s Office of Foreign Assets Control.
30. The **OFAC List** is the *List of Specially Designated Nationals and Blocked Persons* administered by OFAC, as such lists may be amended from time to time.
31. An **offshore bank** refers to a non-U.S. bank that possess a license to conduct banking activities that prohibits the licensing entity from conducting banking activities with the citizens of, or in the local currency of, the jurisdiction that issued the license.

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32. **Physical Presence** means a place of business that is maintained by a foreign bank and is located at a fixed address, other than solely an electronic address or a post-office box, in a country in which the foreign bank is authorized to conduct banking activities, at which location the foreign bank employs one or more individuals on a full time basis, maintains operating records related to its banking activities, and is subject to inspection by the banking authority that licensed the foreign bank to conduct banking activities.
33. A **Politically Exposed Person** or **PEP** is a term used for individuals who are or have been entrusted with prominent public functions in a foreign country, for example Heads of State or of government, senior politicians, senior government, judicial or military officials, senior executives of state owned corporations, important political party officials, etc. Business relationships with family members or close associates of PEPs involve reputational risks similar to those with PEPs themselves. See FATF 40 Recommendations Glossary at ([www.fatfgafi.org/glossary/0,3414,en\\_32250379\\_32236889\\_35433764\\_1\\_1\\_1\\_1,00.html#34285860](http://www.fatfgafi.org/glossary/0,3414,en_32250379_32236889_35433764_1_1_1_1,00.html#34285860)).
34. The *Preliminary Guidance* is MFA's original *Preliminary Guidance for Hedge Funds and Hedge Fund Managers on Developing Anti-Money Laundering Programs*, published on March 28, 2002.
35. A **Private Investment Company** or **PIC** is a type of international business corporation, typically used to hold individual funds and investments in which ownership can be vested through bearer shares or registered shares, which is incorporated frequently in countries that impose low or no taxes on company assets or that are bank secrecy havens. PICs can offer confidentiality of ownership, as the shares of a PIC may be held by a trust, which may hold assets centrally, and provide intermediaries between private banking customers and the potential beneficiaries of the PICs. As a result, PICs are typically viewed by regulators as posing money laundering risk and, therefore, requiring enhanced due diligence, as appropriate. See *Bank Secrecy Act Anti-Money Laundering Examination Manual*, Federal Financial Institutions Examination Council, at pp. 285-86 (2006).

36. A **Prohibited Foreign Shell Bank** means a bank incorporated in a jurisdiction in which it has no physical presence and which is unaffiliated with a regulated financial group.
37. A **Prohibited Investor** is: (1) An individual or entity whose name appears on: (a) any lists of prohibited persons and entities as may be mandated by applicable law or regulation, including the *List of Specially Designated Nationals and Blocked Persons* administered by OFAC as such lists may be amended from time to time; (b) such other lists of prohibited persons and entities as may be mandated by applicable U.S. law or regulation consider specifying other lists to be verified; or (c) such other lists of prohibited persons and entities as may be provided to the administrator by the Hedge Fund Manager;
- (2) An individual or entity who is from a country or territory prohibited by the OFAC sanctions programs;
- (3) An individual or entity who is a resident in, or organized or chartered under the laws of, a jurisdiction that has been designated by the Secretary of the U.S. Department of Treasury under Section 311 of the PATRIOT Act as warranting special measures due to money laundering concerns; or
- (4) A Prohibited Foreign Shell Bank.
38. **Proposed AML Program Rules**, as amended and supplemented, were rules issued by FinCEN on September 18, 2002, which require UICs to establish AML programs. The Proposed AML Program Rules were later expanded to IAs and CTAs on April 28, 2003 by FinCEN.
39. **RIA** stands for a registered investment adviser.
40. The **SEC** is the U.S. Securities and Exchange Commission.
41. A **Senior Foreign Political Figure** or **SFPF** is: (1) a current or former senior official in the executive, legislative, administrative, military, or judicial branches of a non-U.S. government (whether elected or not), a current or former senior official of a major non-U.S. political party, or

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a current or former senior executive of a non-U.S. government-owned commercial enterprise; (2) a corporation, business, or other entity that has been formed by, or for the benefit of, any such individual; (3) an immediate family member of any such individual; and (4) a person who is widely and publicly known (or is actually known by the Hedge Fund Manager or the Hedge Fund) to be a close associate of such individual. For purposes of this definition, a “senior official” or “senior executive” means an individual with substantial authority over policy, operations, or the use of government-owned resources. See 31 C.F.R. § 103.175(r).

42. **SFPF/PEP** is a short-hand term used to refer to a Senior Foreign Political Figure or Politically Exposed Person.
43. **Senior Management** refers to members of a group of senior executives or other management body with the authority and responsibility to direct and oversee a Hedge Fund Manager’s day-to-day activities on behalf of a Hedge Fund or Hedge Funds.
44. **Sound Practices** is MFA’s *Sound Practices for Hedge Fund Managers*.
45. A **SAR** is a Suspicious Activity Report.
46. An **underlying Investor** is the beneficial owner of shares of stock in a company.
47. **Unregistered Investment Companies** or **UICs** are certain investment companies that are not registered with the SEC, including private investment funds, Hedge Funds, private equity funds, venture capital funds, commodity pools, and real estate investment trusts.
48. The term **U.S.-regulated financial institution** includes institutions subject to the AML provisions of the Patriot Act.
49. **USAAct of 2001** or **PATRIOT Act** or **the Act** means the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (PATRIOT) Act of 2001 (Pub. L. No. 107-56).

## **ANNEX B: Model Anti-Money Laundering Attestation**

- 1. For use in dealings with Registered Investment Adviser (“RIA”)/  
Unregistered Investment Companies (“FUNDS”) – Annex B-1**
- 2. For use in dealings with Unregistered Investment Advisers/Non-U.S.  
Regulated Investment Advisers (“IA”) and Unregistered Investment  
Companies (“FUNDS”) – Annex B-2**



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## ANNEX B-1: Model Anti-Money Laundering Attestation

For use in dealings with Registered Investment Adviser (“RIA”)/  
Unregistered Investment Companies (“FUNDS”)\*

Name: \_\_\_\_\_

Address: \_\_\_\_\_

On behalf of the RIA named above, and the FUNDS it manages [or the FUNDS managed by its affiliates] (hereafter “RIA/FUNDS”), the undersigned represents and warrants that:

1. The RIA is an Investment Adviser registered with the U.S. Securities and Exchange Commission and under the Investment Advisers Act of 1940 [or a Commodity Trading Advisor (“CTA”) or Commodity Pool Operator (“CPO”) registered under the Commodity Exchange Act].
2. The RIA/FUNDS has implemented and currently maintains AML procedures that are reasonably designed to be consistent with the AML provisions of *Sound Practices for Hedge Fund Managers*, which Managed Funds Association believes are generally in accord with the requirements of the Bank Secrecy Act, as amended by the PATRIOT Act of 2001 (the “PATRIOT Act”).
3. The RIA/FUNDS has adopted procedures reasonably designed to comply with the laws, regulations, and Executive Orders administered by the U.S. Department of the Treasury’s Office of Foreign Assets Control (“OFAC”), including the *List of Specially Designated Nationals and Blocked Persons* administered by OFAC, as such list may be amended from time to time.

\* *This form can be used for all FUNDS introduced by an IA, and should be prepared on the letterhead of the IA. Where the IA is affiliated with an RIA, the form for an RIA should be used.*

4. The RIA/FUNDS or its designee, including, as appropriate, the FUNDS' administrator, will retain relevant documentation with respect to the investor/shareholder,<sup>1</sup> including identification information, obtained in accordance with the above procedures for five years after the date on which the investor/shareholder withdraws from the FUND.
5. Upon a reasonable request, the RIA agrees to recertify in writing the representations and warranties provided herein.

### CERTIFICATION

On behalf of the RIA/FUNDS, the undersigned hereby certifies that I have read the foregoing representations and warranties, and acknowledge that the foregoing representations and warranties are true and correct.

RIA Name: \_\_\_\_\_

Address: \_\_\_\_\_

By: Name of Compliance Officer  
or Senior Manager: \_\_\_\_\_

Title: \_\_\_\_\_

Signature: \_\_\_\_\_ Date: \_\_\_\_\_

or:

By: FUND's Administrator<sup>2</sup> : \_\_\_\_\_

Name of Authorized Person: \_\_\_\_\_

Title: \_\_\_\_\_

Signature: \_\_\_\_\_ Date: \_\_\_\_\_

<sup>1</sup> The term "investor/shareholder," as used herein, means any "direct investor" or any intermediary or nominee who makes an investment on behalf of other investors/shareholders. A "direct investor" is an investor/shareholder who invests in a Hedge Fund as principal and not for the benefit of any third party.

<sup>2</sup> In appropriate circumstances, this representation letter may be signed by the FUND's Administrator, and prepared on its letterhead.

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## ANNEX B-2: Model Anti-Money Laundering Attestation

For use in dealings with Unregistered Investment Advisers/  
Non-U.S. Regulated Investment Advisers (“IA”) and  
Unregistered Investment Companies (“FUNDS”)\*

Name: \_\_\_\_\_

Address: \_\_\_\_\_

On behalf of the IA named above, and the FUNDS it manages (hereafter “IA/FUNDS”), the undersigned represents and warrants that:

1. The IA is organized under the laws of [Insert name of jurisdiction] [and regulated by [Insert name of applicable regulator]].
2. The IA/FUNDS has implemented and currently maintains anti-money laundering procedures that are reasonably designed to be: (1) consistent with the anti-money laundering provisions of *Sound Practices for Hedge Fund Managers* (“*Sound Practices*”), which Managed Funds Association believes are generally in accord with the requirements of the Bank Secrecy Act, as amended by the PATRIOT Act of 2001 (the “PATRIOT Act”); and (2) compliant with applicable anti-money laundering laws, rules, and regulations of its own jurisdiction.
3. The IA/FUNDS has, consistent with *Sound Practices*, applied, and will continue to apply, its anti-money laundering procedures to all investors/shareholders<sup>1</sup>, and will, in accordance with the laws of its own jurisdiction, take reasonable measures to identify all investors/shareholders.

\* *This form can be used for all FUNDS introduced by an IA, and should be prepared on the letterhead of the IA. Where the IA is affiliated with an RIA, the form for an RIA should be used.*

<sup>1</sup> *The term “investor/shareholder,” as used herein, means any “direct investor” or any intermediary or nominee who makes an investment on behalf of other investors/shareholders. A “direct investor” is an investor/shareholder who invests in a Hedge Fund as principal and not for the benefit of any third party.*

4. The IA/FUNDS has, consistent with *Sound Practices*, undertaken appropriate due diligence efforts with respect to each investor/shareholder, including enhanced scrutiny with respect to senior foreign political figures<sup>2</sup> /politically exposed persons,<sup>3</sup> the preclusion of any prohibited foreign shell bank,<sup>4</sup> and the screening of any country, territory, individual and/or entity prohibited pursuant to applicable economic sanctions programs, including, without limitation, all applicable sanctions regimes promulgated or administered by the U.S. Department of Treasury's Office of Foreign Assets Control ("OFAC"), the United Nations, the European Union, and/or any other applicable jurisdiction's economic sanctions regime.<sup>5</sup>

<sup>2</sup> A "senior foreign political figure" is defined as: (1) a current or former senior official in the executive, legislative, administrative, military or judicial branches of a non-U.S. government (whether elected or not), a current or former senior official of a major non-U.S. political party, or a current or former senior executive of a non-U.S. government-owned commercial enterprise; (2) a corporation, business, or other entity that has been formed by, or for the benefit of, any such individual; (3) an immediate family member of any such individual; and (4) a person who is widely and publicly known (or is actually known by the IA or the FUND) to be a close associate of such individual. For purposes of this definition, a "senior official" or "senior executive" means an individual with substantial authority over policy, operations, or the use of government-owned resources; and "immediate family member" means a spouse, parents, siblings, children, and spouse's parents or siblings.

<sup>3</sup> A "politically exposed person" is a term used for individuals who are or have been entrusted with prominent public functions in a foreign country, for example, heads of state or of government, senior politicians, senior government, judicial or military officials, senior executives of state-owned corporations.

<sup>4</sup> A "prohibited foreign shell bank" is a bank incorporated in a jurisdiction in which it has no physical presence and which is unaffiliated with a regulated financial group.

<sup>5</sup> U.S. IAs/FUNDS must comply with the sanctions programs administered by OFAC, including the List of Specially Designated Nationals and Blocked Persons administered by OFAC, as such list may be amended from time to time.

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5. The IA/FUNDS or its designee, including, as appropriate, the FUNDS' Administrator, will retain relevant documentation, including identification information, obtained in accordance with the above procedures [for at least five years] after the date on which the investor/shareholder withdraws from the FUND.
6. Upon a reasonable request, the IA/FUNDS agrees to recertify the representations and warranties provided herein.

### CERTIFICATION

On behalf of the IA/FUNDS, the undersigned hereby certifies that I have read the foregoing representations and warranties, and acknowledge that the foregoing representations and warranties are true and correct.

