

January 15, 2009

The Asset Managers' Committee to the President's Working Group on Financial Markets ("AMC") is releasing today the final version of Best Practices for the Hedge Fund Industry (the "Report"), which are a set of comprehensive best practices for asset managers that are designed to answer the call of the President's Working Group on Financial Markets ("PWG") to reduce systemic risk and foster investor protection.

During the period in which we drafted, received comments and finalized the Report, global markets entered a period of tremendous stress. While we do not yet know the full impact of this stress on the financial system, we recognize that it will be significant for all market participants, including hedge funds. Substantial discussion and debate by policymakers on how to address these challenges is underway. While no set of best practices can provide solutions to the complex issues facing the financial industry today, we believe that regardless of the results of that debate, the promotion of robust industry practices, such as those set forth in the Report, will be critical to and consistent with the goal of reducing systemic risk.

We believe that the Report's framework for business practices and controls, which includes checks and balances and appropriate use of third-party service providers, provides strong protection for investors. In particular, this Report also recommends that all hedge funds employ qualified, independent auditors, and should thoroughly investigate the qualifications of all service providers to the fund, including custodians, prime brokers (which will often provide custodial services) and, where applicable, third-party administrators. We believe that, when taken together with the recommendations in the Investors' Report, which stresses that investors review critical third-party service providers as part of the diligence process, the goal of protection of investors and their assets will be well-served.

I. Introduction

The AMC, which comprises institutional alternative asset managers representing diverse strategies and perspectives, was formed as a private sector committee by the PWG in September 2007. Our first task was to develop guidelines that define best practices for the hedge fund industry.

We undertook an extensive process to produce the Report in which we drew upon the strong and effective practices of many managers and on the existing recommendations for sound industry practices developed by a variety of other groups. We also met with various members of the financial services industry to receive input and discuss their perspectives. As is described in more detail in the Executive Summary of the Report, we considered these sources and the practices in place in other industries in order to introduce innovative and far-reaching practices that exceed existing industry-wide standards and raise the bar for even the largest and most sophisticated hedge fund managers.

On April 15, 2008, we released a draft of the Report and provided a 60-day period for comments from industry participants and other interested constituencies through a publicly available website. We believe that it was important to our efforts to produce industry best practices with the greatest level of input possible. During the comment period, members of the AMC and our representatives, as well as representatives of counsel to the AMC, participated in various forums, designed to raise awareness of the Report, including speaking at a number of industry conferences and participating in small industry get-togethers in order to facilitate and encourage input on the Report.

We received formal letters from eleven commenters, some with general comments and many with specific comments. Most of the comment letters expressed general support for the efforts of the AMC and for the Report itself. We appreciate the thoughtful comments we received, and we have amended the Report in certain respects to reflect those comments that we believe further the fundamental goal of the best practices to reduce systemic risk and foster investor protection. We also incorporated certain comments that were intended to clarify parts of the Report that commenters felt needed greater clarification. This letter sets forth a summary explanation of our consideration of the principal comments received in the release of the final Report.

II. Implementation

The Executive Summary of the Report calls for all managers to carefully assess their specific practices against the practices in the Report and adopt the best practices applicable to their business. It notes that what is critical is that managers are able to explain to investors how they have implemented and adopted the practices in the Report.

One commenter suggested that the Report state that the purpose of adopting best practices lies with the adoption of the frameworks as principles and not necessarily with adoption of specific best practices.¹ Another commenter specifically requested the Report include an affirmative statement that “simply because a manager does not follow a particular best practice does not necessarily mean the manager has a poor or weak compliance program”.² On the other hand, another commenter recommended requiring full adoption of a “comprehensive set of ethical and professional industry standards” rather than permitting managers to “pick and choose among recommendations”, which arguably leads to variable compliance.³

¹ Amber Partners, Ltd. (hereinafter, the “Amber Partners letter”).

² Managed Funds Association (hereinafter, the “MFA letter”).

³ CFA Institute Centre for Financial Market Integrity (hereinafter, the “CFA Institute letter”). *See also* the Association of British Insurers (hereinafter, the “ABI letter”), which calls for adoption of a “comply or explain” ethos and notes that the Report is “less strong ... in how decisions by the asset manager to depart from full adherence are to be reached, reported on and justified to investors.”

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. Moreover, in order to raise the bar for even the largest managers, the Report includes some best practices that smaller managers may be unable to adopt, especially at inception, but which the AMC believes will provide helpful guidance and direction as these managers build and develop their businesses. 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.

