

## Hedge Fund Oversight: Key Action Items for Hedge Funds, Broker-Dealers and Other Market Professionals

### I. Overview

On February 22, 2007, the President's Working Group on Financial Markets (PWG) issued its much-anticipated report on hedge fund oversight (Report).<sup>1</sup> In recent weeks, the Report has been the subject of significant public scrutiny, including hearings on hedge fund regulation before the House Financial Services Committee on March 14, 2007. In general, the Report takes the view that risks associated with private pools of capital are best borne by creditors, broker-dealers, and sophisticated investors who are capable of identifying, analyzing, and bearing those risks. While many have welcomed this view, some have called for greater hedge fund regulation. In particular, the Report has been characterized as "a welcome call to inaction,"<sup>2</sup> a regulatory "light touch" for the industry,<sup>3</sup> and an endorsement of "a hands-off approach."<sup>4</sup> Critics, such as Connecticut Attorney General Richard Blumenthal, have decried the Report as "vague" and "unenforceable," and repeated earlier warnings that lack of regulation on the federal level could lead to inconsistent state initiatives. William Galvin, Secretary of the Commonwealth of Massachusetts, said that the decision to rely on market discipline to cope with hedge fund risk is "simply the wrong approach to an increasing problem."<sup>5</sup> This debate mirrors the broader international debate over regulating the risks associated with the increasing role of hedge funds in the global financial markets.<sup>6</sup>

Currently, the PWG is chaired by Treasury Secretary Henry M. Paulson and composed of the chairs of the Federal Reserve Board, the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission.<sup>7</sup> The PWG originally was established in 1988 to enhance the integrity, efficiency, orderliness, and competitiveness of financial markets and to maintain investor confidence following the stock market crash of 1987. The last PWG report, which was issued in

1999 following the near-collapse of Long Term Capital Management in 1998, focused on preventing systemic risk and recommended greater transparency of hedge fund information.

### II. Best Practices for Market Professionals

The Report sets out principles to guide financial regulators in addressing issues presented by the explosive growth of the hedge fund industry, which has grown, by some estimates, to \$1.4 trillion in assets from about \$50 billion in 1998. It echoes the themes of systemic risk and investor protection from the 1999 PWG report, but places the onus of mitigating market risks on creditors, counterparties (e.g., banks and prime brokers), and investors. Noting that market discipline has improved and that the market has "matured and expanded considerably" since the 1999 PWG guidelines were issued, the Report stops short of calling for new legislation. Rather, it advocates market discipline—specifically, the risk management practices of regulated counterparties and due diligence on the part of investors—as the most effective means of addressing systemic risk and investor protection concerns.

In accordance with its principles-based approach, the Report recommends a series of non-binding guidelines that regulators and market participants should undertake to further the goals of protecting investors and reducing risk to the overall financial system:

- A. **Investors** should (1) understand the risks and consider the suitability of investments in private pools in light of their investment objectives, risk tolerance, and the principle of portfolio diversification; (2) perform due diligence regarding the fund's investment objectives, strategies, risks, risk management capabilities, fees, liquidity, performance history, etc.; (3) evaluate a pool's manager and

personnel, including their background, experience, disciplinary history, and any conflicts of interest; and (4) evaluate a pool's service providers and the providers' independence from the pool managers.

- B. **Fiduciary Managers** should (1) consider the suitability of an investment in a private pool within the context of the overall portfolio, evaluating investment objectives, strategies, risks, fees, liquidity, performance history, etc.; (2) perform ongoing due diligence to ensure that their investment decisions are prudent and in keeping with the principle of portfolio diversification and with their fiduciary duties to act in the best interests of their beneficiaries; (3) evaluate a pool's manager and personnel, including their background, experience, disciplinary history, and any conflicts of interest; and (4) evaluate a pool's service providers and the providers' independence from the pool managers.

For those less sophisticated investors who are indirectly exposed to hedge funds through holdings of pension funds, fund-of-funds, or other similar investment vehicles, the PWG places the burden on fiduciaries that manage such vehicles to conduct suitability and due diligence determinations in the best interests of their beneficiaries.

