MANAGED FUNDS ASSOCIATION

Sound Practices for Hedge Fund Managers

2009 Edition

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Foreword

Managed Funds Association ("MFA") is pleased to present its 2009 edition of *Sound Practices for Hedge Fund Managers* ("*Sound Practices*"), which represents the newest version of our seminal publication. *Sound Practices* presents a dynamic blueprint for hedge fund managers to strengthen business practices through a strong framework of internal policies and procedures.

The 2009 edition of *Sound Practices* is the most robust, comprehensive best practices guidance available today. MFA's *Sound Practices* demonstrates our ongoing commitment to address regulatory and public policy issues by incorporating the recommendations provided in the President's Working Group on Financial Markets' ("PWG") *Best Practices for the Hedge Fund Industry Report of the Asset Managers' Committee* and by providing additional guidance that goes beyond the scope of that report.

MFA has also been actively and cooperatively engaged with policy makers and regulators to develop ways to enhance market discipline, prevent systemic risk, and increase investor protection. MFA is also engaged with policy makers, regulators, and industry participants in connection with the global effort to harmonize and promote sound business practices for the industry.

Now in its fifth iteration, *Sound Practices* has been updated and enhanced by leading members of MFA in collaboration with service providers and other industry participants to provide peer-to-peer recommendations for establishing the highest standards of professional conduct in virtually every aspect of a hedge fund manager's business.

First published in 2000, MFA's *Sound Practices* is the original principles-based guidance designed for the global hedge fund industry and also provides powerful tools for investors as they consider adding hedge funds to their portfolios. MFA's *Sound Practices* includes a model due diligence questionnaire designed for all types of investors including pension fund managers, college and university endowments, nonprofit organizations, and other sophisticated investors. Today, more than ever before, investors will

benefit from MFA's due diligence questionnaire as they undertake robust diligence when considering an investment in a hedge fund. Investors can also benefit from reviewing the recommendations in *Sound Practices* as they consider operational, governance, and other matters as part of their diligence when making an investment.

The 2009 edition of *Sound Practices* provides comprehensive updates in every area of guidance including recommendations for disclosure and responsibilities to hedge fund investors; valuation policies and procedures; risk management; trading and business operations; compliance, conflicts of interest, and business practices; anti-money laundering; and business continuity and disaster recovery practices.

MFA's *Sound Practices* recommendations, if adopted, will enhance the ability of hedge fund managers to manage operations, satisfy responsibilities to investors, comply with applicable regulations, and address unexpected market events.

Please contact MFA staff with any questions or if we can provide any additional information.

Sincerely,

/s/ Richard H. Baker

Richard H. Baker
President and CEO

Introduction

Managed Funds Association ("MFA") publishes *Sound Practices for Hedge Fund Managers ("Sound Practices")* for the benefit of its members and the global Hedge Fund[1] industry. Currently in its fifth edition (previous editions were published in 2000, 2003, 2005, and 2007), *Sound Practices* contains recommendations that provide Hedge Fund Managers with a framework of internal policies, practices, and controls from a peer-to-peer perspective. MFA principally directs the recommendations in *Sound Practices* toward U.S. and non-U.S.-based Hedge Fund Managers with business operations and investments in the United States and its territories. MFA recognizes, however, the truly global nature of the Hedge Fund marketplace, and has developed the recommendations in *Sound Practices* to be useful tools for Hedge Fund Managers around the world. *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.

MFA remains committed to ensuring that *Sound Practices* stays at the forefront of updating, enhancing, and promoting standards of excellence in the Hedge Fund industry. To that end, MFA dedicates resources to updating *Sound Practices* as appropriate and to educating industry participants, including investors, about *Sound Practices* and the importance of tailored implementation of the recommendations in the document.

[1] The terms Hedge Fund and Hedge Fund Manager are defined later in this Introduction under the sub-heading titled, *General Considerations Relating to Hedge Funds, Hedge Fund Managers, and Investors.* Other capitalized terms and certain technical words and phrases used in this document that are not defined in the text itself are defined in the glossary, which can be found in Appendix I.

Introduction

About MFA

MFA is the voice of the global alternative investment industry. Its members are professionals in Hedge Funds, funds of Hedge Funds and managed futures funds, as well as industry service providers. 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 include the vast majority of the largest Hedge Fund groups in the world who manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York, NY. For more information, please visit: ***www.managedfunds.org.***

Public Policy & the Hedge Fund Industry

The 2009 edition of *Sound Practices* demonstrates the continued commitment of MFA and its members to address both the current regulatory environment and public policy issues surrounding Hedge Funds. In September 2007, the President's Working Group on Financial Markets (the "PWG") tasked two private-sector committees comprised of well-respected Hedge Fund Managers (the "AMC") and investors to prepare and release complementary sets of best practices for Hedge Fund Managers and Hedge Fund investors. In preparing their respective reports, the committees reviewed recommendations from existing industry practice guides, including the 2007 edition of *Sound Practices,* and MFA directly engaged with, and provided comments to, both committees during the development of their reports. MFA strongly supports the work undertaken by both committees in producing comprehensive and substantive reports.

Even though the recommendations in the AMC's report and the 2007 edition of *Sound Practices* have significant overlap and are generally consistent with each other, the MFA updated and enhanced *Sound Practices* to incorporate the recommendations in the *Best Practices for the Hedge Fund Industry Report of the Asset Managers' Committee,* which was released on January 15, 2009 (the "***AMC Report***"). The 2009 edition of *Sound Practices* also includes additional recommendations beyond those contained in the *AMC Report* including, among others, recommendations with respect

to anti-money laundering ("AML") and business continuity and disaster recovery. In addition to the update to recommendations, the 2009 edition of *Sound Practices* contains overarching principles of sound business practices for the industry, which are the foundation for the specific recommendations in the document.

Implementation of *Sound Practices* will contribute meaningfully to the internal soundness of Hedge Fund Managers and the Hedge Funds they operate, as well as to the strength of the financial markets in which they participate. The recommendations in *Sound Practices* are designed to provide a framework for all Hedge Fund Managers, regardless of regulatory jurisdiction, to develop sound business operations, which will contribute to a robust, competitive, and stable global financial marketplace.

The Role of Hedge Funds in Global Financial Markets

Hedge Funds are key participants in global capital markets and their growth and diversification have strengthened those markets. The activities of Hedge Fund Managers differ greatly from those of depository institutions and credit providers. For example, unlike other financial institutions, Hedge Funds, which invest risk-based capital, perform critical functions for capital markets by providing: liquidity and price discovery to capital markets; capital to companies to allow them to grow or turn around their businesses; and sophisticated risk management to investors such as pension funds, to allow those pensions to meet their future obligations to plan beneficiaries.

By investing risk-based capital, Hedge Fund Managers provide needed liquidity to financial markets, which can help dampen market volatility and 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 provide investors with valuable portfolio diversification—such diversification can reduce individual investor risk and, as a result, overall market risk. Indeed, policy makers have consistently recognized and acknowledged the important benefits that Hedge Funds bring to capital 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 risks they take. Overall, however, most economists agree that the rise of hedge funds has been a positive development for investing 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 New York University Law School, New York, NY (April 11, 2007)

History of *Sound Practices* and Related Initiatives

A small group of Hedge Fund Managers published the first edition of *Sound Practices for Hedge Fund Managers* in 2000, which focused primarily on risk management, in direct response to the PWG's 1999 report titled, *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management.* MFA subsequently published the 2003 and 2005 editions to update developing industry practices and expand the subject matter covered. The 2007 edition of *Sound Practices* directly responded to the request made by the PWG's *Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital* issued in February 2007 (the "*PWG Agreement*"), which called for 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."

As part of its ongoing educational outreach effort to promote the recommendations in *Sound Practices,* MFA in 2008 hosted a series of educational seminars around the country. These events brought together Hedge Fund Managers, investors in Hedge Funds, financial regulators, and other industry participants to promote and discuss the recommendations, as well as to solicit comments and generate discussion regarding evolving industry practices.

The 2009 edition of *Sound Practices* was prepared based on extensive discussions and collaboration among MFA's members, including leading Hedge Fund Managers, service providers and other industry participants.

Current Financial and Regulatory Climate

Since the publication of the 2007 edition of *Sound Practices,* global financial markets have experienced significant volatility and uncertainty, adversely affecting all market participants, including Hedge Funds. Counterparty failures, massive government rescue measures for highly regulated financial services firms, large-scale frauds, and unprecedented losses have highlighted the importance of sound business practices (including risk management) and investor due diligence practices. In response to these extraordinary market events, policy makers and regulators around the globe, as well as international regulatory bodies have engaged in substantial discussion and debate regarding how best to reestablish a sound financial system and restore the orderly operation of capital markets.

MFA has been actively and cooperatively engaged with policy makers and regulators in developing ways to improve market stability and promote sound business practices. We continue to urge coordinated global dialogue among all concerned policy makers, regulators, and industry participants as a matter of priority.

Sound Practices answers both domestic and international public sector calls to improve market discipline. While MFA recognizes that no set of industry practices can provide all of the answers to the problems plaguing capital markets, our continuing efforts to promote widespread adoption and

implementation of the recommendations in this document, and our continued coordination with policy makers, regulators, counterparties and other industry groups, should help achieve the key goals articulated by the PWG "to enhance market discipline, mitigate systemic risk, augment regulatory safeguards regarding investor protection, and complement regulatory efforts to enhance market integrity."

On November 15, 2008, world leaders of the G20 Summit on Financial Markets and the World Economy met in Washington, D.C. and issued the following declaration regarding industry best practices for private pools of capital:

> *[By March 31, 2009] Private sector bodies that have already developed best practices for private pools of capital and/or hedge funds should bring forward proposals for a set of unified best practices. Finance Ministers should assess the adequacy of these proposals, drawing upon the analysis of regulators, the expanded [Financial Stability Forum], and other relevant bodies.* – G20 Summit Statement

On March 14, 2009, the G20 issued a progress report on the action items from the November 15 meeting, in which the G20 noted that MFA along with other industry groups committed to publish jointly a common set of principles regarding industry practices. The addition of principles to the 2009 edition of *Sound Practices* will be beneficial as MFA works with other industry groups to create this common set of principles.

Through the publication of the 2009 edition of *Sound Practices* (which substantially incorporates the *AMC Report*) and our collaborative initiatives with non-U.S. industry groups, MFA and its members have taken the first step in unifying the various sets of industry best practices to meet the calls of the G-20 and IOSCO to support transparent, stable, and efficient global financial markets.

Objectives of *Sound Practices*

1. Strengthen Business Practices of the Hedge Fund Industry through a Strong Framework of Internal Policies and Practices. The recommendations in the 2009 edition of *Sound Practices* serve to educate Hedge Fund Managers by providing peer group consensus on standards for internal management controls on the covered subjects 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, and, as mentioned above, incorporate the recommendations in the *AMC Report*. Strong industry practices are an important complement to sound regulation and both are important components of a sound financial system. The *Sound Practices* recommendations, if adopted, should enhance the ability of Hedge Fund Managers to manage their 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 consistently written the recommendations in each edition of *Sound Practices* with both 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 in *Sound Practices* are not static, one-size-fits all requirements that all Hedge Fund Managers must follow in exactly the same manner. Rather, each Hedge Fund Manager should assess, tailor and apply the recommendations, as appropriate, in light of: the overarching principles set out in the document; and based on the size, nature, and complexity of its organization, strategies, and resources; as well as the objectives of the Hedge Fund(s) it manages.

In the *AMC Report,* the PWG AMC expressed its agreement with this principle:

> *Given the vastly different sizes, strategies, products and other salient characteristics of a hedge fund manager's business, the AMC believes that the way in which the best practices are adopted will vary by necessity.... To be effective in the goals of protecting investors and reducing systemic risk, best practices for hedge fund managers must take account of the differences in managers' businesses.*

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 in *Sound Practices.* Other, generally smaller, Hedge Funds may have personnel who perform multiple functions 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 in *Sound Practices* 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. By implementing the recommendations in light of their business models, Hedge Fund Managers in aggregate will contribute to overall market soundness.

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). The term Hedge Fund describes a wide range of investment vehicles that can vary substantially in terms of size, strategy, business model, and organizational structure. 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 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) its investors are primarily limited to high net worth individuals and institutions; (3) it is not registered as an investment company under relevant laws (*e.g., *the Investment Company Act); (4) its assets are managed by a professional investment management firm that is compensated, in part, based upon the 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.

[3] The nature and structure of Hedge Funds and their relationships with Hedge Fund Managers vary substantially, and these assumptions may not apply to all Funds or 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 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:[3]

- A professional investment management firm (a "Hedge Fund Manager") manages the assets of each Hedge Fund;
- The term Hedge Fund Manager includes Managers that are registered with the Securities and Exchange Commission ("SEC") as investment advisers, and those exempt from registration, under the Investment Advisers Act;
- A 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 Manager, with the authority and responsibility to direct and oversee the Manager's activities (a 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, or 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, or an affiliate of the Manager, (*e.g.,* as the general partner or managing member of the Fund) or an independent body that delegates the investment management function of the Fund to the 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 Manager provides its investment advice to the Fund in accordance with the investment strategy and objectives set forth in the Fund's offering documents, rather than any specific objectives or directives of any individual Fund investor.

As noted above, a Hedge Fund Manager typically receives compensation based, in part, 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.

Relationship Between Hedge Funds and Their Investors. Certain legal documents, which may include an offering or private placement memorandum ("PPM"), limited partnership or limited liability company agreement, subscription agreement, or similar contracts (referred to collectively in this document as "offering documents"), govern the relationship between a Hedge Fund and its investors. 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 Fund and generally with limited voting rights. A Hedge Fund investor's liability is generally limited to the extent of its investment in a Fund.

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

U.S. laws and regulations generally require investors in Hedge Funds—whether institutional or individual investors—to satisfy certain criteria, such as net worth or other financial sophistication standards, in order to invest in a Fund. To further bolster investor protection, managers of certain institutional investors, such as pension fund plans and endowments, 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. Irrespective of their jurisdiction of origin, investors in Hedge Funds should have the ability to understand and evaluate for themselves an investment in a Fund and the corresponding risks. The *PWG Agreement* also supports this approach:

> *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.

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.

Organization of the Recommendations

The recommendations in the 2009 edition of *Sound Practices* are divided into seven substantive chapters or sections.

Chapter 1: Disclosure to investors and counterparties and other practices to assist a Hedge Fund in fulfilling its responsibilities to its investors.

Chapter 2: Implementation of valuation policies and procedures and governance and oversight of the valuation functions.

Chapter 3: Risk measurement, monitoring, and management designed to ensure that the risk policies of the Hedge Fund Manager are observed.

Chapter 4: Policies and procedures with respect to a Hedge Fund Manager's core trading and business operational processes.

Chapter 5: Establishing a culture of compliance, including a compliance framework, to address regulatory compliance and managing potential and actual conflicts of interest.

Chapter 6: Developing an AML program.

Chapter 7: Developing business continuity/disaster recovery plan.

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 Chapter 4).

Appendix IV: Sample attestations and other documents related to a Hedge Fund Manager's AML program.

Appendix V: U.S. regulatory filings that may be applicable to a Hedge Fund Manager (not exhaustive, but provides a starting point for a Manager in identifying applicable filing requirements and developing policies to comply with such requirements).

Appendix VI: Checklist for Hedge Fund Managers to consider developing a compliance manual.

Appendix VII: Checklist for Hedge Fund Managers to consider in developing a code of ethics.

No Substitute for Legal or Other Professional Advice

The recommendations in *Sound Practices* 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 advisors in determining the applicability of the recommendations to their business operations and appropriate methods for implementing the applicable recommendations.

Acknowledgments

MFA would like to thank our HFAC Sound Practices Initiatives Subcommittee, as well as our Strategic Partner and Sustaining Member Sound Practices Committee for their assistance in preparing the 2009 edition of *Sound Practices.* MFA would also like to acknowledge Willkie Farr & Gallagher LLP for their advice and counsel throughout the drafting process.

Disclosure and Investor Protection

I. Disclosure Framework

1.1

A Hedge Fund Manager should establish a disclosure framework designed to disclose material information to investors with sufficient frequency and detail, including with respect to financial and risk information and potential conflicts of interest, so that investors are able to: (1) make informed decisions regarding investments in a Hedge Fund; and (2) appropriately monitor or manage the risks associated with exposure to the Fund.[1]

1.1.1 A robust disclosure framework is critical to the protection of investors' interests. The framework should also include guidelines to address providing information to counterparties (commensurate with the relationship with the counterparties), subject to appropriate assurances of confidentiality.

1.2

The framework should include the information to be provided to investors and the manner and frequency with which it will be provided (recognizing that disclosure to investors may take a variety of forms), including:

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

[1] *All disclosure to investors or potential investors in a Hedge Fund, whether in offering material or in other communications, is subject to the anti-fraud provisions of Section 206 of the Investment Advisers Act and the rules thereunder. In particular, Rule 206(4)-8 prohibits the making of false or misleading statements to investors or prospective investors in pooled investment vehicles, such as a Fund.*

- Investor communications (such as letters) and other reporting (such as risk reports); and
- Timely disclosure of material information in certain circumstances.
- Guidelines for the disclosure of potential conflicts of interest;
- Guidelines for the qualifications of investors in the Hedge Fund; and
- Guidelines relating to disclosure to counterparties.

II. Disclosure of Material Information in Offering Materials

2.1

A Hedge Fund Manager should provide potential investors with a PPM or other offering documents or supplemental materials sufficiently in advance of a subscription to permit investors to adequately consider that information in formulating their investment decisions.

2.1.1 For Hedge Funds open to new investments, PPMs should be updated or supplemented at least annually in light of ongoing developments or more frequently in the event that a material change occurs that makes the PPM materially inaccurate or misleading in light of other information provided by the Hedge Fund Manager.

2.1.2 Any updated PPMs should be provided to all investors in the Hedge Fund or the relevant changes should be communicated to existing investors through other correspondence. If a previously closed Hedge Fund is re-opened, the PPM should be assessed to determine if it should be updated to reflect developments since the last time the Fund was open to new investments.

2.2

The PPM should outline the scope of the Hedge Fund's operations, including broad descriptions of the investment philosophy, strategies, and products, the significant risks of an investment in the Fund, and other information necessary to allow potential investors to make informed investment decisions.

2.2.1 The specific types of information appropriate to provide to investors will vary depending on the strategies and/or structure of the Hedge Fund.

2.2.2 When outlining the scope of the PPM and determining what information to disclose to investors, a Hedge Fund Manager should consider the importance of protecting confidential information that, if disclosed, could adversely impact the interests of the Hedge Fund or its investors.

2.2.3 The following is a (non-exhaustive) list of types of information that should be included in a PPM (to the extent such information is material and relevant to the Hedge Fund):

- The legal structure of the Hedge Fund, including jurisdiction of organization and control of the Hedge Fund Manager;
- The Hedge Fund's investment objectives, strategies, and permissible investments;
- The key investment management and other senior personnel acting on behalf of the Hedge Fund, including:
  - (1) Biographical information (including relevant educational and employment history and other business activities engaged in by any such person); and
  - (2) Information regarding any material violations of securities or investment-related laws or regulations, or any disciplinary action for professional misconduct taken against any such person.

- The terms of an investment in the Hedge Fund, including:
  (1) A description of applicable fees and charges, including the Hedge Fund's compensation structure (*e.g.,* the calculation of incentive fee (or allocation) arrangements and management fees);
  (2) Allocation of expenses such as research, legal fees, and travel (*i.e.,* which expenses are borne by or among the Hedge Fund(s) and which are borne by the Hedge Fund Manager), including a Manager's policies on the use of soft dollar arrangements;
  (3) A description of withdrawal or redemption rights and restrictions (including withdrawal payment and notice provisions, lock-up periods, notice requirements, withdrawal penalties or fees, gates, withdrawal suspension provisions, and other redemption limitations, including variations in the time frame for investor redemptions);
  (4) Whether fees may be paid by the Hedge Fund to affiliates of the Hedge Fund Manager and, if so, for what services;
  (5) A description of the Hedge Fund Manager's trade allocation policies;
  (6) A description of the use of side pockets (where applicable), including the criteria for determining when and whether to place investment positions in and remove them from side pockets, and the basis on which fees are charged;
  (7) Provisions relating to liability and indemnification of the Hedge Fund Manager to and by the Hedge Fund;
  (8) Material aspects of a Hedge Fund Manager's code of ethics; and
  (9) A description of the Hedge Fund Manager's framework for providing information and financial statements to investors.
- Discussion of the elements of the Hedge Fund Manager's valuation framework, such as:
  (1) The use of fair value accounting in accordance with GAAP or other substantially similar accounting principles such as IFRS in calculating valuations and NAV. The discussion should

also address the use of any non-GAAP measures to compute and report certain asset valuations, fees, subscriptions, or redemptions;

(2) The role of any third parties, including (where applicable) the Hedge Fund's fund administrator, with significant involvement in the valuation of the investment positions in the Fund's portfolio;

(3) A description of the Hedge Fund Manager's disclosure regarding its valuation policy and the manner in which the Manager oversees its valuation policy, such as a Valuation Committee;

(4) A description of the methodologies used to value the Hedge Fund's investment positions, including the methodology used in valuing various types of investment positions, the valuation of investment positions in any side pockets, and the use of internal and external pricing sources; and

(5) Ways in which the Hedge Fund Manager mitigates potential conflicts of interest in the valuation process (including involvement of portfolio management personnel in the valuation process).