IA Name: \_\_\_\_\_

Address: \_\_\_\_\_  
\_\_\_\_\_

By: Name of Compliance Officer  
or Senior Manager: \_\_\_\_\_

Title: \_\_\_\_\_

Signature: \_\_\_\_\_ Date: \_\_\_\_\_

or:

By: FUND's Administrator<sup>6</sup> : \_\_\_\_\_

Name of Authorized Person: \_\_\_\_\_

Title: \_\_\_\_\_

Signature: \_\_\_\_\_ Date: \_\_\_\_\_

<sup>6</sup> *In appropriate circumstances, this representation letter may be signed by the FUND's administrator, and prepared on its letterhead.*

## ANNEX C: Proposed Template for Anti-Money Laundering Policies and Procedures\*

MFA believes that the template below sets forth the key elements that should be included in a Hedge Fund Manager's AML policies, procedures, and controls. AML compliance will be undergoing great change as regulations implementing the PATRIOT Act are promulgated and as industry guidance develops over time, and MFA anticipates that it will periodically update this template accordingly. Similarly, a Hedge Fund Manager should therefore update its AML policies, procedures, and controls as necessary to reflect applicable law and regulation and developing industry practice.

Given the degree to which Hedge Funds vary in size and organizational structure, as well as in the profile of their Investor bases, MFA believes that no one standard or model AML program can be appropriate for all Hedge Fund Managers. The appropriateness of policies and procedures for a Hedge Fund Manager will depend on a number of factors, including, but not limited to: (1) laws and regulations applicable to the Hedge Fund and Hedge Fund Manager; (2) the specific risks presented by the Investor base of each Hedge Fund that is managed by the Hedge Fund Manager; (3) the Hedge Fund Manager's relationships with its fund administrator and its Investor intermediaries; and (4) the Hedge Fund Manager's available resources. Consequently, a Hedge Fund Manager's AML policies, procedures, and controls need to be tailored to the specific circumstances presented and should only be adopted on the advice of qualified professional advisers.

\* *Unless otherwise defined, capitalized terms shall have the meanings ascribed to them in the 2007 AML Guidance.*

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[Name of Hedge Fund Manager]

## ANTI-MONEY LAUNDERING POLICIES, PROCEDURES AND CONTROLS

Dated as of [insert date adopted/last updated]

### I FUNDAMENTAL ELEMENTS OF ANTI-MONEY LAUNDERING PROGRAM

#### A. Policy Statement

This section should clearly set forth the Hedge Fund Manager's policy against money laundering and any activity that facilitates money laundering or the funding of terrorist activity. (See Recommendation 1.1.) This policy should be adopted at the Hedge Fund Manager's highest executive level.

The following is an example of such a policy statement:

"[SENIOR MANAGEMENT/THE BOARD OF DIRECTORS] HAS DETERMINED THAT IT IS THE POLICY OF \_\_\_\_\_ TO SEEK TO PREVENT THE MISUSE OF THE FUNDS IT MANAGES AND ITS PERSONNEL AND FACILITIES FOR PURPOSES OF MONEY LAUNDERING AND TERRORIST FINANCING. \_\_\_\_\_ HAS ADOPTED AND ENFORCES RIGOROUS POLICIES, PROCEDURES AND CONTROLS TO DETECT AND DETER THE OCCURRENCE OF MONEY LAUNDERING AND OTHER ILLEGAL ACTIVITY.]"

A statement could also be included to emphasize that: (1) AML compliance is the responsibility of every employee of the Hedge Fund Manager; and (2) any employee that detects activity that seems to be suspicious should immediately report such activity to the Anti-Money Laundering Compliance Officer.

## **B. Objectives of the Anti-Money Laundering Program**

This section should clearly set forth the objectives of the Hedge Fund Manager's AML program. (See Recommendation 1.1.) These objectives should include the detection and deterrence of instances of money laundering, terrorist financing, and other illegal activity. This section should also provide that all employees of the Hedge Fund Manager should be generally informed of the AML policy and procedures adopted by the Hedge Fund Manager and be familiar with the substance and intent of such policy and procedures (see Recommendation 1.3).

## **C. Basic Elements of the Anti-Money Laundering Program**

This section should state the four basic elements of an AML program for UICs, IAs, and CTAs under Section 352 of the PATRIOT Act: (1) the development of internal policies, procedures, and controls; (2) the designation of a compliance officer; (3) an ongoing employee training program; and (4) an independent audit function to test programs. Such programs should be in writing and approved by Senior Management (see Recommendation 1.2).

## **D. Role of Senior Management and the Anti-Money Laundering Compliance Officer**

This section should clearly identify the Anti-Money Laundering Compliance Officer appointed by the Hedge Fund Manager and provide sufficient contact details for this person. This section should also describe the role of Senior Management and the Anti-Money Laundering Compliance Officer in the development, adoption, and enforcement of written AML policies, procedures, and controls, and that it is the responsibility of the Anti-Money Laundering Compliance Officer, in consultation with Senior Management, as appropriate, to decide whether to accept or reject an Investor when the Investor has been categorized as high risk. In addition, this section



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should provide that the Anti-Money Laundering Compliance Officer determine whether to delegate the performance of Investor identification procedures to a third party (see Recommendation 1.4).

### **E. Investor Identification Policies and Procedures**

This section should state that the Hedge Fund Manager should establish written policies and procedures regarding Investor identification, which is addressed in Part II below. In addition, the Hedge Fund Manager should periodically review and update their AML policies and procedures (see Recommendation 1.5).

### **F. Responsibilities of the Anti-Laundering Compliance Officer**

This section should clearly identify the responsibilities of the Anti-Money Laundering Compliance Officer. See Recommendation 1.6 for a discussion of the role and possible responsibilities of the Anti-Money Laundering Compliance Officer. This section might also include a statement that: (1) encourages the employees of the Hedge Fund Manager to seek the assistance of the Anti-Money Laundering Compliance Officer in addressing any money laundering-related concerns that they may have; and (2) directs the employees of the Hedge Fund Manager to immediately report suspicious activity to the Anti-Money Laundering Compliance Officer.

### **G. Employee Training Program**

This section should describe the Hedge Fund Manager's employee training program (see Recommendation 1.7) and in particular a training program might set forth:

- (1) The general content of the Hedge Fund Manager's AML training program(s);
- (2) Regularity with which the training program will be conducted;

- (3) Person(s) responsible for conducting the program (*e.g.*, the Anti-Money Laundering Compliance Officer);
- (4) The requirement that each employee comply with the Hedge Fund Manager's policies and procedures;
- (5) Depending on their function, the group of employees that will be required to attend the AML training program(s) and procedures to ensure attendance; and
- (6) The procedures for creating and maintaining records of all AML training sessions conducted, including the dates and locations of the training sessions and the names and departments of attendees, and maintenance of these records for a minimum specified period (*e.g.*, five years).

#### **H. Independent Audit Function**

This section should provide for an independent audit function to assess the Hedge Fund Manager's compliance with, and the effectiveness of, its AML program (see Recommendation 1.8). In particular the independent audit function might set forth:

- (1) Regularity with which the independent audit will be performed (*e.g.*, annually at a specified time);
- (2) Person(s) responsible for performing the audit (*e.g.*, appropriate member of Senior Management or external professionals);
- (3) Procedures applicable to auditing performance of third parties upon whom the Hedge Fund Manager relies for the performance of Investor identification procedures and other AML responsibilities;
- (4) Evaluation of the Hedge Fund Manager's compliance with applicable AML laws and regulations and the Hedge Fund Manager's own AML program;
- (5) Reporting of the results of such evaluation to the audit committee of the board of directors or similar oversight body of the Hedge Fund or Hedge Fund Manager; and

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- (6) Appropriate follow-up to ensure that any deficiencies detected in the course of the audit of its AML program are addressed and rectified.

### I. Representations to Counterparties on Policies and Procedures

This section sets forth the understanding that the Hedge Fund Manager may be required to make AML attestations to financial institutions, and provides *Model Anti-Money Laundering Attestation* attached as Annex B (see Recommendation 1.9).

## II. INVESTOR IDENTIFICATION POLICIES AND PROCEDURES

### A. Objectives

This section should provide that the Hedge Fund Manager should establish and maintain reasonable procedures that are designed to identify Investors (see Recommendation 2.1).

### B. Consider Characteristics of Investor Base

This section should provide that the Hedge Fund Manager's Investor identification procedures should take into account the risks of the Investor base of the Hedge Fund it manages.

### C. General Premise

This section should state that the Hedge Fund Manager's Investor identification procedures are based on the general premise that the Hedge Fund Manager should only accept an investment from a new Investor after its performance of one of the following due diligence steps: (1) undertaking reasonable due diligence efforts with respect to the Direct Investor; (2) undertaking reasonable due diligence efforts with respect to the identity of an Investor, who is investing on behalf of other underlying Investors, and the underlying Investors themselves; or (3) determining whether it is acceptable to rely on Investor due diligence performed by a third party.

## D. Investor Identification Procedures

This section should describe in detail the procedures undertaken by the Hedge Fund Manager to conduct reasonable due diligence efforts with respect to the identities of Investors to the extent reasonable and practical and to ensure that Prohibited Investors are not permitted to invest in the Hedge Fund it manages (see Recommendations in Part II). To the extent that the Hedge Fund Manager relies on third parties to perform certain Investor identification procedures (as discussed in Part V of the *2007 AML Guidance* and as addressed in Part V of this template), this section should take into account those arrangements as applicable.

Investor identification procedures should be based upon the specific characteristics presented by the following types of Investors:

### (1) Natural persons

See Recommendation 2.2.1 for examples of the types of procedures that might be included here.

### (2) Corporations, partnerships and comparable legal entities

See Recommendation 2.2.2 for examples of types of procedures that might be included here.

### (3) Prohibited Investors

This section should clearly identify those types of Investors that are prohibited from investing in the Hedge Fund managed by the Hedge Fund Manager. See Recommendation 2.3 for examples of the types of Investors that should be prohibited from investing; a Hedge Fund Manager or Hedge Fund may wish to identify other types of Investors that are prohibited. This section should also include procedures that provide for screening for Prohibited Investors, including:

- a. Investors whose names appear on any lists of prohibited persons and entities as may be mandated by applicable law or regulation, including the *List of Specially Designated Nationals*

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*and Blocked Persons* administered by the U.S. Department of Treasury's OFAC<sup>1</sup>, as such lists may be amended from time to time;

- b. Investors who are from a country or territory prohibited by the OFAC sanctions programs;
- c. Investors who are resident in, or organized or chartered under the laws of, a jurisdiction that has been designated by the Secretary of the U.S. Department of Treasury under Section 311 of the PATRIOT Act as warranting special measures due to money laundering concerns; or
- d. Prohibited Foreign Shell Bank.

### (4) High Risk Investors

This section should identify the types of Investors that the Hedge Fund Manager considers to be “high risk” and requiring enhanced Investor identification procedures. Examples of High Risk Investors are discussed in Recommendation 2.4 and include:

- a. Investors not located in a FATF jurisdiction;
- b. Non-U.S. PICs<sup>2</sup>;
- c. A SFPF/PEP, an immediate family member, or close associate of a SFPF/PEP<sup>3</sup>;

<sup>1</sup> OFAC's List of Specially Designated Nationals and Blocked Persons *may be accessed at* ([www.treas.gov/ofac](http://www.treas.gov/ofac)).

<sup>2</sup> See definition of “Private Investment Companies” in Appendix A and the BSA Anti-Money Laundering Examination Manual, *Federal Financial Institutions Examination Council*, at pg. 292 (2007) ([www.ffiec.gov/pdf/bsa\\_aml\\_examination\\_manual2007.pdf](http://www.ffiec.gov/pdf/bsa_aml_examination_manual2007.pdf)).

<sup>3</sup> See definition of SFPF in Appendix A and the final rule implementing Section 312 of the PATRIOT Act, 31 C.F.R. § 103.175(r); see also definition of a PEP in Appendix A and the FATF 40 Recommendations Glossary at ([www.fatf-gafi.org/glossary/0,3414,en\\_32250379\\_32236889\\_35433764\\_1\\_1\\_1\\_1,00.html#34285860](http://www.fatf-gafi.org/glossary/0,3414,en_32250379_32236889_35433764_1_1_1_1,00.html#34285860)).

- d. Any Investor resident in, or organized or chartered under the laws of, a Non-Cooperative Jurisdiction<sup>4</sup>;
- e. Any Investor whose subscription funds originate from, or are routed through, an account maintained at a Prohibited Foreign Shell Bank, an offshore bank, a bank organized or chartered under the laws of a Non-Cooperative Jurisdiction, or a bank or financial institution subject to special measure under Section 311 of the PATRIOT Act;
- f. Any Investor that is a Foreign Bank subject to enhanced due diligence under Section 312 of the PATRIOT Act; or
- g. Any Investor who gives the Hedge Fund Manager reason to believe that the source of its subscription funds may not be legitimate.

This section should then address the enhanced Investor identification procedures that should be applied to High Risk Investors.

The procedures should distinguish between:

- a. Natural persons

See Recommendation 2.4.1 for examples of the types of procedures that might be included here.

- b. Legal entities

See Recommendation 2.4.2 for examples of the types of procedures that might be included here.

<sup>4</sup> *There are presently no countries or territories that have been designated by FATF as non-cooperative with international AML efforts.*

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### **E. Inadequate Information**

This section should specify the Hedge Fund Manager's procedures for handling situations when there is inadequate information obtained with respect to Investors, or Investor identification procedures cannot be performed. When Investor subscriptions are approved, this section should specify the Hedge Fund Manager's procedures for monitoring such Investors (see Recommendation 2.5).