- C. **Hedge Funds** should (1) provide clear and meaningful disclosures and provide information frequently enough and with sufficient detail that creditors, counterparties, and investors may stay informed of strategies, the amount of risk being taken by the pool, and any material changes; (2) maintain information, valuation,<sup>8</sup> and risk management systems in order to provide this information; and (3) strengthen processing, clearing, and settlement arrangements for credit derivatives and other over-the-counter derivatives.
- D. **Broker-Dealers** should (1) ensure that sales promotions of hedge funds provide balanced disclosures of risk and return; (2) perform due diligence to determine that the hedge fund or fund of hedge funds is suitable for any customer; and (3) perform customer-specific suitability determinations.
- E. **Counterparties, Creditors, and Prime Brokers** should (1) commit sufficient resources and maintain policies and procedures to define, implement, and enhance best risk management practices; (2)

undertake due diligence of their ability to manage their exposures to market, credit, liquidity, and operational risks before extending credit to private pools; (3) limit their exposure to losses from default by private pools through financing terms, tightening credit terms where sufficient information is not forthcoming from a particular private pool; (4) use stress testing to evaluate the impact of adverse market events; and (5) strengthen processing, clearing, and settlement arrangements for credit derivatives and other over-the-counter derivatives.

Indeed, broker-dealers that plan to offer portfolio margining to hedge funds and other customers will need to implement detailed customer approval and risk procedures, and have these procedures approved by their designated examining authorities.<sup>9</sup> On April 2, 2007, the new portfolio margining rules adopted by the New York Stock Exchange LLC (NYSE), National Association of Securities Dealers, Inc. (NASD), and Chicago Board Options Exchange (CBOE) will go into effect.<sup>10</sup> Under these rules, eligible hedge fund and other customers may obtain enhanced leverage by using portfolio margining accounts.

- F. **Risk Managers/Supervisors** should (1) clearly communicate their expectations regarding counterparty credit risk management, taking into account developments in financial markets and advances in best practices; and (2) work together with regulators to ensure that supervisory expectations regarding counterparty risk management practices and market integrity are met.

### III. Additional Best Practices for Hedge Funds: IOSCO's Principles for Valuation of Hedge Fund Portfolios

Following issuance of the PWG Report, the International Organization of Securities Commissions (IOSCO) released its own report on "Principles for the Valuation of Hedge Fund Portfolios" (IOSCO Paper) on March 13, 2007.<sup>11</sup> Like the PWG Report, the IOSCO Paper seeks to address the challenges and risks posed by the growing influence and importance of hedge funds in the global capital markets, but focuses in particular on the challenges to hedge funds of properly valuing their financial instruments. The IOSCO Paper points out that the inherent conflicts of interest between the interests of hedge fund managers, whose advisory and/or performance fees are based on the value of a fund's portfolio and its performance, and their investors,

are magnified when hedge funds invest in illiquid or complex financial instruments that are difficult to value. Accordingly, the IOSCO Paper recommends that hedge funds implement comprehensive policies and procedures for valuing financial instruments and identifies nine principles that should be included in these policies and procedures:

- A. Comprehensive, documented policies and procedures should be established for the valuation of financial instruments held or employed by a hedge fund. These policies and procedures should address such issues as the competence and independence of personnel who are responsible for valuing the financial instruments and the specific investment strategies of the hedge fund and the financial instruments in the investment portfolio.
- B. The policies should identify the methodologies that will be used for valuing all of the financial instruments held or employed by the hedge fund, including inputs, models, and the selection criteria for pricing and market data sources.
- C. The financial instruments held or employed by hedge funds should be consistently valued according to the policies and procedures. The policies and procedures should outline a mechanism that enables the monitoring of whether the party or person who has responsibility for valuing financial instruments is following the policies and procedures.
- D. The policies and procedures should be reviewed periodically to ensure their continued appropriateness.
- E. The hedge fund's governing body (e.g., Board of Directors, General Partner) should seek to ensure that an appropriately high level of independence is brought to bear in the application and review of the policies and procedures. Independence may be achieved by using third-party pricing services, independent reporting lines, and a valuation committee.
- F. The policies should seek to ensure that the individual values generated by the policies and procedures—and, in particular, any valuation influenced by the hedge fund's manager—undergo an appropriate level of independent review. The policies also should include specific controls to ensure that objectivity is brought to bear in considering values that are obtained from external sources.

