

## Securities Briefing Series



### **PWG Hedge Fund Committees Announce Best Practices**

#### **Presidents Working Group on Financial Markets' Hedge Fund Committees Release Industry Best Practices—Part I**

On April 15, 2008, US Treasury Secretary Henry M. Paulson, Jr., introduced the separate reports of two private sector committees of the President's Working Group on Financial Markets ("PWG"). The committees, comprised of respected industry professionals, were charged with developing "best practices" for hedge funds and hedge fund investors. The Asset Managers' Committee ("AMC" or the "Committee"), led by committee Chair Eric Mindich, CEO of Eton Park Capital Management, released "Best Practices for the Hedge Fund Industry" ("AMC Report" or the "Report"). The Investors' Committee ("IC"), led by committee Chair Russell Read, CIO of the California Public Employees' Retirement System, released "Principles and Practices for Hedge Fund Investors" ("IC Report"). The AMC Report and IC Report each acknowledge that hedge fund managers and investors are accountable for the implementation of appropriate practices and strong controls in support of their respective activities. While the AMC Report may be more directly relevant to hedge fund operations, the AMC specifically encourages hedge fund managers to use the IC Report as a guide for their interactions with investors. Similarly, the IC recommends that investors use the AMC report as a guide in conducting due diligence for their hedge fund investments. The collaboration between the AMC and IC and the release of these reports marks the first time that fund managers and investors have worked together to improve investor education and hedge fund management.

This Part I of our Securities Briefing Series addresses the AMC Report. Part II, to be released next week, will address the recommendations of the IC Report.

#### **The Asset Managers' Committee Report**

The AMC Report calls on hedge funds to adopt best practices in all aspects of their operations, and specifically addresses disclosure, valuation, risk management, trading and business operations, and compliance, conflicts and business practices. The Committee suggests that managers use the recommendations to assess their specific practices and continue, amend or adopt practices going forward that are appropriate to the manager's funds and business. The Report stresses flexibility as necessary to meet the complex financial issues facing funds today and in the future, and adaptation as appropriate to address specific investment strategies, operating risks and manager innovations. The AMC Committee identified five key areas in which improved practices would most effectively promote investor protection and reduce systemic risk. According to

the Treasury Department, the authors of the Report, firms with over \$140 billion in assets under management will set an example for the industry by implementing their recommendations in the AMC Report. A summary of some of the key highlights of the AMC Report follows.

## Disclosure

The AMC Report recommends that each manager establish a framework designed to disclose material information to investors with sufficient frequency and detail to enable investors to make informed decisions about investing in the fund and to monitor and manage risks associated with such investment. •<sup>1</sup> Thus, policies should describe the forms of disclosure the fund will make, the timing or intervals of delivery, and, to some extent, the content thereof. The framework should address: (i) the form and frequency of an offering or private placement memorandum (“PPM”), annual audited financial statements, performance information, investor communications (such as risk reports) and timely disclosures of other material information; (ii) guidelines for disclosure of potential conflicts of interest; (iii) guidelines for the qualifications of investors; and (iv) guidelines relating to disclosures to counterparties.

The Report discusses the basic purpose and minimum recommended content of the PPM and recommends that the PPM be updated or supplemented when a material change or event occurs that makes the existing PPM inaccurate or misleading in light of other information previously provided by the manager. The recommended content includes information about any material violations of securities or investment-related laws or regulations, and any disciplinary actions suffered for professional misconduct. • The Report’s recommendation is thus a little broader than the duty already borne by registered advisers, under the Investment Advisers Act of 1940 (the “Advisers Act”) Rule 206(4)-4, to disclose such items to the extent the legal or disciplinary event is material to an evaluation of the adviser’s integrity or its ability to meet contractual commitments to clients.