- The possible risks associated with an investment in the Hedge Fund, such as risks associated with:

(1) The Hedge Fund's incentive fee (or allocation) arrangement;

(2) Reliance on and potential loss of key investment personnel;

(3) Lack of assurance as to the success of the Hedge Fund's investment strategies;

(4) Specific strategies or particular types of investment instruments and markets;

(5) Valuation of investment positions, including valuation of investments with no readily ascertainable market value;

(6) Limited liquidity and potential restrictions on redemptions (including restrictions relating to redemption gates, side pocket investments, redemption suspensions, and in-kind distributions);

(7) Use of leverage and margin (including leverage embedded in derivative instruments) and the possible loss of funding;

(8) Broker and other counterparty credit risk exposure and impact of potential failure;

(9) Investors' reliance on a Hedge Fund Manager's discretion in making investment decisions;

(10) A Hedge Fund Manager's flexibility, to the extent disclosed in the PPM, to allocate investments by the Hedge Fund among different strategies and instruments;

(11) Investments in foreign jurisdictions;

(12) Presence or absence of regulatory oversight;

(13) The amount of flexibility the Hedge Fund Manager has with respect to the implementation of the investment strategy, risk exposure, leverage, and other key risks of the Hedge Fund;

(14) Additional disclosures when there is a material shift in investment strategy, risk exposure, leverage, and other key risks of the Hedge Fund to the extent that they go beyond what has already been disclosed to investors; and

(15) Other factors related to investment strategy or products that make an investment speculative or risky.

- Potential conflicts of interest in the Hedge Fund's operations (*e.g.,* soft dollar arrangements, relationships with prime brokers and other counterparties or services providers, compensation arrangements for investor referrals, and interests of the Hedge Fund Manager in other Funds or accounts);
- Tax, ERISA, and other regulatory and legal matters relevant to the Hedge Fund, including timing on the provision of Schedule K-1s (when applicable);
- Identity of any fund administrator(s) or third-party valuation service providers used by the Hedge Fund; and
- Use of prime brokers or other lending sources.

III. Responsibilities to Investors

3.1

A Hedge Fund Manager should develop disclosure controls and procedures to ensure timely and accurate disclosure of material information to investors.

3.1.1 A Hedge Fund Manager should either establish a committee or designate an employee with overall responsibility for providing disclosures and for reviewing disclosure documents for accuracy and consistency.

3.1.2 A Hedge Fund Manager should establish procedures for updating and distributing any required information to investors and regulators.

3.1.3 In the case of a Hedge Fund Manager that is registered as an investment adviser, these procedures should address required updates to the Manager's Form ADV.

3.2

A Hedge Fund Manager's disclosure framework should include policies and procedures designed to provide investors with updated, material information on a regular and ongoing basis to permit investors to adequately consider that information in formulating their investment decisions.

3.2.1 The nature of the communications and the information included in a Hedge Fund Manager's communications with its investors should be tailored as appropriate to the structure of the Manager and the relevant Hedge Fund, consistent with the principles outlined in this section and recognizing, in certain circumstances, the importance of protecting confidential information that, if disclosed, could adversely impact the interests of the Fund or its investors.

3.2.2 Updated information may be communicated to investors in a variety of forms, depending on the nature of the information being communicated (*i.e.,* whether the information is a material development or part of the regular or ongoing provision of information about the Hedge Fund).

3.2.3 If a Hedge Fund Manager seeks to modify the objectives, strategies, or other terms of a Hedge Fund, the Manager should consider whether disclosure to investors is necessary and whether consent should be obtained from investors in light of the materiality of such changes, the variety of objectives employed by the Manager, and disclosure previously provided to investors.

3.2.4 The following are types of information that Hedge Fund Managers should consider providing to investors:

- **Investor Letters or Other Similar Communications** – Investor letters (or other similar communications) may be written in any form or style that the Hedge Fund Manager desires (generally, at least on a quarterly basis) and would generally be expected to include updated information on developments relating to the Hedge Fund, such as:

  (1) Significant shifts in investment strategy or key risk exposures (such as market, credit, leverage, liquidity, and operational risks);

  (2) Changes in key personnel;

  (3) Performance information together with examples or narrative as the Hedge Fund Manager considers appropriate and useful; and

  (4) Business, market, or other significant developments, as appropriate.

- **Risk Reports** – The extent of risks taken and the approach to risk management are integral to the investment approach of a Hedge Fund Manager. A Hedge Fund Manager should disclose its approach to investors and provide information it believes will be informative to investors in light of that approach. Accordingly, a Hedge Fund Manager should communicate regular risk information (generally, at least on a monthly basis) that is appropriate to the Hedge Fund and its investment strategies, such as information regarding:

(1) Assets under management; and

(2) Risk management (including qualitative discussions, as appropriate), including:

(a) Asset types;

(b) Geography;

(c) Leverage employed by the Hedge Fund (including the basis on which it is calculated);

(d) Concentration of positions; and

(e) Material changes in asset allocation.

- **Performance-Related Financial Information** – Regular reporting of performance may take a variety of forms and should be provided with frequency established by the Hedge Fund Manager that is appropriate to the nature of the Hedge Fund and the information being provided. The timing and content may include:

(1) Quantitative information:

(a) Annual audited financial statements prepared in accordance with U.S. GAAP or IFRS;

(b) Estimated Hedge Fund performance (at least on a monthly basis) that clearly indicates it provides only an estimate of the Fund's performance and may not include other material expenses and items that go into calculating NAV (*e.g.,* it may not include fee and expense accruals); and

(c) NAV to each investor (generally, at least on a monthly basis), which should reflect each investor's specific capital account balance or share value, taking account of fee and expense accruals in addition to trading profit and loss attributable to each investor's capital account or shares.

(2) Qualitative information about the Hedge Fund's performance, using a narrative description, which will help investors better understand the Fund's financial performance during the relevant period of time, recognizing that financial statements provide limited opportunities for qualitative discussion. This discussion may

be in any form (*e.g.,* investor letters, annual summaries, or other disclosure) that the Hedge Fund Manager desires and should include factors underlying the Hedge Fund's performance.

- **Investment-Related Financial Information** – In addition to performance information, the Hedge Fund Manager should provide financial information to help investors assess the risks in the valuation of the Hedge Fund's investment positions (*i.e.,* the potential for variability in the ultimate realization of the Fund's investment positions). Managers will need to work closely with their auditors for purposes of implementing FAS 157 and the related practices. Depending upon the extent to which the Hedge Fund Manager invests in illiquid and difficult-to-value investments, the Manager should seek to make disclosures at least quarterly and include:

(1) Disclosure of the percentage of the Hedge Fund's portfolio value that is comprised of each level of the FAS 157[2] valuation hierarchy; and

(2) Supplementing FAS 157's requirement that Hedge Fund Managers disclose the percentage of realized and unrealized profit and loss that is derived from FAS 157 Level 3 assets by making such disclosure with respect to Level 1 and 2 assets.

If the Hedge Fund Manager deems it advisable, it should discuss with its auditors or counsel how performance information should be provided (*e.g.,* on a net or gross basis) and inform investors of the chosen methodology. In addition, the Hedge Fund Manager should identify if the manner of determining the information is not consistent across positions or levels.

[2] *FAS 157 establishes a "fair value hierarchy" that differentiates between the types of inputs used to determine the fair value of an asset or liability. The level in the fair value hierarchy within which the fair value measurement is classified is determined based on the lowest level input that is significant to the fair value measurement in its entirety.*

- **Quotes** – To the extent that a Hedge Fund Manager deems it material, a Manager should disclose the percentage of the value of a Hedge Fund's portfolio for which only one quote was relied upon and the percentage for which multiple quotes were relied upon.

- **Specific Event Reporting** – In certain circumstances, it is appropriate to disclose updated information or the occurrence of specific events to investors on a more timely basis than that provided in the regular course of the Hedge Fund Manager's disclosure framework.

  (1) As with all disclosure to investors, a Hedge Fund Manager should assess the materiality of the event in considering whether disclosure is appropriate. In determining the appropriate timing and form of any reporting of specific events to investors, a Hedge Fund Manager should take into account factors such as:

    (a) The nature of the information;

    (b) The Hedge Fund's investment program;

    (c) Whether disclosure of such information may compromise the Hedge Fund's competitive position or ability to properly manage the portfolio; and

    (d) Whether the Hedge Fund is currently accepting subscriptions or redemptions.

  (2) Depending on the circumstances, the following are types of information that should, when material, be disclosed to investors promptly after occurrence:

    (a) Changes to the Hedge Fund's valuation policies;

    (b) Changes to certain key investment personnel (*e.g.,* partners and executive officers) or with key third-party service providers (such as a fund administrator) other than in the ordinary course of business;

(c) Changes in biographical or disciplinary information in respect of investment and other key personnel of the Hedge Fund Manager;

(d) Entry into side letters (or parallel managed accounts) that grant terms to certain investors that may, in certain circumstances, adversely impact other investors;

(e) Occurrence of operational issues that may have an adverse impact on the Hedge Fund;

(f) Discovery of fraud or wrongdoing by the Hedge Fund Manager or a significant service provider; and

(g) Market events that may significantly impact the Hedge Fund's performance.

3.3

A Hedge Fund Manager's disclosure framework should be designed to provide all investors with a consistent level of information.

3.3.1 In providing diligence information, a Hedge Fund Manager may consider developing its own standard presentation. A Hedge Fund Manager may employ different forms of presentation among investors, or individually answer questions from investors in the course of due diligence reviews or ongoing investor inquiries, provided the Manager does not selectively disclose material information among investors.

3.3.2 If a Hedge Fund Manager receives requests from an investor for additional disclosure or clarification of existing disclosure, the Manager should consider whether to make the disclosure and, if appropriate, should be willing to make such information available to all investors upon request.

IV. Potential Conflicts of Interest - Side Letters and Parallel Managed Accounts

Side Letters

A *"side letter"* generally means an agreement whereby a Hedge Fund Manager agrees to provide an investor with certain information, makes certain representations, or provides investment terms in the Hedge Fund that are not made available to other investors in the Fund. While the use of side letters may frequently benefit all investors in the Hedge Fund (*e.g.*, in that it enables a Hedge Fund Manager to attract early, large, or strategic investors), or otherwise be immaterial to other investors, in certain circumstances the terms of a side letter may have the potential to adversely impact other investors in a Fund.

4.1

In circumstances where side letters provide certain investors with terms that may adversely impact other investors in the Hedge Fund, a Hedge Fund Manager should make such disclosure, as may be reasonably necessary, to enable other investors to assess the possible impact of such side letters on their investments.

4.1.1 The Hedge Fund Manager should disclose, in the manner the Manager deems appropriate, the existence of side letters containing key terms such as those set forth below, which are generally more likely to adversely impact other investors:

- Enhanced control rights (*e.g.*, over investment decisions or the hiring of or changes in key personnel);
- Transparency;
- Preferential liquidity/redemption rights, *"key person"* provisions, and redemption *"gate"* waivers;

Potential Conflicts of Interest

- If preferential fees are made available, a statement to that effect;
- Terms that materially alter the investment program disclosed in the Hedge Fund's offering documents; and
- Terms that may affect allocation of investment opportunities.

Other Managed Accounts

A *"parallel managed account"* is a separate account established by a Hedge Fund Manager for a specific investor that is not an investment in a Hedge Fund, but through which the investor invests in substantially similar strategies and investments as the Fund, but invests through a separate account rather than through the Fund itself. Parallel managed accounts may be sought by investors for a variety of reasons, including the need to comply with particular regulatory requirements or to impose limits on the Hedge Fund's investment program beyond what has been agreed to by other investors in the Fund.

4.2

A Hedge Fund Manager should analyze whether the terms of any parallel managed accounts it manages may adversely impact investors in a Hedge Fund and make such disclosure as may be reasonably necessary to enable investors to assess the possible impact of such terms on their investments.

- In such circumstances, the same principles that apply to the disclosure of side letters should apply, as appropriate, to the disclosure of parallel managed accounts.

4.3

A Hedge Fund Manager may also manage more than one Hedge Fund with similar investment strategies, which may raise similar considerations as those raised by managing parallel managed accounts.

V. Participation of Investors

5.1

A Hedge Fund Manager should evaluate whether and document how each investor's qualifications satisfy requisite legal standards appropriate to the structure of the Hedge Fund.

5.1.1 An investor's suitability should typically be documented through subscription agreements. In addition to addressing the specific standards necessary for exemptions under the Securities Act, the Investment Company Act, and other applicable U.S. and non-U.S. registration requirements, Hedge Fund Managers should obtain representations from investors that the investor is likely to understand the material risks of investing in the Hedge Fund, such as:

- An acknowledgement that the investor has received and understands the Hedge Fund's PPM and organizational documents, has had an opportunity to obtain additional information and ask questions of the Hedge Fund Manager, and is making an independent investment decision based on these documents and the investor's independent investigation of the Fund;
- An acknowledgement that the investor has the experience and knowledge in financial and business matters necessary to evaluate the merits and risks of the investment and is able to bear such risks; and

- An acknowledgement that the investor understands the terms of its investment and the operation of the Hedge Fund, including minimum investment, redemption rights, liquidity provisions, allocation and fee structure, and other terms that the Hedge Fund Manager thinks appropriate.

VI. Disclosure to Counterparties

6.1

A Hedge Fund Manager should foster positive and cooperative relationships with credit and lending counterparties (including prime brokers, derivative counterparties, and other creditors), so that both the Manager and counterparties may adequately assess the risks associated with the relationship.

6.1.1 Commensurate with the scope and nature of the relationship between the Hedge Fund Manager and its counterparties, the Manager and its counterparties should agree at the beginning of their relationship as to the types of information and frequency with which it will be provided. Types of appropriate information may include:

- Quantitative and qualitative disclosures regarding the strategies employed by the Hedge Fund and the allocations between or among such strategies;
- Disclosure of the Hedge Fund Manager's risk management framework (including its approach to market and liquidity risk); and
- Quantitative and qualitative disclosures of the Hedge Fund's performance and NAV.

6.1.2 In making disclosures to counterparties, the Hedge Fund Manager should be willing to assist counterparties in understanding and interpreting disclosures. This may include making investment management and other key personnel available upon reasonable request of the counterparty to answer questions as part of the counterparty's due diligence.

6.1.3 A Hedge Fund Manager should consider whether it is appropriate for the level of communication with its counterparties to increase under certain circumstances (*e.g.,* during times of market stress that may affect the Hedge Fund's strategies and performance, including during periods of increased volatility or tightening credit terms).

6.1.4 In connection with any disclosures to counterparties, a Hedge Fund Manager should consider information about the counterparties' information barriers and policies regarding the separation of functions generally and consider whether it is appropriate to seek assurance, as part of its counterparty contracts, that financial and other confidential information provided by the Manager is only used for credit evaluation or other acceptable purposes and will not be made available to any member of the counterparties' trading desk(s) or department(s).

Valuation

I. Valuation Framework

1.1

A Hedge Fund Manager should establish a comprehensive and integrated valuation framework to provide for clear, consistent valuations of all the assets in the Hedge Fund's portfolio, while mitigating potential conflicts that may arise in the valuation process. The framework should include:

- Agovernance mechanism, such as a Valuation Committee or other responsible body or person(s); this body or person(s) should have ultimate responsibility for: (1) establishing and reviewing compliance with the Hedge Fund Manager's valuation policies; and (2) providing consistent and objective oversight and implementation of the Manager's valuation policies and procedures;
- Thedevelopment by the Hedge Fund Manager of well-documented valuation policies and procedures, as well as guidelines to evaluate exceptions and to test and review compliance with the policies and procedures; and
- Sufficientlyknowledgeable and independent personnel supported by adequate resources who are separate from and do not directly report to the trading or portfolio management function and who are responsible for the valuation of the Hedge Fund's investment positions and for implementing the Hedge Fund Manager's policies and procedures.

II. Valuation Governance

2.1

A Hedge Fund Manager should establish a governance mechanism, such as a valuation committee or other responsible body or person(s) ("Valuation Committee") that has oversight responsibility for establishing and reviewing compliance with valuation policies and providing consistent and objective oversight over the valuation function.

2.1.1 Participants in the Valuation Committee should include all appropriate key members of the Hedge Fund Manager's senior management (such as its Chief Executive Officer and Chief Financial Officer, if applicable, it being understood that their responsibilities may include portfolio management).

2.1.2 The Valuation Committee should approve valuations. It is understood that the Valuation Committee will not review the valuation for every investment in the Hedge Fund's portfolio, but should ascertain that the methodology set forth in the valuation policy is being followed. In addition, the Valuation Committee should review material adjustments or exceptions to the valuation policy.

2.1.3 While portfolio managers or trading personnel may participate in the Valuation Committee, the Valuation Committee should be structured to provide an appropriate degree of independence from portfolio management and trading. The Valuation Committee should be structured to benefit from the expertise of such personnel while, to the extent practical, mitigating potential conflicts of interest created by their involvement with the Valuation Committee. The members of the Valuation Committee should collectively understand the totality of the Hedge Fund Manager's business, including, but not limited to, the range and complexity of instruments traded, stipulations contained in the Hedge Fund's governing and offering documents, and liquidity terms.

2.1.4 The role and responsibilities of the Valuation Committee should be designed based on the structure, investment strategies, and portfolio of the Hedge Fund Manager and the Hedge Fund(s) it advises. Typical functions the Valuation Committee should perform include:

- Developingthe methods and sources used for valuing various classes of investment positions and material changes in such methods and sources;
- Reviewingand approving the Hedge Fund Manager's guidelines and policies for classification of the Hedge Fund's assets within FAS 157's valuation hierarchy;
- Wherebroker quotes are relied upon to value a particular type of asset, reviewing quantitative and qualitative information, such as the appropriateness and consistency of the sources (*e.g.,* counterparty, dealer, or other source), recent trade activity and outliers, the nature of the quote (*e.g.,* whether the quote is an indicative price or a binding offer), and, where appropriate, the process by which such quotes are obtained and reconciled with the Hedge Fund's fund administrator's records (such process having been appropriately documented);
- Noless frequently than quarterly, approving the final valuations for the Hedge Fund's portfolio (and reviewing with the fund administrator or third-party valuation advisor of the Fund any material reconciliations, where applicable);
- Minutesof Valuation Committee meetings should be kept and copies provided to the Hedge Fund's auditors, as appropriate; and
- Designatingcertain individuals or groups (discussed below) to be responsible for undertaking or reviewing certain valuation decisions and functions.

2.2

The Valuation Committee should no less frequently than once a year review and test or oversee the testing of the Hedge Fund Manager's valuation policies and procedures to seek to ensure that: (1) they are sufficient to achieve their intended purpose in light of applicable laws, regulations, rules, best practices, and other surrounding circumstances; (2) the policies and procedures function as designed; and (3) all personnel understand their respective roles under the policies and procedures.

2.2.1 Reviews should be conducted no less frequently than annually, and upon the occurrence of certain material events (*e.g.,* a shift in the Hedge Fund's investment strategy, geographies, assets, instruments, or sectors or a change in market conditions or availability of pricing information for certain types of investment positions). Reviews should address issues, such as:

- The fairness of the valuation policies and procedures;
- Theability of the Hedge Fund Manager's personnel to consistently, fairly, and accurately apply the valuation policies and procedures;
- Theselection and oversight of third-party service providers with significant involvement in the valuation process (including, if applicable, the Hedge Fund's fund administrator or third-party valuation advisor) and the continued ability of those providers to consistently, fairly and accurately apply and, when appropriate, validate the Hedge Fund Manager's valuation policies and procedures;
- Valuationmethodologies used by the Hedge Fund Manager and appropriate changes in inputs or market conditions, including illiquid markets; and
- Anymaterial exceptions that were made to the Hedge Fund's valuation polices and procedures (*e.g.,* material price overrides).

2.2.2 For Hedge Fund Managers using pricing models or other pricing methods that are not based solely on market quotes for actively-traded securities, this review should include periodic back-testing by appropriate valuation personnel or third-party service providers, when applicable, of a sample of valuations, to the extent possible and where it is likely to provide a reasonable base of comparison, against the recent sale prices of investment positions. This analysis can assist the Valuation Committee in assessing the quality of models and other evaluative processes being employed internally or by third-party service providers. As such, back-testing may be particularly appropriate for assets in Levels 2 and 3 of the FAS 157 valuation hierarchy. Back-testing analysis should focus on identifying trends in valuations versus sale prices, not the accuracy of individual marks for individual investment positions. Differences should be expected and viewed in the context of the overall analysis, especially since back-testing has inherent limitations, particularly during periods of market stress.

2.3

The Valuation Committee should have adequate authority and resources to perform its oversight duties.

2.3.1 The Valuation Committee should have the authority and resources to consult with the Hedge Fund's independent auditor, fund administrator (if any), a third-party valuation firm, or legal advisor, when appropriate, to understand and assess new accounting requirements impacting fair value and in situations where it is unclear how the valuation policy should be applied to certain investment positions or to unique facts and circumstances.

III. Implementation of Valuation Policies

3.1

A Hedge Fund Manager should have knowledgeable and qualified internal personnel (who may also perform other functions for the Hedge Fund) or qualified third parties to implement the valuation policies and procedures on a day-to-day basis.

3.1.1 The personnel carrying out the valuation function should be responsible for the appropriate pricing of the portfolio in accordance with the valuation policy and should handle the collection and evaluation of counterparty prices, broker quotes, exchange prices, and third-party pricing feeds.