### **F. Investor Record Retention**

This section should describe the Hedge Fund Manager's procedures regarding retention of documents reviewed as part of its performance of Investor identification procedures (see Recommendation 2.6).

### **G. Risk Focused Review of Existing Investors**

This section should address the Hedge Fund Manager's procedures for the periodic review of the adequacy of its due diligence performed on existing Investors (see Recommendation 2.7).

### **H. Anti-Money Laundering Risks Associated with Receipt/Transfer and Redemption of Funds**

This section should describe the Hedge Fund Manager's procedures for receipt, transfer, and redemption of funds with respect to Investors. Specifically, this section should provide that the Hedge Fund Manager should only accept wire transfers from financial institutions in FATF jurisdictions and that such funds should only be credited upon redemption to that same Investor's bank or brokerage account, unless otherwise approved by the Anti-Money Laundering Compliance Officer and/or Senior Management. Also, this section should state that any requests for early redemption should be evaluated by the Anti-Money Laundering Compliance Officer and/or Senior Management. Decisions regarding these instances should be documented (see Recommendation 2.8).

### III. SUSPICIOUS AND/OR CRIMINAL ACTIVITY MONITORING AND REPORTING

#### A. Suspicious Activity Monitoring

This section should address the fact that the U.S. Department of Treasury encourages the Hedge Fund and Hedge Fund Manager to file a SAR voluntarily. This section should also address offshore Hedge Funds and administrators who may be required to file a comparable suspicious activity report in accordance with the laws of their own jurisdiction. See Recommendation 3.1 for examples of “red flags” which may require the filing of SARs.

#### B. Suspicious Activity Reporting

This section should provide a statement directing employees of the Hedge Fund Manager to immediately report suspicious activity to their immediate supervisor and the Anti-Money Laundering Compliance Officer. This section should also provide a statement directing employees of the Hedge Fund Manager to keep any such SARs confidential. The statement should warn employees not to discuss the suspicious activity or the fact that it has been referred to the Anti-Money Laundering Compliance Officer with the Investor concerned or any third party, except where requested by FinCEN or an appropriate law enforcement or regulatory agency (see Recommendation 3.2).

#### C. Recordkeeping

This section should address the recordkeeping procedures for SARs and supporting documentation related to such SARs, as such documentation should be retained for a period of at least five years (see Recommendation 3.3).



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### IV. OFAC POLICIES AND PROCEDURES

This section should set forth the Hedge Fund Manager's policies and procedures for screening Investors against the list of countries, territories, individuals, and/or entities prohibited pursuant to the laws, regulations, and executive orders administered by OFAC, including the *List of Specially Designated Nationals and Blocked Persons* administered by OFAC, as such list may be amended from time to time. This section should provide that these procedures may be contracted out to a third-party service provider. This section should also set forth the Hedge Fund Manager's policies and procedures for dealing with Investors prohibited by OFAC, including the reporting of such Investors to OFAC.

### V. PERFORMANCE OF INVESTOR IDENTIFICATION AND OTHER AML PROCEDURES BY THIRD PARTIES

#### A. Relationships between the Hedge Fund Manager and Third Parties

This section should address the fact that the U.S. Department of Treasury has recognized the ability of a Hedge Fund or Hedge Fund Manager to contractually delegate the implementation and operation of certain aspects of its AML compliance program to third parties (*e.g.*, fund administrators, IAs, CPOs, CTAs, broker-dealers, and futures commission merchants), although the Hedge Fund and Hedge Fund Manager remain fully responsible for the program. In addition, this section should provide that the Hedge Fund Manager may rely upon Investor identification procedures being performed by third parties, such as placement agents of Investor intermediaries (*e.g.*, fund of funds and nominees who invest in a Hedge Fund on their client's behalf (see Recommendation 5.1)).

## **B. Delegation of Elements of Hedge Fund Manager’s Anti-Money Laundering Program to Third Parties – Fund Administrators, IAs, and CTAs**

This section should provide that the Anti-Money Laundering Compliance Officer should be involved in the decision to delegate to, and select, a third party, who should perform certain elements of the Hedge Fund Manager’s AML program, and determine whether such delegation is reasonable and appropriate (see Recommendation 5.2).

## **C. Reliance on Third Parties – Placement Agents/ Financial Institutions**

This section should provide that the Anti-Money Laundering Compliance Officer should also determine whether it is generally appropriate to rely on the Investor identification procedures being performed by a third party that introduced the Investor to the Hedge Fund. See Recommendation 5.3 for examples of such third parties which may include placement agents, asset aggregators, or other financial institutions (*e.g.*, certain Investor intermediaries, nominees, or fund of funds).

This section should also provide that, to the extent that the third party does not perform certain procedures that are included in the Hedge Fund Manager’s AML procedures, the Hedge Fund Manager should expressly request that the third party perform such procedures prior to accepting a new Investor.

## **D. Allocation of Responsibilities between the Parties**

This section should provide that, regardless of whether a Hedge Fund delegates its Investor identification procedures to a third party or relies on another financial institution, there should be an agreement with such third party clearly allocating AML responsibilities between the third party and the Hedge Fund and its Hedge Fund

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Manager (see agreements with fund administrators and Investor intermediaries attached hereto as Annexes D-1 and D-2, respectively). This section should also contemplate the way in which a Hedge Fund or its Hedge Fund Manager may periodically assess the third party's compliance with its AML policies, procedures, and controls. This section should also specify how the Hedge Fund Manager will conduct due diligence on the third party's AML policies (see Recommendation 5.4).

### **E. Risk-Based Assessment of Third Parties' Anti-Money Laundering Procedures**

The section should address a Hedge Fund Manager's risk-based assessment of a third parties' AML procedures before determining whether it should delegate to or rely on a third party in performing AML functions (see Recommendation 5.5).

### **F. Further Assurances**

This section should set forth further assurances from third parties that a Hedge Fund Manager may consider before determining whether it should delegate to, or rely on, a third party for purposes of performing certain AML functions. See Recommendation 5.6 for examples of the types of further assurances that a Hedge Fund Manager may wish to consider from a third party.

## **VI. ADDITIONAL BSA REQUIREMENTS**

### **A. Policy Relating to Cash and Cash Equivalents**

This section should require the Hedge Fund Manager to implement policies, procedures, and controls that limit the acceptance of cash or cash equivalents such as money orders and traveler's checks. In addition, this section should address the reporting responsibilities of a Hedge Fund and Hedge Fund Managers with respect to the receipt of one or more related cash or cash equivalent transactions that ex-

ceed \$10,000 on the IRS/FinCEN Form 8300. This section should also address the legal prohibition against “structuring” in order to evade this reporting requirement (see Recommendations 6.1).

#### **B. Foreign Bank and Financial Accounts Report**

This section should set forth the responsibilities of a U.S.-based Hedge Fund and a U.S.-based Hedge Fund Manager to report any financial interest in, or signature or other authority over, any non-U.S. financial accounts, including bank securities or other types of financial accounts in a foreign country, if the aggregate value of those financial accounts exceeds \$10,000 at any time during the calendar year (see Recommendations 6.2).

#### **C. Reports of Transportation of Monetary Instrument**

This section should address the reporting responsibilities of a Hedge Fund and a Hedge Fund Manager with respect to the physical transportation of cash or cash-like monetary instruments of more than \$10,000 into or outside of the United States to the U.S. Customs Service on a FinCEN Form 105. This section should also address the legal prohibition against “structuring” in order to evade this reporting requirement (see Recommendation 6.3).

### **VII. GENERAL RECORDKEEPING REQUIREMENTS**

This section should set forth the general recordkeeping requirements for a Hedge Fund Manager to retain documents for a period of at least five years.

### **VIII. CONCLUSION**

Any questions, comments or concerns regarding the Hedge Fund Manager’s AML policies, procedures, and controls should be directed to the Anti-Money Laundering Compliance Officer.

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### ANNEX D: Sample Provisions for Fund Administrators, Investor Intermediaries, and Subscription Documents

1. Sample Provisions for Fund Administrators – Annex D-1
2. Sample Provisions for Investor Intermediaries – Annex D-2
3. Sample Provisions for Subscription Documents – Annex D-3

## ANNEX D-1: Sample Provisions for Fund Administrators\*

Below are examples of representations and covenants that a Hedge Fund Manager might seek from a fund administrator. These examples are provided for illustrative purposes only and should not be viewed as prescriptive requirements, or as addressing the only issues to consider when seeking representations and covenants from a fund administrator. The appropriateness of representations and covenants will depend on a number of factors, including, but not limited to: (1) the AML policies, procedures, and controls established by the Administrator; (2) the Hedge Fund Manager's AML program; (3) the risks presented by a Hedge Fund's Investor base; and (4) the jurisdiction in which the laws of the Administrator is located. Consequently, such provisions need to be tailored to the specific circumstances presented and should only be adopted on the advice of qualified legal counsel.

### (1) Provisions Related to the Fund Administrator's Anti-Money Laundering Program

- The fund administrator has adopted and implemented AML policies, procedures, and controls that comply and will continue to comply in all respects with the requirements of applicable AML laws and regulations in its home country jurisdiction.
- The fund administrator has provided the Hedge Fund Manager with a copy or a summary of its AML policies, procedures, and controls, and will promptly provide the Hedge Fund Manager with any [material/substantive] amendment thereto. [Alternatively, the Hedge Fund Manager may wish to incorporate the fund administrator's AML policies, procedures, and controls into its agreement with the fund administrator so that the fund administrator's AML policies, procedures, and controls could only be amended with the consent of the Hedge Fund Manager.]
- The fund administrator strictly adheres to, and will at all times during its relationship with the Hedge Fund Manager strictly adhere to its AML policies, procedures, and controls.
- The fund administrator agrees to [annually] submit, at its own expense, to an independent audit by [the Hedge Fund Manager]

\* *Unless otherwise defined, capitalized terms shall have the meanings ascribed to them in the 2007 AML Guidance.*

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[external auditors or other experts agreed by the Hedge Fund Manager] to assess its compliance with and the effectiveness of its AML policies, procedures, and controls.

### (2) Provisions Related to Prospective Investors

- The fund administrator will verify the identities of, and conduct due diligence (and, where appropriate, enhanced due diligence) with regard to, all prospective Investors and, where applicable, the principal beneficial owners on whose behalf an Investor makes an investment in accordance with its AML policies, procedures, and controls and [this Agreement/Amendment].
- The fund administrator will hold evidence of the identities of each Investor and, where applicable, the beneficial owners on whose behalf an Investor makes an investment in accordance with its AML policies, procedures, and controls and [this Agreement/Amendment], maintain such evidence for at least five years following an Investor's final redemption from [applicable fund(s)], [and make such information available to the Hedge Fund Manager promptly [upon request]].
- The fund administrator will [take all reasonable and practical steps to] ensure that it does not accept or maintain subscription funds, directly or indirectly, from:
  - (a) An individual or entity whose name appears on:
    - (i) Any lists of prohibited persons and entities as may be mandated by applicable law or regulation, including the *List of Specially Designated Nationals and Blocked Persons* administered by the U.S. Department of Treasury's OFAC;<sup>1</sup>
    - (ii) [Such other lists of prohibited persons and entities as may be mandated by [applicable][U.S.] law or regulation] [consider specifying other lists to be verified]; or

<sup>1</sup> OFAC's list may be accessed at ([www.treas.gov/ofac](http://www.treas.gov/ofac)).

- (iii) Such other lists of prohibited persons and entities as may be provided to the fund administrator by the Hedge Fund Manager;
  - (b) An individual or entity who is from a country or territory prohibited by the OFAC sanctions programs;
  - (c) An individual or entity who is a resident in, or organized or chartered under the laws of, a jurisdiction that has been designated by the Secretary of the U.S. Department of Treasury under Section 311 of the PATRIOT Act as warranting special measures due to money laundering concerns; or
  - (d) A Prohibited Foreign Shell Bank.
- Prior to accepting an investment from a High Risk Investor, the fund administrator will conduct enhanced due diligence with regard to such High Risk Investor, [as provided by the fund administrator's AML policies, procedures, and controls] [as agreed upon between the Hedge Fund Manager and the fund administrator], in addition to routine Investor identification procedures. High Risk Investors include:
  - (a) An individual or entity not located in a FATF jurisdiction;
  - (b) A non-U.S. PIC;
  - (c) SFPF/PEP, any member of a SFPF/PEP's Immediate Family, or any Close Associate of a SFPF/PEP;
  - (d) An individual or entity resident in, or organized or chartered under the laws of, a Non-Cooperative Jurisdiction;
  - (e) An individual or entity whose subscription funds originate from, or are routed through, an account maintained at a Prohibited Foreign Shell Bank, or an offshore bank, or a bank organized or chartered under the laws of a Non-Cooperative Jurisdiction, or a bank or financial institution subject to special measures under Section 311 of the PATRIOT Act;



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- (f) An entity that is a Foreign Bank subject to enhanced due diligence under Section 312 of the PATRIOT Act; or
  - (g) An individual or entity who gives the fund administrator reason to believe that the source of its subscription funds may not be legitimate.
- The fund administrator and the Hedge Fund Manager agree that, absent any suspicious circumstances, the fund administrator may rely upon the due diligence procedures performed with respect to Investors whose investment funds are transmitted by the following sources: [Identify institutions/entities that the Hedge Fund Manager has determined to be worthy of reliance.] For example, a Hedge Fund Manager may determine that certain of the following may be relied upon:
    - A U.S.-regulated financial institution where the Investor is a customer of the U.S.-regulated financial institution and the customer's investment funds are wired from its account at the U.S.-regulated financial institution;
    - A regulated foreign financial institution organized [in a FATF jurisdiction] [in a jurisdiction determined by the Hedge Fund Manager to have an acceptable AML regime] where the Investor is a customer of the regulated foreign financial institution and the customer's investment funds are wired from its account at the foreign financial institution;
    - An Investor intermediary that [has been approved by the Hedge Fund Manager] [is itself a U.S.-regulated financial institution or a regulated foreign financial institution organized [in a FATF jurisdiction] [in a jurisdiction determined by the Hedge Fund Manager to have an acceptable AML structure]].