Another new content recommendation is the call for PPM descriptions of the manager’s frameworks for the disclosure and valuation practices recommended by the Report. • The AMC Report also calls for PPM disclosure of certain details that, although common and sensible, are not universal PPM disclosure practices. These include addressing research expenses specifically in the allocation of expenses disclosure; stipulating for what services the fund may pay fees to affiliates of the manager; describing trade allocation policies; describing liability and indemnification of and by the manager, by and to the fund; numerous specifics around the manager’s oversight of its valuation policies and the means used to mitigate potential conflicts of interest; the criteria for determining when to use side pockets; and disclosure of possible risks arising from valuation of investments with no readily ascertainable market value, from explicit and implicit leverage, and from use of prime brokers and others as lenders. •

The Report also stipulates that if the manager incorporates new information in the PPM for new investors, the update should be provided to all investors in the fund. •

Addressing practices to provide investors with regular ongoing communications, the Report acknowledges that it is appropriate for the manager to consider, *inter alia*, the structure of the manager and the fund, the principles outlined in the AMC Report and the importance of protecting confidential information that,

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<sup>1</sup> The Report expressly purports to set standards that exceed existing industry-wide standards. We have placed a bullet (•) at the end of each sentence in which we describe what we perceive as a recommendation that exceeds industry-wide standards or that could be viewed to make lesser or variant practices undesirable going forward.

if disclosed, could adversely affect investors' interests. The form in which updates are communicated may vary, depending on the nature of the information included. The Report recommends six types of communications managers should consider and the information that such communications would generally be expected to cover. The Report anticipates: (i) investor letters, covering significant shifts in investment strategy or key risk exposures, changes in key personnel, performance information and business or market developments; (ii) risk reports, covering assets under management, the manager's approach to risk management, and key risk metrics such as asset types, concentration and leverage (including the basis on which it is calculated); (iii) performance reports, including quantitative and qualitative information, discussed further below; (iv) FAS 157<sup>2</sup> and supplemental investment-related financial information ("FAS 157 Disclosure Report"), covering the percentage of the fund's portfolio comprised of assets at each level of the FAS 157 valuation hierarchy and the percentage of realized and unrealized profit and loss (P&L) derived from Level 3 and Level 2 assets;<sup>3</sup> (v) disclosure of the percentage of the fund portfolio value represented by assets for which only one valuation quote was relied upon and the percentage for which multiple quotes were relied upon; and (vi) reports covering other specific events the manager considers to be material in light of the fund's investment program, offering status and competitive position, including key personnel biographical and disciplinary information, entry into side letters or establishment of parallel managed accounts under terms that may adversely impact other investors, and discovery of fraud or wrongdoing by the manager or other service providers. • The Report contemplates that these disclosures would be at intervals appropriate for the particular fund or manager, except that quarterly intervals are preferable for investor letters and risk reports.

With regard to performance reports, the AMC Report suggests that the quantitative information may include annual audited financial statements prepared in accordance with GAAP<sup>4</sup>, estimated fund performance that clearly indicates it is an estimate and that it has been prepared gross of certain fees, expenses and/or other items that are ordinarily included in calculating NAV, and investor-specific NAV. • It is worth noting that many funds cannot claim GAAP conformance due to the treatment of organizational expenses or perhaps other accounting practices. In addition, managers that choose to prepare performance estimates as described in the AMC Report should take precautions to assure that materials prepared for existing investors are not used with prospective investors or otherwise in a manner that might constitute them as marketing materials that do not comply with prevailing standards under the Advisers Act, under rules of the Financial Industry Regulatory Authority ("FINRA")(if sold through brokers), or established in a manager's own compliance policies and procedures.

The AMC Report suggests that managers should work to provide investors with a consistent level of information. The Report also suggests that one road to consistency might be to adopt a standard presentation, the contents of which would follow guidance provided by the Managed Funds Association's 2007 Sound

<sup>2</sup> Financial Accounting Standard 157 ("FAS 157") sets forth a hierarchy of assets based on the reliability of available pricing information: Level 1 assets have observable market prices (such as exchange-listed stock prices); Level 2 assets have some observable market price information other than quoted prices (such as broker quotes for OTC securities); and Level 3 assets have no observable market price information (such as private investments). FAS 157 must be implemented for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years.