The standard for implementation nevertheless extends beyond principles to the specific best practices and requires that a manager that does adopt a different practice be prepared to explain its rationale to investors in light of its business.

The AMC considered the comments received on implementation and continues to believe that the Report strikes the right balance. Therefore, we have not made any changes to the discussion of the application of the best practices to managers or how managers should implement the best practices in the Report.

III. Investor Interests

One commenter noted that the Report should promote a commitment to transparency and openness to investors.⁴ We believe that the Report supports this important commitment. The Report provides that managers should develop a disclosure framework that makes clear to investors what types of information they will be receiving, and on how frequent a basis, and notes that a robust disclosure framework is critical to the protection of investors' interests. The Report also notes that the framework should be designed to disclose information to investors in a manner that enables them to make informed decisions regarding investments in the fund and appropriately monitor or manage risks associated with exposure to the fund.

One commenter suggested that the priority of clients' interests should be referenced more prominently in the Report and should be discussed in a separate, dedicated section.⁵ This comment is consistent with one of the underlying principles of the Report that the manager should act in the best interests of the fund. To give additional emphasis to this point, we have added a specific sentence to the discussion of the code of ethics to this effect. We do, however, believe that the Report as a whole is clearly consistent with the commenter's point and therefore we have not included a separate, dedicated section, nor have we included specific reference to the investor's perspective in all sections.

⁴ ABI letter.

⁵ CFA Institute letter.

IV. Due Diligence

We received a comment noting that the Report and the Investors' Report should be more consistent in terms of due diligence expectations.⁶ Specifically, the commenter noted that it viewed the list of expectations compiled by the Investors' Committee as exceeding that included by the AMC in the Report. Although there were collaborative efforts by the two committees on the reports, we note that the two reports were not aimed at the same audience or focused on the same issues. We think it is reasonable that the Investors' Committee Report would provide its investor audience with issues investors should consider in conducting due diligence in light of their own investment profiles. From the manager's perspective, and as reflected in the Report, we think the focus should be on a clear statement by managers about the information that they will provide, consistent with the best practices, so investors can make an informed decision as to whether or not to invest.

One commenter's letter noted that peer groups and indexes are unreliable for evaluating hedge fund performance and recommended using Monte Carlo simulations for performance evaluations.⁷ We believe that the Report encourages reporting to investors that exceeds current industry practices, including a qualitative discussion of fund performance from the manager's perspective that will help investors to better understand a fund's financial performance during the relevant period of time. However, the evaluation techniques that investors use and the specific issues raised in this comment letter are outside the scope of the Report.

V. Disclosure/Reporting Requirements

Most of the specific comments received related to the best practices for disclosure and reporting. For convenience of review, we have made an effort to group them under sub-headings.

Monthly Reports

One commenter suggested that managers should report performance information and risk metrics at least monthly rather than quarterly.⁸ With respect to all disclosures, the Report provides that managers should develop a disclosure framework that makes clear to investors what types of information they will be receiving and on how frequent a basis. We would expect that, in many cases, a manager will determine that providing certain information on a monthly basis is appropriate. However, it may also be the case

⁶ Albourne Partners, Ltd. (hereinafter, the "Albourne letter").

⁷ Letter by Mr. Ron Surz of PPCA Inc. and RCG Capital Partners, LLP.

⁸ Albourne letter.

that quarterly reporting is appropriate in light of a manager’s investment strategy, portfolio, or any other characteristic of the manager’s business or fund’s profile.

In light of this comment, we have decided to amend the best practices to note that, with regard to risk information, monthly reporting is preferable. With regard to performance-related financial information, we have amended the best practices to suggest that quantitative information regarding estimated fund performance be provided at least on a monthly basis and that a NAV calculation to each investor should be provided preferably on a monthly basis.

PPM Annual Updates

One commenter suggested that the Report provide that private placement memorandums (“PPMs”) be updated on a regular basis, regardless of whether a material change occurs, and regardless of whether a fund is open or closed to investments.⁹ While nothing in the Report precludes that approach (as part of the disclosure framework that the Report states that managers should create), we believe the principle behind this comment is fully addressed by the list of ongoing information that the Report recommends as best practices. With respect to funds open for investment, we believe this comment is also already addressed, but have made a clarifying change to the Report to emphasize the responsibility of managers to update.