### **(3) Provisions Related to Suspicious Activity**

- The fund administrator will immediately notify the Anti-Money Laundering Compliance Officer of the Hedge Fund Manager if it knows, or has reason to suspect, that a prospective or existing Investor, or the principal beneficial owners on whose behalf a prospective or existing Investor has made or is attempting to make, an investment, is among other things, any individual or entity who gives the fund administrator reason to believe that the source of its subscription funds may not be legitimate.
- The fund administrator will immediately notify the Anti-Money Laundering Compliance Officer of the Hedge Fund Manager if it becomes aware of any suspicious activity or pattern of activity or any activity that may require further review to determine whether it is suspicious.

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### ANNEX D-2: Sample Provisions for Investor Intermediaries\*

Below are sample representations and covenants that a Hedge Fund Manager might seek from an Investor intermediary, which, for purposes of this annex, may include, without limitation, an introducing firm, an asset aggregator, a nominee, or a fund of funds (each, an “Intermediary”). These examples should not be viewed as prescriptive requirements, or as addressing the only issues to consider in obtaining representations and covenants from an Intermediary. The appropriateness of representations and covenants will depend on a number of factors, including, but not limited to: (1) the AML policies, procedures, and controls established by the Intermediary; (2) the Hedge Fund Manager’s own AML program; and (3) the risks presented by a Hedge Fund’s Investor base; and (4) the jurisdiction in which the laws of the Intermediary is located. Consequently, such provisions need to be tailored to the specific circumstances presented and should only be adopted on the advice of qualified legal counsel.

#### (1) Provisions Relating to Status of Intermediary

- The Intermediary is (*select one as applicable*):
  - (a) A U.S.-regulated financial institution or intermediary based in a FATF jurisdiction; or
  - (b) An unregulated entity based in a FATF jurisdiction.
- [*Where Intermediary invests in its own name:*] The Intermediary is subscribing/will subscribe for shares in the [applicable fund(s)] as a record owner in its capacity as [agent/representative/nominee] on behalf of one or more underlying Investors, and agrees that the representations, warranties and covenants made in the subscription agreement are made by it on behalf of itself and the underlying Investors.

\* Unless otherwise defined, capitalized terms shall have the meanings ascribed to them in the 2007 AML Guidance.

- [*Where Intermediary is a banking entity:*] The Intermediary has (select one as applicable):
  - (a) A Physical Presence; or
  - (b) It does not have a Physical Presence, but is a regulated affiliate.
- [*Where Intermediary invests on behalf of other Investors:*] The Intermediary: (1) has all requisite power and authority from the underlying Investors to execute and perform the obligations under the subscription agreement; (2) has carried out Investor identification procedures with regard to all underlying Investors; and (3) has established the identity of all underlying Investors, holds evidence of such identities [and will make such information available to the Hedge Fund Manager upon request].

## 2) Provisions Relating to Intermediary's Anti-Money Laundering Program

- The Intermediary has adopted and implemented AML policies, procedures, and controls that comply and will continue to comply in all respects with the requirements of applicable AML laws and regulations in its home country jurisdiction.
- The Intermediary has provided the Hedge Fund Manager with a copy or summary of its AML policies, procedures, and controls, and will immediately provide the Hedge Fund Manager with any [material/substantive] amendment thereto.
- The Intermediary strictly adheres to, and will at all times during its relationship with the Hedge Fund Manager strictly adhere to, its AML policies, procedures, and controls.
- The Intermediary agrees to [annually] submit to an independent audit at the direction of the Hedge Fund Manager to assess its compliance with and effectiveness of its AML policies, procedures, and controls.

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### (3) Provisions Relating to Prospective Investors

- The Intermediary will verify the identities of, and conduct due diligence (and, where appropriate, enhanced due diligence) with regard to, all prospective Investors and, where applicable, the principal beneficial owners on whose behalf an Investor is seeking to make an investment, in accordance with its AML policies, procedures, and controls.
- The Intermediary will hold evidence of the identity of each Investor and, if applicable, the beneficial owners on whose behalf an Investor is seeking to make an investment, maintain such evidence for at least five years from the date of an Investor's complete redemption from the [applicable fund(s)], [and agrees to make such information available to the Hedge Fund Manager [and the fund administrator] promptly [upon request]].
- The Intermediary will [take all reasonable and practical steps to] ensure that [it does not make an investment, directly or indirectly, for or on behalf of] [it does not introduce any Investor that is]:
  - (a) An individual or entity whose name appears on:
    - (1) Any lists of prohibited persons and entities as may be mandated by applicable law or regulation, including the *List of Specially Designated Nationals and Blocked Persons* administered by the U.S. Department of Treasury's OFAC, as such lists may be amended from time to time;
    - (2) [Such other lists of prohibited persons and entities as may be mandated by applicable U.S. law or regulation] [consider specifying other lists to be verified]; or
    - (3) Such other lists of prohibited persons and entities as may be provided to the fund administrator by the Hedge Fund Manager;

- (b) An individual or entity who is from a country or territory prohibited by the OFAC sanctions programs;
- (c) An individual or entity who is a resident in, or organized or chartered under the laws of, a jurisdiction that has been designated by the Secretary of the U.S. Department of Treasury under Section 311 of the PATRIOT Act as warranting special measures due to money laundering concerns; or
- (d) A Prohibited Foreign Shell Bank.

#### (4) Provisions Related to High Risk Investors

- Prior to making an investment for or on behalf of a High Risk Investor, the Intermediary will conduct enhanced due diligence with regard to such High Risk Investor, [as provided by the Intermediary's AML policies, procedures, and controls][as agreed upon between the Hedge Fund Manager and the Intermediary], in addition to routine Investor identification procedures. High Risk Investors include:
  - An individual or entity not located in a FATF jurisdiction;
  - A non-U.S. PIC;
  - A SFPF/PEP, any member of a SFPF/PEP's Immediate Family, or any Close Associate of a SFPF/PEP;
  - An individual or entity resident in, or organized or chartered under the laws of, a Non-Cooperative Jurisdiction;
  - An individual or entity whose subscription funds originate from, or are routed through, an account maintained at a Prohibited Foreign Shell Bank, or an offshore bank or a bank organized or chartered under the laws of a Non-Cooperative Jurisdiction, or a bank or financial institution subject to special measures under Section 311 of the PATRIOT Act;
  - An entity that is a Foreign Bank subject to enhanced due diligence under Section 312 of the PATRIOT Act; or

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- An individual or entity who gives the Intermediary reason to believe that the source of its subscription funds may not be legitimate.

### (5) Provisions Related to Suspicious Activities

- The Intermediary will immediately notify the Anti-Money Laundering Compliance Officer of the Hedge Fund Manager if it knows, or has reason to suspect, that a prospective or existing Investor, or the principal beneficial owners on whose behalf a prospective or existing Investor has made or is attempting to make, an investment, is, among other things, any individual or entity who gives the Intermediary reason to believe that the source of its subscription funds may not be legitimate.
- The Intermediary agrees to immediately notify the Anti-Money Laundering Compliance Officer of the Hedge Fund Manager if it becomes aware of any suspicious activity or pattern of activity or any activity that may require further review to determine whether the activity or pattern of activity is suspicious.

## ANNEX D-3: Sample Provisions for Subscription Documents\*

Below are examples of types of provisions that a Hedge Fund Manager might include in subscription documentation in connection with its Investor identification procedures. These examples should neither be viewed as prescriptive requirements, nor as exhaustive or addressing the only issues to consider in developing provisions related to Investor identification in subscription documentation. Consequently, such provisions need to be tailored to the specific circumstances presented and should only be adopted on the advice of qualified legal counsel.

### (1) Provisions Relating to Identity of Investor

- Investor represents that all evidence of identity provided is genuine and all related information furnished is accurate.
- Investor agrees to provide any information deemed necessary by the Hedge Fund Manager in its sole discretion to comply with its AML program and related responsibilities from time to time.

### (2) Provisions Relating to Purpose of Investment

For an Investor investing for its own account:

- Investor is subscribing for shares in the [applicable fund(s)] for its own account, risk and beneficial interest.
- Investor is not acting as agent, representative, intermediary/nominee, or in any similar capacity for any other person.<sup>1</sup>
- No other person will have a beneficial or economic interest in the shares being purchased by the Investor.
- Investor does not have any intention or obligation to sell, distribute, assign or transfer all or a portion of the shares to any other person.

\* *Unless otherwise defined, capitalized terms shall have the meanings ascribed to them in the 2007 AML Guidance.*

<sup>1</sup> *The term “person” means any nominee account, beneficial owner, individual, bank, corporation, partnership, limited liability company, or any other legal entity.*



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For an Investor Intermediary investing in its own name on behalf of other Investors, which, for these purposes, may include, without limitation, an introducing firm, an asset aggregator, a nominee or a fund of funds:

- The Intermediary is subscribing for shares in the [applicable fund(s)] as a record owner in its capacity as [agent/representative/nominee] on behalf of one or more underlying Investors, and agrees that the representations, warranties, and covenants made in the subscription agreement are made by it on behalf of itself and the underlying Investors.
- The Intermediary: (1) has all requisite power and authority from the underlying Investors to execute and perform the obligations under the subscription agreement; (2) has carried out agreed Investor identification procedures with regard to all underlying Investors; and (3) has established the identity of all underlying Investors [, and] holds evidence of such identities [, and will make such information available to the Hedge Fund Manager upon request].

### (3) Provisions Relating to Prohibited Investors

- Investor acknowledges that the Hedge Fund Manager prohibits any investment in the Hedge Fund by or on behalf of Prohibited Investors:
  - (a) An individual or entity whose name appears on:
    - (1) Any lists of prohibited persons and entities as may be mandated by applicable law or regulation, including the *List of Specially Designated Nationals and Blocked Persons* administered by the U.S. Department of Treasury's OFAC<sup>2</sup> as such lists may be amended from time to time;
    - (2) [Such other lists of prohibited persons and entities as may be mandated by applicable U.S. law or regulation consider specifying other lists to be verified]; or

<sup>2</sup> OFAC's list may be accessed at ([www.treas.gov/ofac](http://www.treas.gov/ofac)).

- (3) Such other lists of prohibited persons and entities as may be provided to the fund administrator by the Hedge Fund Manager;
  - (b) An individual or entity who is from a country or territory prohibited by the OFAC sanctions programs;
  - (c) An individual or entity who is a resident in, or organized or chartered under the laws of, a jurisdiction that has been designated by the Secretary of the U.S. Department of Treasury under Section 311 of the PATRIOT Act as warranting special measures due to money laundering concerns; or
  - (d) A Prohibited Foreign Shell Bank.
- Investor represents and covenants that neither it, nor any person controlling, controlled by, or under common control with, it, nor any person having a beneficial interest in it, is a Prohibited Investor, and that it is not investing and will not invest in [the applicable fund(s)] on behalf of or for the benefit of any Prohibited Investor. Investor agrees to promptly notify the [Investor relations representative/fund administrator/Anti-Money Laundering Compliance Officer of the Hedge Fund Manager] of any change in information affecting this representation and covenant.
  - Investor acknowledges that, if, following its investment in [the applicable fund(s)], the Hedge Fund Manager, the fund administrator or [the applicable fund(s)] reasonably believes that Investor is a Prohibited Investor [or has otherwise breached its representations and covenants [hereunder/as to its identity]], the Hedge Fund Manager may be obligated to freeze its investment, either by prohibiting additional investments, declining any redemption requests and/or segregating the assets constituting the investment in accordance with applicable regulations, or its investment may immediately be redeemed by [the applicable fund(s)], and it shall have no claim against the Hedge Fund Manager, the fund administrator or [the applicable fund(s)] for any form of damages as a result of any of the aforementioned actions.

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- Investor acknowledges that additional investments by Investor may be refused and/or a request for redemption may be delayed or declined if the Hedge Fund Manager, the fund administrator, or [the applicable fund(s)] reasonably believes it does not have satisfactory evidence of the Investor's identity.