<sup>3</sup> Because FAS 157 is newly adopted, the AMC Report notes that implementing these policies will be time intensive and will require working with the fund's independent auditors.

<sup>4</sup> The reference to GAAP in the AMC Report is to US generally accepted accounting principles. The Report notes, however, that there are other widely accepted accounting principles, in particular, the International Financial Reporting Standards (IFRS), which may be adopted by a manager for its fund. The Report notes that it supports the use of standards that are substantially similar to GAAP.

Practices for Hedge Fund Managers and/or similar publications by the Alternative Investment Management Association. The Report admonishes that, notwithstanding the freedom to employ different forms of presentation and to respond to individual investor inquiries, managers should avoid selectively disclosing material information among investors. When one investor asks a manager for additional information, the managers should consider whether to make the disclosure and, if appropriate,<sup>5</sup> should be willing to make the information available to all investors on request. • Currently, managers often struggle with (or overlook) whether or not to strive for information equivalence. Differences in investor sophistication, and in content and format demands, can make such a goal difficult, if not impossible, to attain. The fact that this Report is intended to be read also by investors may facilitate information equivalence if investors adopt the concept that equivalence itself is a valuable objective.

The Report identifies side letters and parallel managed accounts as types of potential conflicts meriting special disclosure. The Report acknowledges that some side letters are beneficial (*e.g.*, in attracting early or large investments) or immaterial to investors who are not party to them. It also notes that some side letters have the potential to harm non-party investors under certain circumstances. The latter should be disclosed to investors as reasonably necessary to enable non-party investors to assess the possible impact of such side letters on their investments. • Terms that may require special disclosure include enhanced control rights over investment decisions or the engagement of the manager or key personnel, preferential liquidity or redemptions rights, including gate waivers, the existence of preferential fees, and any other terms that materially alter the investment program disclosed in the PPM. Similarly, if a manager establishes a parallel managed account for an investor, the terms of such account may also, in some circumstances, give rise to the same concerns as side letters. In such cases, the same disclosure principles should apply. • Apart from the inclusion of preferential fees as a key concern, the recommendations as to side letters are similar to principles previously articulated by the FSA and speeches of the staff of the SEC and thus may already be standard practice for many managers. The clear extension of these principles to parallel managed accounts may prompt managers to review the terms of such accounts and evaluate whether such disclosures are warranted at the next reasonable opportunity.

As to investor qualifications, the Report recommends that managers evaluate whether each investor satisfies applicable legal standards and document how each investor's qualifications were established. • In addition to the qualifications necessary to obtain exemption from registration under US securities laws, the Report specifically recommends that managers take into account non-US requirements and generic representations that investors have received appropriate disclosure and understand the risks and other terms of the investment.

Finally, the AMC Report also emphasizes the need for disclosure to counterparties such as banks and broker-dealers in order to promote stable relationships between funds and counterparties, thus mitigating systemic risk. The report recommends that funds and counterparties agree on the type of information provided to counterparties when the parties begin their relationship. • The Report suggests that managers should be willing to assist counterparties' understanding of fund disclosures, including through access to key personnel,

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<sup>5</sup> The Committee does not specify what is meant by "if appropriate" in this context. Presumably, information that is specific to the requesting investor or his/her/its account is an example of information not appropriate for sharing with other investors. Currently, some managers may feel comfortable concluding that certain investors, or certain types of investors, require different information, in substance or depth. For example, some managers may have determined that it is reasonable to give more information to pension plans than to other investors based on the view that pension plan fiduciaries, which are themselves subject to separate fiduciary responsibilities and investment guidelines, require customized information that other investors do not want or could not utilize. It is impossible to say whether the Committee intended to suggest by using "if appropriate" that such customized information could be reasonably denied to non-plan investors.

and should consider whether it is appropriate to increase communication levels during periods of market stress affecting the fund's portfolio. This is an interesting gloss in that the recommendation also implies a mirrored recommendation to counterparties, namely, that they should not automatically tighten policies and resources as against all types of hedge funds when market stress emerges that implicates only certain hedge fund strategies. The Report also notes that, in considering disclosures to counterparties, it is appropriate for managers to seek assurances from counterparties about information barriers that will prevent information shared by the manager for credit evaluation purposes from being made available to the counterparty's trading desk.