3.1.2 The valuation function should be appropriately segregated from the Hedge Fund Manager's portfolio management function, although portfolio management personnel may be involved in valuation analysis and methodology given their expertise in certain positions. The degree of segregation that is appropriate will vary based on, among other things, the nature of any related conflicts of interests (*e.g.,* the use of performance-based fees) and complexity and discretion inherent in the valuation process. The valuations should be approved by the Valuation Committee.

3.1.3 In the event that portfolio management personnel do not believe that the valuation of an investment is appropriate, a Hedge Fund Manager should have in place policies that seek to mitigate any conflict between portfolio management personnel and valuation personnel. For example, the Hedge Fund Manager may develop a process for portfolio management personnel to "challenge" the determinations of valuation personnel in which the ultimate decision as to the appropriate price for a "challenged asset" would be made by participants in the Valuation Committee after consideration of pricing support provided by valuation personnel and input from the applicable portfolio management personnel.

3.1.4 To the extent that third parties are used, a Hedge Fund Manager should provide for appropriate oversight and monitoring by conducting initial and periodic due diligence on third parties that are appointed to perform valuation services.

IV. Valuation Policies and Procedures

4.1

A Hedge Fund Manager should adopt and implement comprehensive, written valuation policies and procedures, consistent with industry best practice, that provide for the fair, consistent, and verifiable valuation of all assets of a Hedge Fund.

4.1.1 Adequate valuation policies and procedures are critical to the design and effectiveness of the Hedge Fund Manager's portfolio valuation process. The valuation framework should be designed to promote consistent application of such policies and procedures and seek to provide appropriate information to investors and counterparties with a clear understanding of the limitations of such policies and procedures.

4.2

A Hedge Fund Manager's valuation policies and procedures should identify (by title or group) the parties (inside and outside the Manager) engaged in the valuation process.

4.2.1 This should include any external parties involved in the valuation process *(e.g.,* fund administrators or third-party valuation firms), participants in the Valuation Committee and personnel responsible on a day-to-day basis for implementing the Hedge Fund Manager's valuation policies. With respect to external parties involved in the valuation process, the Hedge Fund Manager should clearly delineate such parties' roles and responsibilities (particularly with respect to fund administrators valuing portfolios and with respect to investment positions where the third party is unable to independently substantiate prices) and provide for appropriate oversight and monitoring of the third party.

4.3

A Hedge Fund Manager's valuation policies and procedures should identify the appropriate methodologies to be used in valuing various types of investments.

4.3.1 Valuation methodologies should be established contemporaneously with the acquisition of a particular type of asset (where not otherwise already established) and applied consistently thereafter. Where the Hedge Fund Manager undertakes a new type of investment, the valuation methodology should be approved by the Valuation Committee and become part of the valuation policy. If there is a change in the investment that warrants a change in the application of policy, this change should be approved by the Valuation Committee.

4.3.2 Methodologies should include sources of prices for different types of investment positions, the priority of sources within the valuation process, and procedures for the use of such sources, such as:

- Automatedprice feeds from exchanges and liquid OTC markets (*e.g.,* for valuing exchange-traded securities);
- Commonmodels used widely by other market participants and based on market observable inputs such as prices of similar actively-traded assets and liabilities (*e.g.,* for valuing a total return swap on a corporate bond or exchange-traded equity);
- Brokerquotes for certain OTC securities (*e.g.,* for valuing convertible bonds and derivatives), including policies to address the existence and quality of multiple broker quotes for a particular investment;
- Discountedcash flow analysis and how discount rates are developed (*e.g.,* for valuing a private loan);
- Customizedor proprietary models used for investment positions with unique features, based in part on unobservable (*i.e.,* non-market) inputs (*e.g.,* for valuing a private equity investment);
- Other valuation methodologies appropriate for the type of asset;

- The process used to effect valuation adjustments; and
- Determinationas to when inputs may become unreliable resulting in the need to utilize other data sources or methods to determine value.

4.3.3 When valuing assets with multiple market prices, a Hedge Fund Manager should consider the exit price and what the Hedge Fund would realize as of the time that the Fund closes its books.

4.4

A Hedge Fund Manager's valuation policies and procedures should adopt an appropriate accounting standard, such as U.S. GAAP or IFRS, and ensure that its procedures are designed to mark individual investments and the resultant NAV at "fair value" as dictated by applicable accounting standards.

4.5

A Hedge Fund Manager's valuation policies should establish appropriate internal documentation procedures to support the valuation for each type of asset.

4.5.1 A Hedge Fund Manager generally should maintain robust and contemporaneous documentation to support the valuation of its assets, and, in particular, the value of its illiquid investment positions with no readily ascertainable market value in accordance with guidelines established by the Valuation Committee after considering various qualitative and quantitative factors. In this regard, it would be prudent for the Hedge Fund Manager to engage in a dialogue with the Hedge Fund's independent auditor in respect of the adequacy of the Manager's documentation procedures for its various types of investment positions.

4.5.2 The valuation policies and procedures should establish appropriate procedures for the use of pricing sources, including price feeds, inputs to models, broker quotes, and other information received from third-party valuation service providers.

4.5.3 The valuation policies and procedures should establish procedures for the valuation of investments placed in "*side pockets*", where applicable.

4.5.4 The valuation policies and procedures should establish appropriate procedures for recording any material exceptions taken to the Hedge Fund Manager's ordinary valuation policies and the reasons for such exceptions. Similarly, the policies and procedures should establish a process for handling and documenting price overrides, including the review of price overrides.

4.5.5 The valuation policies and procedures should establish appropriate procedures and controls to mitigate potential conflicts of interest in the valuation process (including involvement of portfolio management personnel in the valuation process).

4.6

A Hedge Fund Manager's valuation policies and procedures should establish procedures for valuing investment positions with no readily ascertainable market value.

4.6.1 Certain investment positions in the Hedge Fund's portfolio may have no readily ascertainable market value. For many Hedge Fund Managers these types of investments (*e.g.,* private equity investments) are an important source of potential returns for the Hedge Fund. Generally, as part of the disclosure in the Hedge Fund's offering documents, investors should be informed of whether these types of investments may be made by the Fund and how and when these investments will be valued.

4.6.2 Market prices, while an important input for measuring fair value, are not necessarily determinative if an active market does not exist for the security being valued. When markets are less active, broker quotes and other valuation sources may not reflect market information from market transactions and may rely on other sources, such as models with inputs based on the information available only to the broker. A Hedge Fund Manager should have an adequate understanding of the inputs used by the broker (or pricing vendor) to determine the level of reliance that should be placed on the quotes

or should decide if alternative valuation methods are more appropriate. In making this determination, a Hedge Fund Manager should place less reliance on quotes that do not reflect the result of market transactions. Further, the nature of the quote *(e.g.,* whether the quote is an indicative price or a binding offer) should be considered when weighing the available evidence. Similarly, transactions in inactive markets should be used as inputs when measuring fair value, but should not necessarily be determinative. There are a number of factors that may be indicative of an inactive market, including wide bid-ask spreads or a relatively small number of bidding parties.

4.6.3 In the case of investment positions with no readily ascertainable market value it may be appropriate to utilize properly controlled internal valuations given the absence of adequate external valuations. In such instances, a Hedge Fund Manager must be particularly vigilant as the potential conflicts inherent in valuing investment positions can be more pronounced in this context. To mitigate these conflicts, valuation policies and procedures should address the circumstances in which the Hedge Fund Manager may rely upon models, the required support and documentation when using a model and the manner and frequency of reviewing models. In particular, any material exceptions or unusual situations arising in the context of a pricing model (*e.g.,* the creation of a unique pricing model for a particular asset) should be documented and reviewed by the Valuation Committee.

4.7

A Hedge Fund Manager's valuation policies and procedures should include, as appropriate, guidelines regarding the use of side pockets and similar arrangements.

4.7.1 A side pocket is a mechanism used to account for certain investments of a Hedge Fund that are illiquid and have no readily ascertainable market value. Certain funds provide for side pockets to protect investors by avoiding the need for them to transact (redeeming or investing) in respect of such investments, where there is greater inherent subjectivity in their valuation prior to realization or other key event. Moreover, by not assessing an incentive fee or allocation until the investment in a side pocket is realized (or deemed realized) an additional potential valuation conflict is avoided.

4.7.2 When a Hedge Fund provides for the use of side pockets and other similar arrangements, the Hedge Fund Manager should include in its policies and procedures guidelines regarding their use, such as the appropriate considerations for determining if/when an asset should be moved into or out of a side pocket (including, where applicable, any related hedges and financial transactions). Relevant considerations include:

- Theavailability of third-party evidence of value *(i.e.,* whether any observable market inputs, broker quotes, or other types of evidence exists that can provide an indication of value);
- Theextent to which the investment is inherently difficult to value (*e.g.,* equity investments in private versus public companies);
- Thenature of the market for the investment (*i.e.,* whether the market is developed or emerging, highly liquid, or illiquid and the extent to which the market is regulated);
- Theanticipated ability to exit the investment (including whether the investment is freely tradable or subject to contractual, legal or regulatory limitations on its realization, or, where applicable, the stage of development of a business and how soon it may be ready to go public); and
- Anyapplicable contingencies or special events upon which the investment's realization will depend.

4.7.3 The nature and frequency of review of particular side pockets or other similar arrangements should be appropriate to the type of investment and market conditions that may be expected to have an impact on that investment.

4.7.4 The policies for valuation of investments held in side pockets or other similar arrangements should be the same as the policies applied to investments not held in those arrangements, as required by accounting rules.

4.7.5 A Hedge Fund Manager's valuation policies and procedures should provide for regular review and approval by appropriate personnel of any placement or transfer of an investment to or from a side pocket or other similar arrangement, other than a transfer upon the sale of the asset. Recognizing that there are many circumstances in which a transfer of an investment to a side pocket may be appropriate, the Hedge Fund Manager should have a process to review and approve such transfers. It may be prudent for the Valuation Committee to review or approve any such transfers.

Risk Management

I. Risk Management Framework

1.1

Risk is inherent in the investment process and is essential for return. The goal of risk management is not to eliminate risk, but to understand it and manage it prudently in the context of related expected returns.

1.2

A Hedge Fund Manager should establish a comprehensive and integrated risk management framework that is suited to the size, portfolio management process, and investment strategies of its funds.

1.3

Through the risk management framework, a Hedge Fund Manager should identify the risks inherent in its investment strategies and measure and monitor its Hedge Funds' exposure to these risks to be consistent with the Manager's risk profile. The risk management framework should be communicated to investors to enable them to assess whether a Hedge Funds' risk profile is appropriate for them and how the investment is performing against the Funds' intended risk profile.

1.4

The framework should address:

- Identification of material risks to which a Hedge Fund may be subject;

- Measurement of the principal categories of risk (including liquidity risk, leverage, market risk, counterparty credit risk, and operational risk);
- A regular process of risk monitoring, appropriate for the size of the Hedge Fund, the Hedge Fund Manager's portfolio management process, and the complexity of its investment strategies;
- Policies and procedures establishing measurement and monitoring criteria; and
- Knowledgeable personnel to measure and monitor risk in accordance with the policies and procedures.

II. The Hedge Fund Manager's Overall Approach to Risk Management

Identification and Design

2.1

Senior management of a Hedge Fund Manager should identify the overall risk profile for each Hedge Fund it manages and develop a risk management process designed to measure, monitor, and manage those risks in a manner consistent with each Fund's risk profile.

2.1.1 A Hedge Fund's risk profile should be tailored to its size and strategy, as well as the Hedge Fund Manager's investment activities.

2.1.2 The principal, widely recognized categories of risk are liquidity risk (including both asset and funding liquidity), leverage, market risk, counterparty credit risk, and operational risk (each discussed below).

2.1.3 A Hedge Fund Manager should consider the extent to which each category of risk applies to its Hedge Funds, and the kinds of methods that will be used to measure, monitor, and manage the applicable risks (such as

stress testing and scenario analysis, VAR, volatility measures, concentrations metrics, and other approaches). In particular, stress testing and scenario analysis are often desirable risk management practices.

2.1.4 While objective measures of risk are critical to understanding how the portfolio behaves, qualitative factors are also important when analyzing portfolio risks.

2.2

A Hedge Fund Manager should provide adequate disclosure to investors to enable investors to make informed decisions about: (1) the risk profile of the Hedge Fund; and (2) how the Fund is performing in light of its risk profile.

Measurement, Monitoring, and Management

2.3

A member of senior management, such as a Chief Risk Officer or person with similar responsibilities, or a Risk Committee, should establish risk measurement criteria and implement a process to monitor each Hedge Fund's risk profile.

2.3.1 Implementation of a Hedge Fund Manager's risk measurement and monitoring process should be tailored to the overall structure of its Hedge Funds, investment and trading strategies, the level of centralization of the decision-making process, the capital allocation process, and consistency with the overall investment and risk profile of such Funds.

2.3.2 When establishing a risk management framework, a Hedge Fund Manager should determine: (1) which risk measures (*e.g.,* capital, concentration, or liquidity) should be monitored within the overall framework; and (2) whether to apply risk constraints (such as limits) and how to apply them (*e.g.,* whether to adopt hard limits, which can never be exceeded, or soft guidelines, which involve discussions of the current risk level faced by the portfolio).

The Hedge Fund Manager's Overall Approach to Risk Management

2.3.3 Resources should be appropriately allocated among the risk management tools designated by the Hedge Fund Manager.

2.3.4 A Hedge Fund Manager generally should use portfolio values used to calculate a Hedge Fund's net asset value for risk monitoring purposes unless the Manager determines that a different approach is justified.

2.3.5 Senior management 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 Fund investors in the Fund's offering documents.

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

2.4

A Hedge Fund Manager should periodically review its risk measurement, monitoring, and management activities to account for any relevant changes in a Hedge Fund's risk profile, historical events, new methodologies, and other relevant factors.

2.4.1 When possible, material risks should be quantified and monitored.

2.4.2 Material risks which are not quantifiable or measurable should still be monitored.

2.4.3 A Hedge Fund's portfolio should be reviewed on a periodic basis (the frequency of this review depending on factors such as the nature of the portfolio and market conditions). This review should include an assessment of whether the portfolio is performing consistently with expectations (based on the identified and measured risks) and, when it varies, review the factors that might be affecting the portfolio.

2.4.4 When appropriate, risk should be measured and monitored on a sub-portfolio basis. "Risk portfolios" may be segregated by one or

more of the following categories: (1) Hedge Fund; (2) asset class; (3) type of instrument; (4) counterparty; (5) industry sector; (6) maturity; or (7) other categories that the Hedge Fund Manager believes are appropriate to effectively measure, monitor, and manage risks.

2.5

A Hedge Fund Manager should understand the biases and limitations of its chosen risk measurement methodologies (including models) and adjust for these in measuring, monitoring, and making decisions about risk.

2.5.1 No risk management process is capable of providing a complete representation of all of the risks facing a Hedge Fund or accurately measuring every one of those risks.

2.6

Risk reports describing a Hedge Fund's exposures to the key risks identified by the Hedge Fund Manager should be prepared and distributed to senior management responsible for the Fund and other appropriate personnel with a frequency appropriate to the nature of the Fund.

2.6.1 Appropriate personnel of the Hedge Fund Manager should be generally informed of the overall risk management framework for each Hedge Fund.

Personnel

2.7

Senior management should appoint knowledgeable personnel to supervise risk analysis, measurement, and monitoring and to take responsibility for the creation of policies and procedures covering all areas of risk management.

The Hedge Fund Manager's Overall Approach to Risk Management

2.7.1 This supervisory role may be performed by a Chief Risk Officer (or other person with similar responsibilities) or by a formal Risk Committee comprised of members of senior management with sufficient experience and the relevant background to understand the complexities of the risk framework. In that role, these persons may also be involved in the portfolio management process.

2.7.2 The Chief Risk Officer (or other person with similar responsibilities) should have open access to, and engage in regular dialogue with, the portfolio managers, as well as the Hedge Fund Manager's senior management so that he/she can acquire and maintain a clear understanding of the Hedge Fund's positions and strategies.

2.8

Senior management should not outsource risk monitoring or management and must maintain responsibility for the overall risk framework.

2.8.1 External services providers may be used for risk measurement functions, provided that such outsourcing is not a substitute for an adequate understanding of risk by senior management personnel.

2.8.2 Responsibility for any outsourced parts of the process should continue to lie with the senior management or its designees, such as the Chief Risk Officer or designated Risk Committee.

2.9

A Hedge Fund Manager should train all relevant personnel on the risk measurement, management, and monitoring processes and policies of each Hedge Fund 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 affect risk measurement, management, and/or monitoring.

III. Categories of Risk

3.1

Within its risk management framework, a Hedge Fund Manager should consider what categories of risks are material to each Hedge Fund and adopt risk management measures most appropriate to its investment approach. The emphasis on the categories of risk that will need to be measured, monitored, and managed will vary depending on the products the Hedge Fund Manager trades, investment strategies, and frequency of trading it chooses for its Hedge Funds.

3.1.1 The balance of this section describes the principal categories of risk that a Hedge Fund Manager may need to measure, monitor, and manage in the operation of its business.

3.1.2 Selected examples of measuring techniques and risk management tools that may be applicable to each category of risk are also identified below.

3.1.3 The particular risk management methods undertaken by a Hedge Fund Manager should be appropriately tailored to the specific risks faced by a Hedge Fund and its risk profile. Certain of the risk categories and risk management tools described below may be less relevant to a particular Hedge Fund Manager. A Hedge Fund Manager may also determine that it should monitor risk categories and use risk management tools not described below.

Liquidity Risk

Liquidity is a Hedge Fund's ability to meet its need for cash.

3.2

A Hedge Fund Manager should monitor and manage liquidity levels in a manner reasonably designed to ensure that the Hedge Fund will be able to meet its obligations.

3.2.1 The following are types of factors that a Hedge Fund Manager should take into account in managing liquidity: (1) the risk of a reduction in the funding provided by lending counterparties, including changes to initial margins/credit

support and timing or size of variation margin calls, as per various agreements with counterparties; (2) the terms of redemption rights by investors and the amount of investor capital that is subject to those redemption rights; and (3) changes in market liquidity conditions (including trading volume, bid-ask size and spread, and the possible effect of crowdedness/concentration of trading strategies) that may alter the ability of the Manager to sell securities with minimum adverse price impact or otherwise manage the liquidity of the Hedge Fund.

3.3

A Hedge Fund Manager should seek to increase the stability of external factors affecting the Hedge Fund through prudent agreements with lenders and investors.

3.3.1 A Hedge Fund Manager should thoroughly understand and regularly review the material terms in its credit and lending agreements, including the interaction of those terms, cross-default and cross-collateralization provisions, and their impact on collateral management and requirements. These terms may affect the availability of funding in the event of certain extreme market conditions or triggering events (*e.g.,* limitations on prime brokers' obligations to provide financing under certain circumstances or NAV triggers) and the overall risk faced by a Hedge Fund. In addition, the Hedge Fund Manager should review these agreements from the perspective of how they protect the Hedge Fund from the risks arising in the event of adverse developments with respect to the counterparty.

3.3.2 A Hedge Fund Manager should understand and review the material terms of its credit and lending agreements, including the interaction of the terms in such agreements (*e.g.,* cross-default and cross-collateralization provisions) and their impact on collateral management.

3.3.3 A Hedge Fund Manager should be aware of the risks of holding certain short-term cash-like instruments (such as money market investments and short term securities that depend on a liquidity put) as a substitute for cash in light of the potential for illiquidity, unexpected delays in satisfying redemptions and the resulting mismatches in funding requirements.

3.3.4 A Hedge Fund Manager should plan for potential periods of funding and liquidity stress. Among other things, a Hedge Fund Manager should evaluate the possibility of a reduction in funding provided by lending counterparties, including changes to margin/credit support, changes to collateral requirements (*e.g.*, amount, type of assets), and the timing or size of margin calls.

3.4

A Hedge Fund Manager should consider conducting regular liquidity stress scenario analyses on the Hedge Fund(s) it manages in order to understand and better manage each Fund's ability to meet obligations in light of such Fund's portfolio.

3.4.1 A Hedge Fund Manager should assess the cash and borrowing capacity of each of its Hedge Funds giving consideration to the potential for large drawdowns and conditions of severe market stress (including the likelihood of increased redemption requests during periods of severe market stress).

3.4.2 A Hedge Fund Manager should consider creditor reluctance to release collateral or to fund credit facilities, decisions to increase "haircuts" and collateral requirements, and use of contractual rights to terminate trading relationships based on NAV triggers.

3.4.3 A Hedge Fund Manager should consider the effect of changes in market liquidity conditions that may affect the Manager's ability to sell securities under favorable terms or otherwise manage the liquidity of its portfolios.

Leverage Risk

Leverage is the practice of using borrowed money to make investments. For portfolios without derivative contracts, leverage may be defined as the market value of assets relative to the portfolio's capital. For more complex portfolios or portfolios containing derivatives, it may be more appropriate to estimate leverage by analyzing the risk of different strategies and understanding the potential for extreme losses arising from those strategies.

Categories of Risk

3.5

A Hedge Fund Manager should manage its use of leverage to match the risk profile established for the Hedge Fund based on its size, portfolio structure, and specific investment strategies.

3.5.1 The Hedge Fund Manager should monitor changes in this measure over time as part of its risk management framework, and should take account of on and off-balance sheet assets (*e.g.,* derivative instruments, including OTC derivatives) in measuring leverage.