Specific Event Reporting

One commenter suggested removing the materiality clause from the practice of specific event reporting.¹⁰ This commenter noted that the list of examples included in the Report for specific event reporting are likely items that investors would consider material. This same commenter also noted that the Report could urge managers to make certain disclosures without suggesting that managers do so only if the disclosure will not compromise the fund’s competitive position.¹¹ We believe the impairment of a fund’s competitive position is a legitimate concern from the perspective of both managers and investors and the Report appropriately allows managers to balance the requirement of disclosing information to investors with the necessity of protecting the fund’s competitive position. In addition, we believe that the concept of materiality is widely accepted, including in the public company context that formed the inspiration for some of the elements of the disclosure best practices, and is important to the effectiveness of communications between managers and investors. We, therefore, did not make a change to reflect these comments.

⁹ CFA Institute letter.

¹⁰ CFA Institute letter.

¹¹ CFA Institute letter.

Reporting Standards

One commenter suggested that the Report fails to discuss investment performance and should also encourage fund managers to comply with the Global Investment Performance Standards (“GIPS”).¹² We believe that in fact investment performance is covered by the Report’s discussion of reporting. The Report does not prescribe the documents or format in which the information should be conveyed, but includes investment performance as an example of information that would be expected to be included in investor letters. In addition, during the course of developing the best practices, we discussed suggestions for specific standards in the context of reporting and other areas of the Report. We continue to believe the Report should not endorse one particular methodology, which may not be well suited to every manager’s strategy, but instead should encourage managers to set forth clear disclosure frameworks that take account of their strategies and portfolios so that investors understand how performance information will be conveyed. Accordingly, the Report has not been amended to recommend manager compliance with GIPS.

Another commenter advocated setting industry standards for reporting to investors, recommending that particular formats be developed to create greater transparencies and efficiencies.¹³ While such a suggestion might be helpful, we believe that it is not practical and that the diversity of managers and strategies would make such a standard virtually impossible to create in a way that would be meaningful for all managers and firms. Accordingly, we believe the best approach is the one taken by the Report to establish broad standards for reporting information to investors.

Risk Factors

One commenter recommended that the Committee should add the following to its list of recommended disclosures of risk factors: (a) investors are relying on the discretion of the manager and have no ability to make investment decisions, and (b) the manager has flexibility in allocating investments by the fund among the strategies and investment instruments to the extent disclosed in the PPM.¹⁴ We agree that if these risk factors are applicable to a fund, a manager should include them. We have amended the text of the Report accordingly.

This same commenter suggested that a fund’s PPM should adequately disclose the risks associated with the manager’s discretion in implementing investment strategy, risk exposure, and leverage, and that, therefore, additional disclosure should be recommended

¹² CFA Institute letter.

¹³ Mr. Seth Berlin’s letter.

¹⁴ MFA letter.

only when there is a significant shift in these key areas.¹⁵ We believe the Report adequately qualifies disclosure requirements by requiring that the information be material. We do, however, note that the best practices for reporting encourage managers to update investors about significant shifts in investment strategy or key risk exposures through investor letters or other similar communications (Disclosure section, subsection II.2(a)(i)).

Conflicts of Interest

One commenter recommended that the definition of “parallel managed accounts” should be narrowed to include only situations in which an investor invests in substantially similar strategies and in substantially similar investments as a fund but through a separate account.¹⁶ We believe this is consistent with our original intent and accordingly have amended the “parallel managed account” definition to make this clear.

The same commenter recommended that in addition to the disclosure suggested for parallel managed accounts, managers should disclose “material conflicts of interest that may arise when a manager has multiple client accounts with overlapping mandates or investment strategies.”¹⁷ We point out that this is mentioned in the Compliance, Conflicts and Business Practices section, subsection III.C.

Single Dealer Quotes

The Report provides that managers should consider disclosing the percentage of the value of the fund’s portfolio for which only one quote was relied upon and the percentage for which multiple quotes were relied upon (Disclosure section, subsection II.2(e)). One commenter noted that this disclosure of single dealer quotes could be misleading to investors, and therefore, the Committee should consider deleting this recommendation.¹⁸ We do not think disclosure of this information is misleading to investors. We believe that providing this information will be useful to investors in relation to the valuation of a fund’s portfolio. If for some reason a manager believes that more clarity is needed, for example, because the product is one for which single dealer quotes are used even though there is a liquid, active and deep market, managers are free to include whatever additional explanations they consider necessary to supplement the disclosure. This is one of the many areas in which the AMC intentionally sought to go beyond current practice and we would view deletion of this best practice as inconsistent with the AMC’s goals for the Report.