### (4) Other Possible Disclosures and Acknowledgements

- Investor represents that [except as otherwise disclosed to the Hedge Fund Manager in writing,]:
  - (a) It is located in a FATF jurisdiction;
  - (b) It is not a non-U.S. PIC;
  - (c) It is not a SFPPF/PEP, any member of a SFPPF/PEP's Immediate Family, or any Close Associate of a SFPPF/PEP;
  - (d) It is not a resident in, or organized or chartered under the laws of, a Non-Cooperative Jurisdiction;
  - (e) It is not resident in, or organized or chartered under the laws of, a jurisdiction that has been designated by the Secretary of the U.S. Department of Treasury under Sections 311 of the PATRIOT Act as warranting special measures due to money laundering concerns;
  - (f) It is not a Foreign Bank subject to enhanced due diligence under Section 312 of the PATRIOT Act;
  - (g) Its subscription funds do not originate from, or will they be routed through, an account maintained at a Prohibited Foreign Shell Bank, an offshore bank, or a bank organized or chartered under the laws of a Non-Cooperative Jurisdiction, or a bank or financial institution subject to special measures under Section 311; or
  - (h) It has not given the Hedge Fund Manager any reason to believe that the source of its subscription funds is not legitimate.

- Investor acknowledges and agrees that any redemption proceeds paid to it will be paid to the same account from which its investment in [the applicable fund(s)] was originally remitted, unless [Anti-Money Laundering Compliance Officer, in its sole discretion], agrees otherwise.
- Investor acknowledges and agrees that the Hedge Fund Manager may release confidential information about it and, if applicable, any underlying Investor or beneficial owner, to regulatory or law enforcement authorities, if [Senior Management], in its sole discretion, determines that it is in the best interests of [the applicable fund(s)] to do so.

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### ANNEX E: Sample Board Resolutions

1. **Adopting Anti-Money Laundering Program and Policy Statement Against Money Laundering and Terrorist Financing – Annex E-1**
2. **Appointing Anti-Money Laundering Compliance Officer – Annex E-2**

## ANNEX E-1: Sample Board Resolution Adopting Anti-Money Laundering Program and Policy Statement Against Money Laundering and Terrorist Financing

[Name of Hedge Fund Manager]

WHEREAS, a proposed draft of the anti-money laundering program (the “Program”) developed by [Name of Hedge Fund Manager] (the “Company”) and attached hereto as Exhibit A has been distributed to each member of the Board of Directors of the Company.

WHEREAS, a proposed draft of the Company’s policy statement against money laundering and terrorist financing (the “Policy Statement”), attached hereto as Exhibit B, has been distributed to each member of the Board of Directors.

NOW, THEREFORE, BE IT RESOLVED, that the Program, in the form submitted to the Board of Directors and attached hereto as Exhibit A, be, and the same hereby is, approved and adopted, to be effective as of the date of adoption of this resolution.

RESOLVED FURTHER, that the Policy Statement, in the form submitted to the Board of Directors and attached hereto as Exhibit B, be, and the same hereby is, approved and adopted, to be effective as of the date of adoption of this resolution.

RESOLVED FURTHER, that the officers of the Company be, and each acting alone is, hereby authorized, empowered and directed, for and on behalf of the Company, to take or cause to be taken any and all actions as such officers may deem necessary or advisable to carry out and perform the responsibilities and obligations of the Company under the Program and the Policy Statement.

RESOLVED FURTHER, that the officers of the Company are, and each acting alone is, hereby authorized to do and perform any and all such acts as such officers shall deem necessary or advisable, to carry out the purposes and intent of the foregoing resolutions.

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### ANNEX E-2: Sample Board Resolution Appointing Anti-Money Laundering Compliance Officer

[Name of Hedge Fund Manager]

WHEREAS, [Name of the Hedge Fund Manager]'s anti-money laundering program (the "Program") requires the appointment of an Anti-Money Laundering Compliance Officer who will be responsible for the day-to-day administration of the Program in accordance with the provisions thereof.

RESOLVED, that \_\_\_\_\_ is hereby appointed as the Anti-Money Laundering Compliance Officer of [Name of Hedge Fund Manager] to serve until [his][her] successor shall be duly appointed or, if earlier, until [he][she] resigns, is removed from office or is otherwise disqualified from serving as the Anti-Money Laundering Compliance Officer.

RESOLVED FURTHER, that the Anti-Money Laundering Compliance Officer is hereby authorized to do and perform any and all such acts and functions as [he][she] is charged with under the provisions of the Program.

## ANNEX F: Members of Financial Action Task Force on Money Laundering\*

- |               |                                |
|---------------|--------------------------------|
| 1) Argentina  | 17) Japan                      |
| 2) Australia  | 18) Luxembourg                 |
| 3) Austria    | 19) Mexico                     |
| 4) Belgium    | 20) Kingdom of the Netherlands |
| 5) Brazil     | 21) New Zealand                |
| 6) Canada     | 22) Norway                     |
| 7) China      | 23) Portugal                   |
| 8) Denmark    | 24) The Russian Federation     |
| 9) Finland    | 25) Singapore                  |
| 10) France    | 26) South Africa               |
| 11) Germany   | 27) Spain                      |
| 12) Greece    | 28) Sweden                     |
| 13) Hong Kong | 29) Switzerland                |
| 14) Iceland   | 30) Turkey                     |
| 15) Ireland   | 31) United Kingdom             |
| 16) Italy     | 32) United States              |

**Please Note:** The list of FATF members is amended periodically. FATF members are not per se FATF jurisdictions.

\* *Unless otherwise defined, capitalized terms shall have the meanings ascribed to them in the 2007 AML Guidance.*



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### ANNEX G: List of FATF Non-Cooperative Jurisdictions\*

Currently, there are no countries and territories designated by FATF as non-cooperative in the fight against money laundering. An updated list of FATF NCCT jurisdictions is available at ([www.oecd.org/fatf](http://www.oecd.org/fatf)).

**Please Note:** The list of Non-Cooperative Jurisdictions is amended periodically. For a current list of Non-Cooperative Jurisdictions, please refer to the FATF Web site at ([www.fatf-gafi.org/pages/0,2987,en\\_32250379\\_32235720\\_1\\_1\\_1\\_1\\_1,00.html](http://www.fatf-gafi.org/pages/0,2987,en_32250379_32235720_1_1_1_1_1,00.html)).

\* *Unless otherwise defined, capitalized terms shall have the meanings ascribed to them in the 2007 AML Guidance.*

## ANNEX H: Lists Maintained by the Office of Foreign Assets Control\*

### A. Persons and Entities Subject to OFAC Sanctions

See *List of Specially Designated Nationals and Blocked Persons* at ([www.treas.gov/ofac](http://www.treas.gov/ofac)).<sup>1</sup>

### B. Countries Subject to OFAC-Administered Sanctions as of June 2007<sup>2</sup>

- |                                     |                        |
|-------------------------------------|------------------------|
| 1. Belarus                          | 7. Liberia             |
| 2. Cote d'Ivoire (Ivory Coast)      | 8. Myanmar (aka Burma) |
| 3. Cuba                             | 9. North Korea         |
| 4. Democratic Republic of the Congo | 10. Sudan              |
| 5. Iran                             | 11. Syria              |
| 6. Iraq                             | 12. Western Balkans    |
|                                     | 13. Zimbabwe           |

**Please Note:** These lists are amended periodically. For current OFAC Lists, please refer to the OFAC Web site at ([www.treas.gov/ofac](http://www.treas.gov/ofac)).

\* *Unless otherwise defined, capitalized terms shall have the meanings ascribed to them in the 2007 AML Guidance.*

<sup>1</sup> *This list includes Specially Designated Global Terrorists, including those persons listed in Executive Order 13224 – Blocking Property and Prohibiting Transactions With Persons Who Commit, Threaten to Commit or Support Terrorism.*

<sup>2</sup> *The OFAC-administered sanctions targeting specific countries take many different forms. The sanctions are generally couched in terms of identifying certain targeted individuals or certain prohibited transactions, which may or may not include transactions such as Hedge Fund investments. Compliance with regulations promulgated by OFAC are beyond the scope of the 2007 AML Guidance.*

## Guidance for Hedge Funds and Hedge Fund Managers on Developing Anti-Money Laundering Programs

### ANNEX I: Money Laundering Advisories Issued by the Financial Crimes Enforcement Network of the U.S. Department of Treasury\*

As of June 2007, FinCEN has issued advisories with regard to deficiencies in the AML regimes of the following jurisdictions:

- 1) Belarus
- 2) Burma (Myanmar)
- 3) Nauru
- 4) North Korea

**Please Note:** FinCEN advisories with regard to the AML regimes in certain jurisdictions are issued and withdrawn by the U.S. Department of Treasury periodically. Advisories are also issued by FinCEN that generally describe trends and developments related to money laundering and financial crime. Please refer to the FinCEN Web site at (*[www.fincen.gov](http://www.fincen.gov)*).

\* *Unless otherwise defined, capitalized terms shall have the meanings ascribed to them in the 2007 AML Guidance.*

## ANNEX J: Countries and Financial Institutions That Have Been Designated by the U.S. Department of Treasury as Being of “Primary Money Laundering Concern”\*

The countries and financial institutions listed below have been designated by the U.S. Department of Treasury as being of “primary money laundering concern” and are currently subject to special AML measures under Section 311 of the PATRIOT Act. An updated list of such countries and financial institutions is available at ([www.fincen.gov/reg\\_bsaregulations.html](http://www.fincen.gov/reg_bsaregulations.html)).

- 1) Burma (Myanmar)
- 2) Myanmar Mayflower Bank
- 3) Asia Wealth Bank
- 4) Banco Delta Asia
- 5) Commercial Bank of Syria (includes Syrian Lebanese Commercial Bank)
- 6) VEF Banka

The U.S. Department of Treasury has proposed to similarly designate the countries and financial institutions listed below as being of “primary money laundering concern” and to impose special measures against them. Notices of final designations and the imposition of special measures will be posted at ([www.fincen.gov/reg\\_bsaregulations.html](http://www.fincen.gov/reg_bsaregulations.html)).

- 1) Nauru
- 2) Belmetalnergo (includes Infobank)
- 3) First Merchant Bank OSH Ltd. (of Cyprus), including its subsidiaries, FMB Finance Ltd., First Merchant International Inc., First Merchant Finance Ltd., and First Merchant Trust Ltd.
- 4) Infobank (including Belmetalnergo)

\* *Unless otherwise defined, capitalized terms shall have the meanings ascribed to them in the 2007 AML Guidance.*

## APPENDIX V

# U.S. Regulatory Filings by Hedge Fund Managers

Listed below are regulatory filings organized by regulatory agencies (excluding tax-related, broker-dealer, and state “blue sky” filings) that a Hedge Fund Manager may be required to file in the United States. The regulatory filings made by a Hedge Fund Manager will vary depending on the type and volume of trading in which it engages, its business model, and the jurisdictions in which it operates. For example, like other market participants and institutional investors, a Hedge Fund Manager is required to make certain regulatory filings in the United States if the size of the positions it holds in certain markets reaches “reportable” levels. In addition, some Hedge Fund Managers are regulated entities in the United States or are otherwise subject to a regulatory regime, and, like other similarly situated entities, are required to make certain filings in that capacity. MFA notes that this appendix includes the requirement to file Form ADV with the SEC under the Advisers Act, but does not address the requirements applicable to registered investment advisers pursuant to filing that form. A Hedge Fund Manager may also be subject to regulatory reporting and filing requirements in jurisdictions in which it conducts its business; however, this document does not address non-U.S. filings.

### Federal Reserve Bank

#### Treasury Securities Position and Foreign Exchange Transaction Reporting

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- |                             |   |
|-----------------------------|---|
| 1. Large Position Reporting | Report of positions in specific Treasury security issues that exceed the large position threshold specified by the U.S. Department of Treasury (minimum \$2 billion).<br><br>Reports are filed in response to notices issued by the U.S. Department of Treasury if such threshold is met. |
|-----------------------------|---|

*continued*

## U.S. Regulatory Filings by Hedge Fund Managers

Federal Reserve Bank	
	Reports are filed with the Federal Reserve Bank of New York and are not public.
2. Form T FC-1	<p>Report of weekly, consolidated data on foreign exchange contracts and positions of major market participants.</p> <p>Reports are filed throughout the calendar year by each foreign exchange market participant having more than \$50 billion equivalent in foreign exchange contracts on the last business day of any calendar quarter during the previous year.</p> <p>The reports are filed with the appropriate Federal Reserve Bank acting as agent for the U.S. Department of Treasury and are not public.</p>
3. Form FC-2	<p>Report of monthly, consolidated data on the foreign exchange contracts and foreign currency denominated assets and liabilities of major market participants.</p> <p>Reports are filed throughout the calendar year by each foreign exchange market participant having more than \$50 billion equivalent in foreign exchange contracts on the last business day of any calendar quarter during the previous year.</p> <p>The reports are filed with the appropriate Federal Reserve Bank acting as agent for the U.S. Department of Treasury and are not public.</p>
4. Form FC-3	Report of quarterly, consolidated data on the foreign exchange contracts and foreign currency denominated assets and liabilities of major market participants.

## Federal Reserve Bank

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Reports are filed throughout the calendar year by each foreign exchange market participant that has more than \$5 billion equivalent in foreign exchange contracts on the last business day of any calendar quarter during the previous year and that does not file Form FC-2.

Reports are filed with the appropriate Federal Reserve Bank acting as agent for the U.S. Department of Treasury and are not public.