3.5.2 A Hedge Fund Manager should monitor leverage with a frequency appropriate to the characteristics of the underlying portfolio taking into account the potential impact of various interrelated factors such as: (1) asset types, sectors, and positions; (2) overall liquidity profile of the portfolio; (3) trading strategies employed by the Manager; (4) volatility of assets and trading strategies; and (5) the crowdedness/concentration of trading strategies.

3.5.3 A Hedge Fund Manager should thoroughly understand the terms on which prime brokers, lenders, and other trading counterparties provide leverage to the Hedge Fund and seek sustainable credit, margin, and funding terms in order to manage a Fund's leverage prudently and minimize additional stress when market conditions become volatile. Important terms may include constraints on the portfolios (*e.g.,* concentration, diversification, and liquidity limits) and prime brokers' and counterparties' rights to alter these terms and/or to terminate the arrangement.

3.5.4 A Hedge Fund Manager should take into account the impact of employing leverage on any positions with embedded leverage, such as certain types of derivatives and other structured products.

Market Risk

Market risk is the financial risk brought about from changes in the market price of investments in the Hedge Fund.

3.6

A Hedge Fund Manager should regularly evaluate market risk, incorporating some or all of the following risk measures, as applicable to the Hedge Fund's size and portfolio management processes and the complexity of its investment strategies. A Hedge Fund Manager should model its risk management framework through the inclusion of some or all of the following risk measures.

3.6.1 A Hedge Fund Manager should seek to identify the size and direction of its exposures to major market risk factors (*e.g.,* equity indices, interest rates, credit spreads, foreign exchange rates, and commodities prices). These exposures should be considered both on a gross (longs plus shorts) and net (longs less shorts) basis and examined both within individual strategies and portfolios and across the entire Hedge Fund. Risk systems should also distinguish between linear exposures (*i.e.,* prices that change proportionately with changes in the overall market) and non-linear exposures (*i.e.,* those that arise from instruments such as options, convertibles, and callable bonds).

3.6.2 A Hedge Fund Manager should conduct stress tests and scenario analyses of its portfolio. Stress testing and scenario analyses can be useful in assessing the vulnerability of a portfolio to various events. They should be designed to capture both market events (directional movements) and situations of market illiquidity. The frequency of such testing should depend on the nature of the portfolio, the risks to which it is exposed, the frequency of turnover, and changes in market conditions, among other factors. The Hedge Fund Manager should identify which market variables to stress, how much to stress them by and over what time frame. Stress tests and scenario analyses can be based on standardized measures, historical events, and/or unique scenario analyses.

- Standardized stress tests involve shocking major market factors by a constant amount or percentage moves (*e.g.,* "All interest rates rise by 100 basis points", or, "Equity prices drop by 10%"). Using both approaches enhances stress testing with regard to factors that may undergo regime shifts (*i.e.,* moving from tight to wider credit spreads, or from a low to higher volatility environment). These tests are useful tools to translate risk exposures into potential profits and losses given a major change in the market.

- Historical scenario analyses aim to measure the expected behavior of the portfolio if a period of known market stress reoccurs in the future. The calculation process must adjust for new instruments and changes in market structure.
- Unique scenario analyses aim to measure the expected behavior of the portfolio during an unexpected period of stress, as specified by risk management.

- Historical risk measures aim to understand the historical behavior of a portfolio versus expectations and can be used as a predictor of future behavior when asset composition and market conditions are relatively stable. If the Hedge Fund Manager determines to monitor historical statistical portfolio risk measures, the Manager should do so by analyzing measures such as realized volatility, return as a function of volatility, worst drawdown, historical beta and correlation with relevant market indices. It is prudent to analyze these measures at a frequency appropriate to the characteristics of the Hedge Fund in order to understand how these realized risk measures may differ over various time horizons. Such measures may become less relevant if the asset or strategy composition of the portfolio changes frequently, the market structure evolves (*e.g.,* regime shifts), or the periodicity of valuation is inappropriate (*e.g.,* daily volatility may be an inappropriate measure for investment positions that are marked-to-market monthly).

- Forward-looking statistical risk measures aim to forecast the expected behavior of the portfolio through quantitative techniques using assumptions on the volatility and correlations of assets in the portfolio. If a Hedge Fund Manager determines to use prospective statistical measures as a risk monitoring tool, the Manager should consider which forecasted statistical measures are applicable to its portfolio. Two common, though not universally used, examples are Value-at-Risk and Expected Loss.

3.6.3 When using forward-looking statistical measures, their shortcomings should be recognized. These measures commonly use a normal distribution of returns as the basis of the calculations. However, because financial markets frequently exhibit unusual, so called “fat-tailed” behavior, many forward-looking statistics systematically underestimate portfolio risk. Moreover, assumptions

concerning the volatility of the assets in the portfolio and the correlations between assets may not reflect actual experience. In addition, these measures may be difficult to calculate for multi-asset portfolios and portfolios with optionality.

3.7

Where appropriate, risk measures should be conducted at both the overall Hedge Fund and portfolio level, as well as by individual investment strategy, asset class, industry group, geographical region, or other dimensions. A Hedge Fund Manager should also determine the frequency and time frame for which risk measures will be calculated.

3.7.1 The frequency of a Hedge Fund Manager's review of a portfolio's market risk should take into account the nature of the portfolio and the risks to which it is exposed, the portfolio's turnover rate, changes in market conditions, and other relevant factors. Certain risk measures may provide more insight when looked at over time. A particular data point may be more useful when viewed in the context of how that same measure has changed over previous days, weeks, and months.

3.8

A Hedge Fund Manager should periodically review the performance of models used to measure and monitor market risk and adjust as appropriate to maximize effectiveness.

3.8.1 Risk management is a subjective process and a Hedge Fund Manager should understand the biases and limitations inherent in risk models, such as assumptions in the inputs and limitations of historical data. A Hedge Fund Manager should use results from these risk models after quantitatively taking into account these limitations.

3.8.2 A Hedge Fund Manager should consider measuring risk estimates over time against the realized return of the portfolio.

3.8.3 Changes to models and assumptions should be made to factor in new data and to account for previously unrecognized relationships or risk factors.

Counterparty Credit Risk

3.9

A Hedge Fund Manager should monitor its Hedge Fund's exposure to counterparty credit risk (including, as applicable, prime brokers, custodians, derivatives dealers and lending, trading, cash management, and depositor counterparties) and understand the impact of potential counterparty loss of liquidity or failure.

3.9.1 A Hedge Fund Manager should assess creditworthiness when selecting and transacting with counterparties (recognizing that subsidiaries and affiliates of counterparties may have different creditworthiness than parent companies).

3.9.2 A Hedge Fund Manager should understand the complexity of the legal relationships a Hedge Fund may have with its prime brokers and any other significant lending or derivatives counterparties and their affiliates, including: (1) understanding the legal entity with which the Fund has contracted and the Fund's ability or inability to close out or net positions with a certain counterparty or prime broker and its affiliates in the event of an insolvency proceeding or other default; (2) understanding the way in which the prime broker finances the Fund's positions, including whether it uses U.S. and/or non-U.S. broker-dealers or banks, whether assets are segregated and rehypothecated, and the location in which its positions are held; (3) knowing the identity of custodians and sub-custodians used by the prime broker in various locations and, depending on the availability of resources, assessing the risk associated with the use of such custodians and sub-custodians, particularly in developing markets; and (4) understanding whether, and to what degree, its assets will be protected in the event of an insolvency of the counterparty. Factors to be taken into account include the risk/reward of investing and the size of the business with that particular counterparty or sub-custodian.

3.9.3 When evaluating counterparty risk, a Hedge Fund Manager should consider both credit exposure, as well as business disruption risks.

3.10

A Hedge Fund Manager should measure and monitor its credit exposure to each counterparty (as appropriate given the level of the Hedge Fund's exposure to each counterparty).

3.10.1 As part of this process, a Hedge Fund Manager should weigh the desirability of diversifying counterparty credit risk by using multiple prime brokers and counterparties against any increases in the complexity and practicality of settlement, reconciliation processes, and daily collateral management. A Hedge Fund Manager should dedicate appropriate resources to manage its collateral movements and, where possible, aim to reduce mismatches at a counterparty (*e.g.*, by maintaining reasonably hedged portfolios at each prime broker).

3.10.2 To minimize risk in the event of market stress, a Hedge Fund Manager should consider taking steps to increase its access to liquidity, such as diversifying its exposure to counterparties by opening cash and custody accounts at financial institutions other than its prime brokers.

Operational Risk

3.11

A Hedge Fund Manager should have a strong operational infrastructure that is commensurate with the complexity of its business, to manage and mitigate operational risks resulting from inadequate or failed internal processes, people and systems, or from external events.

3.11.1 One or more senior management officials, who may include a Chief Operating Officer, with functions separate from investment management, should oversee the Hedge Fund Manager's operational areas.

3.11.2 A Hedge Fund Manager should implement and maintain strong internal controls to minimize the risk of loss as a result of operational risk.

Categories of Risk

3.11.3 Controls to reduce operational risk may include, as applicable: (1) use and maintenance of a centralized position data set; (2) adoption of trade capture devices; and (3) prompt reconciliation of trading information with the Hedge Fund's prime broker or settlement agent and fund administrator (if any).

3.12

A Hedge Fund Manager should monitor its overall level of operational risk, either internally or through third-party review.

3.12.1 This review may take into account the following characteristics of a Hedge Fund (as applicable to a particular Fund): (1) assets and products; (2) staffing and resources; (3) infrastructure (including information technology resources, business continuity, and disaster recovery planning); and 4) compliance and regulation.

Legal and Compliance Risk

3.13

A Hedge Fund Manager should adopt a compliance manual that establishes compliance policies in key operational areas to seek to mitigate the risk of regulatory non-compliance.

3.13.1 A Hedge Fund Manager should appoint a Chief Compliance Officer to ensure that compliance policies are followed and enforced.

Trading and Business Operations

I. Trading and Business Operations Framework

1.1

A Hedge Fund Manager should develop a comprehensive and integrated framework to manage its trading and business operations, taking into account the size and complexity of its activities, the nature of its investment activities, and the requirements of its investment strategies.

1.1.1 The framework should include policies and procedures that provide for appropriate checks and balances for the Hedge Fund Manager's key operational systems and accounting controls, including:

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

1.2

A Hedge Fund Manager should task a member of its senior management with the primary responsibility for managing the Manager's trading and business operations, supported by adequate internal and/or external personnel with the appropriate levels of skills and experience, in light of the Manager's operations.

1.2.1 This senior manager—who can be a Chief Operating Officer or person with similar responsibilities and who possesses experience and skills appropriate in light of the complexity of the Hedge Fund Manager's business operations—should ensure that the Manager's operational functions coordinate and work in partnership with other senior managers, such as investment, legal, risk, and compliance professionals.

1.3

A Hedge Fund Manager should develop investment and trading policies for each Hedge Fund it manages based upon the Fund's specific investment objectives as described in its offering documents.

1.3.1 These policies should include monitoring the trading activities and performance of each portfolio manager (including any external portfolio managers).

1.4

A Hedge Fund Manager should review at least annually and update as appropriate its investment and training policies, as well as its operational policies and practices. Updates should address, among other considerations, material changes to: (1) a Hedge Fund's structure or investment strategy; (2) market events; or (3) applicable regulations.

II. Counterparties

2.1

Hedge Fund Managers interact with a variety of counterparties and should conduct reasonable due diligence when selecting the counterparties of the Hedge Fund(s) that they manage.

2.1.1 Typical counterparties that a Hedge Fund will encounter include:

- Executing brokers;
- OTC derivative counterparties;
- Prime brokers;
- Stock loan and repo counterparties;
- Banks;
- Cash management counterparties; and
- Custodians.

2.1.2 When selecting counterparties, the key factors that a Hedge Fund Manager should consider include:

- Creditworthiness, reputation, experience, identity, and legal and regulatory regime (*e.g.,* insolvency laws and customer protection rules) of the specific counterparty, its parent company, and any affiliates of its parent company, as appropriate;
- Ability to provide an appropriate level of service to the Hedge Fund Manager in light of the Manager's business needs (including complexity of products and frequency of trading), such as: (1) efficient and timely transaction processing, reporting, clearing, and settlement; (2) financing capabilities necessary to support the Manager's business; and (3) staffing that is adequate to meet the Manager's needs, including the support and reporting of information needed to prepare books and records; and
- Stability of the terms on which the counterparty is willing to provide service to the Hedge Fund Manager (such as term funding lock-ups for prime brokers).

Counterparties

2.2

A Hedge Fund Manager should negotiate and maintain with its counterparties signed agreements governing the terms of the counterparty relationship (*e.g.*, account opening, prime brokerage, stock lending, ISDA, custodial arrangements, and give-up agreements).

2.2.1 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 practicable thereafter.

2.3

A Hedge Fund Manager should carefully review and understand the details of the terms of counterparty agreements and the risks that can affect a counterparty's obligation to extend credit or provide other services (such as terms that can increase collateral requirements).

2.3.1 A Hedge Fund Manager may also want to 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.

2.3.2 A Hedge Fund Manager should, to the extent appropriate and feasible, seek to negotiate standardized events of default and other termination or collateral events to achieve consistency in documentation.

2.3.3 A Hedge Fund Manager should consider using provisions that limit or mitigate a counterparty's ability to terminate or make demands for collateral solely at its 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.

2.3.4 A Hedge Fund Manager should be aware of its obligations to settle trades, extend credit, or provide other services under its agreements with counterparties.

2.3.5 A Hedge Fund Manager should consider negotiating provisions to guard against cross-account liability to the extent that the Manager uses the same counterparty for two or more of its Hedge Funds.

2.3.6 A Hedge Fund Manager should consider the terms and conditions required for the movements of margin and cash.

2.3.7 When multiple counterparties are used, a Hedge Fund Manager should devote appropriate resources to managing the operations of its Hedge Fund(s) across those multiple counterparties.

2.3.8 To the extent practicable, a Hedge Fund Manager should establish procedures or processes for ensuring that: (1) appropriate communication exists between the Manager and the Fund's counterparties, third-party administrators, and/or other third-party service providers; (2) the appropriate service providers have the proper trade capture and other capabilities to enable timely execution and documentation of transactions; and (3) service providers are aware of and able to implement the Manager's transactional policies and procedures.

III. Cash, Margin, and Collateral Management

3.1

A Hedge Fund Manager should have a framework for effectively managing its cash balances and for processing any margin or collateral calls from its prime brokers, financing, and OTC derivative counterparties.

Cash, Margin, and Collateral Management

3.1.1 In developing this framework, a Hedge Fund Manager should:

- Carefully consider industry practices and developments in this area;
- Understand and monitor compliance with its credit agreements;
- Understand and monitor the amount and type of collateral required to support positions, as well as the daily balance of the positions;
- Verify marks used by each of its Hedge Funds' counterparties to value its Funds' positions for collateral purposes;
- Evaluate a counterparty's ability to cross-margin positions;
- Understand or seek to understand the risks associated with its counterparties' collateral management procedures, and, to the extent practicable, negotiate agreements designed to mitigate those risks (*e.g.,* tri-party custodial or collateral segregation agreements);
- Verify and meet undisputed margin calls in a timely manner; and
- Reconcile positions and marks used for the calculation of margin.

3.1.2 A Hedge Fund Manager should establish policies or processes for investing a Hedge Fund's excess cash, if any, based on established risk parameters and taking into account the credit risk presented by the party with whom cash is invested.

3.2

A Hedge Fund Manager should periodically evaluate the effectiveness of its cash management framework.

3.2.1 In evaluating its cash management policies, a Hedge Fund Manager should consider cash flow needs based on the risk and funding profile of the portfolio and investor subscription and redemption windows.

IV. Selection and Monitoring of Key Service Providers

4.1

A Hedge Fund Manager should select reputable service providers that have the expertise and experience necessary to appropriately support its business.

4.1.1 These service providers may include, where appropriate: (1) providers of accounting, consulting, and proxy services; (2) information technology product vendors; (3) legal counsel; (4) fund administrators (where applicable); (5) sub-advisers; and (6) external portfolio managers.

4.1.2 The Hedge Fund Manager's selection and monitoring process for its service providers should take into consideration each service provider's independence and controls over its activities.

4.1.3 In engaging key service providers, a Hedge Fund Manager should enter into agreements that clearly delineate the service levels to be provided to it.

4.1.4 Such services should be appropriate in light of the Hedge Fund Manager's internal infrastructure and the complexity of the Manager's operations.

4.1.5 Responsibility for any outsourced parts of a Hedge Fund Manager's trading and business operations remains the responsibility of the Manager's senior management or its designees. Appropriate oversight procedures should be implemented for outsourced activities.

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

Selection and Monitoring of Key Service Providers

4.2

After a key service provider is selected, a Hedge Fund Manager should monitor the quality of service provided by such provider and be prepared to find a replacement if the quality of service becomes inadequate.

V. Core Infrastructure and Operational Practices

5.1

A Hedge Fund Manager should develop and document core infrastructure and operational practices tailored to its business.

5.1.1 Requirements for the infrastructure needed will vary depending on the Hedge Fund Manager's business, including the types of investments, volume of trading, and the use of manual processing, as opposed to the availability of automated systems.

5.1.2 A Hedge Fund Manager should consider, based upon the size, nature, and complexity of its organization and of each Hedge Fund it manages, whether the implementation of automated processing systems is appropriate to reduce settlement risk.

5.1.3 A Hedge Fund Manager should provide for appropriate reporting-up policies for resolving material breaks, errors, or other matters that could potentially cause risk of loss to its Hedge Fund(s). The Hedge Fund Manager should employ business process monitoring, analysis, and optimization techniques appropriate to its business to identify and address breaks and inefficiencies in its operations.

5.1.4 Depending on the size and complexity of the organization, the Hedge Fund Manager should endeavor to cross-train personnel, to the extent practicable, or otherwise have appropriate back-up, so that key operations functions are not dependent solely on one individual.

5.2

A Hedge Fund Manager should designate a member of senior management or an appropriate designee to regularly: (1) review trading activities and the performance of each Hedge Fund portfolio; (2) evaluate the associated risk levels; and (3) ensure that the Fund's management and trading activities are consistent with the policies and practices set out in the Fund's governing documents.

5.3

A Hedge Fund Manager should adopt procedures or processes for clearing and settling transactions and for wiring funds.

5.3.1 Such procedures may address:

- The reconciliation of positions and cash accounts across counterparties (and the frequencies of those reconciliations), such as prime brokers, futures clearing accounts, a fund administrator, and front office, including prompt resolution of failed trades;
- Appropriate procedures for cash movements, including designating authorized signatories and instituting appropriate checks and balances;
- The appropriate segregation of duties between investment and operational personnel, including confirmations that should be sent to non-trading personnel;
- The use of industry utilities and software tools in an effort to automate a Hedge Fund Manager's OTC derivatives processes, where the volume and complexity of the Manager's business warrants it;
- The use of industry central clearinghouses and/or exchanges for OTC derivatives, as applicable;
- A process for addressing corporate actions, such as mandatory elections, voluntary elections, dividends, splits, and reorganizations; and
- A process for monitoring and taking timely action on all positions that have expiration dates (*e.g.,* options, warrants, rights, and conversions).

VI. Additional Infrastructure and Operational Practices

6.1

If a Hedge Fund Manager undertakes material trading activities in the OTC derivatives market or other complex markets (such as bank debt, mortgage-backed securities, equity derivatives, structured credit trading, or other private transactions), the Manager should devote the resources necessary to maintain infrastructure, personnel, and processes that are sufficiently robust to handle the added complexities of these instruments and markets, including working closely with counterparties and remaining informed of, and responsive to, overall market trends.

OTC Derivative Practices

6.1.1 A Hedge Fund Manager should assess whether it has the appropriate systems and personnel to manage the extended settlement cycles and unique features of these products. This assessment should include considering whether the Hedge Fund Manager needs to hire or engage personnel with the specific skill sets necessary to appropriately manage such complex products.

6.1.2 The fact that OTC derivatives are individually negotiated transactions that can have unique characteristics and terms makes them especially challenging to manage from an operational and business perspective. Accordingly, when trading in OTC derivatives, a Hedge Fund Manager should consider whether it is necessary or advisable to take the following actions:

- Negotiating appropriate ISDA and similar master agreements with all of its OTC derivatives counterparties;
- Negotiating bilateral collateral agreements with its counterparties when possible and appropriate, taking into account the relative creditworthiness of the parties and the nature of the transactions;

- Implementing appropriate systems to record the material terms of all OTC contracts to facilitate the appropriate pricing and risk management of these portfolios;
- Implementing processes to monitor and promptly report-up the resolution of any derivative transaction not supported by a counterparty term sheet detailing the economics of the trade;
- Implementing policies and procedures for monitoring outstanding confirmations (*e.g.,* confirmations that are not yet received, in review, disputed, or aged) and performing risk analysis, timely mitigation (*e.g.,* prioritization), and expeditious resolution of outstanding confirmations;
- Reviewing counterparty OTC margin calls and instituting a process for assessing when the Hedge Fund Manager should make its own OTC margin calls to brokers, as appropriate;
- Instituting appropriate processes and procedures to facilitate the Hedge Fund Manager's ability to adhere to the industry best practices and standards, such as the use of a central clearinghouse for the clearing and executing of OTC derivative trades (when available), electronic novation consent processing, transaction processing timelines, and other industry standards that may develop; and
- Reviewing final payoffs for OTC derivatives and other complex products.