¹⁵ MFA letter.

¹⁶ MFA letter.

¹⁷ MFA letter.

¹⁸ MFA letter.

Side Letters

One commenter noted a discrepancy between the AMC's recommendation and the Investment Committee's recommendation regarding disclosure of side letters.¹⁹ The Report calls for managers to disclose the material terms of side letters whereas the Investors' Committee Report, at least in one place, suggests investors should request the full letters. The AMC does not mandate a single approach, but rather recommends as a baseline best practice that the material information in any side letter be conveyed to investors. We believe that many investors may not actually request the letters and, if so, they can be left without important disclosure that can impact their investment. Accordingly, we chose an approach that we believe provides meaningful disclosure to investors. We note that the commenter agreed with the approach in our Report.

Valuation Disclosure and FAS 157

One commenter noted that the Report's recommendation of including a discussion of the elements of a manager's valuation policy in the PPM was unclear.²⁰ We believe it was our original intent to suggest that material elements of a manager's valuation policy should be disclosed and have made a clarifying change to the Report.

Two commenters remarked that the Report's FAS 157 disclosure requirements may prove to be "unduly burdensome" and difficult to achieve given "the lack of consensus among industry participants as to the appropriate treatment of a number of products under FAS 157".²¹ We feel that in light of the fact that managers will be required to comply with and make disclosures pursuant to the levels set forth in FAS 157, the recommendations in the Report are appropriate. Although the Report's best practices exceed FAS 157's disclosure requirements, we emphasized that we understand it may take time for managers to implement. Furthermore, we note that to the extent a manager believes that inconsistent application of FAS 157 could make disclosure potentially misleading or confusing, managers are free to supplement the disclosure by explaining the types of instruments that are in each category to minimize confusion.

VI. Valuation

In addition to the comments noted above relating to disclosure of valuation policies and FAS 157, there were several specific comments regarding valuation. These comments generally related to issues of independence and use of third-party administrators, segregation of functions and valuation policies.

¹⁹ MFA letter.

²⁰ MFA letter.

²¹ Amber Partners letter; MFA letter.

One commenter highlighted the divergent views between the Asset Managers' Committee Report and the Investors' Committee Report on the delegation of valuation to third parties.²² We agree with the commenter that in fact there are differences in how industry participants view the role of third-party administrators. From the perspective of providing guidance to managers, we note that the Report simply emphasizes the need for a manager to be responsible for its chosen valuation process.

One commenter noted that an independent valuation process is of the "utmost importance" in reducing the risk of fraud.²³ We agree that there must be an established system of segregation of functions and controls to address the conflicts that must be mitigated in the valuation process. We also agree that a third-party administrator's independence in this regard may be valuable. Again, the Report simply emphasizes the need for a manager to be responsible for its chosen valuation process. In drafting the Report, the AMC did not want investors to take undue comfort in valuations provided by the administrator. Managers should make sure to maintain the appropriate level of independence in their valuation process and should remain responsible for the process.

One commenter observed that the recommendation in the Valuation Section, subsection II.3, suggesting segregation of valuation personnel from portfolio management personnel, is confusing.²⁴ It was our original intent to state that the implementation of valuation policies should be effected by a "valuation function" that would consist of knowledgeable, qualified internal personnel or a qualified third party and would be separate from the portfolio management function. We did not intend to suggest that portfolio management personnel could not be members of the Valuation Committee. We believe that portfolio management personnel may be involved in valuation analysis and methodology given their expertise in certain positions. Therefore, we have clarified this in the Report.

One commenter suggested that the Report should include "more detailed valuation guidance" and should refer to third-party valuation specialists when referencing hard-to-value assets.²⁵ We believe there is great variation within the realm of valuation methodologies, especially given the wide range of investments made by different managers, and that more detailed guidance would not be feasible in the context of this Report. Moreover, as discussed above, we agree that managers may consider using third-party valuation specialists in certain circumstances, but should ultimately remain responsible for all valuations.

²² MFA letter.

²³ Amber Partners letter.

²⁴ MFA letter.

²⁵ The commenter wished for its identity to remain confidential.

This same commenter also recommended that the Report should propose that the Valuation Committee’s functions include approving final valuations of a fund’s portfolio.²⁶ We note that the Report already does so in the Valuation section, subsection I.2(b)(iv).