## **Valuation**

In a significant departure from valuation practices recommended in some prior prominent publications on best practices, the AMC Report appears to be informed by the role of valuation in recent industry crises and also by the experience of the fund managers on the Committee. Previously, delegation of valuation to third-party service providers was suggested as a panacea to the conflict of interest inherent in performance fees. In many cases, managers have been reluctant or unable to implement true third-party valuation because it is often inadequate given the manager's superior understanding of the portfolio instruments. The AMC Committee acknowledges this and instead recommends that managers implement a valuation framework designed to assure clear, consistent valuations and to segregate functions between the portfolio management team and the non-trading personnel to minimize potential conflicts inherent in the valuation process. The Report recommends the framework include (i) documented valuation policies, including guidelines to test exceptions and for periodic review; (ii) a valuation committee or other governance mechanism, responsible for establishing and monitoring the policies and procedures; and (iii) identifying knowledgeable and independent personnel separate from the portfolio management function who are responsible for implementation of the policies and procedures. •

The Report recommends that the valuation committee be comprised of key members of senior management, yet also be structured to provide an appropriate degree of independence from the portfolio management function. The Report describes appropriate functions for the valuation committee. Noteworthy items include, but are not limited to, reviewing the manager's policies for classification of fund assets under the FAS 157 valuation hierarchy; conducting quantitative and qualitative review of the use of broker quotes as a valuation source, including review of quotes against trade activity, review of outliers and review of reconciliation of disparate quotes; and designating individuals or groups to take responsibility for review of particular valuation decisions. • The valuation committee is also advised to review the policies and procedures at least annually and upon the occurrence of material events, such as a shift in strategy, geographic or sector allocations, a change in market conditions or an event affecting availability of pricing information. • The Report implies that the valuation committee should be looking for red flags and any emerging "patterns" that warrant modification. It also details some issues the valuation committee's review should address, including the continued effectiveness of any service providers with delegated valuation responsibility, and the circumstances of any material exceptions. Finally, the valuation committee should conduct back-testing of a sample of valuations, with particular attention to Level 2 and Level 3 assets, to assess the quality of models and other evaluative processes. • The Report helpfully notes that back-testing should not be viewed as a test of the accuracy of individual marks, and that the differences likely to be identified should be used to focus on trends worthy of the valuation committee's further attention.

As previously noted, the Report recommends that implementation personnel be knowledgeable, qualified and independent of the portfolio management function. The Report acknowledges that it would not be

inappropriate to include a “challenge” mechanism to provide portfolio managers some input into the valuation process, provided the ultimate decision as to the appropriate price for a challenged asset would be made by the valuation committee, after consideration of input from the valuation implementation personnel and the portfolio manager(s).

The AMC Report also outlines recommended elements of a manager’s policies and procedures, including identifying the parties engaged in the process and their roles; identifying methodologies, providing that methodologies be established contemporaneously with first acquisition and applied consistently thereafter (unless a subsequent change is approved by the valuation committee); identifying pricing sources and their relative priority; and establishing good documentation procedures, with special attention to valuation of illiquid investments, positions with no readily available market quotations and material exceptions.

Finally, the AMC Report suggests that managers adopt policies for the appropriate use of “side pockets,” and notes that the common practice of excluding side pocket assets from performance fee calculations until a realization event is appropriate to mitigate potential conflicts of interest. The policies should articulate the factors considered in determining whether and when an asset should be placed in a side pocket, including: (i) the availability of third-party evidence of value; (ii) the inherent difficulty in valuing the investment; (iii) the nature of the market for investment; (iv) anticipated liquidity (taking into account any contractual or regulatory limitations on realization of the investment); and (v) any special events upon which the investment’s realization is contingent.