## Treasury Auction Filings

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### 5. Treasury Auction

Treasury security reports filed as necessary. Confirmations must be filed by any customer who is awarded a par amount of \$500 million or more in U.S. government securities in a Treasury auction. The confirmations must include a customer's reportable net long position, if any.

Confirmations are filed with the Federal Reserve Bank to which the bid was submitted and is not public.

## Treasury International Capital Forms

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### 6. Forms CQ-1 and CQ-2

Forms filed by U.S. persons having claims on, or financial liabilities to, foreigners having balances on deposit with foreign banks (in the United States or abroad) or otherwise engaging in transactions in securities or other financial assets with foreigners. Forms CQ-1 (Financial Liabilities to, and Claims on, Foreigner Residents) and

*continued*

## U.S. Regulatory Filings by Hedge Fund Managers

### Federal Reserve Bank

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CQ-2 (Commercial Liabilities to, and Claims on, Foreigner Residents) are quarterly reports, which collect data on financial and commercial liabilities to, and claims on, unaffiliated foreigners held by non-banking enterprises in the United States. The forms must be filed when the consolidated total of such liabilities is \$50 million or more during that period or \$25 million or more during that period, respectively.

The forms are filed with the Federal Reserve Bank of New York and are not public except for aggregate information.

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#### 7. Form S

Form filed by any U.S. person purchasing or selling \$2 million or more of long-term marketable domestic and foreign securities in a month in direct transactions with foreign persons.

The form is filed with the Federal Reserve Bank of New York and is not public except as to aggregate information.

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### Securities and Exchange Commission

Sale of Securities by an Issuer Exempt from Registration under Regulation D or Section 4(6) under the Securities Act of 1933, As Amended

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#### 8. Form D

Notice of sale filed after securities, such as interests in a private hedge fund, are sold in reliance on a Regulation D private placement exemption or a Section 4(6) exemption from the registration provisions of the Securities Act of 1933, as amended. The form is filed with the SEC and relevant states and is publicly available.



## Securities and Exchange Commission

### Secondary Sale of Restricted and Control Securities under Rule 144 of the Securities Act of 1933, As Amended

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#### 9. Form 144

Form filed as notice of a proposed sale of restricted securities or securities held by an affiliate of the issuer in reliance on Rule 144 of the Securities Act of 1933, as amended, when the amount sold during any three-month period exceeds 500 shares or units or has an aggregate sales price in excess of \$10,000. The form is filed with the SEC and the principal national securities exchange, if any, on which such security is traded and is publicly available.

### Ownership of Equity Securities Publicly Traded in the United States

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#### 10. Schedule 13D

Disclosure report filed by an investor, including a Hedge Fund and its Hedge Fund Manager, who beneficially owns more than 5% of a class of equity securities publicly traded in the United States. The report identifies the source and amount of the funds used for the acquisition.

This reporting requirement is triggered by direct or indirect acquisition of more than 5% of beneficial ownership of a class of equity securities publicly traded in the United States. Amendments must be filed promptly for material ownership changes or for changes to the beneficial owner's intentions regarding the issuer of securities. Some investors may instead report on short-form Schedule 13G, if they are eligible. See Item 11.

The report is filed with the SEC and is publicly available.

*continued*

## U.S. Regulatory Filings by Hedge Fund Managers

### Securities and Exchange Commission

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11. Schedule 13G

Short-form disclosure report filed by a passive investor, including a Hedge Fund and its Hedge Fund Manager, who would otherwise have to file a Schedule 13D but who owns less than 20% of the subject securities (or is a certain U.S.-regulated investment business) and has not purchased the securities for the purpose of influencing control of the issuer.

This reporting requirement is triggered by direct or indirect acquisition of beneficial ownership of more than 5% of a class of equity securities publicly traded in the United States. Amendments must be filed annually, as well as monthly (for U.S.-regulated investment businesses) or promptly (for other passive investors) if ownership changes by more than 5% of a class of securities.

The report is filed with the SEC and is publicly available.

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12. Forms 3, 4, and 5

A statement of ownership filed by directors, officers, or owners of more than 10% of a class of equity securities of a public company. The initial filing is on Form 3 and changes are reported on Form 4. The annual statement of beneficial ownership of securities is on Form 5. The statements contain information on a reporting person's relationship to the company and on purchases and sales of the company's equity securities.

Form 3 reporting is triggered by: (1) acquisition of more than 10% of the equity securities of a public company; (2) the reporting person becoming a director or officer; or (3) the equity securities becom-

## Securities and Exchange Commission

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ing publicly traded, as the case may be. Form 4 reporting is triggered by any open market purchase, sale, or an exercise of options of those reporting under Form 3. Form 5 reporting is required annually for those insiders having exempt transactions not reported on Form 4.

The statements are filed with the SEC and are publicly available.

## Registered and Unregistered Institutional Investment Managers

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### 13. Form 13F

Quarterly position report filed by registered and unregistered institutional investment managers (*i.e.*, any person, other than a natural person, investing in or buying and selling securities for its own account, and any person exercising investment discretion with respect to the account of any other person) with investment discretion over \$100 million or more in equity securities publicly traded in the United States. Reports contain position information about the equity securities under the discretion of the Hedge Fund Manager, and the type of voting authority exercised by the Hedge Fund Manager.

The reporting requirement is triggered by an institutional investment manager holding equity securities having an aggregate fair market value of at least \$100 million on the last trading day of a calendar year and requires a report as of the end of that year and each of the next three quarters.

The reports are filed with the SEC and are publicly available.

*continued*

## U.S. Regulatory Filings by Hedge Fund Managers

### Securities and Exchange Commission

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#### Material Associated Persons of Registered Broker-Dealers

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##### 14. Form 17-H

Material Associated Persons Reports, (“MAPRs”) filed by registered broker-dealers. Some Hedge Fund Managers are affiliated with registered broker-dealers. MAPRs generally include material affiliates and parents and may therefore include an affiliated Hedge Fund Manager or the related Hedge Fund. Broker-dealers must report: (1) an organizational chart of the broker-dealer; (2) risk management policies of the broker-dealer; (3) material pending legal proceedings; and 4) additional financial information including aggregate positions, borrowing, and off-balance sheet risk for each MAPR.

The reporting requirement is triggered by status as a broker or dealer registered under Section 15 of the Securities Exchange Act of 1934, as amended.

This report is filed with the SEC quarterly and cumulatively at year-end and is not public.

There are also a variety of filings with the SEC and the securities self-regulatory organizations that must be made by registered broker-dealers and their associated persons.

#### Investment Adviser Registration under the Investment Advisers Act of 1940

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##### 15. Form ADV

The SEC’s uniform application for investment adviser registration filed by a Hedge Fund Manager eligible to register with the SEC under the Advisers Act. This form is divided into two parts. Information submitted in Part I is filed electronically with the National Association of Securities Dealers

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## Securities and Exchange Commission

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Investment Adviser Registration Depository and includes information regarding, among other things, the investment adviser's business, their educational background, and whether they have been sanctioned for violating securities or other laws. Information in Part II is geared primarily toward the adviser's clients. Part II contains information relating to the business practices, fees, investment strategies, and conflicts of interest the investment adviser may have with its clients. Part II is not submitted to the SEC but is deemed to be filed so long as a copy is maintained in the adviser's files and is subject to review by the SEC. Part II (and Part I) are required to be updated annually, within 90 days of the adviser's fiscal year end, and whenever it becomes materially inaccurate. However, certain changes may require the investment adviser to promptly amend Part I.

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## Commodity Futures Trading Commission and National Futures Association

### Commodity Trading Advisors ("CTAs") and Commodity Pool Operators ("CPOs")

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16. CPO and CTA  
Registration Forms  
7-R and 8-R;  
Available Exemptions

An individual or entity operating or soliciting funds for a commodity pool, which would include a Hedge Fund Manager for a Hedge Fund that trades futures or options on futures, may be required to register as a CPO, unless it qualifies for an exemption from registration. An exemption from registration is available if the pool is: (1) sold only to accredited investors,

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## U.S. Regulatory Filings by Hedge Fund Managers

### Commodity Futures Trading Commission and National Futures Association

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“knowledgeable employees”; or certain qualified eligible persons; and (2) engaged in limited trading of commodity interests (as measured by certain portfolio tests) (CFTC Regulation 4.13(a)(3)). There is also an exemption from registration for CPOs that admit only highly sophisticated participants, which include: (1) natural persons who are qualified purchasers, knowledgeable employees, or non-U.S. persons; and (2) entities that are qualified eligible persons or accredited investors (CFTC Regulation 4.13(a)(4)).

An individual or entity that, for compensation or profit, advises others (directly or indirectly) as to the value of or advisability of buying or selling futures contracts or options on futures generally must register as a CTA unless it qualifies for the statutory exemption in Section 6m(1) of the Commodity Exchange Act or the exemption provided in CFTC Regulation 4.14(a)(8). Providing advice indirectly includes having the authority to allocate the assets of a fund or account to another CTA to trade. A CTA may avail itself of the Section 6m(1) exemption if the CTA has provided futures trading advice to 15 or fewer persons (legal organizations being deemed a single person) in the past 12 months and does not generally hold itself out to the public as a CTA. CFTC Regulation 4.14(a)(8) permits a CTA to claim exemption from registration if its futures trading advice is incidental to its securities advice and is given only to certain limited categories of clients, including pools

Commodity Futures Trading Commission  
and National Futures Association

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operated under Regulation 4.13(a)(3) or 4.13(a)(4). These exemptions are available to Hedge Fund Managers, whether or not registered with the SEC or a state authority.

The documents required for registration as a CPO or CTA are: (1) a completed Form 7-R (which provides CPO or CTA information); (2) a completed Form 8-R (which provides biographical data) and fingerprint card for each principal (defined to include executive officers, directors, and 10% owners), branch office manager, and associated person (defined to include persons soliciting fund interests or accounts or supervising persons so engaged), and proof of passage of the “Series 3” exam for each associated person; and (3) proof of passage of the “Series 3” and futures branch office manager exams for each branch office manager.

A person seeking to rely on either the CFTC Regulation 4.13(a)(3) or 4.13(a)(4) CPO registration exemption must furnish to each prospective participant in the relevant pool: (1) a statement that the person is exempt from registration with the CFTC as a CPO and that, unlike a registered CPO, it is not required to deliver a disclosure document and a certified annual report to participants in the pool; and (2) a description of the criteria pursuant to which it qualifies for the exemption from registration. A person seeking to rely on any of the CPO registration exemptions must file with NFA an online notice claiming the relevant exemption and

*continued*

## U.S. Regulatory Filings by Hedge Fund Managers

### Commodity Futures Trading Commission and National Futures Association

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providing certain information specified in the relevant rule. These disclosures and filings must be made no later than the time at which a subscription agreement for the relevant pool is delivered to a prospective participant in such pool.

CFTC Regulation 4.13 requires a person claiming exemption from CPO registration thereunder to: (1) keep all books and records prepared in connection with its activities as a CPO for five years from the date of preparation (and maintain such books in a readily accessible place for the first two years of such period); and (2) ensure that annual reports to pool participants (if provided) are prepared in accordance with generally accepted accounting principles consistently applied (and, if certified, certified in accordance with CFTC Regulation 1.16).

A person relying on the CFTC Regulation 4.14(a)(8) exemption from CTA registration must keep all books and records prepared in connection with its activities as a CTA for five years from the date of preparation (and maintain such books in a readily accessible place for the first two years of such period). There are also additional requirements with respect to the notice that a CTA must file with NFA to claim its exemption from registration.

Applications for registration are filed with and approved by NFA under authority granted to it by the CFTC and the registration documents are generally public except for fingerprint cards, although confiden-



Commodity Futures Trading Commission  
and National Futures Association

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tiality may be requested for certain information relating to the principals.

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17. Form 3-R

Form 3-R is used to report changes to information contained in Form 7-R. The form is filed with NFA and is public, though confidentiality may be requested for certain information relating to principals.

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18. Form 8-T  
Associated Person  
Termination

Form 8-T filed within 20 days of the termination of an associated person, principal, or branch manager. The form is filed with NFA and is generally public.

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19. Annual Report

An annual report of a pool must be filed pursuant to CFTC Regulation 4.22(c) by a pool's registered CPO (unless the CPO is exempt under CFTC Regulation 4.7, as described below). The annual report must contain certain information, such as actual performance information and fees, and must be distributed to each participant in the pool.

A registered CPO must file the annual report with NFA within 90 days of the pool's fiscal year-end. The annual report is generally publicly available; however, the CFTC is prohibited from disclosing information that would separately disclose the business transactions or market positions of any person, trade secrets, or names of any investors.

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20. CPO/CTA  
Questionnaire

This is an annual compliance questionnaire concerning business activities of registered-CPOs or CTAs. The questionnaire is filed electronically with NFA and is not public.

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## U.S. Regulatory Filings by Hedge Fund Managers

### Commodity Futures Trading Commission and National Futures Association

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#### 21. NFA Self-Audits

To satisfy continuing supervisory responsibilities, NFA members must annually review their operations using a self-examination checklist. The checklist focuses on a member's regulatory responsibilities and solicits information on whether a member's internal procedures are adequate for meeting those responsibilities.