One commenter suggested that the Committee qualify its recommendations regarding valuation method consistency in the event of an illiquid market.²⁷ We agree that managers should have as part of their valuation framework an approach for dealing with changes in inputs or market conditions, including illiquid markets. We have therefore amended the Report to clarify this.

One commenter noted that a manager may elect to include certain specifics (such as pricing sources) in an internal reference guide rather than as part of its formal valuation policy, and the Committee should amend the Report reflecting this change.²⁸ We believe that the inclusion of certain types of information in the formal valuation policy, particularly to the extent that it relates to process rather than general policy, may not be required. However, we reviewed the examples provided in the Report and think they are intended to provide at least general guidelines as part of a manager’s valuation policy, depending on its strategy and portfolio. Therefore, we have not made a change to the Report.

VII. Codes of Ethics, Compliance and Conflicts Committee

One commenter made several recommendations with respect to the best practices relating to codes of ethics and compliance matters. We also received a comment relating to the best practice that managers should have a Conflicts Committee.

Code of Ethics

The commenter recommended that the Report state that employees “will act in conformity” with the code instead of undertaking to “behave in conformity with it.”²⁹ We believe this comment reflects our original intent, and, therefore, have amended this language accordingly.

This commenter’s letter also recommends that a code of ethics apply to all the manager’s employees rather than to certain identified individuals.³⁰ We believe that this may be appropriate in many circumstances and have therefore taken this comment.

²⁶ Confidential letter.

²⁷ Confidential letter.

²⁸ MFA letter.

²⁹ CFA Institute letter.

³⁰ CFA Institute letter.

However, we recognize that a manager may appropriately determine that certain policies do not apply, or apply differently to certain types of employees, depending on the nature of an employee’s responsibilities, duties and access to information. We have, therefore, clarified that, in circumstances where one or more policies do not apply to all employees, managers should clearly identify the types of employees to whom those policies apply.

Finally, this commenter objected to the sentence in the Report that states that the subject matter in the code of ethics or the compliance manual is determined by what the manager believes is most effective.³¹ The commenter suggested this implied that ethical standards should be driven by a manager’s business imperatives. We think this commenter misunderstood the intent and plain reading of the Report, which simply suggests that a manager can determine how to allocate certain subjects between its code of ethics and compliance manuals in light of its business.

Compliance Matters

The commenter recommended that the Report provide “policies and procedures to guide employees” if they come across material, non-public information.³² We believe the Report already appropriately addresses the guideline of providing such policies while giving managers the needed flexibility to tailor policies to their individual firms.

The commenter suggested that the Report call on asset managers to use soft dollars solely for the clients’ benefit.³³ As we indicated, we believe it is appropriate for managers to have a policy on the use of soft dollars. We also believe that a manager’s policy should be disclosed to investors. We have therefore amended the Report to read that policies on the use of soft dollars should be among the terms of an investment that should be disclosed to investors in a PPM.

Conflicts Committee

One commenter recommended that we should eliminate the best practice requiring managers to have a Conflicts Committee to review potential conflicts and assist in dealing with unanticipated conflicts that may arise. This commenter stated that a manager may elect to address conflicts of interest through other means.³⁴ In drafting the Report, we believed that the establishment of a Conflicts Committee would be an extremely effective and powerful tool in encouraging managers to address conflicts systemically and as they arise. We believe that this comment would not be consistent

³¹ CFA Institute letter.

³² CFA Institute letter.

³³ CFA Institute letter.

³⁴ MFA letter.

with our express desire to ask managers to establish a Conflicts Committee. Accordingly, we have not amended the Report.

VIII. Fund Governance

One commenter suggested that the Report address fund governance.³⁵ By fund governance, we believe the commenter was suggesting that the Report provide that the fund's board or other governing body oversee the manager and the fund's practices. The Report recognizes the importance this issue has played in other industry practices, particularly those outside the United States. While we agree that fund governance is an important issue, we did not want to put responsibility for overseeing the implementation of the best practices on a corporate form that is not universally applicable to all funds. We believe that it was critical in drafting the Report to recognize that managers are in a position to adopt and implement the best practices and that it was not necessary for a board or other fund governing body to take preliminary steps before the best practices could be implemented.

IX. Conclusion

There were several general comments about the industry, comments directed toward groups other than managers over which the Asset Managers' Committee could not dictate best practices, and comments that were outside the scope of the Report. In addition, we made a small number of non-substantive changes to the Report. We have not summarized these comments or changes here.

We wish to thank all of the commenters, as well as all of the industry participants who provided feedback on the Report.

³⁵ Albourne letter.