- G. A hedge fund's policies and procedures should describe the process for handling and documenting price overrides, including the review of price overrides by an independent party.
- H. The hedge fund's governing body should conduct initial and periodic due diligence on third parties that are appointed to perform valuation services.
- I. The arrangements in place for the valuation of the hedge fund's investment portfolio should be transparent to investors, including valuation policies of the hedge fund, skills and experience of all parties involved in valuation, any material conflicts of interest and information about the nature and degree of any contracted pricing services.

#### IV. Likelihood of SEC Regulation?

It is unclear what, if any, further steps the SEC will take regarding hedge funds. Although the PWG Report states that the “current regulatory structure . . . is working well,”<sup>12</sup> SEC Chairman Christopher Cox said during testimony before the Senate Committee on Banking, Housing and Urban Affairs in July 2006 that he feared that the “program of hedge fund regulation was inadequate” in the wake of the *Goldstein* decision (which invalidated the SEC's rule requiring hedge fund advisers to register with the SEC).<sup>13</sup> More recently, SEC Commissioner Roel C. Campos stated that—far from being a “call to inaction”—the Report made it clear “that regulators have and should use their authority to foster vital and stable capital markets.” Campos further commented that he “read nothing in the [Report] as precluding or discouraging consideration of further regulatory action if the circumstances were to warrant it.”<sup>14</sup>

In the immediate term, the SEC is considering whether to raise the minimum net worth threshold for investing in hedge funds from \$1 million to \$2.5 million and adopt new antifraud rules applicable to hedge funds.<sup>15</sup> These antifraud rules would supplement the existing regulatory regime that holds hedge funds accountable under general antifraud, civil liability, and other provisions of the federal securities laws. Without addressing the specific SEC proposals, the Report seemingly supports efforts to ensure that only the most sophisticated investors invest in hedge funds.<sup>16</sup> On the enforcement front, the growing number of cases against hedge fund advisers

for, among other things, misappropriation of fund assets, insider trading, misrepresentation of portfolio performance, inaccurate disclosure of trading strategies, market manipulation, and improper valuation of assets,<sup>17</sup> indicates that the Report should in no way be taken as a sign of complacency or future inaction by the regulators.