### ***Risk Management***

Risk management is the third key area identified by the Committee. The Report recommends that managers establish a comprehensive and integrated risk management framework, tailored to the characteristics of the fund(s). Managers should communicate the risk management framework to investors so that they may evaluate whether the fund’s risk profile is appropriate for them and how well the fund is performing against its risk goals. • The framework should identify the material risks to which the fund is subject and identify how these risks will be measured; provide a process for regular monitoring that is appropriate for the size of the assets, the portfolio management process, and the complexity of the strategies; capture the foregoing in written policies and procedures; and assure that knowledgeable and properly resourced personnel are assigned to implement the policies and procedures. • In particular, the Report recommends that senior management determine the risk profile for the fund, and that the manager’s risk personnel develop and implement processes designed to meet this profile. The Report helpfully points out that the policies (and presumably also disclosures to investors) should recognize that risk measures have limitations, and that output from risk measures provide greater insight when monitored over time.

The AMC Report notes that the assessment of counterparty credit risk is essential to effective risk management. In particular, the Report states that fund managers should: (i) understand the complex legal relationships with counterparties and their affiliates, including which legal entity is the counterparty to a particular contract, the fund’s ability or inability to close out or net positions, rights in bankruptcy, and the identity of custodians and sub-custodians used by the fund’s prime broker(s); (ii) monitor their exposure to each counterparty and weigh the benefits of diversification of counterparty credit risk (for example by using multiple prime brokers) against any detriment arising from increased complexity of settlement, reconciliation and collateral management processes; and (iii) consider opening cash and custody accounts at financial institutions other than the prime brokers in order to attempt to mitigate liquidity risk in the event of market stress.

It is noteworthy that the Report recommends that senior management should not outsource the risk management and monitoring function and must maintain responsibility for the entire risk framework. Nonetheless, the Report notes that if the manager does use an external risk measurement provider, outsourcing of this function should not take the place of senior management having an adequate understanding of risk, and any outsourced components of the risk management process should continue to be the responsibility of senior management.

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

The Report goes on to suggest that managers develop a comprehensive and integrated framework to manage trading and business operations, again taking into account the specific characteristics of its activities and investment strategies. This framework should include (i) operational and accounting controls relating to selection of counterparties, cash, margin and collateral management, selection of key service providers, infrastructure and operations, operational and accounting processes, and disaster recovery; (ii) systems, infrastructure and automation appropriate to the scale of operations and regular review thereof; and (iii) appointment of a chief operating officer or similar office within senior management, with skills and resources appropriate to the complexity of the manager's operations. • The Report details considerations relevant to each of these topics. Some points represent basic common sense and some seem to be good lessons gleaned from the market turmoil of the last twelve months. These include recommendations that managers review counterparty agreements and identify the conditions that affect the counterparty's obligation to extend credit or provide other services (such as terms that can increase collateral requirements), monitor compliance with credit agreements, monitor collateral requirements, verify marks used by counterparties to value collateral, and verify and meet margin calls in a timely matter.

Other noteworthy practices the Report recommends include making sure key service provider agreements clearly delineate the service levels to which the fund is entitled, considering the implementation of automated trade processing systems, adopting policies for resolving material breaks, errors and inefficiencies, and cross-training personnel to mitigate the key-man risk within individual functions. With regard to cash and transactions, the Report emphasizes checks and balances such as reconciliation processes, use of appropriate authorized signatories, assuring that trade confirmations are sent to non-trading personnel, and processes for attending to corporate actions and expiration dates on instruments that have them. Managers engaging in OTC derivatives and other complex markets are advised to devote appropriate resources that are sufficiently robust to handle the complexity of these instruments and to consider the need for special systems or personnel with specific capabilities to manage complex investments. The Report provides detailed examples of controls specific to various types of complex instruments. The Report also recommends core accounting processes that document trading activity, contractual arrangements, NAV calculation and other financial data that will be generally familiar to registered advisers subject to the recordkeeping requirements of the Advisers Act. Finally, the Report recommends disaster recovery and business continuity planning that will also be familiar to registered advisers.