Practices for Other Complex Products

6.1.3 **Bank Loans** – A Hedge Fund Manager may want to seek legal advice from appropriately skilled internal or external counsel in order to manage the documentation of bank loan transactions, particularly in the distressed debt arena.

6.1.4 **Mortgaged Backed Securities/Collateralized Mortgage Obligations** – A Hedge Fund Manager should assess whether it has appropriate systems and personnel to manage the unique features of these products, such as the processing of monthly pay-downs and understanding the payment waterfalls.

Additional Infrastructure and Operational Practices

6.1.5 **Structured Credit Trading** – A Hedge Fund Manager should assess whether it has the appropriate systems and personnel necessary to manage the unique features of structured credit products, such as the financing component, waterfall structures, and correlations of these credit products.

6.1.6 **Private Transactions** – A Hedge Fund Manager should assess whether it has appropriate resources such as internal and external legal, tax, and structuring expertise that is adequate to support private transactions. In addition, custodial arrangements may be needed to provide for appropriate safeguarding of investment positions of this type. There should be periodic confirmation with counterparties of open positions.

6.1.7 **Transactions in Foreign Markets** – Foreign market transactions require an understanding by personnel or service providers of local regulatory, market and tax infrastructure, and settlement conventions.

6.2

A Hedge Fund Manager should regularly assess the appropriate level of staffing and resources for complex or unique trading strategies from an operational and business risk perspective and be willing to maintain that level.

VII. Core Accounting Processes

7.1

A Hedge Fund Manager needs to have appropriate systems, processes, and personnel in place, such that the trading activities of its Hedge Funds and all related contractual arrangements and agreements can be appropriately recorded from an accounting perspective to allow for the calculation of both Fund level and investor-level net NAVs, as well as the production of other important financial data that is necessary to meet investor, risk, financial statement, regulatory reporting (as appropriate), and tax reporting requirements.

7.1.1 A Hedge Fund Manager should have internal or external personnel with an appropriate level of accounting knowledge and experience.

7.1.2 A Hedge Fund Manager should have access to systems appropriate to the needs and complexities of the firm, which are capable of correctly recording the trading and non-trading activities of its Hedge Fund(s) from an accounting perspective. These may include:

- Systems that maintain important trading-related data, including quantity, cost-basis, market-value, realized and unrealized trading gains/losses, interest and dividends, and trading-related fees and expenses;
- A general ledger that includes trading data (whether in detailed or summarized form), as well as non-trading-related data, such as management fees and expenses;
- An allocation process that allocates the Hedge Fund level results to individual investors to allow for reporting at the investor level; and
- Processes to ensure that all non-trading related activities are appropriately recorded from an accounting perspective, including management fees, incentive fee (or allocation) arrangements, and other fees and expenses, as outlined in the Hedge Fund's organizational documents (these processes are in addition to the valuation processes discussed in Chapter 2 Valuation).

7.1.3 A Hedge Fund Manager should implement a month-end close process (or if not monthly, then at least as often as required by the Hedge Fund's organizational documents). Some processes that may be appropriate in light of the characteristics of a particular Hedge Fund include:

- Verification that any material valuation adjustment is appropriately recorded;
- Verification that all non-trading-related activity is appropriately recorded;
- Allocation of the fund level NAV to individual investors; and
- Preparation and distribution to investors of statements that detail their current NAV and other related financial data.

7.1.4 A Hedge Fund Manager should implement an annual process to produce its annual financial statements and related footnotes, which will be audited by the Hedge Fund's independent accounting firm.

7.1.5 A Hedge Fund Manager should implement an annual process to produce investor level tax information, as needed by investors, in accordance with the regulations promulgated by the relevant taxing authority.

7.1.6 A Hedge Fund Manager should periodically assess its operational controls in light of the changing needs of its business, particularly where there have been changes to the activities of the organization.

7.1.7 Responsibility for any outsourced parts of a Hedge Fund Manager's core accounting processes remains the responsibility of the Manager's senior management or its designees.

VIII. Core Information Technology Processes

8.1

A Hedge Fund Manager should establish policies and procedures to control changes to any information technology, including software applications, data, hardware, and information technology infrastructure.

8.1.1 These policies and procedures should include, to the extent feasible:

- Authorization controls over the development or acquisition of information technology resources;
- Version control management;
- Segregation of personnel and technical environments for the development, testing, and implementation of changes;
- Appropriate testing and approval of changes prior to usage in production for all systems, spreadsheets, applications, and application equivalents; and
- Back-out and recovery plans in the event of an implementation problem.

8.2

A Hedge Fund Manager should establish policies and procedures for logical and physical security over information technology infrastructure.

8.2.1 These policies and procedures should include, to the extent feasible:

- 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 authority (*e.g.,* read-only, update) a user or process has to systems and data;
- Appropriate review procedures to the extent the information technology functions are outsourced; and
- Audit logging and monitoring controls internally and at the network perimeter.

IX. Best Execution and Soft Dollar Arrangements

9.1

A Hedge Fund Manager should seek best execution in its trading activities for the benefit of each Hedge Fund it manages.[3]

9.1.1 Factors a Hedge Fund Manager may consider in seeking best execution include, but are not limited to:

- Prompt and reliable execution;
- The financial strength, integrity, and stability of the broker or counterparty;
- The quality, comprehensiveness, timeliness, and frequency of available research and market information provided by the executing broker;
- 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.

[3] *For a discussion of these issues by regulators, see the SEC's Guidance Regarding Client Commission Practices under Section 28(e) of the Exchange Act at* ***www.sec.gov/rules/interp/2006/34-54165.pdf*** *and, as applicable, the FSA's Consultation Paper on Bundled Brokerage and Soft Commission Arrangements at* ***www.fsa.gov.uk/pubs/cp/cp176.pdf.***

9.2

A Hedge Fund Manager, if applicable to its operations and trading activities, should develop policies relating to the use of these arrangements.

9.2.1 Soft dollar arrangements may impact the evaluation of best execution. For that reason, a Hedge Fund Manager relying on the safe harbor provided by Section 28(e) of the Exchange Act should determine whether the brokerage and research services are covered within the safe harbor (as set forth in Section 28(e) of the Exchange Act).

9.2.2 A Hedge Fund Manager with soft dollar arrangements that fall outside of the safe harbor provided by Section 28(e) of the Exchange Act should ensure that its arrangements are consistent with its duties to its Hedge Funds and determine whether the products and services received fall within the disclosed usage of soft dollar arrangements.

9.2.3 All soft dollar arrangements should be fully disclosed to investors in the Hedge Fund's offering documents and Form ADV, if applicable.

Compliance, Conflicts, and Business Practices

I. Compliance, Conflicts, and Business Practices Framework

1.1

A Hedge Fund Manager should establish a comprehensive and integrated compliance and business practices framework that is supported by adequate resources. The goal of the framework is to provide guidance to the Hedge Fund Manager and its personnel in respect of ethical, regulatory, compliance, and conflict of interest situations. Critical to the success of the framework is a strong culture of compliance.

1.1.1 The framework should include:

- A written code of ethics that establishes principles governing the conduct of the Hedge Fund Manager's personnel;
- A written compliance manual that addresses: (1) the various rules and regulations governing the Hedge Fund Manager's operations; (2) potential conflicts of interest that may arise in the course of those operations; and (3) the maintenance and preservation of adequate records;
- The establishment of a conflicts committee or other responsible body (the "Conflicts Committee") to review and address potential conflicts;
- Regular training of personnel on the material elements of the compliance program; and
- A compliance function that includes: (1) a Chief Compliance Officer to monitor and maintain the Hedge Fund Manager's compliance program; (2) appropriate disciplinary procedures and sanctions to address violations of the Manager's compliance program; and (3) an annual review of the Manager's compliance program.

II. Culture of Compliance

2.1

A Hedge Fund Manager should establish a culture of compliance, grounded in the commitment and active involvement of the most senior leaders of the Manager and fostered throughout the organization.

2.1.1 A Hedge Fund Manager registered with a regulatory body in the United States, such as the SEC or the CFTC, or with like-regulatory bodies in a non-U.S. jurisdiction, is subject to specific obligations that a non-registered 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, regulations, and industry best practices (such as those recommendations set out in *Sound Practices*) to 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.

2.1.2 Particularly important to creating a culture of compliance are the following:

- Encouragement by senior management to personnel to raise any concerns or questions (facilitated by an environment that is free from fear of retribution);
- Ability to communicate concerns to senior management;
- Active participation by senior management in compliance meetings and training sessions;
- The role of the Chief Compliance Officer (or other person with similar responsibilities) should be regarded as institutionally significant and should be vested with sufficient authority to implement the compliance program; and
- Senior management should consult regularly and encourage employees to consult regularly with the Chief Compliance Officer and his or her delegates whenever issues arise that could raise compliance issues.

2.1.3 Maintaining high ethical standards of integrity in the Hedge Fund Manager's business must be the responsibility of senior management and each employee.

III. Code of Ethics

3.1

A Hedge Fund Manager should develop and adopt a written code of ethics that establishes guidelines that are designed to foster integrity and professionalism among the Manager and its personnel and its commitment to act in the best interests of the Hedge Fund.

3.1.1 Whether particular policies or subjects are addressed in the code of ethics or compliance manual (discussed further below in Sub-section IV) should be determined by the Hedge Fund Manager taking into account what it believes is most effective for its business.

3.1.2 The code of ethics should address, at a minimum, the following issues, to the extent relevant to the Hedge Fund Manager's structure and operations:[4]

- Standards of conduct that require the Hedge Fund Manager's personnel to operate with integrity and professionalism;
- The fiduciary capacity of the Hedge Fund Manager and its personnel (including the priority of the interests of each Hedge Fund it advises and its investors over the interests of the Manager and its personnel);

[4] *For additional guidance regarding the regulations governing codes of ethics required to be adopted by investment advisers registered with the SEC, see Investment Advisers Act Rule 204A-1 and SEC Release No. IA-2256, effective August 31, 2004, 69 F.R. 41696. See, also, Appendix VI - Checklist for Hedge Fund Managers to Consider in Developing a Code of Ethics.*

- Compliance with applicable federal securities laws;
- Protection of confidential information about its Hedge Funds and their investors and any such information received by the Hedge Fund Manager from third parties;
- Personal trading by the Hedge Fund Manager and its personnel who are involved with portfolio management and/or trading, on whom the Manager should consider imposing heightened personal trading requirements tailored to the individual's role or function;
- The receipt or provision of gifts and entertainment by the Hedge Fund Manager and its personnel;
- A review or approval process for considering the compatibility of personnel's internal role with outside directorships and other business interests;
- An internal reporting policy for conduct inconsistent with the code of ethics without fear of retribution;
- Other policies that the Hedge Fund Manager considers appropriate given its particular characteristics and operations; and
- The appropriate use of material, non-public information.

3.2

The code of ethics should apply to all employees. To the extent that certain policies do not apply, or apply differently to certain types of employees, depending on the nature of their responsibilities, duties, and access to information, the Hedge Fund Manager should clearly identify the types of employees (*e.g.*, investment professionals) to whom those policies apply.

3.2.1 A Hedge Fund Manager should consider whether service providers or consultants should be subject to all or any portion of the code of ethics. Alternatively, a Hedge Fund Manager may review the codes of ethics of its service providers, or otherwise conduct due diligence on such service providers, to obtain reasonable comfort that such service providers will act in a manner that is consistent with the Manager's code of ethics.

3.2.2 A Hedge Fund Manager should require that its employees certify on at least an annual basis that they have read and understood the code of ethics and that they will act in conformity with it.

3.3

The code of ethics should reflect the nature of the Hedge Fund Manager's business.

3.3.1 While "off-the-shelf" codes of ethics may provide useful background and guidance, a Hedge Fund Manager's code should be appropriately adapted to fit its business.

IV. Compliance Manual

General Elements of the Compliance Manual

4.1

A Hedge Fund Manager should identify and evaluate the critical elements to be addressed in its compliance manual in light of the focus of, and conflicts relating to, its business and operations.

4.2

A Hedge Fund Manager should develop a written compliance manual that outlines its policies and procedures for complying with laws, rules, and regulations (domestic or international) applicable to its Hedge Funds' business operations and trading activities.

4.2.1 A Hedge Fund Manager should consider addressing the following topics in its compliance manual (to the extent relevant):[5]

- **Marketing and Communication:**

  (1) Determination of what materials constitute sales and marketing materials;

  (2) Procedures for communicating with third parties (including media and Web site communications);

  (3) Procedures for using third-party marketers to solicit investments, where this practice is permitted; and

  (4) Procedures for review of any marketing materials used by the Hedge Fund Manager, including review of performance presentation standards.

- **AML:**

  AML policies and procedures and compliance with the Bank Secrecy Act, as applicable, such as: (1) procedures for identifying investors prior to subscription and periodic review of the Hedge Fund's investor base; and (2) where any part of AML compliance is delegated to an administrator or other third party, periodic review of the delegate's practices (including its consistent application of those practices).

- **Trading and Business Practices:**

  (1) Procedures for the prompt and accurate recording of transactions;

  (2) Trade allocation policies, such as policies in respect of allocations among funds and managed accounts or proprietary accounts, where applicable;

  (3) A procedure for proxy voting;

  (4) A trade error policy;

[5] *For additional guidance regarding the regulations governing compliance policies and procedures required to be adopted by investment advisers registered with the SEC, see SEC Release No. IA-2204, effective February 5, 2004, 68 F.R. 74714. See, also, Appendix VI - Checklist for Hedge Fund Managers to Consider in Developing a Compliance Manual.*

(5) A best execution policy and procedures that include selection criteria for executing brokers, and provide for identification and review of such criteria by a best execution committee (where applicable) or by senior management;

(6) A policy for the use of soft dollar arrangements and bundled commissions that may include:

- Review of the Hedge Fund Manager's use of soft dollar arrangements for consistency with the practices outlined in disclosure to investors or compliance with Section 28(e) of the Exchange Act (where applicable); and
- Heightened review of transactions with affiliated broker-dealers (where applicable) to monitor that the use of soft dollar arrangements is consistent with what has been disclosed to investors;

(7) Policies prohibiting manipulation, such as:

- Prohibition of late trading, market-timing, front-running, the spreading of false rumors, or sham transactions, as appropriate in light of the Hedge Fund Manager's business;
- Procedures for hedging and short sales in connection with offerings of securities (such as in connection with private investment in public equity transactions); and
- Procedures for participating in new issuances of securities and complying with representations to brokers regarding eligibility for such issuances;

(8) Policies and procedures to prevent, detect, and address the misuse of material, non-public information and insider trading (including in respect of price or market-sensitive information and confidential information obtained from brokers, consultants, or other third parties), which may include the use of information barriers, restricted lists, or other appropriate procedures;

(9) Policies and procedures designed to prevent obtaining material, non-public information while conducting research and information gathering when investing in public companies;

(10) Policies and procedures for personal trading by personnel of the Hedge Fund Manager, such as identifying personnel subject to restrictions and establishing appropriate procedures to control that trading (*e.g.,* mandatory pre-approval or clearance of certain transactions and investments in initial public offerings or private placements, prohibition of or restriction on trading certain types of investments, restricted lists, black-out periods, and holding periods); and

(11) Procedures for monitoring ERISA requirements including prohibited transactions, if applicable.

- **Monitoring:**

  (1) A Hedge Fund Manager should establish a system to monitor compliance with its compliance policies and procedures.

  (2) Appropriate monitoring will vary with the nature of the Hedge Fund Manager's activities and the characteristics of its Hedge Fund(s), but should include review of records or other documentation produced in the ordinary course of business that can be useful in assessing the Manager's compliance with its policies.

- **Regulatory Filings:**

  (1) A Hedge Fund Manager should identify required U.S. and international regulatory filings (such as the Hart-Scott-Rodino Antitrust Improvements Act of 1976, Sections 13 and 16 of the Exchange Act, short sale reporting, and comparable non-U.S. reporting requirements) 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.

(2) 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 Manager operating, trading, and/or marketing in the United States. A Hedge Fund Manager should monitor for changes in regulatory requirements to ensure that its compliance program and policies are current. A Hedge Fund Manager should also review similar types of filing requirements in other jurisdictions.

4.3

The policies of a Hedge Fund Manager regarding international operations or investment activity should be designed to comply with laws, rules, and regulations to which it is subject in each jurisdiction where it conducts trading activities or business.

Recordkeeping

4.4

A Hedge Fund Manager should establish policies and procedures for the creation, maintenance, and retention of accurate, complete, and required business records that are appropriate to its size and level of activity and comply with all applicable laws.

4.4.1 Registered Hedge Fund Managers must comply with specific books and recordkeeping rules as required by law. Regardless of a Hedge Fund Manager's registration status, business records that are important to the Manager and its Hedge Funds should be maintained. Examples may include contracts, constituent documents, trade data, accounting records, documents relating to valuation, records or agendas of meetings of any principal committees (such as the Valuation, and Conflicts Committees), performance history backup, investor communications, and correspondence. A Hedge Fund Manager should employ, where reasonable, appropriate electronic data management systems.

Compliance Manual

4.4.2 Recordkeeping policies and procedures should focus on key business records and should address, where applicable:[6]

- The duration of retention, which may vary by type of record;
- The manner of retention, which should protect against unauthorized alteration or untimely destruction;
- Communication of the retention policy to all employees as it applies to them;
- Accurate and complete recording of trading activities; and
- Methods to access documents retained pursuant to the policy.

Conflicts of Interest

4.5

A Hedge Fund Manager should identify the potential conflicts of interest that may arise in its specific businesses and should adopt policies and procedures reasonably designed to mitigate or address such conflicts in a consistent and standardized way.

4.5.1 Conflicts are inherent in the asset management business as in many other financial services businesses. The key to appropriately handling conflicts is to have a process in place for identifying them and addressing them. The types of conflicts that may exist in a Hedge Fund Manager's business will vary based on its structure, the structure of its Hedge Fund(s), and the types of activities that it conducts.

[6] *Investment Advisers Act Rule 204-2 sets out minimum record retention requirements for Hedge Fund Managers that are registered as investment advisers under the Investment Advisers Act. Hedge Fund Managers that are registered as investment advisers at a state level, are typically subject to similar requirements under the laws and regulations of the applicable state.*

4.5.2 The following are types of potential conflicts that may be applicable to a particular Hedge Fund and that a Hedge Fund Manager should consider in light of its business operations:

- Conflicts between the Hedge Fund Manager and its Hedge Fund(s), such as:
  (1) Conflicts arising from a Hedge Fund Manager's proprietary trading or proprietary holdings in specified investments;
  (2) Conflicts arising from the valuation process;
  (3) Conflicts relating to the allocation of costs and expenses between the Hedge Fund Manager and the Hedge Fund;
  (4) Conflicts relating to transactions or business arrangements with affiliates, such as brokerage arrangements, cross-trades, principal trades, and the provision of any other services by affiliates; and
  (5) Conflicts relating to relationships with third-party service providers (*e.g.,* prime and other brokers, vendors, and fund administrators), such as the use of soft dollar arrangements, capital introduction, and consulting services or use of affiliated brokers or custodians.
- Conflicts between Hedge Funds managed by the same Hedge Fund Manager or between Funds and separate accounts managed by the same Manager (*e.g.,* conflicts in the allocation of investment opportunities);
- Conflicts between employees (including family members) of the Hedge Fund Manager and its Hedge Fund, such as:
  (1) Conflicts arising from personal trading (including front-running);
  (2) Conflicts arising from private investment activities;
  (3) Conflicts arising from outside business activities; and
  (4) Conflicts arising from the receipt or provision of gifts and entertainment.
- Conflicts between investors, such as conflicts arising from side letters or parallel managed accounts that may grant preferential terms to certain investors or adversely impact others.

4.5.3 A Hedge Fund Manager should establish a Conflicts Committee to review and deal with circumstances that may require a review of specific facts. Not all potential conflicts can be predicted or otherwise addressed in a standard manner. A Conflicts Committee should be authorized to address conflicts on a case-by-case basis and, if appropriate, grant waivers from the Hedge Fund Manager's standard policies. The purpose of the Conflicts Committee would be to assess new or potential conflicts, as they arise, that have not previously been addressed or that are otherwise not addressed by the Hedge Fund Manager's standardized procedures. A Conflicts Committee may include the Hedge Fund Manager's Chief Compliance Officer and/or other members of senior management (as appropriate to the internal organization of the Manager and its Hedge Funds).

4.5.4 A Conflicts Committee should review at least annually the effectiveness of the Hedge Fund Manager's conflict management process.

4.5.5 A Conflicts Committee should also determine whether amendments or new policies are necessary or appropriate in light of its review. The Conflicts Committee should keep appropriate records of how material conflicts were addressed.

Training and Educating Personnel

4.6

A Hedge Fund Manager should establish a robust training program to educate personnel in respect of its compliance program.

4.6.1 This training program should be developed in light of the following considerations (to the extent relevant):

- Training should foster an understanding of all parts of the compliance framework;
- Training should be tailored to the type of business undertaken by the Hedge Fund Manager and should incorporate examples relevant to that business. It should focus on identifying compliance issues particular to the Hedge Fund Manager's operations and on preventing market abuse;

- When material changes occur, but at least annually, the Hedge Fund Manager should organize and make available to personnel performing a significant business function a compliance training session addressing topics identified by the Chief Compliance Officer and by employees as relevant to the activities of such employees. The Hedge Fund Manager may enlist the services of outside experts, such as outside counsel, to conduct these sessions;
- Training should address circumstances where it would be appropriate to seek guidance from the Chief Compliance Officer or other member of senior management regarding a compliance matter; and
- Because junior personnel will often develop greater compliance awareness through open and informal discussions with their supervisors and the Chief Compliance Officer, such contact should be encouraged as part of the training process.