## NOTES

1. See Agreement Among PWG and US Agency Principals on Principles and Guidelines Regarding Private Pools of Capital (Feb. 22, 2007) ("Report"), available at [http://www.treasury.gov/press/releases/reports/hp272\\_principles.pdf](http://www.treasury.gov/press/releases/reports/hp272_principles.pdf).
2. *Hedge Fund Realities*, Wall St. J., Feb. 26, 2007, at A18.
3. Jeremy Grant & Anuj Gangahar, *Brussels Backs 'Light Touch' for Hedge Funds*, FT.com, Feb. 24, 2007, available at [www.msnbc.msn.com/id/17303793](http://www.msnbc.msn.com/id/17303793).
4. Kara Scannell, Joellen Perry, & Alistair MacDonald, *No Consensus on Regulating Hedge Funds*, Wall St. J., Jan. 5, 2007, at C1.
5. Jeremy Grant, *US Treasury Defends New Guidelines for Hedge Funds*, FT.com, Feb. 28, 2007, available at [www.msnbc.msn.com/id/17379847](http://www.msnbc.msn.com/id/17379847).
6. Kara Scannell, Joellen Perry, & Alistair MacDonald, *No Consensus on Regulating Hedge Funds*, Wall St. J., Jan. 5, 2007, at C1. The Financial Services Authority (FSA) applies a principles-based approach to regulation of hedge funds and private equity. See Dan Waters, Director of Retail Policy and Asset Management Sector Leader, Financial Services Authority, Remarks Before the International Bar Association and American Bar Association: FSA Regulation of Alternative Investments (Mar. 12, 2007), at 6. More recently, however, the European Parliament Socialist Group published a report calling for tighter regulation of hedge funds and private equity groups, including increased transparency, minimum standards with respect to valuation, and more stringent disclosure requirements. See PSE Socialist Group in the European Parliament, *Hedge Funds and Private Equity - A Critical Analysis*, <http://www.socialist-group.eu/gpes/newsdetail.do?lg=en&id=33839&href=home>.
7. In addition, other interested government agencies also participate on an ad hoc basis.
8. See *infra* Section III.
9. Generally, "portfolio margining" is a method of setting margin requirements for a securities account based on a determination of the net risk of all positions in the account, giving effect to all potentially offsetting positions.
10. See NYSE Rules 431, 726; NASD Rules 2520, 2860; CBOE Rules 12.4, 9.15(c).
11. See Technical Comm. of the Int'l. Org. of Secs. Comm'ns, Consultation Report, Principles for the Valuations of Hedge Fund Portfolios (2007), <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD240.pdf>.
12. See Report, *supra* note 1.
13. *Regulation of Hedge Funds: Before the S. Comm. On Banking, Housing, and Urban Affairs* (July 25, 2006) (statement of Hon. Christopher Cox, Chairman, Securities and Exchange Commission), at 5. See also *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).
14. Roel C. Campos, Commissioner, SEC, Remarks Before the Hedge Fund Institutional Forum Corporate Funds Roundtable (Mar. 5, 2007), at 2.
15. *Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles*, 72 Fed. Reg. 400 (Jan. 4, 2007).
16. *But see* Fin. Servs. Auth., Funds of Alternative Investment Funds (FAIFs), Consultation Paper 07/6 (2007); Alternative Inv. Mgmt. Assoc., AIMA's Summary of the FSA's Consultation Paper on Funds of Alternative Investment Funds - CP 07/06 (2007). Interestingly, the FSA recently has made a move in the other direction, setting out proposals to introduce retail-oriented funds of alternative investment funds into the existing FSA regulatory regime. Dan Waters, FSA Director of Retail Policy and Asset Management Sector Leader, has stated that "[a]sset management is a dynamic and innovative industry and we believe it is important that consumers can get access to the latest techniques to manage their own savings and investments. We think the time is right to permit access to a wider range of innovative strategies through authorised onshore vehicles." See Press Release, Fin. Servs. Assoc., *Wider Access for Retail Customers to Alternative Investments* (Mar. 27, 2007), available at <http://www.fsa.gov.uk/pages/Library/Communication/PR/2007/040.shtml>.
17. *Regulation of Hedge Funds: Before the S. Comm. On Banking, Housing, and Urban Affairs* (July 25, 2006) (statement of Hon. Christopher Cox, Chairman, Securities and Exchange Commission), at 4.

## V. Conclusion

At this time, market participants should undertake to review their risk management systems and controls, internal policies and procedures, and conduct the due diligence and suitability determinations described above. Although the PWG has not recommended new legislation, both the PWG and IOSCO have set forth a variety of best practices that market participants should implement and follow.

### FOR MORE INFORMATION ON THIS OR OTHER SECURITIES MATTERS, PLEASE CONTACT:

<b>Brandon Becker</b>	<a href="mailto:brandon.becker@wilmerhale.com">brandon.becker@wilmerhale.com</a>	+1 202 663 6979
<b>Bruce H. Newman</b>	<a href="mailto:bruce.newman@wilmerhale.com">bruce.newman@wilmerhale.com</a>	+1 212 230 8835
<b>Jeannette K. Boot</b>	<a href="mailto:jeannette.boot@wilmerhale.com">jeannette.boot@wilmerhale.com</a>	+1 212 295 6507
<b>Stephanie R. Nicolas</b>	<a href="mailto:stephanie.nicolas@wilmerhale.com">stephanie.nicolas@wilmerhale.com</a>	+1 202 663 6825
<b>Julia Y. Lee</b>	<a href="mailto:julia.lee@wilmerhale.com">julia.lee@wilmerhale.com</a>	+1 202 663 6846