A written attestation affirming completion of the self-examination checklist must be signed and dated by a CPO/CTA's supervisory personnel. The attestation must be retained by the member for five years and provided to NFA upon request.

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#### 22. Certain Claims for Exemption for CPOs and CTAs

Filings made pursuant to CFTC Regulation 4.12(b)(3) (notice of claim for exemption from certain requirements by a CPO that complies with the Securities Act of 1933, as amended, and manages a Hedge Fund with limited trading in commodity futures and options) and CFTC Regulation 4.7(d) (notice of claim for exemption by a CPO or CTA with "qualified eligible persons" as investors).

CFTC Regulation 4.5 provides an exclusion from the definition of the term CPO for certain qualifying persons. Any person who desires to claim the exclusion provided by CFTC Regulation 4.5 must file a notice of eligibility with NFA.

CFTC Regulation 4.6 provides an exclusion for certain persons from the definition of the term CTA. Any person claiming exclusion under CFTC Regulation 4.6 must

Commodity Futures Trading Commission  
and National Futures Association

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submit to these special calls from the CFTC requiring the person to demonstrate compliance with such regulation.

These statements are filed with the CFTC and NFA and are public.

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23. Disclosure Document

CPOs and CTAs are generally required to prepare detailed disclosure documents containing specified information. These documents are filed with NFA and provided to investors but are not publicly available.

However, CPOs and CTAs operating under CFTC Regulation 4.7, are exempt from the disclosure document requirement and are only required to provide all material disclosures (and include specified legends on their materials). In addition, under the exemption provided in CFTC Regulation 4.8, Hedge Funds whose Hedge Fund Managers are exempt under CFTC Regulation 4.12(b) or which sell interests solely to “accredited investors” and rely on the safe harbor provisions of Rules 505 or 506 of Regulation D under the Securities Act of 1933, as amended, may begin soliciting, accepting, and receiving money upon providing the CFTC and the Hedge Fund investors with disclosure documents for the Hedge Fund, which requirement may be satisfied through providing a private placement memorandum.

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24. Year-End Financial  
Reports for § 4.7 Funds

Annual reports for Hedge Funds for which a CPO has filed an exemption under CFTC Regulation 4.7 must contain a Statement of

*continued*

## U.S. Regulatory Filings by Hedge Fund Managers

Commodity Futures Trading Commission and National Futures Association	
	<p>Financial Condition, a Statement of Income (Loss), appropriate footnote disclosure, other material information, and a legend to any claim for exemption. The annual report must be presented and computed in accordance with generally accepted accounting principles consistently applied and, if certified by an independent public accountant, it must be in accordance with CFTC Regulation 1.16.</p> <p>The annual report is filed with NFA and distributed to each investor and is not public.</p>
25. Form 40	<p>“Statement of Reporting Trader” filed pursuant to CFTC Regulation 18.04 by persons who receive a special call by the CFTC, or its designee, for holding positions equal to or in excess of specified levels. The form generally must be filed within ten business days after the call. Specified levels are set separately for each type of futures contract. Form 40 requires disclosure of information regarding ownership and control of futures and option positions held by the reporting trader, as well as the trader’s use of the markets for hedging. Hedging exemptions from speculative position limits must be reported. The CFTC often issues a special call for a Form 40 after receiving a Form 102 (described below).</p> <p>The form is filed with the CFTC and is not publicly available.</p>
26. Form 102	<p>Form 102 is filed pursuant to CFTC Regulation 17.01 by clearing members, futures</p>

## Commodity Futures Trading Commission and National Futures Association

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commission merchants, and foreign brokers. The form identifies persons, including Hedge Funds, having financial interest in, or trading control of, special accounts in futures and options. The CFTC provides preliminary information regarding whether positions and transactions are commercial or noncommercial in nature. The form must be filed when the account first becomes reportable (*i.e.*, when it first contains futures or options positions equal to or in excess of specified levels). The form must be updated when information concerning financial interest in, or control of, the special account changes. In addition, the form is used by exchanges to identify accounts reported through their large trader reporting systems for both futures and options.

The form is filed with the CFTC and is not public.

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## Selected Stock and Futures Exchange Reports

### Application for Exemption from Speculative Position Limits

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#### 27. Speculative Position Limit Exemption

This application is filed for exemption from speculative position limits. Exchanges generally have speculative position limits for physical commodities and stock index contracts, and the CFTC has speculative position limits for certain agricultural commodities. Exemptions from such limits are generally available for hedging transactions. Financial contracts, such as interest rate contracts, generally have “position accountability” levels rather than strict position

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## U.S. Regulatory Filings by Hedge Fund Managers

### Commodity Futures Trading Commission and National Futures Association

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limits. Accounts or account controllers exceeding position accountability levels must justify their positions to an exchange or the CFTC upon request. Generally, an application for any speculative position limit exemption must show that such position is a *bona fide* hedging, risk management, arbitrage, or spread position. The filing is made with the appropriate exchange in the case of physical commodities and stock index contracts and with the CFTC in the case of certain agricultural commodities.

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### Federal Trade Commission and U.S. Department of Justice Filings Made Prior to Mergers and Acquisitions

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#### 28. Hart-Scott-Rodino Notice

This notification is filed prior to the consummation of certain mergers, acquisitions, and joint ventures. The notification includes information about the transaction and the participants in the transaction.

As a general matter, both the acquiring person and the acquired person must file notifications when either the acquiring person or the acquired person is engaged in U.S. commerce or an activity affecting U.S. commerce, and either of the following two tests is met:

(1) (A) one person has either total assets or annual net sales of \$119.6 million or more (threshold adjusted annually); and the other person has either total assets or annual net sales of \$12.0 million or more (threshold adjusted annually); and (B) as a result of the transaction, the acquiring person will hold

## Federal Trade Commission and U.S. Department of Justice

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an aggregate total amount of more than \$59.8 million (threshold adjusted annually) of the voting securities and assets of the acquired person; or

(2) as a result of the transaction, the acquiring person will hold an aggregate total amount of more than \$239.2 million (threshold adjusted annually) of the voting securities and assets of the acquired person, regardless of the sales or assets of the acquiring and acquired persons.

Acquisitions of voting securities are exempt from filing if they are made “solely for the purpose of investment” and if, as a result of the acquisition, the securities held do not exceed 10% of the outstanding voting securities of the issuer. Securities are acquired “solely for investment purposes” if the person acquiring the securities has no intention of participating in the formulation, determination, or direction of the basic business decisions of the issuer.

The Hart-Scott-Rodino Act and rules thereunder contain various other exemptions, which are complex and require familiarity with the concepts and terminology of this legislation. The formation of partnerships and limited liability companies is potentially subject to notification under Hart-Scott-Rodino, as the result of changes to the Hart-Scott-Rodino rules that became effective on April 7, 2005.

The notice is filed with the Federal Trade Commission and the U.S. Department of Justice and is not public.

## APPENDIX VI

# Checklist for Hedge Fund Managers to Consider in Developing a Compliance Manual

The following checklist has been drafted to assist Hedge Fund Managers in developing their own compliance policies and procedures. MFA expects that the contents and specific details of a Hedge Fund Manager's policies and procedures will vary significantly depending on factors specific to each Hedge Fund Manager, such as, among other things, organizational structure and the strategies of the Hedge Funds undertaken by the Hedge Fund Manager. In addition, Hedge Fund Managers that are required to register under Advisers Act will need to adopt policies and procedures that meet the requirements of Rule 206-4(7).<sup>1</sup> Some of the requirements of that Rule are summarized in the checklist below for the benefit of SEC-registered Hedge Fund Managers, but may also be considered as a reference for non-registered Hedge Fund Managers, to the extent they are appropriate for their operations. By providing this list, MFA does not intend to advocate the adoption of policies and procedures containing any particular provision, or to provide an exhaustive list of the provisions that should be included. MFA hopes that Hedge Fund Managers will consider the various categories set forth in this checklist in developing policies and procedures that are tailored to, and include all provisions appropriate for, their own businesses.

<sup>1</sup> *All Rules and Sections listed in Appendix VI are in accordance with the Advisers Act.*



## Checklist for Hedge Fund Managers to Consider in Developing a Compliance Manual

### I. Applicability and General Provisions

- **Identify Covered Personnel.** Explain what employees, officers, directors, and other personnel at the Hedge Fund Manager are covered (“covered personnel”). Note that Rule 206-4(7) requires registered investment advisers’ compliance policies to apply to the adviser and any supervised person (“any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser”).
- **Purpose of Policies and Procedures.** Set forth policies and procedures that are reasonably designed to prevent violations of such policies and procedures from occurring, and to detect and address violations that have occurred. Note that Rule 206(4)-7 requires all registered investment advisers to adopt and implement policies and procedures reasonably designed to prevent the investment adviser and its personnel and the entity he or she is advising from violating the Advisers Act and its rules and regulations.

- **Use and Distribution.** Distribute policies and procedures to all covered personnel and make clear that it is the responsibility of the covered personnel to understand the contents of the policies and procedures.

### II. Chief Compliance Officer

- **Appointment and Responsibilities of the Chief Compliance Officer.** Explain that there must be a chief compliance officer or other similar individual (the “Chief Compliance Officer”)\* appointed and that the Chief Compliance Officer is assigned primary responsibility for coordinating and supervising compliance with applicable laws and regulations, as well as all internal procedures adopted by the investment adviser. Note that Rule 206-4(7) requires registered investment advisers to designate an individual responsible for administering the policies and procedures of the Hedge Fund Manager.

\* *Recommendations for sound practices relating to the Chief Compliance Officer are contained in Section 5—Regulatory Controls.*

### III. Elements of Policies and Procedures

#### A. Investment Adviser as Fiduciary

Include information detailing a Hedge Fund Manager's applicable fiduciary duties and explain that the adviser must act solely in the best interests of its client and must make full and fair disclosure of all material facts about the Hedge Fund Manager's business and business practices to its clients.

- Note that all investment advisers, whether registered or unregistered, are subject to the antifraud provisions of Section 206, which generally makes it unlawful for an investment adviser to engage in fraudulent, deceptive, or manipulative conduct.

In addition, note that in adopting Rule 206(4)-7, the SEC indicated that advisers should consider their fiduciary obligations under the Advisers Act and formalize policies and procedures to address them.

#### B. Portfolio Management Processes

Include provisions addressing controls and procedures for various portfolio management processes.

- **Allocate Investment Opportunities Fairly among Funds.** Create procedures for allocating opportunities that relate to types of investments involved, and

investment strategies employed by the Hedge Fund Manager and operational processes, including policies on partial fills, *de minimis* reallocations, deviations from allocation policy, and allocations of "New Issues". Establish a committee, designate an employee, or otherwise allocate responsibility to review the facts and circumstances of opportunities to ensure that the Hedge Fund Manager addresses its applicable fiduciary duties.

- **Maintain Portfolios Consistent with Funds' Objectives.** Undertake reviews of portfolios (electronic and/or manual reviews) and establish controls in order to detect departures from established investment objectives.
- **Disclose Information about Portfolio Management Processes.** Develop disclosure controls to consider whether and the way in which policies and changes to policies should be reviewed and communicated to investors.
- **Comply with Applicable Regulatory Restrictions.** Evaluate and address applicable regulatory requirements, including filing requirements with various government regulators\* and establish timelines and assign oversight responsibility for compliance to the Chief Compliance Officer or a designated employee.

## Checklist for Hedge Fund Managers to Consider in Developing a Compliance Manual

*\* A list of required U.S. filings that Hedge Fund Managers may be required to file is contained in Appendix V—U.S. Regulatory Filings by Hedge Fund Managers.*

In the case of registered investment advisers, this requirement covers a number of substantive provisions under the Advisers Act, including:

- Filing and updating Form ADV;
- Proxy voting policies and procedures;
- Custody requirements;
- Procedures for solicitation activities;
- Books and records;
- Insider trading policies and codes of ethics;
- Advertising; and
- Requirements for an advisory contract.

### C. Trading Practices

Include provisions addressing procedures for trading practices and execution of strategies.

- **Transaction Review.** Name authorized traders for transactions, establish procedures for specific periodic review of certain transactions and orders, include a retention policy for transaction reports, and describe procedures

for handling transactions upon completion, including distribution of confirmations. Establish a procedure for handling and reporting execution errors.

- **Conflicts Review.** Establish effective review and approval processes for dealing with any conflicts of interest that arise, including in connection with Soft Dollar Arrangements\* or other services from brokers. This should include policies for selection of broker-dealers, use of affiliated broker-dealers, use of agency crosses, and disclosure to investors about the process for dealing with these potential conflicts.\*\*

*\* Suggestions for soft dollar and best execution practices are addressed in Section 6—Trading Relationship Management, Monitoring, and Disclosure.*

*\*\* Note that Section 206(3) makes it unlawful for any investment adviser, whether registered or unregistered, to act as a principal on the other side of a transaction from a client, without first disclosing it and obtaining the written consent of the client.*

- **Aggregated Trade Review.** Fairly allocate aggregated trades among Hedge Funds. Establish procedures for when to aggregate trades, how to allocate aggregated trades, and how to review adherence to policy.