V. Compliance Function

Dedication of Resources and Appointment of Chief Compliance Officer

5.1

A Hedge Fund Manager should establish and devote adequate resources to a compliance function to oversee, implement, and review the Manager's compliance program.

5.2

A Hedge Fund Manager should appoint a Chief Compliance Officer or other member of senior management (as appropriate to the size, complexity, and resources of the Manager), with sufficient knowledge and experience, to oversee and administer the Manager's compliance program.

5.2.1 The Chief Compliance Officer's duties may include:

- Identifying compliance risks (in consultation with other senior personnel);
- Monitoring compliance with policies and procedures;
- Conducting an annual review and assessment of the Hedge Fund Manager's compliance framework (including the compliance manual); and
- Providing for staff awareness of the Hedge Fund Manager's compliance policies and procedures through training and other methods appropriate for the Manager's business.

5.2.2 The Chief Compliance Officer should have adequate resources to seek the advice of external experts on compliance matters when needed. This may be especially important where the Hedge Fund Manager operates in international markets outside the location of the Manager.

5.2.3 The Chief Compliance Officer should be able to devote sufficient time to the performance of his or her functions.

5.2.4 Employees should report all compliance matters to the Chief Compliance Officer or other designated staff.

5.2.5 In addition to a Chief Compliance Officer, other members of senior management may be appointed to oversee compliance in specific areas.

5.2.6 The Chief Compliance Officer should be involved in relevant aspects of the Hedge Fund Manager's business operations and all aspects of its 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, oversight, and enforcement, as appropriate, of policies and procedures and compliance monitoring.

Discipline and Sanctions

5.3

A Hedge Fund Manager should promptly and conclusively address any non-compliance with the policies or procedures described in the various parts of the compliance program.

5.3.1 To this end, policies and procedures may provide for the following:

- Non-compliance with the code of ethics or compliance manual should be internally reported to the Chief Compliance Officer according to the reporting procedures stated in these documents;
- Disciplinary responsibility generally lies with senior management. Accordingly, the Chief Compliance Officer should have access to and report to senior management and should recommend appropriate disciplinary action to senior management;
- The Chief Compliance Officer or general counsel should conduct an internal review of allegations or evidence of wrongdoing, as necessary; and
- A range of sanctions may be appropriate for non-compliance, such as (depending on the severity of the infraction and an employee's compliance history) reprimands, censure, suspension, termination, and, where applicable and practical, restitution, and disgorgement of profits.

Annual Compliance Review

5.4

A Hedge Fund Manager should review its compliance framework, including compliance policies and procedures, at least annually to assess its effectiveness.

5.4.1 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.

5.4.2 A more frequent review of aspects of the compliance framework is appropriate upon the occurrence of events that necessitate more immediate changes. Each component of the compliance framework should be reviewed by the Chief Compliance Officer in light of significant changes and factors relevant to the Hedge Fund Manager's business, such as:

- Legislative and regulatory developments;
- Changes in business practices;
- Variations in the Hedge Fund Manager's strategies and products;
- The growth of the Hedge Fund Manager's business; and
- Employee conduct.

5.4.3 In lieu of a one time annual review, a Hedge Fund Manager may consider conducting the review of its policies and procedures on a rolling basis throughout the year, or other appropriate schedule to ensure that they remain current.

Anti-Money Laundering

Although the Department of the Treasury has not issued rules for Hedge Funds and Hedge Fund Managers, Funds and their Managers should adopt and implement AML programs consistent with Section 352 of the USA PATRIOT Act as a matter of sound business practice. The AML program should be tailored to the business and operations of the Hedge Fund Manager including the nature and location of investors, relationships with third parties, and applicability of AML rules in non-U.S. jurisdictions.

Hedge Fund Managers 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 the recommendations in this chapter. Major institutions should find acceptable MFA's Model Anti-Money Laundering Attestations, attached as part of Appendix IV, which were developed in consultation with a wide range of major international financial institutions.

I. AML Framework

1.1

A Hedge Fund Manager should adopt a written AML program, which should be approved by senior management of the Hedge Fund or Manager.[9] As part of its AML program, a Hedge Fund Manager should adopt written policies and procedures that are designed to prevent and detect money laundering and any activity that facilitates money laundering, the funding of terrorist activities, or violations of OFAC regulations.

[9] *A sample resolution of the board of directors of a Hedge Fund Manager adopting policy statement against money laundering and terrorist financing is attached in Appendix IV.*

1.1.1 The basic elements of a Hedge Fund's AML program should include:

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

II. Senior Management

2.1

In addition to approving the AML Program, senior management of a Hedge Fund Manager should also designate an Anti-Money Laundering Compliance Officer and provide the officer with adequate authority and resources to effectively implement the Manager's AML program.

2.1.1 Senior management and the Anti-Money Laundering Compliance Officer should continue to be involved in the development, adoption, and enforcement of written AML policies, procedures, and controls to help ensure the efficacy of the Hedge Fund Manager's AML program.

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

- Coordination 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;
- In consultation with senior management, as appropriate, deciding whether to accept or reject an investor based on the money laundering risks that have been identified;

- In consultation with senior management, as appropriate, deciding whether to delegate the performance of investor identification procedures to a third party;
- 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.

2.1.3 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 responsibilities within the organization where money laundering activity could occur (*e.g.,* persons who are responsible for processing subscriptions and redemptions).

III. Investor Identification Policies and Procedures

3.1

As part of its AML program, a Hedge Fund Manager should establish and maintain Investor Identification Procedures that are reasonably designed to identify investors in its Hedge Funds, to the extent reasonable and practical.

3.1.1 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.

3.1.2 The Hedge Fund Manager's Investor Identification Procedures should further be based on the premise that the 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).

3.1.3 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.

3.1.4 A Hedge Fund Manager may wish to develop a due diligence checklist to facilitate the performance of Investor Identification Procedures.

3.1.5 Hedge 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.[10]

[10] *Sample provisions that could be included in subscription documents are attached in Appendix IV. The Hedge Fund Manager also may 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.*

3.1.6 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 ("SFPF/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.

3.1.7 In order to confirm the identity of a natural person investor, a Hedge Fund Manager should take reasonable steps to ascertain the investor's name and address, and, if applicable, social security number or taxpayer identification number. When funds are wired to the Hedge Fund Manager or the administrator from a financial institution located in a "*FATF jurisdiction*"[11] 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.

3.1.8 When a natural person 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.

[11] *An FATF jurisdiction is a country or territory that is in good standing with the FATF. 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).*

3.1.9 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, such a certification should be obtained.

3.1.10 In order to confirm the identity of a legal entity investor, 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. When 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.

3.1.11 When the legal entity 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.

3.1.12 When the legal entity 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), 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. In those circumstances when a Hedge Fund Manager believes that additional information from an investor is necessary to prove that it has implemented and complies with AML policies, procedures and controls, the Manager should treat such investor as a High Risk Investor;
- 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.

3.1.13 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. 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 management and the Anti-Money Laundering Compliance Officer.

IV. High Risk Investors

4.1

Prior to accepting an investment from an investor that the Hedge Fund Manager has reason to believe presents high risk factors with regard to money laundering or terrorist financing, the Manager should conduct enhanced due diligence with regard to the investor, in addition to standard Investor Identification Procedures.

4.1.1 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.

4.1.2 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;
- Private investment companies domiciled or with a principal place of business in a non-FATF juridiction;
- An 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 country or territory designated by FATF as a Non-Cooperative Jurisdiction;

- Any investor whose subscription funds originate from, or are routed through, an account maintained at a Prohibited Foreign Shell Bank, or an "offshore bank",[12] 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 USA PATRIOT Act;
- Any investor that is a Foreign Bank subject to enhanced due diligence under Section 312 of the USA PATRIOT Act;[13] or
- Any investor who causes the Hedge Fund Manager to believe that the source of its subscription funds may not be legitimate.

4.1.3 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 or legal entities:

- 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;
- Assessing the investor's business reputation through review of generally available media reports or by other means;

[12] *Here the term "offshore bank" refers to a non-U.S. bank that possesses 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.*

[13] *Foreign Banks subject to enhanced due diligence pursuant to Section 312 of the USA 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 (*e.g., *Non-Cooperative Jurisdictions); or (3) that are licensed in a non-U.S. country that has been designated by the Secretary of the Treasury as warranting special measures due to money laundering concerns, such as Section 311 special measures.*

- 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 or PEP is involved, taking reasonable steps to determine whether the funds are derived from political corruption;
- 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;
- For legal entities, reviewing recent changes in the ownership or senior management of the investor; and
- For legal entities, 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.

V. Prohibited Investors

5.1

Certain potential investors pose an unacceptable risk of money laundering or terrorist financing and a Hedge Fund Manager should identify those persons as Prohibited Investors and not accept any investment from or on behalf of such persons.

5.1.1 A Hedge Fund Manager should identify the following as Prohibited Investors:

- 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[14] as such lists may be amended from time to time;

[14] *All current OFAC lists may be accessed at* ***www.treas.gov/ofac.***

- An individual or entity who is from a country or territory prohibited by the OFAC sanctions programs;
- 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 Treasury under Section 311 of the USA PATRIOT Act as warranting special measures due to money laundering concerns; or
- A Prohibited Foreign Shell Bank (see below).

5.1.2 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.[15]

5.1.3 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: (1)(a) has a Physical Presence or (b) does not have a Physical Presence, but is affiliated with a regulated financial group; and (2) does not provide services to Prohibited Foreign Shell Banks.

VI. Risk-Based Monitoring of Investors

6.1

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.

[15] *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.*

Risk-Based Monitoring of Investors

6.1.1 Although Hedge Funds and Hedge Fund Managers are not currently required to monitor and report suspicious activity under Section 356 of the USA PATRIOT Act, FinCEN encourages Funds and Managers to file SARs voluntarily. Moreover, an offshore Hedge Fund or fund administrator may be required to file a comparable SAR under the laws of its own jurisdiction.

6.1.2 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, especially if the requests are that the proceeds be wired to unrelated third parties or bank accounts in foreign countries;
- 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 in which he or she purports to be engaged;
- 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 an expected investment strategy for a similarly situated investor (*e.g.,* investments of unexpected risk or duration), or exhibits a lack of concern regarding the investment program, related risks, the management team, or other attributes of the Hedge Fund's investment program;
- An investor attempts, with unusual frequency and absent exigent circumstances, to make investments, request redemptions, or transfer funds (taking into account the differences between direct investors and investor intermediaries, as appropriate);
- 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;
- 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.

6.1.3 Based on its own risk assessment, a Hedge Fund Manager should periodically review 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.

6.1.4 In addition, Hedge Fund Managers should consider conducting a review of publicly available databases on at least an annual basis in order to determine whether to continue the relationship.

6.1.5 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 reasonable reason for doing otherwise, 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 to make an exception and authorize such payment, 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.

6.1.6 In the event an investor makes a request for an early redemption, the Anti-Money Laundering Compliance Officer, in conjunction with senior management, should 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.

VII. Suspicious Activity Reporting

7.1

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.

7.1.1 A Hedge Fund Manager should seek to establish effective lines of communication for addressing suspicious activity detected by its Hedge Fund's fund administrator or another third party on which the 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 Manager's Anti-Money Laundering Compliance Officer of any suspicious activity relating to its Funds.

7.1.2 The AML program should 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.

7.1.3 The AML program should 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.

7.1.4 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.

VIII. OFAC Compliance

8.1

A Hedge Fund Manager should establish and maintain risk-based policies and procedures, in light of the nature of the Manager's business and the investment activities of its Hedge Funds, which are designed to comply with OFAC regulations.

8.1.1 OFAC regulations apply to all U.S. Hedge Funds and U.S. Hedge Fund Managers.

8.1.2 A Hedge Fund Manager's OFAC policies and procedures should establish criteria for the Manager to conduct risk-based diligence on parties with which the Manager or its Hedge Funds transact, which may include investors, intermediaries, counterparties and entities in which a Fund invests.

8.1.3 If a Hedge Fund Manager wishes to engage in a transaction with a party which resides in, is a citizen of, or has a principal place of business in, a country or territory named on the OFAC List, or that party's name appears on the OFAC List, 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.

8.1.4 A Hedge Fund Manager should consider whether it should request representations from a party with which it transacts stating that the counterparty is in compliance with applicable U.S. federal, state, or international AML laws and regulations.

8.1.5 Hedge Fund Managers should note one important distinction between AML rules and OFAC regulation with respect to investor diligence. OFAC guidance states that its requirements regarding diligence on investors extend to the beneficial owners of omnibus accounts established by an intermediary.[16]

8.1.6 A Hedge Fund Manager may delegate portions of its OFAC policies and procedures to a third party approved by the Anti-Money Laundering Compliance Officer (such as the fund administrator), subject to the Anti-Money Laundering Compliance Officer's satisfaction with the fund administrator's compliance procedures.

8.1.7 OFAC regulations do not provide a safe harbor from liability if a Hedge Fund Manager delegates responsibilities to another entity.[17] Responsibility for any outsourced parts of a Hedge Fund Manager's OFAC policies and procedures remains the responsibility of the Manager's senior management or its designees.

8.1.8 If the Hedge Fund Manager identifies assets which it believes may be subject to OFAC rules, the Manager should consult with external advisors about whether such assets should be frozen, appropriate regulatory authorities should be contacted, and any reporting obligations.

[16] *See OFAC Releases "Opening Securities and Futures Accounts from an OFAC Perspective" (November 5, 2008) and "Risk Factors for OFAC Compliance in the Securities Industry" (November 5, 2008).*

[17] *Id.*

IX. Performance of Anti-Money Laundering Procedures by Third Parties

9.1

A Hedge Fund Manager may decide to contractually delegate the implementation and operation of certain aspects of their AML program to other entities through which the company conducts its business. A Hedge Fund Manager that elects to delegate responsibility for aspects of the AML program continues to remain fully responsible for the effectiveness of the program.

9.1.1 Examples of entities to which a Hedge Fund Manager may elect to delegate include fund administrators, IAs, CPOs, CTAs, broker-dealers (including prime brokers), and futures commission merchants.[18]

9.1.2 Hedge Fund Managers often rely on third parties such as placement agents or asset aggregators for the introduction of investors to the Hedge Fund. Likewise, certain investor intermediaries, including funds of Hedge Funds and nominees, may invest in Funds 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.

9.1.3 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,

[18] *Consistent with this approach, Hedge Fund Managers typically delegate to a fund administrator the processing of subscription documents and compliance with AML laws and regulations applicable in the Hedge Fund's jurisdiction of organization. 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.*

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 a fund administrator, IA, CPOs, or CTAs.

9.1.4 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;[19]
- 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;

[19] *As used herein, the term "U.S.-regulated financial institution" includes institutions subject to the AML provisions of the USA 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 U.S.-regulated financial institution confirming the existence of a customer relationship and the performance of customer due diligence.*

- An investor intermediary, nominee, fund of Hedge Funds, or asset aggregator that is itself a U.S.-regulated financial institution; or
- An investor intermediary, nominee, fund of Hedge Funds, or asset aggregator that is itself a regulated foreign financial institution organized in a FATF jurisdiction.

9.1.5 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 Manager's AML policies and procedures (*e.g.,* determination of whether an investor is a Prohibited Investor), the Manager should either expressly 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.

9.1.6 Regardless of whether a Hedge Fund delegates its Investor Identification Procedures to an administrator, IA, CPO, 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 Fund investments should clearly allocate AML responsibilities between the third party and the Fund and its Hedge Fund Manager, as appropriate.

9.1.7 The Hedge Fund Manager should conduct due diligence with respect to the AML policies of the third party by familiarizing itself with such policies (for example, by obtaining a copy or a summary of the third party's AML policies) and determining whether the policies meet the standards set by the Manager.

9.1.8 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.

9.1.9 A Hedge Fund's agreement with its fund administrator should specifically allocate between the fund 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.[20] Sample representations and covenants that could be sought from fund administrators are included in Appendix IV.

9.1.10 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 Manager. Sample representations and covenants that could be sought from investor intermediaries in this regard are included in Appendix IV.

9.1.11 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).

9.1.12 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 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 regime of another jurisdiction, a Hedge Fund Manager may wish to review pronouncements of U.S. governmental agencies and multilateral organizations[21] regarding the AML laws and regulations in such other jurisdiction;

[20] *The Hedge Fund Manager may wish to seek amendments (in the form of a letter or otherwise) to its existing agreements with fund administrators.*

[21] *In this regard, a Hedge Fund Manager may wish to consult pronouncements and publications by FATF, FinCEN, and the State Department's INCSR Report.*

- 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.

9.1.13 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 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.
- 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, as well as its compliance with them as they relate to the Hedge Funds managed by the Hedge Fund Manager.

9.1.14 In the case of an intermediary or nominee, obtaining evidence of, or representations as to, its authority to make the contemplated investment.

X. Additional BSA Requirements

10.1

A Hedge Fund Manager's AML program should be designed to be broad enough to address additional applicable requirements under the BSA.

10.1.1 Given the close association between cash transactions and money laundering, Hedge Fund Managers 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.

10.1.2 Pursuant to both the USA 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.

10.1.3 The AML procedures should also address the responsibility of U.S. Hedge Funds and U.S. Hedge Fund Managers 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 sought guidance from the IRS with respect to the reporting rule and how it applies in various scenarios that commonly arise in the Hedge Fund industry.

10.1.4 The AML procedures should also address the responsibility of Hedge Funds and their Hedge Fund Managers 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.

XI. Employee Training Program

11.1

Employees of the Hedge Fund Manager should be generally informed of the AML policies and procedures adopted by the Manager, familiar with the substance and intent of the Manager's AML policy and procedures, and given appropriate training on how to implement their responsibilities under the Manager's AML program.

11.1.2 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.

11.1.3 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.

XII. Independent Audit

12.1

A Hedge Fund Manager's AML program should include an independent audit to assess compliance with and the effectiveness of its AML program. Based on the results of the independent audit, the Hedge Fund Manager should update its AML program as advisable or necessary.

12.1.1 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 Manager's compliance with applicable AML laws and regulations and the 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.

12.1.2 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.

12.1.3 Hedge Fund Managers 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 Funds managed. 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.

XIII. Recordkeeping

13.1

Hedge Fund Managers should establish procedures designed to ensure that all relevant documentation with respect to the AML program is retained for a period of at least five (5) years, or such longer period as may be required by applicable law or regulation.

13.1.1 A non-exclusive list of records that a Hedge Fund Manager should retain include:

- Copies of documents reviewed as part of the performance of its Investor Identification Procedures. A Hedge Fund Manager might require that these documents be retained for so long as an investor remains invested in one of the Manager's Hedge Funds 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 Identification Procedures' records retention policy:

  (i) Copies of documents reviewed in connection with Investor Identification Procedures or enhanced due diligence procedures;

  (ii) Investor identification checklists, if any, or similar due diligence documentation;

  (iii) Any other documents required to be retained by applicable AML legislation;

  (iv) The Hedge Fund Manager should maintain copies of all documentation, records, and communications relating to a reported transaction on behalf of each Hedge Fund, including all SARs and supporting documentation related to the SARs; and

  (v) Records of all AML training sessions conducted, including the dates and locations of the training sessions and the names and departments of attendees.

Business Continuity/Disaster Recovery (BC/DR) Principles

As a fiduciary, a Hedge Fund Manager, whether or not registered with any federal, state, or non-U.S. regulator, is subject to certain obligations to its clients, including among others, a duty of care. Such duty necessitates, among other things, that the Hedge Fund Manager reasonably provide for the continuation of its essential operations and services in the event of a natural disaster, market disruption, terrorist attack, loss of a key person, or business emergency. The following principles should be incorporated into a business continuity, disaster recovery, and crisis management plan ("BC/DR Plan").

I. General Principles

1.1

Any BC/DR Plan needs to be reasonably designed to: (1) identify and prioritize critical business functions; (2) protect the Hedge Fund Manager's personnel from harm; (3) permit the orderly continuation of the Manager's key business operations; (4) protect client assets; and (5) permit the Manager to maintain communications with clients, investors in any Hedge Funds it manages, regulators, and other parties as necessary in the event of a crisis or business disruption.

1.2

A Hedge Fund Manager should develop, implement, and test on a regular basis a comprehensive BC/DR Plan.

1.2.1 The BC/DR Plan should be tailored to the Hedge Fund Manager's individual operations, but needs, among other things, to provide clear written policies and procedures designed to facilitate the Manager's preparations for events that could have a significant effect on personnel, investment, administrative, and other essential elements of the Manager's operations.

1.2.2 In developing a BC/DR Plan, a Hedge Fund Manager needs to identify and replicate each of the systems and services central to its business and articulate business recovery and resumption objectives sufficient to enable the Manager to achieve the underlying purpose of the BC/DR Plan. Business continuity planning should be an integrated function of all material business decisions that are covered by the BC/DR Plan.

1.2.3 Sound business practices, as well as a Hedge Fund Manager's fiduciary duties to its clients, require that it maintain a process for responding to emergencies, contingencies, and disasters. There is no one-size-fits-all BC/DR Plan. Each BC/DR Plan should include long-term and short-term strategies and be tailored to fit the individual needs of a Hedge Fund Manager. BC/DR Plans should vary based on, among other things, a Hedge Fund Manager's size, nature, and complexity of its activities, the Manager's resources, and identified threats to the Manager's ability to conduct its business.