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

In its final recommendations, the AMC Committee advocates that managers adopt a compliance framework, supported by adequate resources, that "provides guidance to the [m]anager and its personnel in respect of ethical, regulatory, compliance and conflict of interest situations." • Thus, the stated goal of the compliance framework is something less than assuring compliance with all relevant federal securities laws, which is the goal of compliance programs for registered advisers. The recommended elements include a written

code of ethics governing personal conduct; a compliance manual that addresses applicable rules and regulations, potential conflicts of interest and the maintenance of adequate records; establishment of a conflicts committee to review conflicts; regular training of personnel on the material elements of the compliance program; and functions that support the compliance program (including a chief compliance officer to monitor and maintain the program), appropriate sanction authority and an annual review.

The Report emphasizes that creating a culture of compliance is a critical element to establishing an effective compliance framework. It notes that key elements of fostering such a culture should include: (i) senior management encouraging personnel to report any questions or concerns without the fear of retribution; (ii) the ability to address such concerns with senior management; (iii) senior management playing an active role in compliance meetings and training; (iv) establishing institutional significance for the role of Chief Compliance Officer; and (v) regular consultation by the Chief Compliance Officer with senior management and personnel regarding compliance issues.

The Report recommends that managers adopt a written code of ethics in order to promote professionalism and integrity among the manager and its personnel. Each manager should decide whether certain policies should be covered in the code of ethics or in the compliance manual based on its individual business. The Report notes that the code of ethics should not be generic or “off the shelf,” but, rather, should be appropriately tailored to the manager’s particular business. The code of ethics should clearly state which employees are subject to it and should require a certification by each employee that they have read and understand the code, and will comply with its contents. The Report recommends that guidelines set forth in the code of ethics should address at least the following issues: (i) general standards of integrity and professionalism; (ii) the fiduciary nature of the manager and its employees, in particular, the priority of the interests of the fund and investors over the interests of the manager and its employees; (iii) the protection of confidential fund and client information; (iv) personal trading by employees; (v) the receipt of gifts and provision of entertainment by employees and third parties; (vi) an approval or review process to consider any conflicts between an employee’s internal role and outside business interests, including directorships; and (vii) a reporting mechanism for violations of the code of ethics.

The Report notes that critical elements of the manager’s compliance manual should reflect specifics of the manager’s business and outline policies and procedures for complying with laws, rules and regulations, whether domestic or international, that pertain to the fund’s business. The compliance manual should address many of the same elements covered by compliance manuals of registered advisers, including: (i) marketing and communications, including communications with third parties (such as the media), procedures for using third-party marketers to solicit investments (where permitted), and procedures for the review of marketing materials used by the manager; (ii) anti-money laundering measures and compliance with the Bank Secrecy Act (if applicable); (iii) policies regarding accurate and prompt recording of transactions; (iv) trade allocation policies; (v) procedures for proxy voting; (vi) trade error policies; (vii) a best execution policy including selection criteria for brokers and the identification and review of such criteria by senior management or a best execution committee; (viii) policies regarding the use of soft-dollars; (ix) policies prohibiting market manipulation and to prevent, the misuse of material non-public information; and (x) policies regarding position reporting requirements under federal securities laws, other regulatory frameworks, and comparable non-US reporting requirement laws.

Furthermore, the AMC Report stresses that managers should establish a surveillance system to monitor compliance with the policies and procedures set forth in the compliance manual. It notes that an appropriate



surveillance system will depend on the nature of the business of the manager and the fund, and should include a review of records and documentation produced in the ordinary course of the manager's business.

As to recordkeeping, managers should establish policies and procedures regarding the creation, maintenance and retention of business records that are appropriate in light of the manager's business operations. Documents critical to the manager and the fund should be retained, including contracts, constituent documents, trade data, accounting records, documents pertaining to valuation and any records of meetings of principal committees (e.g. the conflicts committee). Recordkeeping policies and procedures should address the duration and manner of retention, including how to protect records from unauthorized alteration or untimely destruction, and retention policies should be communicated to all personnel, as applicable to their particular responsibilities.