#### D. Trading Activity

Procedures should address proprietary trading of the Hedge Fund Manager and personal trading activities of supervised persons. Note that this element may be covered by other policies adopted by Hedge Fund Managers. In the case of registered investment advisers, Section 204A requires advisers to adopt insider trading policies, and Rule 204-1 requires registered investment advisers to adopt codes of ethics which are required to contain provisions covering personal trading activities.\*

- Establish policies to direct that any trading by employees and affiliates will be conducted in a manner that is consistent with the requirements of the policies and in a manner consistent with the applicable fiduciary duties owed by the Hedge Fund Manager.

\* *Suggestions for elements of trading policies and codes of ethics are addressed in Appendix VII—Checklist for Hedge Fund Managers to Consider in Developing a Code of Ethics.*

#### E. Disclosures

Develop disclosure controls and procedures to ensure prompt and accurate disclosure to investors and any applicable regulators, including account statement disclosures.

- Establish a committee or a designated employee to review required disclosure documents for accuracy and consistency.
- Establish procedures for updating and distributing any required information to investors and regulators. In the case of registered investment advisers, this procedure should address required updates in Form ADV and required financial and disciplinary information in Rule 206(4)-4.

Note that Section 207 prohibits any person from willfully making any untrue statement of a material fact, or willfully omitting to state any material fact that is required to be stated, in any registration application or report filed with the SEC.

## Checklist for Hedge Fund Managers to Consider in Developing a Compliance Manual

### F. Safeguarding Client Assets

Develop procedures to safeguard client assets from conversion or inappropriate use by advisory personnel.

- Limit authority and access to client accounts to designated employees and require approval of the Chief Compliance Officer for deviations from that policy.
- Monitor activity of employees with access to client accounts to ensure adherence to procedures.

### G. Recordkeeping

Create policies that address maintaining complete and accurate records of the Hedge Fund Manager and all Hedge Funds it manages.

- These policies and procedures should be designed to ensure the retention of accurate and complete records and may include, as appropriate, maintenance of original copies of all records, including those created in email, protection against electronic destruction, development of searchable indices of stored data and records, and policies relating to access to records. A Hedge Fund Manager should also establish a policy relating to the length of time records are required to be retained that is appropriate for its organizational structure and business activities.

Note that Rule 204-2 identifies certain books and records that must be prepared and retained by registered investment advisers. For purposes of Section 204, books and records include records of the private funds for which the adviser or a related person acts as general partner, managing member, or in a similar capacity. This Rule specifies the time periods for which such books and records must be retained, which is generally five years.

### H. Marketing and Fees

Include procedures to address marketing activities, including use of solicitors and payment of fees.

- Develop disclosure controls to ensure that arrangements are fully and accurately disclosed. Note that if a registered investment adviser pays a cash fee to a person soliciting investors, the adviser must meet the requirements of Rule 206(4)-3.
- Develop disclosure controls to ensure that any performance fees are fully and accurately disclosed. Note also that registered advisers of 3(c)(1) funds may be subject to limitations on the ability to charge performance fees. Section 205(a)(1) generally prohibits a registered investment adviser from

receiving a performance fee. However, Rule 205-3 permits a registered investment adviser to receive a performance fee from certain eligible clients. Registered advisers should establish the qualifications for “eligible clients” in accordance with the rule.

### **I. Valuation**

Include processes to value holdings and assess fees based on those valuations.\*

*\* Suggestions for valuation practices are included in Section 3—  
Determination of Net Asset Value.*

### **J. Safeguards for Privacy Protection of Client Records and Information**

Adopt policies to address administrative and physical safeguards for the protection of customer records and information.

- Develop procedures and lists of employees permitted to access client information. Set forth policy for providing client information to affiliates and non-affiliated third parties. Consider requiring pre-approval of client or Chief Compliance Officer.

Note that the SEC’s Regulation S-P (“Privacy of Consumer Financial Information”) requires registered investment advisers to adopt policies and procedures reasonably designed to: (1) ensure the confidentiality of customer records and information; (2) protect against any anticipated threats or hazards to the security of customer records and information; and (3) protect against unauthorized access or use of customer records or information that could result in substantial harm or inconvenience to any consumer. Registered investment advisers are required to distribute a notice of their privacy policy to each of their underlying investors in a fund that are natural persons at the time a person becomes an investor in a Hedge Fund and, going forward, on an annual basis.

### **K. Business Continuity, Disaster Recovery, and Crisis Management Plans**

Develop procedures to reduce risk to clients as a result of unforeseen events that would impact the adviser’s ability to continue active management of the clients’ assets.\*

*\* Recommendations for BC/DR plans are included in Section 7—Business Continuity, Disaster Recovery, and Crisis Management.*

## Checklist for Hedge Fund Managers to Consider in Developing a Compliance Manual

### L. Anti-Money Laundering

Develop policies and procedures in connection with the prevention of money laundering. This section should include the policy of the Hedge Fund Manager regarding cash or cash equivalent bearer instruments, its documentation policies, its reporting and disclosure obligations, as well as the role of the Chief Compliance Officer.\*

*\* A more in-depth review is included in Appendix IV—Guidance for Hedge Fund Managers on Developing Anti-Money Laundering Programs (Release No.2).*

### IV. Review and Updating of Policies

- Establish processes for reviewing the policies and procedures to determine their adequacy and the effectiveness of their implementation.
- Update policies in the event of significant changes to business or unforeseen market events.

Note that Rule 206(4)-7 requires registered investment advisers to conduct this review no less frequently than annually.

### V. Acknowledgment and Training

- Develop requirements for employees, such as requiring an employee to sign a written statement acknowledging his or her receipt and understanding of, and agreement to abide by, the policies.
- Require periodic training of employees to ensure understanding of, and compliance with, policies and procedures.

## APPENDIX VII

# Checklist for Hedge Fund Managers to Consider in Developing a Code of Ethics

The following checklist is intended to assist Hedge Fund Managers in developing their own codes of ethics or conduct. MFA expects that the codes of ethics or conduct among different Hedge Fund Managers will vary significantly depending on factors specific to each Hedge Fund Manager, including organizational structure and the types of Hedge Funds advised by the Hedge Fund Managers. By providing this checklist, MFA does not intend to advocate the adoption, of a code of ethics or conduct containing any particular provision, and does not intend to provide an exhaustive list of the provisions that should be included. Instead, it is MFA's hope that Hedge Fund Managers will consider the various elements of this checklist in developing a code of ethics or conduct that is specifically tailored to their own businesses. Moreover, particular provisions identified below may be contained in one or more other policy manuals, memoranda, or other documents.

Hedge Fund Managers should be aware that those required to register with the SEC must establish, maintain, and enforce a code of ethics pursuant to Rule 204A-1 of the Advisers Act<sup>1</sup> and must offer in Part II of their Form ADV to provide such code to clients and prospective clients. The requirements of that rule are summarized in the checklist below for the benefit of registered Hedge Fund Managers, but may also be considered as a reference for unregistered Hedge Fund Managers to the extent such requirements are appropriate to their operations. To be adequately implemented, Hedge Fund Managers should consider supporting the principles of conduct set forth in any code of ethics or conduct with compliance policies.

<sup>1</sup> *All Rules and Sections listed in Appendix VII are in accordance with the Advisers Act.*



## Checklist for Hedge Fund Managers to Consider in Developing a Code of Ethics

Hedge Fund Managers should consider including the following provisions:

### Applicability of the Code

- Identification of personnel covered (“covered personnel”) by the code of ethics or conduct (“the Code”).
- Emphasis on the adherence to the provisions of the Code.

Note that Rule 204A-1 requires registered Hedge Fund Managers to make the Code available to all clients and potential clients of any Hedge Fund advised by the Hedge Fund Manager, upon request.

### Standards of Conduct

- A provision setting forth standards of business conduct for covered personnel.
- A statement that covered personnel are to comply with all applicable federal securities laws, including the various applicable provisions of the Advisers Act, U.S. Investment Company Act of 1940, the Securities Act of 1933, the Securities Exchange Act of 1934, and all applicable rules and regulations adopted by the SEC. Note that Rule 204A-1 requires codes of ethics to include provisions requiring supervised persons to comply with applicable federal law.

- Articulation of covered personnel’s fiduciary duty to act in the client’s best interest. For certain Hedge Fund Managers, the scope of the duties to clients may be set forth in investment management agreements, offering documents, or other written materials, and the Code may make reference to these.

Note that Rule 204A-1 requires standards of conduct that reflect the registered investment adviser’s fiduciary obligations and the fiduciary obligations of its supervised persons.

- A statement that covered personnel should strive to act in a professional and ethical manner.
- Incorporation of the Hedge Fund Manager’s fundamental ideals (such as integrity, honesty, trust, *etc.*), as well as the legal, ethical, and moral obligations with which covered personnel should comply.

### Personal Trading

- Policies emphasizing that the interests of clients will at all times be placed first, and that covered personnel will not take advantage of their positions for personal benefit.
- Procedures for personal trading, such as “blackout periods”, restricted lists, reviews, holding periods, and prohibitions on certain types of trades.

- Procedures for the required pre-approval/clearance of certain transactions, such as IPOs, private placements/limited offerings, or securities on any restricted list.

Note that Rule 204A-1 requires pre-approval before “access persons” (as defined in Rule 204A-1(e)(1)) may directly or indirectly acquire beneficial ownership in any security in an IPO or limited offering.

### Reporting of Holdings

- Procedures for covered personnel to file an initial holding report or account statement, covering all their current holdings in specified investments. This holding report should be updated periodically. Note that Rule 204A-1 contains specific reporting requirements for “access persons”, including the content and timing of holding reports and transaction reports.
- With respect to implementation of the foregoing bullet, Hedge Fund Managers may consider setting up a system to have copies of brokerage statements and confirmations of covered personnel delivered directly to the Hedge Fund Manager.
- Procedures to report all specified types of personal transactions on a quarterly basis to designated personnel.

- Requirement that the chief compliance officer should review the personal security reports to check for any trading improprieties. Note that Rule 204A-1 requires Hedge Fund Managers to review personal securities transactions and holdings periodically.

### Client Information

- Policies that identify confidential client information, and then ensure that the information is not disclosed, other than in the necessary course of business (*i.e.*, on a “need to know” basis).
- Policies to prevent the misuse of information.

Note that these confidentiality policies may also be contained within the compliance policies and procedures. See Appendix IV—Guidance for Hedge Funds and Hedge Fund Managers on Developing Anti-Money Laundering Programs (Release No. 2) for more information on AML policies as they affect confidentiality policies.

## Checklist for Hedge Fund Managers to Consider in Developing a Code of Ethics

### Insider Trading

- Formulation of policies that are designed to: prevent and detect insider trading; reflect the nature of the Hedge Fund Manager's business and type of instruments traded; and include procedures, such as a restricted list and the monitoring of trading activity by covered personnel.
- Implement policies to prevent the misuse of material, non-public information, such as controlling access to the information through a gatekeeper and controlling the ability to make copies of such information.

### Gifts and Acts of Hospitality

- Creation of policies on the giving or receiving of business gifts and other acts of hospitality that may create the appearance of impropriety.
- Inclusion of provisions that require mandatory reporting of gifts accepted in the course of business. Consider whether gifts should need to cross a certain threshold, depending on the nature of the Hedge Fund Manager's business, before such reporting would be required.

### Acknowledgement, Certification, and Training

- Requirement that covered personnel sign an acknowledgement that they have received the Code. Note that Rule 204A-1 requires supervised persons to acknowledge receipt of the Code and any amendments.
- Provisions concerning training staff on the principles and policies of the Code.
- Designation of a person that covered personnel can seek advice for any questions about the Code.
- Requirement for conducting annual recertification of the policies in the Code.
- Requirement that a record be kept of the acknowledgements by supervised persons. Note that Rule 204-2(a)(12)(iii) requires a record of acknowledgements for each supervised person to be kept for five years.
- Requirement that a record be kept and maintained by appropriate supervisory personnel of the Code and any amendments to the Code. Note that Rule 204-2(a)(12)(i) requires a record of the Code to be kept for five years.

## Violations of Code

- Provision for a reporting mechanism for any violations of the Code.

Note that Rule 204A-1 requires a code of ethics to contain provisions requiring supervised persons to report any violations of the code of ethics promptly to the chief compliance officer or, provided the chief compliance officer also receives reports of all violations, to other persons designated in the code of ethics.

- Provision for whistleblower protection to those who report violations.
- Provisions designed to ensure that sensitive information about violations is kept confidential until otherwise notified by the designated person.
- Policies for when and how an investigation is initiated and carried out, as well as who has responsibility to undertake the investigation.
- Determination of whether records of every violation or alleged violation will be kept and for how long. Note that Rule 204-2(a)(12)(ii) requires that a record be kept of any violation of the Code and any action taken as a result of the violation.

## Sanctions

- Development of appropriate sanctions for breaches of the provisions of the Code, such as suspension, letter of censure, restitution, and termination.

For further reference materials on drafting a Code, please see the following resources:

- *Asset Manager Code of Professional Conduct* (2005) from the CFA Centre for Financial Market Integrity ([www.cfainstitute.org/centre/ethics/asset/pdf/asset\\_manager\\_code.pdf](http://www.cfainstitute.org/centre/ethics/asset/pdf/asset_manager_code.pdf)); and
- SEC final rule release on the Investment Adviser Code of Ethics ([www.sec.gov/rules/final/ia-2256.htm](http://www.sec.gov/rules/final/ia-2256.htm)).