1.2.4 The situations that a comprehensive BC/DR Plan should address include, without limitation, the loss of key: (1) personnel; (2) facilities; (3) technology; and (4) equipment/service, due to:

- Natural disasters;
- Weather and geographic events predictable in the location(s) where the Hedge Fund Manager has offices;

- Fires;
- Acts of terrorism;
- Pandemics;
- Information technology system malfunctions or corruption; and
- Similar highly disruptive events.

1.2.5 At a minimum, the actions taken by a Hedge Fund Manager in developing its BC/DR Plan should include, to the extent applicable:

- Identifying and assessing all mission critical systems, financial assessments, operations, middle, back, and front office functions, equipment, and outsourced dependencies and relationships, the likelihood of a failure and minimum service requirements;
- Identifying and assessing credible risks and potential risks that could reasonably be expected to affect the Hedge Fund Manager's ability to conduct its business;
- Establishing back-up facilities and systems, that are, to the extent appropriate, located in one or more reasonably separate geographic areas from the Hedge Fund Manager's primarily facilities and systems (*e.g.*, primary and back-up facilities could be located in different areas and different power grids and different telecommunication vendors may be used), which may include arrangements for the temporary use of facilities, systems, and personnel provided by third parties;
    - Considering the identity, minimum number of staff, space, supplies, and equipment required at the recovery site;
    - Backing-up or copying essential documents and data (*e.g.,* general ledger, portfolio management systems) and storing the information off-site in either hard-copy or electronic format;[22]
    - Considering the potential business interruptions encountered by third parties and identifying ways to minimize their effects;

[22] *The BC/DR Plan should identify the documents and files that are backed-up, where the back-up copies are maintained, whether they are maintained in electronic or hard copy, and how often records are backed-up.*

- Considering how to comply with any required regulatory reporting;
- Developing a communication plan to contact essential parties such as employees, customers, brokers, service providers, disaster recovery specialists, and regulators; and
- Determining how the Hedge Fund Manager will safeguard or conduct the orderly liquidation of, its clients' funds and securities in the event the Manager determines that it is unable to continue its business.

1.2.6 A Hedge Fund Manager should identify potential contingencies and should conduct a business analysis to prioritize such contingencies and the response to them. The Hedge Fund Manager should consider the effects of various disasters and the risk of losing access to one or a group of the Manager's key systems and the maximum acceptable downtime and recovery time objectives for each system or function, as well as the potential effect on counterparties. When designating a maximum acceptable downtime, in addition to the importance of the underlying function, the Hedge Fund Manager may consider the likelihood of the disaster occurring, as well as a cost-benefit analysis of the different methods of addressing the risk. The BC/DR Plan should be scalable to deal with different scenarios and to address varying likelihoods of potential disruptions and combinations of potential effects.

1.2.7 In addition to considerations of maximum acceptable downtime and recovery time objectives, a Hedge Fund Manager should also consider data recovery point objectives that establish the data levels that the Manager needs to recover following an incident.

1.2.8 A Hedge Fund Manager should also consider creating checklists to follow in the event of a business disruption or evacuation both to allow critical functions to be operational in the short term and to assist in any system recovery and restarting the Manager's operations.

1.2.9 A Hedge Fund Manager should consider creating a matrix or similar mechanism for identifying each function, its importance, and the targeted recovery time and data recovery point in the event of a business disruption event.

1.2.10 An effective BC/DR Plan should allow, to the greatest extent practical, that appropriate personnel have the ability to monitor the Hedge Fund Manager's portfolio positions and execute transactions when necessary in the event of a market emergency or severe market disruption.

1.2.11 Depending on the Hedge Fund Manager's operations, risks, size and budgetary constraints, a Manager should make arrangements for use of alternative physical facilities, if the Manager's premises become unavailable. In considering arrangements for alternative physical facilities, the Hedge Fund Manager should consider the ability to recover technology and business processes, the maximum allowable recovery time, data recovery point objectives, and other pertinent considerations. For some Hedge Fund Managers this will include the establishment of an alternate facility, which may be a "hot site" or a "mirrored site". 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. Hedge Fund Managers should consider ensuring that designated personnel have access to appropriate equipment and communication facilities from home or other facilities in the case of short-term inaccessibility of the Managers' offices.

1.2.12 Consideration of the geographic impact of the potential threats identified by the Hedge Fund Manager, along with other appropriate considerations, should be given when selecting the geographic location of the alternate facilities.

1.3

A comprehensive BC/DR Plan requires that senior management dedicate resources sufficient to enable the Hedge Fund Manager to achieve the underlying purpose of the BC/DR Plan in terms of internal personnel (as appropriate), systems and equipment, and funding. If a Hedge Fund Manager does not have internal personnel and resources to achieve such purpose, the Hedge Fund should hire third-party experts and service providers to help establish and implement its BC/DR Plan.

1.3.1 Developing a BC/DR Plan requires the involvement of senior management personnel involved in various aspects of the Hedge Fund Manager's operations, including IT, treasury, accounting, trading, and operations.

1.3.2 A Hedge Fund Manager should designate one person with ultimate responsibility for developing, monitoring, and executing the BC/DR Plan.

1.3.3 Personnel roles and responsibilities with respect to the BC/DR Plan should be clearly defined.

1.3.4 A Hedge Fund Manager should determine whether it is necessary to use third-party service providers and vendors in establishing or implementing portions of the Manager's 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.

1.3.5 BC/DR Plans of a Hedge Fund Manager relying on a third party for any mission critical system should address that relationship and provide for the performance of such third party to be monitored.

1.4

In developing its BC/DR Plan, a Hedge Fund Manager needs to identify and replicate all systems the Manager reasonably requires so as to ensure the safety and preservation of the portfolio assets of its clients, including Hedge Funds it manages, near-uninterrupted operation of its investment activities, ongoing compliance with regulatory reporting requirements, and satisfaction of all contractual obligations essential to the operation of its business.

1.4.1 A Hedge Fund Manager should consider maintaining back-up power (*e.g.*, uninterruptible power supplies, generators) onsite in the event that its main power source is disrupted.

1.4.2 To the extent that its own personnel are not trained in providing redundant information technology and other services, a Hedge Fund Manager 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. A Hedge Fund Manager also may consider using outside vendors to back-up, copy, store, and protect its documents.

1.4.3 Hardware and telecommunications (*e.g.*, internet, phone) redundancy should be incorporated in the BC/DR Plan.

1.5

On at least an annual basis (and more frequently, as appropriate), a Hedge Fund Manager needs to conduct testing and provide training to its personnel on its BC/DR policies and procedures.

General Principles

1.5.1 A comprehensive BC/DR Plan is of no practical use if it cannot be implemented when needed. A BC/DR Plan may need to be implemented under situations of extreme stress and it is essential that the appropriate personnel be sufficiently versed with the specifics of the BC/DR Plan.

1.5.2 Training should ensure that all personnel understand how they and the Hedge Fund Manager will respond to events that have a significant effect on personnel, investment, and other key business operations. A summary of the BC/DR Plan should be included, as well as a discussion of the specific provisions applicable to all personnel, such as the evacuation process, alternative work locations and systems, contact persons, and employee alert and check-in systems.

1.5.3 A Hedge Fund Manager should consider providing additional training to personnel with key responsibilities related to the BC/DR Plan.

1.5.4 On at least an annual basis (and more frequently, as appropriate) and upon any material change to a Hedge Fund Manager's operations, the Manager needs to review and test its policies and procedures adopted as part of the BC/DR Plan to ensure that they are sufficient to achieve their intended purpose in light of applicable laws, regulations and rules[23], and other surrounding circumstances, that those policies and procedures can be implemented and performed as designed, and that all personnel understand their respective roles under the policies and procedures. A Hedge Fund Manager needs to update such policies and procedures, as necessary or appropriate, in light of such review and testing.

1.5.5 The level of testing activities should be commensurate with the importance of the relevant business process and the risk of disruption.

[23] E.g., *NFA Compliance Rule 2-38, NASD Rule 3510, or NYSE Rule 446.*

1.5.6 The test results should be compared to concrete recovery-time objectives and goals. Generally, recovery-time objectives and goals need not be regarded as hard and fast deadlines that must be met in every emergency situation. Various external factors surrounding a disruption such as time of day, scope of disruption, and status of critical infrastructure—particularly telecommunications—can affect actual recovery times.

1.5.7 A Hedge Fund Manager should consider periodically running firm-wide disaster scenarios to test the implementation of the BC/DR Plan.

1.5.8 Test plans, enactments of the plans (or elements thereof), and results should be adequately documented (noting effectiveness and any changes made as a result).

1.5.9 A Hedge Fund Manager should consider maintaining auditable track records of data protection activity in order to enable those responsible for system maintenance to ensure the protection of critical data and systems, and validate compliance with policies.

1.6

In developing, maintaining, and implementing its BC/DR Plan, a Hedge Fund Manager should appoint an oversight person or team of persons with overall responsibility for monitoring regulatory and reporting compliance requirements in the event of a disaster or unexpected interruption to business operations.

1.6.1 A Hedge Fund Manager may be subject to a number of reporting requirements with U.S. or international regulators. A regulator may not exempt a Hedge Fund Manager from regulatory and reporting requirements as a result of a disaster, particularly if the disaster is specific to the Manager or is limited to a small geographic area.

II. Contingency Planning, Crisis Management and Disaster Recovery

2.1

A Hedge Fund Manager's BC/DR Plan needs to include policies and procedures reasonably designed to ensure the continuity of business operations in the event of temporary or permanent loss of key personnel.

2.1.1 The BC/DR Plan should provide for the prompt disclosure of a key person event to clients, Hedge Funds, and other investors.

2.1.2 The BC/DR Plan should ensure compliance with any key person provisions that exist in any fund documents or agreements with investors or counterparties.

2.1.3 The BC/DR Plan should consider potential investor actions (such as withdrawals) in response to a key person event.

2.1.4 A Hedge Fund Manager should develop a succession planning protocol in the event of the loss of a key person.

2.1.5 Hedge Fund Managers may want to consider cross-training among its employees in order to ensure that its employees can perform all non-revenue generating functions that are minimally necessary for business continuity.

2.2

A Hedge Fund Manager's BC/DR Plan needs to include policies and procedures designed to: (1) protect and/or evacuate personnel in the event of a natural disaster, market disruption, terrorist attack, or similar situation, making the work environment unsafe; and (2) prepare employees in the event of such a situation making it impossible or inadvisable to reach or work out of the Manager's office.

2.2.1 A comprehensive BC/DR Plan addresses and prepares for: (1) the potential need to immediately evacuate the premises; and (2) any condition that makes the Hedge Fund Manager's offices unusable.

2.2.2 Hedge Fund Managers providing for alternate physical facilities should identify how many employees such facilities will accommodate and the facilities and services that will be available there. The Hedge Fund Manager should identify the minimum necessary employees to perform critical functions and which employees will be prepared to relocate to the alternate facility on at least a short-term basis. To the extent applicable, a Hedge Fund Manager should take into account the likelihood of employees relocating to an alternate physical facility located in a different geographical area, and may need to factor employees' families safety into its BC/DR Plan.

2.2.3 In the case of natural disasters that are predicted by weather forecasts, a Hedge Fund Manager should consider whether to "activate" its recovery site and/or system before the disaster occurs.

2.3

A Hedge Fund Manager's BC/DR Plan needs to include clear procedures with respect to communication with the Manager's personnel, clients, investors in any Hedge Funds managed by the Manager, service providers, and other third parties of importance to the operation of the Manager's business, which communication procedures contemplate a primary and back-up method of delivery (*e.g.*, telephone, email, or emergency contact communication).

2.3.1 An effective communication plan requires that a Hedge Fund Manager identify the essential parties of the communication plan. A Hedge Fund Manager should, therefore, maintain a list of key personnel and third parties and their contact information. For example, essential parties will typically include senior management, portfolio managers, risk managers, brokers and trading counterparties, legal and compliance officers, human resources, advisers (such as counsel and auditors), vendors, and disaster recovery specialists.

2.3.2 The BC/DR Plan should identify the process for contacting key persons. A Hedge Fund Manager should consider whether to include in its communication plan an instant or early notification to alert personnel and key outside parties of an actual or potential disruptive event or emergency.

2.3.3 The communication plan should include redundant methods of notification to alert personnel and key outside parties of an actual or potentially disruptive event or emergency, and to periodically update them about the status of the event or emergency.

2.3.4 A communication plan should include policies on email in the event of a disruptive event.

2.3.5 A Hedge Fund Manager should consider using its Web site (if it has one) or a toll-free telephone number to communicate to employees, investors, and other parties in the event of a disaster that significantly impacts the Manager's facilities.

2.3.6 A Hedge Fund Manager, particularly one that does not maintain alternate facilities in a different geographic area, should consider obtaining cell phones with area codes outside its geographic area, as well as laptops with wireless cards. Landlines within the impacted area and even cell phones with a local area code may not prove reliable in the case of a regional disaster. Similarly, call forwarding through local switching stations may prove to be unreliable.

2.3.7 A Hedge Fund Manager should consider establishing a check-in process to account for personnel, particularly for an evacuation or regional disaster (*e.g.,* terrorist attack, disease, or natural disaster).

2.4

A Hedge Fund Manager's BC/DR Plan needs to provide for both document and IT contingency arrangements that reasonably take into account geography, accessibility of records, security, environment, and cost. The BC/DR Plan needs to include policies and procedures for backing-up, copying, storing, and protecting hard and soft copies of documents essential to the Hedge Fund Manager's business operations, including records relating to regulatory requirements, trade records, and communications.

2.4.1 Appropriate personnel should receive adequate training in how to access data and records from a back-up location.

2.4.2 Data back-up and synchronization can vary in complexity based on the complexity of the Hedge Fund Manager's business, including, but not limited to, shorter acceptable outage periods, greater volume of data, and the distance between primary and back-up locations. Back-up procedures may be periodic (*e.g.*, once a day) or synchronous. If back-up copies are created only periodically, such as at end of day, then a Hedge Fund Manager should consider the potential data loss that could result from a disruption event that occurs towards the end of a day.

2.4.3 A Hedge Fund Manager should seek to ensure that back-up facilities have adequate physical security and access controls over data back-ups.

2.4.4 A Hedge Fund Manager that maintains client physical assets, such as stock certificates and checks, is subject to additional risks. A Hedge Fund Manager should take actions designed to ensure that such assets are maintained in a secure location that is capable of withstanding any reasonably anticipatable disasters. A real time inventory record of such assets should be maintained and such record should be backed-up in accordance with the Hedge Fund Manager's back-up procedures.

Contingency Planning, Crisis Management and Disaster Recovery

2.5

A Hedge Fund Manager needs to establish contingency plans for responding to the failure of its significant counterparties or service providers in the event of a disaster, market disruption, or other event triggering the application of the BC/DR Plan, and addressing, at a minimum, how such failure will affect the Manager's operational, investment, or other risk. Significant counterparties and service providers may include trading systems, brokers and prime brokers, banks, fund administrators (if applicable), clearing systems, data providers, offsite retention storage, credit providers, and other service providers.

2.5.1 A Hedge Fund Manager should identify the relationship with banks, brokers, fund administrators (if applicable), other service providers, and/or counterparties that are critical to its operations and should assess the effect that a significant disruption or disaster would have on key relationships.

2.5.2 A Hedge Fund Manager should be familiar with the BC/DR Plans of significant counterparties, service providers, and markets on which it regularly trades.

2.5.3 Contingency planning should address responses to a third party's failure to provide essential services, including the possible need to use alternate service providers.

2.6

A Hedge Fund Manager should be aware of and use, as appropriate, on an ongoing basis, resources available from federal and local governments and regulators, international regulators, and non-governmental agencies that gather and disseminate information regarding threats targeting the financial services sector and that provide information regarding threats to physical and cyber security.

2.6.1 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 BC/DR Plan. One such service is the Financial Services/ Information Sharing Alert Center ("FS/ISAC") at ***www.fsiac.com.***

2.6.2 The National Futures Association requires its member CTAs and CPOs to maintain a BC/DR Plan at ***www.nfa.futures.org.***

2.6.3 The SEC requires regstered investment advisers to maintain a BC/DR Plan at ***www.sec.gov/spotlight/continuity.htm.***

2.6.4 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

Italicized terms in *Sound Practices* are defined in the glossary. Terms contained in this glossary are defined for the purpose of *Sound Practices* and may have a wider or different meaning outside the context of *Sound Practices*.

AMC | Asset Managers' Committee of the PWG.

AMC Report | The PWG *Best Practices for the Hedge Fund Industry Report of the Asset Manager's Committee*, published January 15, 2009.

AML | Anti-money laundering.

Anti-Money Laundering Compliance Officer | The person appointed by senior management to administer the Hedge Fund Manager's AML program.

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.

BC/DR | Business continuity/disaster recovery.

BC/DR Plan | A business continuity/disaster recovery plan.

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.

Glossary

BSA | Bank Secrecy Act, as amended.

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

CEA | The Commodity Exchange Act, as amended.

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.

close associate of a SFPF/PEP | 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.

CMIR or FinCEN Form 105 | A form published by the U.S. Customs Service on a Report of International Transportation of Currency or Monetary Instruments.

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 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 (*e.g.,* rather than causing a termination of all transactions that are subject to a master agreement).

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.*

conflicts committee | A body within the Hedge Fund Manager that is responsible for reviewing and addressing potential conflicts.

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.

CPO or **commodity pool operator** | 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).

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. 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.

CTA or **commodity trading advisor** | 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).

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.

direct investor | An investor who invests in a Hedge Fund as principal and not for the benefit of any third party.

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.

Exchange Act | The U.S. Securities Exchange Act of 1934, 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.

FATF or **Financial Action Task Force** | 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***), and included in Appendix IV attached hereto.

FATF Jurisdiction | A country or territory that is a member in good standing of the FATF.

FinCEN | The Financial Crimes Enforcement Network of the U.S. Department of the Treasury.

foreign bank | 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.

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

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 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**.

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.

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 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 Twenty or G-20 | A group of Finance Ministers established in 1999 to bring together systematically important industrialized and developing economies to discuss key issues in the global economy.

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.*, Investment Company Act); (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.

High Risk Investor | An Investor that a Hedge Fund Manager has reason to believe presents high risk factors with regard to money laundering or terrorist financing.

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.

IA or **Investment Adviser** | Defined in the Investment Advisers Act 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 Advisers Act, 31 U.S.C. § 80b-2(a)(11).

IFRS | International Financial Reporting Standards.

illiquid instrument | See **liquidity**.

Immediate Family Member | With respect to a SFPF/PEP, a spouse, parents, siblings, children, and spouse's parents or siblings.

INCSR or **International Narcotics Control Strategy Report** | An annual report issued by the U.S. Department of State that assesses the money laundering risks of various countries and jurisdictions.

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.

Investment Advisers Act | The U.S. Investment Advisers Act of 1940, as amended.

Investment Company | 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).

Investment Company Act | The U.S. Investment Company Act of 1940, as amended.

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 Manager's exposure to criminal liability and reputational harm.

IRS | The U.S. Internal Revenue Service.

IT | Information technology.

key person | An individual, principal, or member of a Hedge Fund Manager'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 the Hedge Fund balance sheet positions to a 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, 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 securities 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 mark-to-market, daily, and additional margin may be required if the market value of a position declines.

mark-to-market | The accounting act of recording the price or value of a security, portfolio, account, or other financial asset to reflect its current market value rather than its book value.

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.

NCCT jurisdiction or **Non-Cooperative Jurisdiction** | 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 U.S. representative to the group or organization continues to concur.

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.

OFAC | The U.S. Department of the Treasury's Office of Foreign Assets Control.

OFAC List | The List of Specially Designated Nationals and Blocked Persons administered by OFAC, as such lists may be amended from time to time.

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.

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.

offshore bank | 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.

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.

Patriot Act or **USA PATRIOT Act** | The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act of 2001 (Pub. L. No. 107-56).

PEP or **Politically Exposed Person** | 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***).

Physical Presence | 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.

PIC or **Private Investment Company** | 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).

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 Investment Company Act.

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 Manager or with whom the 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.

Prohibited Foreign Shell Bank | A bank incorporated in a jurisdiction in which it has no physical presence and which is unaffiliated with a regulated financial group.

Prohibited Investor | (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; 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. Treasury under Section 311 of the USA PATRIOT Act as warranting special measures due to money laundering concerns; or (4) A Prohibited Foreign Shell Bank.

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.

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.

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.

RIA | Registered Investment Adviser.

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

SAR | Suspicious Activity Report.

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.

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.

SFPF or **Senior Foreign Political Figure** | (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 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).

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 achieving 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 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.

UICs or **Unregistered Investment Companies** | 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.

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

U.S.-regulated financial institution | Includes institutions subject to the AML provisions of the Patriot Act.

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 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).

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 Asset Managers' Committee recommendations titled *Best Practices for the Hedge Fund Industry Report of the Asset Manager's Committee,* published on January 15, 2009.
- 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.
- U.S. GAAP's Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 157, *Fair Value Measurements.*
- Investment Advisers Act of 1940.
- Commodity Exchange Act.
- Securities Exchange Act of 1934.
- USA PATRIOT Act of 2001.
- *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***).
- *Consultation Papers on Best Execution* (***www.fsa.gov.uk/pubs/cp/cp154.pdf***).
- *Bundled Brokerage and Soft Commission Arrangements* (***www.fsa.gov.uk/pubs/cp/cp176.pdf***).
- Financial Services/Information Sharing Alert Center (***www.fsisac.com***).
- National Futures Association (***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

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.***

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).