As for conflicts of interest, the AMC Report states that the potential for conflicts across the financial services industry must be addressed to ensure investor confidence in managers and the financial markets. The report sets forth potential conflicts relevant to the hedge fund industry, but concludes that because it is impossible to address every potential conflict with a specific policy, fund managers should establish a conflicts committee to review potential conflicts on a case-by-case basis.

The Report recommends conducting vigorous, tailored compliance training for personnel at least annually. The training should address specific topics identified by the Chief Compliance Officer and/or other employees as relevant to such employees' activities. The Report notes that retaining third-party experts, such as outside counsel, to conduct this training may be helpful. Finally, the Report notes that open and informal discussions between employees, supervisors and the Chief Compliance Officer during training is important to fostering a culture of compliance, particularly among junior personnel.

The AMC Report emphasizes that managers must devote adequate resources to the compliance function to ensure that the compliance program is sufficiently implemented, monitored and reviewed. The Report recommends that managers appoint a Chief Compliance Officer or another member of senior management to oversee this compliance function. Other members of senior management may be appointed to oversee compliance within specific areas. All compliance issues should be reported to the Chief Compliance Officer or the designated member of senior management.

The Report emphasizes that an effective compliance framework must include policies regarding discipline and sanctions for non-compliance with policies and procedures. The Report recommends that senior management should generally be responsible for disciplinary action and sanctions in conjunction with the recommendations of the Chief Compliance Officer. Allegations of misconduct should be reviewed internally by the General Counsel or Chief Compliance Officer. The Report recommends that a range of disciplinary actions and sanctions should be available to senior management depending on the severity of the violation. According to the Report, such disciplinary actions and sanctions should include reprimands, censure, suspension, termination and, where applicable and practical, disgorgement of profits and restitution.

Finally, the Report notes that an annual compliance review is essential to an effective and successful compliance framework. Upon the occurrence of events that require more immediate changes, more frequent compliance reviews may be necessary and prudent. The Report stresses that during the annual review, the Chief Compliance Officer should review all components of the compliance framework, particularly in light of any noteworthy changes and factors relevant to the manager's business, including, among other things, legal and regulatory developments, changes in business practices, variations in the manager's strategies and products, employee conduct and changes in the size of the manager's business.

## Conclusion

The AMC Committee focuses on five key areas with respect to which it recommends that managers adopt “comprehensive and integrated frameworks” governing the manager’s relevant practices. We have discussed the areas of concern and the recommendations for each in some degree of detail above. In conclusion, we focus on the use of this new concept of “frameworks,” which is noteworthy because it suggests something other than simply written policies and procedures. Although the authors do not explain why they adopted “framework” as the master unit of best practices, it does suggest that, whether or not a manager adopts a “compliance program” of the type familiar to regulators and lawyers, investor protection and mitigation of systemic risk can still be served by articulating risks and goals and adopting the types of practices the Committee’s frameworks contemplate. While the recommendations are distinct from predecessor publications in their degree of specificity and practicality, and the Committee clearly prioritizes the implementation of the frameworks by the largest hedge funds, the recommendations will still likely be regarded as unwieldy, or unmanageable, by start-up managers and smaller hedge funds. Even if smaller managers require substantial modifications, the critical factor is that each manager adopts identifiable policies so that they are able to explain to investors how its policies address the practice areas described in the AMC Report. By achieving this result, the Committee believes hedge fund managers can demonstrate that they have accepted the responsibility that comes with success and expansion of the industry over the last thirty years.

*The AMC Report can be found at [http://www.amaicmte.org/Public/AMC\\_Report.pdf](http://www.amaicmte.org/Public/AMC_Report.pdf)*

*The text of Secretary Paulson’s opening remarks can be found at <http://www.ustreas.gov/press/releases/hp926.htm>*

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