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.

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?

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.

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].

APPENDIX III

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 Chapter 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.[1] 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 used in financial markets for monitoring market risk—VAR, scenario analyses and stress tests, and back-testing;
- **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

[1] *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.*

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 by 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[2]—it is important to recognize that these risks are interrelated. Indeed, Hedge Fund Managers 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-

[2] *"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;

- **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).

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
Portfolio	*1*	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*
Summary Balance Sheet									
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

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;

- 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[3]

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

[3] *Parameter selection is only applicable for Variance/Covariance matrix.*

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).

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
Portfolio	*1*	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*
Summary Balance Sheet									
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
Risk Measures									
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.

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.[4] 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_j—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 σ_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.

[4] *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.

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.,* VAR/(Cash + 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
Portfolio	*1*	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*
Summary Balance Sheet									
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
Standard VAR (asset Correlation = 0.3)	2.50	2.50	3.76	3.76	5.01	3.61	3.61	2.50	2.50
Liquidity Measures									
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 leverage 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)

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 offsets 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

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
Portfolio	*1*	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*
Summary Balance Sheet									
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
Standard VAR (asset Correlation=0.3)	2.50	2.50	3.76	3.76	5.01	3.61	3.61	2.50	2.50
Leverage Measures									
Accounting-Based Measures									
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
Risk-Based Measures									
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%

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;

- **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 (Supplemental Material)

ANNEX A-1: Model MFA 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 United States 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 anti-money laundering procedures that are reasonably designed to be consistent with the anti-money laundering provisions of Managed Funds Association's *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 USA PATRIOT Act of 2001.

3. The RIA/FUNDS has adopted procedures reasonably designed to comply with the laws, regulations, and Executive Orders administered by the U.S. Treasury Department'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.

4. The RIA/FUNDS or its designee, including, as appropriate, the FUNDS' Administrator, will retain relevant documentation with respect to the investor/shareholder,[1] including identification information,

* *This Form can be used for all FUNDS introduced by an RIA, CTA, or CPO. This Form should be prepared on the letterhead of the RIA, CTA, or CPOs.*

[1] *The term "investor/shareholder," as used herein, means any "direct investor" or any intermediary or nominee that 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.*

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 Administrator[2]: _____

Name of Authorized Person: _____

Title: _____

Signature: _____ Date: _____

[2] *In appropriate circumstances, this representation letter may be signed by the Fund Administrator, and prepared on its letterhead.*

ANNEX A-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 (a) consistent with the anti-money laundering provisions of Managed Funds Association's *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 USA PATRIOT Act of 2001, and (b) 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[1], and will, in accordance with the laws of its own jurisdiction, take reasonable measures to identify all investors/shareholders.

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

* *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 a Registered Investment Adviser ("RIA"), the form for an RIA should be used.*

[1] *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.*

political figures[2]/politically exposed persons,[3] the preclusion of any prohibited foreign shell bank,[4] 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. Treasury Department's Office of Foreign Assets Control ("OFAC"), the United Nations, the European Union, and/or any other applicable jurisdiction's economic sanctions regime.[5]

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.

[2] *A "senior foreign political figure" is defined as (a) 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; (b) a corporation, business, or other entity that has been formed by, or for the benefit of, any such individual; (c) an immediate family member of any such individual; and (d) 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.*

[3] *A "politically exposed person" ("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. Business relationships with family members or close associates of PEPs involve reputational risks similar to those with PEPs themselves.*

[4] *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.*

[5] *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.*

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 Administrator[6]: _____

Name of Authorized Person: _____

Title: _____

Signature: _____ Date: _____

[6] *In appropriate circumstances, this representation letter may be signed by the Fund Administrator, and prepared on its letterhead.*

ANNEX B: 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 USA 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 applicableto the Manager and its Hedge Funds; (2) the specific risks presented by the investor base of the Funds it manages; (3) the Manager's relationships with its fund administrator and its investor intermediaries; and (4) the 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.

Hedge Fund Managers should also refer to Chapter 6 for further guidance in developing their AML policies, procedures, and controls. Unless otherwise defined, capitalized terms shall have the meanings ascribed to them in Appendix I.

[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. 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 (i) anti-money laundering compliance is the responsibility of every employee of the Hedge Fund Manager; and (ii) 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. 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.

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 USA 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.

D. Role of Senior Managment 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 should provide that the Anti-Money Laundering Compliance Officer determine whether to delegate the performance of investor identification procedures to a third party.

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 Manager should periodically review and update its AML policies and procedures.

F. Responsibilities of the Anti-Laundering Compliance Officer

This section should clearly identify the 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 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 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. 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 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

(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 Annexes A-1 and A-2.

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.

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 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 Funds it manages. To the extent that the Hedge Fund Manager relies on third parties to perform certain Investor Identification Procedures, 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

(2) Corporations, partnerships and comparable legal entities

(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. 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 and Blocked Persons administered by the U.S. Department of Treasury's Office of Foreign Assets Control ("OFAC")[1], 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;

[1] *OFAC's* List of Specially Designated Nationals and Blocked Persons may be accessed at ***http://www.treas.gov/offices/enforcement/ofac/***.

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 USA PATRIOT Act as warranting special measures due to money laundering concerns; or

d. A 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 include:

a. Investors not located in a FATF jurisdiction;

b. Non-U.S. private investment companies;[2]

c. A Senior Foreign Political Figure/Politically Exposed Person ("SFPF/PEP"), an immediate family member, or close associate of a SFPF/PEP;[3]

d. Any investor resident in, or organized or chartered under the laws of, a Non-Cooperative Jurisdiction;[4]

[2] *See definition of private investment companies in the "Bank Secrecy Act Anti-Money Laundering Examination Manual," Federal Financial Institutions Examination Council, at pg. 292 (2007):* ***http://www.ffiec.gov/pdf/bsa_aml_examination_manual2007.pdf.***

[3] *See definition of Senior Foreign Political Figure in the final rule implementing Section 312 of the USA PATRIOT Act, 31 C.F.R. § 103.175(r); see, also, definition of a Politically Exposed Person in the FATF 40 Recommendations Glossary at:* ***http://www.fatf-gafi.org/ glossary/0,3414,en_32250379_32236889_35433764_1_1_1_1,00.html#34285860.***

[4] *There are presently no countries or territories that have been designated by FATF as non-cooperative with international AML efforts ("NCCT jurisdictions").*

e. Any investor whose subscription funds originate from, or are routed through, an account maintained at a Prohibited Foreign Shell Bank, an "offshore bank"[5], 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 USA PATRIOT Act;

f. Any investor that is a foreign bank subject to enhanced due diligence under Section 312 of the USA PATRIOT Act[6]; 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

b. Legal entities

[5] *Here the term "offshore bank" refers to a non-U.S. bank that possesses 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.*

[6] *Foreign banks subject to enhanced due diligence pursuant to Section 312 of the USA 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 (*e.g.*, NCCT jurisdictions); or (3) that are licensed in a non-U.S. country that has been designated by the Secretary of the Treasury as warranting special measures due to money laundering concerns, such as Section 311 special measures.*

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.

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.

G. Risk Focused Reveiw 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.

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 Hedge Fund Managers 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.

III. SUSPICIOUS AND/OR CRIMINAL ACTIVITY MONITORING AND REPORTING

A. Suspicious Activity Monitoring

This section should address the fact that the Treasury Department encourages Hedge Funds and Hedge Fund Managers to file a SAR voluntarily. This section should also address offshore Hedge Funds and fund administrators who may be required to file a comparable SAR in accordance with the laws of their own jurisdiction.

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 SAR confidential. The statement should warn employees not to discuss the suspicious activity or the fact that it has been referred to the AML Compliance Officer with the investor concerned or any third party, except where requested by FinCEN or an appropriate law enforcement or regulatory agency.

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 (5) years.

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 Treasury Department 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 Fund and Manager remain fully responsible for the program. In addition, this section should provide that Hedge Fund Managers may rely upon Investor Identification Procedures being performed by third parties, such as placement agents or investor intermediaries (*e.g.,* fund of Hedge Funds and nominees who invest in Funds on their client's behalf).

B. Delegation of Elements of Hedge Fund Manager's Anti-Money Laundering Program to Third Parties – 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.

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. Such third parties may include placement agents, asset aggregators, or other financial institutions (*e.g.,* certain investor intermediaries, nominees, or funds of Hedge 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 Fund and its Hedge Fund Manager. See agreements with fund administrators and investor intermediaries attached hereto as Annexes C-1 and C-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.

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.

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.

VI. ADDITIONAL BSA REQUIREMENTS

A. Policy Relating to Cash and Cash Equivalents

This section should require Hedge Fund Managers 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 Hedge Fund Managers and Hedge Funds with respect to the receipt of one or more related cash or cash equivalent transactions that exceed $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.

B. Foreign Bank and Financial Accounts Report ("FBAR")

This section should set forth the responsibilities of U.S.-based Hedge Fund Managers and U.S.-based Hedge Funds 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.

C. Reports of Transportation of Monetary Instrument

This section should address the reporting responsibilities of Hedge Fund Managers and Hedge Funds 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 Report of Transportation of Currency or Monetary Instruments (FinCEN Form 105). This section should also address the legal prohibition against "structuring" in order to evade this reporting requirement.

VII. GENERAL RECORDKEEPING REQUIREMENTS

This section should set forth the general recordkeeping requirements for Hedge Fund Managers in those documents should be retained for a period of at least five (5) 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.

ANNEX C: Sample Provisions for Fund Administrators, Investor Intermediaries, and Subscription Documents

1. **Sample Provisions for Fund Administrators – Annex C-1**
2. **Sample Provisions for Investor Intermediaries – Annex C-2**
3. **Sample Provisions for Subscription Documents – Annex C-3**

ANNEX C-1: Sample Provisions for Fund Administrators

Below are examples of representations and covenants that a Hedge Fund Manager might seek from a fund administrator (an "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 an 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 laws of the jurisdiction in which 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. Unless otherwise defined, capitalized terms shall have the meanings ascribed to them in Appendix I.

(i) Provisions Related to the Fund Administrator's Anti-Money Laundering Program

- The 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 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 Administrator's AML policies, procedures, and controls into its agreement with the Administrator so that the Administrator's AML policies, procedures, and controls could only be amended with the consent of the Manager.]
- The 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 Administrator agrees to [annually] submit, at its own expense, to an independent audit by [the Hedge Fund Manager] [external auditors or other experts agreed by the Manager] to assess its compliance with and the effectiveness of its AML policies, procedures, and controls.

(ii) Provisions Related to Prospective Investors

- The 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 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 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:

    (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 Office of Foreign Assets Control ("OFAC")[1]

[1] *OFAC's list may be accessed at:* ***http://www.treas.gov/offices/enforcement/ofac.***

(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 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 Treasury under Section 311 of the USA 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 Administrator will conduct enhanced due diligence with regard to such High Risk Investor, [as provided by the Administrator's AML policies, procedures and controls] [as agreed upon between the Hedge Fund Manager and the 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. private investment company;

  (c) A Senior Foreign Political Figure or Politically Exposed Person ("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"[2], 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 USA PATRIOT Act;

(f) An entity that is a foreign bank subject to enhanced due diligence under Section 312 of the USA PATRIOT Act[3]; 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 Administrator and the Hedge Fund Manager agree that, absent any suspicious circumstances, the 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 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:

[2] *Here the term "offshore bank" refers to a non-U.S. bank that possesses 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.*

[3] *Foreign banks subject to enhanced due diligence pursuant to Section 312 of the USA 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 (*e.g., *NCCT jurisdictions); or (3) that are licensed in a non-U.S. country that has been designated by the Secretary of the Treasury as warranting special measures due to money laundering concerns, such as special measures under Section 311 of the USA PATRIOT ACT.*

- 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;[4]

- 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 regime]].

(iii) Provisions Related to Suspicious Activity

- The 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 Administrator reason to believe that the source of its subscription funds may not be legitimate.

- The 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.

[4] *The term "U.S.-regulated financial institution" includes any U.S. branch and 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.*

ANNEX C-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 Hedge 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: (i) the AML policies, procedures, and controls established by the Intermediary; (ii) the Hedge Fund Manager's own AML program; and (iii) the risks presented by a Hedge Fund's investor base; and (iv) 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. Unless otherwise defined, capitalized terms shall have the meanings ascribed to them in Appendix I.

(i) 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 investors ("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.

- [*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 (i) has all requisite power and authority from the Underlying Investors to execute and perform the obligations under the Subscription Agreement; (ii) has carried out Investor Identification Procedures with regard to all Underlying Investors; and (iii) 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].

(ii) 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.

(iii) 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 Office of Foreign Assets Control ("OFAC")[1], 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

[1] *OFAC's list may be accessed at:* ***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 Treasury under Section 311 of the USA PATRIOT Act as warranting special measures due to money laundering concerns; or

(d) A Prohibited Foreign Shell Bank.

(iv) 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. private investment company;
- A Senior Foreign Political Figure or Politically Exposed Person ("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"[2] 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 USA PATRIOT Act;

- An entity that is a foreign bank subject to enhanced due diligence under Section 312 of the USA PATRIOT Act;[3] or
- An individual or entity who gives the Intermediary reason to believe that the source of its subscription funds may not be legitimate.

(v) 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.

[2] *Here the term "offshore bank" refers to a non-U.S. bank that possesses 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.*

[3] *Foreign banks subject to enhanced due diligence pursuant to Section 312 of the USA 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 (*e.g., *NCCT jurisdication); (3) are licensed in a non-U.S. country that has lbeen designated by the Secretary of the Treasury as warranting special measures due to money laundering concerns, such as a special measures under section 311 of the USA Patriot ACT.*

ANNEX C-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. Unless otherwise defined, capitalized terms shall have the meanings ascribed to them in Appendix I.

(i) 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.

(ii) Provisions Relating to Purpose of Investment

For an investor investing for its own account:

- Investor is subscribing for shares in the [applicable Hedge 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.[1]
- 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.

[1] *The term "person" means any nominee account, beneficial owner, individual, bank, corporation, partnership, limited liability company, or any other legal entity.*

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 Hedge Funds (each, an "Intermediary"):

- The Intermediary is subscribing for shares in the [applicable Hedge Fund(s)] as a record owner in its capacity as [agent/representative/nominee] on behalf of one or more investors ("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, holds evidence of such identities [and will make such information available to the Hedge Fund Manager upon request].

(iii) Provisions Relating to Prohibited Investors

- Investor acknowledges that the Hedge Fund Manager prohibits any investment in the Hedge Fund by or on behalf of the following persons (each, a "Prohibited Investor"):

  (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 Office of Foreign Assets Control ("OFAC")[2] as such lists may be amended from time to time;

[2] *OFAC's list may be accessed at* ***http://www.treas.gov/offices/enforcement/ofac/.***

(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 mandated by applicable U.S. law or regulation consider specifying other lists to be verified];

(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 Treasury under Section 311 of the USA 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 Hedge 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 Hedge Fund(s)], the Hedge Fund Manager, the fund administrator or [the applicable Hedge Fund(s)] reasonably believes that investor is a Prohibited Investor [or has otherwise breached its representations and covenants [hereunder/as to its identity]], the 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 Hedge Fund(s)], and it shall have no claim against the Manager, the fund administrator or [the applicable Hedge Fund(s)] for any form of damages as a result of any of the aforementioned actions.

- 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 Hedge Fund(s)] reasonably believes it does not have satisfactory evidence of the investor's identity.

(iv) 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. private investment company;

  (c) It is not a Senior Foreign Political Figure or Politically Exposed Person ("SFPF/PEP"), any member of a SFPF/PEP's Immediate Family, or any close associate of a SFPF/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 Treasury under Section 311 of the USA 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 USA PATRIOT Act;[3]

(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"[4], 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 USA PATRIOT ACT; 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 Hedge Fund(s)] was originally remitted, unless [the Anti-Money Laundering Compliance Officer, in his/her 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 Hedge Fund(s)] to do so.

[3] *Foreign banks subject to enhanced due diligence pursuant to Section 312 of the USA 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 (*e.g., *NCCT jurisdication); (3) are licensed in a non-U.S. country that has lbeen designated by the Secretary of the Treasury as warranting special measures due to money laundering concerns, such as a special measures under section 311 of the USA Patriot ACT.*

[4] *Here the term "offshore bank" refers to a non-U.S. bank that possesses 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.*

ANNEX D-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 substantially 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 substantially 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.

ANNEX D-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 E: Members of Financial Action Task Force on Money Laundering ("FATF")

1) Argentina
2) Australia
3) Austria
4) Belgium
5) Brazil
6) Canada
7) China
8) Denmark
9) Finland
10) France
11) Germany
12) Greece
13) Hong Kong
14) Iceland
15) Ireland
16) Italy
17) Japan
18) Luxembourg
19) Mexico
20) Kingdom of the Netherlands
21) New Zealand
22) Norway
23) Portugal
24) The Russian Federation
25) Singapore
26) South Africa
27) Spain
28) Sweden
29) Switzerland
30) Turkey
31) United Kingdom
32) United States

Please Note: The list of FATF members is amended periodically. FATF members are not *per se* FATF jurisdictions.

ANNEX F: List of FATF Non-Cooperative Jurisdictions ("NCCT 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: ***http://www1.oecd.org/fat***f.

Please Note: The list of Non-Cooperative jurisdictions is amended periodically. For a current list of Non-Cooperative jurisdictions, please refer to the FATF website at: ***http://www.fatf-gafi.org/pages/0,2987,en_32250379_32235720_1_1_1_1_1,00.html.***

ANNEX G: Lists Maintained by the Office of Foreign Assets Control ("OFAC")

A. Persons and Entities Subject to OFAC Sanctions

See list of "Specially Designated Nationals and Blocked Persons" at: ***http://www.treas.gov/offices/enforcement/ofac/.***[1]

B. Countries Subject to OFAC-Administered Sanctions as of March 2009[2]

1. Belarus
2. Cote d'Ivoire (Ivory Coast)
3. Cuba
4. Democratic Republic of the Congo
5. Iran
6. Iraq
7. Liberia
8. Myanmar (aka Burma)
9. North Korea
10. Sudan
11. Syria
12. Western Balkans
13. Zimbabwe

Please Note: These lists are amended periodically. For current OFAC lists, please refer to the OFAC website at: ***http://www.treas.gov/offices/nforcement/ofac/.***

[1] *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.*

[2] *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. Hedge Fund Managers should consult with their counsel regarding compliance with regulations promalgated by OFAC.*

ANNEX H: Money Laundering Advisories Issued by the Financial Crimes Enforcement Network ("FinCEN") of the Department of the Treasury

As of March 2009, FinCEN has issued advisories with regard to deficiencies in the anti-money laundering regimes of the following jurisdictions:

1) Belarus

2) Burma (Myanmar)

3) Nauru

4) North Korea

Please Note: FinCEN Advisories with regard to the anti-money laundering regimes in certain jurisdictions are issued and withdrawn by 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 website at: ***http://www.fincen.gov/.***

ANNEX I: 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. Treasury as being of "primary money laundering concern" and are currently subject to special anti-money laundering measures under Section 311 of the USA PATRIOT Act. An updated list of such countries and financial institutions is available at: ***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. 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: ***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)

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	
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). Reports are filed in response to notices issued by the U.S. Department of Treasury if such threshold is met.

continued

Federal Reserve Bank	
	Reports are filed with the Federal Reserve Bank of New York and are not public.
2. Form T FC-1	Report of weekly, consolidated data on foreign exchange contracts and positions of major market participants. 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. The reports are filed with the appropriate Federal Reserve Bank acting as agent for the U.S. Department of Treasury and are not public.
3. Form FC-2	Report of monthly, consolidated data on the foreign exchange contracts and foreign currency denominated assets and liabilities of major market participants. 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. The reports are filed with the appropriate Federal Reserve Bank acting as agent for the U.S. Department of Treasury and are not public.
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	
	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	
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	
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

Federal Reserve Bank	
	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.
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.
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	
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	
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	
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

Securities and Exchange Commission	
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.
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	
	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	
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

Securities and Exchange Commission	
Material Associated Persons of Registered Broker-Dealers	
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	
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

Securities and Exchange Commission	
	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.
Commodity Futures Trading Commission and National Futures Association	
Commodity Trading Advisors ("CTAs") and Commodity Pool Operators ("CPOs")	
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,

continued

Commodity Futures Trading Commission and National Futures Association

"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

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

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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-

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	tiality may be requested for certain information relating to the principals.
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.
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.
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.
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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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.
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

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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.
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.
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

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	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. The annual report is filed with NFA and distributed to each investor and is not public.
25. Form 40	"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). The form is filed with the CFTC and is not publicly available.
26. Form 102	Form 102 is filed pursuant to CFTC Regulation 17.01 by clearing members, futures

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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.

Selected Stock and Futures Exchange Reports

Application for Exemption from Speculative Position Limits

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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	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.
Federal Trade Commission and U.S. Department of Justice	
Filings Made Prior to Mergers and Acquisitions	
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

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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).[1] 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.

[1] *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.

* *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.

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.*

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[1] 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.

[1] *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***)*; and*
- SEC final rule release on the Investment Adviser Code of Ethics (***www.sec.gov/rules/final/ia-2256.htm***)*.*